

# *Senate Hearings*

*Before the Committee on Appropriations*

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Departments of:

- Transportation
- Treasury
- the Judiciary
- Housing and Urban  
Development
- and Related Agencies  
Appropriations

*Fiscal Year* 2007

109<sup>th</sup> CONGRESS, SECOND SESSION

H.R. 5576

**PART 7**

AMTRAK  
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
DEPARTMENT OF THE TREASURY  
DEPARTMENT OF TRANSPORTATION  
NONDEPARTMENTAL WITNESSES

Departments of Transportation, Treasury, the Judiciary, Housing and Urban Development, and  
Related Agencies Appropriations, 2007 (H.R. 5576)—Part 7

**DEPARTMENTS OF TRANSPORTATION, TREASURY, THE JUDICIARY, HOUSING AND URBAN DEVELOPMENT, AND RELATED AGENCIES APPROPRIATIONS FOR FISCAL YEAR 2007**

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**HEARINGS**

BEFORE A

SUBCOMMITTEE OF THE

COMMITTEE ON APPROPRIATIONS

UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON

**H.R. 5576**

AN ACT MAKING APPROPRIATIONS FOR THE DEPARTMENTS OF TRANSPORTATION, TREASURY, AND HOUSING AND URBAN DEVELOPMENT, THE JUDICIARY, DISTRICT OF COLUMBIA, AND INDEPENDENT AGENCIES FOR THE FISCAL YEAR ENDING SEPTEMBER 30, 2007, AND FOR OTHER PURPOSES

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**PART 7**

**Amtrak**

**Department of Housing and Urban Development**

**Department of the Treasury**

**Department of Transportation**

**Nondepartmental Witnesses**

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**DEPARTMENTS OF TRANSPORTATION, TREASURY, THE JUDICIARY, HOUSING AND URBAN DEVELOPMENT, AND RELATED AGENCIES APPROPRIATIONS FOR FISCAL YEAR 2007**

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**THURSDAY, MARCH 2, 2006**

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

The subcommittee met at 9:32 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Christopher S. Bond (chairman) presiding.

Present: Senators Bond, Murray, Kohl, Dorgan, and Leahy.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

OFFICE OF THE SECRETARY

**STATEMENT OF HON. ALPHONSO JACKSON, SECRETARY**

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Good morning. The Senate Appropriations Subcommittee on Transportation, Treasury, Judiciary, HUD, and Related Agencies will come to order, and it is a pleasure once again to welcome an old friend, Secretary Alphonso Jackson, and extend our sincere thanks for appearing before us today to testify on the Department of Housing and Urban Development's fiscal year 2007 budget request.

Mr. Secretary, we are looking forward to your comments on both the fiscal year 2007 budget as well as HUD's responsibilities with regard to the overwhelming disaster and rebuilding issues facing the gulf coast because of Hurricane Katrina and related storms.

HUD's budget request proposes some \$33.65 billion for fiscal year 2007, a decrease of \$621 million, or 2 percent, from the 2006 funding level. Unfortunately, this request does not reflect the true extent to which many important housing and community development programs are compromised. In particular, because of needed increases to section 8 funding, funding for many widely supported programs, such as CDBG, public housing capital funding, HOPE VI, section 202 for the elderly, and section 811 housing for the disabled has been slashed. In addition, the budget includes a \$2 billion rescission of excess section 8 funds, which we are waiting to see where and how they would be available, also existing FHA sin-

gle-family mortgage insurance program that is marred by a shrinking share of the homeownership market, and increased default rates.

In addition to the very difficult decisions posed by the HUD fiscal year 2007 budget, the subcommittee will also have to face substantial shortfalls in many other accounts, including, for example, a \$400 million gap in proposed Amtrak funding, not enough to support Amtrak's funding needs, and I am not even sure that flat funding would meet the needs in 2007.

Another example of the difficult decisions is the administration proposes to cut \$765 million from the airport improvement program, which is critical to maintaining and improving infrastructure in our airports.

These are just two examples. You have got enough headaches. But these are the range of headaches that we have in the budget that we have been given, and we face huge challenges in balancing the decisions for all our programs in a very tight funding year with HUD, as always, representing one of our largest challenges. And that is why we are always glad to see you here, Mr. Secretary.

I know you have worked hard to defend these programs, and your work is greatly appreciated. You have been able to convince OMB of the importance of the section 8 program, which is adequately funded, even though I am not happy with the mandate that you have to push section 8 into a block grant assistance program. If anybody wants to talk about that, we will be happy to explain to them what we think are the very real and perhaps insurmountable problems with that.

#### CDBG

I am disappointed the CDBG level has been reduced by \$1.15 billion, but I am gratified that HUD was able to keep it, and keep it within this subcommittee, even at what is a significantly smaller budget for 2007. And, again, we appreciate the great leadership you have shown in helping OMB come to some slightly more reasonable judgments and requests.

I think it is critical that HUD maintains the section 8 in public housing, CDBG, and HOME, flagship areas, along with FHA mortgage insurance that is necessary if HUD is to continue to play its role as a leader in housing and community development activities. And it requires adequate funding and your responsibility for these programs.

#### PUBLIC HOUSING OPERATING FUND

The OMB continues to undermine many important programs which are critical to housing and community development needs. I am very much concerned that the public housing operating fund is flat-funded at \$3.56 billion. We are moving toward implementation of an asset-based management of public housing. Unfortunately, the funding level does not meet the needs of these new operating requirements, nor does the funding address HUD's inclination to micromanage how PHAs will have to meet these new requirements.

If you cut the budget significantly of any Government entity, the least you could do is give them the flexibility to use the funds how they can best be utilized. And this is very difficult for you or me

or any of us in Washington to tell a PHA in Washington or Missouri or Texas what their problems are and how they are going to use their funds.

#### HOPE VI

Once again, OMB has gone after one of the programs I started, HOPE VI. They propose rescinding all of the 2006 funding even though it is being used. They propose eliminating HOPE VI in 2007 and reducing the Public Housing Capital Fund by some \$261 million. If enacted, these proposals would substantially diminish the effectiveness of every program that is designed to address the capital needs of PHAs.

More troubling, in support of eliminating HOPE VI, the administration argues PHAs can use their Capital Fund for bond collateral or debt service of loans in support of rehab and construction. Nevertheless, if at the same time capital funds are reduced or eliminated, the administration is undermining its justification for eliminating HOPE VI because lenders simply will not lend, and if they do, the cost of any bonds or debt will increase. So that OMB policy just makes no sense.

#### REDUCTION IN CDBG

Also, obviously, I am concerned over the reduction in CDBG. As you and I and my colleagues know, this is supported by every mayor and Governor in the Nation and reflects the important principles of deferring to State and local decisionmaking and how to address local housing and community development needs instead of relying on some cubicle in the basement of the Old Executive Office Building in Washington. This is an important program, and I am troubled by OMB's continuing efforts to whittle this program to nothing.

I do not have time to highlight all of my concerns with the budget. We will be having lots of correspondence and telephone calls with you over many, many more problems, but I do note the budget undermines funding for section 202 elderly and section 811 disabled housing. Both programs are very important in addressing the needs of our most vulnerable and needy citizens. The elderly housing program is especially important since we know the need for elderly housing will skyrocket for the foreseeable future due to the aging of not only my generation but the baby boomers coming along behind.

And then, once again, this committee has strongly supported the Lead Hazard Reduction program and the Rural Housing and Economic Development programs. These were our programs. They met an important need, and OMB went after them again. Certainly they have my attention. They cut everything that I have worked with my colleagues to put into the HUD portfolio because I think based on our examination and discussions they make sense.

Nevertheless, I know you have tried very hard, Mr. Secretary, to fund many of these programs, but I think there is still hope, and we appreciate your good work. You deserve great credit, and I thank you for fighting for a balance in the funding of HUD programs against what I consider to be the worst instincts of the budget geeks in the basement of OMB. Nevertheless—and if there

are any OMB people here, we will discuss that at greater length, if you wish to. The subcommittee needs to find more funds for HUD programs. We should not be trying to balance the budget and eliminate the deficit on the backs of our communities and most vulnerable citizens.

I am an infrastructure Republican, and many of these programs are not only critical to recipients, communities, and States, but are critical in the creation of jobs, helping leverage new private and public investments in our vital communities and increasing their tax base. I think they are good investments for the Federal Government. They are investments I strongly support.

#### FUTURE OF FHA

Finally, let me share with you my concern over the FHA single-family mortgage program. It is imploding. FHA's share of the market dropped 40 percent in fiscal year 2005. In particular, FHA home sales dropped to 4.3 percent in 2005 compared with 7.6 percent in 2004, despite overall home sales being up 7 percent in 2005. In addition, FHA endorsements dropped 46.7 percent in 2005, while insurance-in-force dropped 13 percent. Finally, and most troubling, default rates increased to 6.36 percent in fiscal year 2005, a 0.2 percent increase over the previous year.

Over the last several years, in every HUD budget hearing, I have raised concerns about the viability and the future of HUD's FHA single-family mortgage insurance program. In every instance, my warnings and questions have been ignored, and I have been advised that the future is bright. The future is not bright unless you consider a burning trash dump bright. It may be time to close out FHA mortgage insurance for single families in deference to the marketplace or re-establish FHA as a private government corporation.

I know that HUD plans to submit legislation to grow FHA receipts by increasing its ability to attract homebuyers with better credit ratings as well as balancing these new receipts to help families with poor credit risk become homeowners.

#### PREPARED STATEMENT

I think we first need to understand whether the FHA single-family mortgage insurance program is needed in today's market, and if so, how it is needed. I am concerned that HUD's new FHA model may be designed to take on more risks, not only risks associated with poor credit homeowners but the risk of lenders who face losses and who under the HUD proposal will be able to pass the risk of these losses onto FHA.

I appreciate your time today, Mr. Secretary, and now it is a pleasure to turn to my ranking member and partner on this subcommittee, Senator Murray.

[The statement follows:]

#### PREPARED STATEMENT OF SENATOR CHRISTOPHER S. BOND

The Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, HUD and Related Agencies will come to order. We welcome Secretary Alphonso Jackson and thank him for appearing before us today to testify on the Department of Housing and Urban Development's fiscal year 2007 budget request. Mr. Secretary, I look forward to your comments on both the fiscal year 2007 budget as well

as HUD's responsibilities with regard to the overwhelming disaster and rebuilding issues facing the Gulf Coast because of Hurricane Katrina and related storms.

HUD's budget request proposes some \$33.65 billion for fiscal year 2007, a decrease of some \$621 million, or some 2 percent, from the fiscal year 2006 funding level of \$34.27 billion. Unfortunately, this funding request does not reflect the true extent to which many important housing and community development programs are compromised. In particular, because of needed increases to section 8 funding, funding for many widely supported programs, such as CDBG, Public Housing Capital funding, HOPE VI, section 202 Elderly and section 811 housing for the disabled, has been slashed. In addition, the budget includes a \$2 billion rescission of excess section 8 funds which are unlikely to be available as well as an existing FHA Single Family Mortgage Insurance program that is marred by a shrinking share of the homeownership market and increased default rates.

In addition to the very difficult decisions posed by the HUD fiscal year 2007 budget, this subcommittee will also have to face substantial shortfalls in many of its other accounts, including, for example, a shortfall of some \$400 million in the proposed Amtrak funding level for fiscal year 2007. This proposed funding level is clearly not enough to support Amtrak's funding needs and I am not sure that even flat funding will meet Amtrak's anticipated expenses in fiscal year 2007. Another harsh example of the difficult decisions faced by this subcommittee is the administration's proposed cut of \$765 million in fiscal year 2007 to the Airport Improvement Program. This program is critical to maintaining and improving the infrastructure of our Nation's airports. And these are only two examples of a number of significant funding hits taken by programs within our jurisdiction. Consequently, this subcommittee is facing huge challenges in balancing the funding decisions for all our programs in a very tight funding year with HUD representing one of our largest challenges.

I am pleased, Mr. Secretary, that you have convinced the administration of the importance of the section 8 program which is adequately funded for the year even if I am dismayed by your continuing support of the administration's proposal to block grant section 8 assistance. And while I am disappointed that CDBG has been reduced by some \$1.15 billion from the fiscal year 2006 level, I am gratified that it continues to be funded within HUD and in this subcommittee even at a proposed paltry \$3.03 billion for fiscal year 2007. I think it is critical that HUD maintain section 8 and Public Housing, CDBG and HOME, and FHA mortgage insurance—these are the 3 flagship areas of housing and community development assistance and HUD's role as the Nation's leader in housing and community development activities depends on adequate funding and responsibility for these programs.

Nevertheless, this administration continues to undermine many important programs within HUD which are critical to the housing and community development needs of our States and communities, especially our low-income communities.

First, I am concerned that the Public Housing Operating fund is flat funded at \$3.56 billion. We are moving toward the implementation of asset-based management of public housing. Unfortunately, the administration's funding level does not meet the needs of these new operating requirements; nor does the funding address HUD's inclination to micromanage how PHAs will have to meet these new requirements. Moreover, the administration has proposed rescinding all fiscal year 2006 HOPE VI funding, eliminating the HOPE VI program for fiscal year 2007 and reducing the Public Housing Capital Fund by some \$261 million. These proposals, if enacted, will substantially diminish the effectiveness of every program that is designed to address the capital needs of PHAs. More troubling, in support of eliminating HOPE VI, the administration argues that PHAs can use their Capital Fund for bond collateral or for the debt service of loans in support of rehabilitation and construction. Nevertheless, if capital funds are reduced or eliminated, the administration is undermining its justification for eliminating HOPE VI because lenders simply will not lend and, if they do, the cost of any bonds or debt will increase. Overall, this administration policy makes little or no sense.

I am also concerned over the proposed reduction to CDBG by some \$1.15 billion in fiscal year 2007. This account is supported by every mayor and governor in the Nation and reflects the important principle of deferring to State and local decision-making in how to address local housing and community development needs, instead of relying on some nameless bureaucrat in a cubical in Washington. This is an important program and I am troubled by the administration's continuing efforts to whittle this program into almost nothing.

I am not going to highlight my every concern with HUD's budget—I will note, however, that the budget undermines funding for the section 202 elderly housing program and the section 811 housing for the disabled program. Both programs are very important since they address the needs of our most vulnerable and needy citi-

zens. The elderly housing program is especially important since we know the need for elderly housing will skyrocket for the foreseeable future due to the aging of the baby boomer population. In addition, the fiscal year 2007 budget eliminates the Lead Hazard Reduction program and the Rural Housing and Economic Development program, both of which I helped to author and both of which meet specific and real needs in our communities.

Nevertheless, Mr. Secretary, I think you have tried hard to push for the HUD budget and to fund many of these programs—perhaps not all the programs, but I think there is still hope for you. In any event, you deserve credit for fighting for a balance in the funding of HUD's programs against what I consider to be the worst instincts of the budget geeks in the basement of OMB. Nevertheless, this subcommittee needs to find more funds for HUD's programs. We should not be trying to balance the cost of the deficit on the backs of our communities and most vulnerable citizens. I am an infrastructure Republican and many of these programs are not only critical to recipients, communities and States but are critical in the creation of jobs, in helping to leverage new private and public investments and in increasing the tax base of our communities. This is a good investment for the Federal Government and it is an investment I support.

Finally, I want to express my concerns over the FHA Single Family Mortgage Insurance program. This program is imploding. FHA's share of the market dropped 40 percent in fiscal year 2005. In particular, FHA home sales dropped to 4.3 percent in 2005 compared with 7.6 percent in 2004, despite overall home sales being up 7 percent in 2005. In addition, FHA endorsements dropped 46.7 percent in fiscal year 2005 while insurance-in-force dropped 13 percent. Finally, default rates increased to 6.36 percent in fiscal year 2005, compared to 6.13 percent in fiscal year 2004.

Over the last several years, in every HUD budget hearing, I have raised concerns about the viability and future of HUD's FHA Single Family Mortgage Insurance program. In every case, I have been ignored and advised that the future is bright. The future is not bright unless you consider a burning trash dump bright. It may be time to close out the FHA Mortgage Insurance program in deference to the marketplace or re-establish FHA as a private government corporation.

I know HUD plans to submit legislation to grow FHA receipts by increasing its ability to attract homebuyers with better credit ratings as well as balancing these new receipts to help families with poor credit risks become homeowners. I think we first need to understand whether the FHA Single Family Mortgage Insurance program is needed in today's market, and, if so, how it is needed. I am concerned that HUD's new FHA model may be designed to take on more risks—not only the risks associated with poor credit homeowners but the risks of lenders who face losses and who, under the HUD proposal, will be able to pass the risks of these losses on to FHA.

Mr. Secretary, I appreciate your time today and I now turn to my ranking member and partner on this subcommittee, Senator Murray.

#### STATEMENT OF SENATOR PATTY MURRAY

Senator MURRAY. Well, thank you very much, Mr. Chairman, and, Mr. Secretary, I welcome you here. I hope we have a productive hearing, although it sounded to me like listening to the statement from the chairman that maybe we should have OMB in front of us. That might be more productive.

Senator BOND. I might lose my temper.

Senator MURRAY. All right. Well, thank you again, Mr. Secretary, for being here today. It has been more than 6 months since Hurricane Katrina reminded all of us of the ongoing poverty that grips so many American families today. After the storm, millions of us gathered around our television sets and saw vulnerable Americans struggling for their dignity and struggling for their lives.

One of the little-known facts about Hurricane Katrina was that public housing authorities across the country made heroic efforts to find housing, to relocate hurricane victims, and I want to commend them today for their hard work and their compassion.

But the sad fact is that every one of those public housing authorities already had long waiting lists of local families who had

been waiting years for housing to become available. That means the efforts to house Katrina victims pushed other poor families further down a very long waiting list. Those families who were pushed down the list were in most cases no less poor, no less desperate, and in some cases, no less homeless than the Katrina victims. And the vast majority of them are still waiting for an available unit today.

We should not be in a position where, if we respond to a disaster, our only choice is to hurt families who have been waiting years for housing. But that is the position we find ourselves in today, and there is one reason why: years of misguided housing budgets. And now we are once again working on a new budget for the coming fiscal year, and we should not make the same mistakes again.

Unfortunately, that is exactly what the President's budget would do. HUD has a very critical mission: to promote homeownership, ensure safe rental housing, house the homeless, rejuvenate desolate communities, and provide hope to a great many struggling Americans.

We are talking about the impoverished elderly. We are talking about disabled citizens who have very unique housing needs. We are talking about the working poor who are climbing the economic ladder.

Now, I have often said that budgets are about priorities, and it is clear that the Bush administration's priorities are not with the missions of the Department of Housing and Urban Development. The President's budget for the coming fiscal year proposes to increase discretionary spending by 3.2 percent, but within that total, HUD is singled out for a cut of 1.8 percent. The Community Development Block Grant is slated for a cut of more than \$1 billion.

#### HOPE VI

All funds for the HOPE VI program that the chairman mentioned, a program designed to demolish and replace our most decrepit public housing units, is proposed for elimination in the Bush budget. In fact, the administration budget goes even further and calls on Congress to eliminate the funding that we have already appropriated for this program in 2006. Housing for the elderly is cut by 26 percent, while housing for the disabled is cut by 50 percent.

These proposed cuts come at a time when every study tells us that these populations are growing, and growing rapidly.

One thing that has been very clear to every American this winter is the fact that utility costs have risen dramatically. It seems that everyone knows that except for the Bush administration. While utility costs have risen dramatically for public housing authorities across America, the Bush administration wants to freeze operating funds for public housing authorities for the fifth year in a row.

Funding for the public housing capital fund, which is intended to keep over 13,000 public housing properties from falling into dilapidated, decrepit, and inhumane conditions, is singled out for an 11 percent cut.

As I said earlier, the President's budget proposes to increase discretionary spending by 3.2 percent, but all of the rhetoric and public housing statements and his OMB Director have sought to divide

this budget into three separate categories: funding for defense, funding for homeland security, and funding for everything else. That implication is pretty clear. In the view of the Bush administration, programs in that third category, programs that educate our children, prevent disease, house the underprivileged, are the least worthy of public funds.

Within this third category, the President proposes to cut overall spending by a half percent, but for HUD, which falls entirely into this third category, the administration is proposing a much larger cut of 1.8 percent.

The message to me is clear: The non-defense, non-homeland security portion of the budget is a low priority for this President, and funding for HUD's work is an even lower priority.

Now, it is worth noting that while the administration is proposing to cut the HUD budget by more than \$620 million, they are proposing to boost spending for exploration systems in NASA by more than \$860 million. Now, like a lot of my colleagues, I do support the overall goal of space exploration. I think it is great. But when it comes to sending an astronaut to Mars or housing our elderly and disabled neighbors here on Earth, there is no doubt where my priorities lie.

Mr. Chairman, last year, with your strong support, we were able to fend off many of the painful cuts that were included in the President's budget for HUD. Unfortunately, we were handed an allocation by a budget resolution that I did not support that resulted in our having to accept some of those proposed cuts. Last year, our appropriations bill did cut Community Development Block Grant program by more than \$0.5 billion. We did cut HOPE VI program by 31 percent.

Now, I am a member of the Budget Committee—as you used to be, Mr. Chairman, and we miss you there.

We do need you back.

#### PREPARED STATEMENT

If we are presented, however, with a budget resolution that continues to cut the Community Development Block Grant program, I want you to know I am going to be the first Senator out of the box offering amendments to restore those cuts.

I hope that together you and I can work toward ensuring that we get a budget resolution this time that will allow us to reject those ill-conceived proposals so we can keep faith with the people who need HUD assistance the most.

Thank you very much, Mr. Chairman, and thank you, Mr. Secretary.

[The statement follows:]

#### PREPARED STATEMENT OF SENATOR PATTY MURRAY

Thank you, Mr. Chairman and welcome Secretary Jackson.

It's been more than 6 months since Hurricane Katrina reminded all of us of the ongoing poverty that grips so many American families.

After the storm, millions of us gathered around our television sets and saw vulnerable Americans struggling for their dignity and struggling for their lives.

One of the little known facts about Hurricane Katrina was that public housing authorities across the country made heroic efforts to find housing to relocate hurricane victims. I want to commend them for their hard work and compassion.

But the sad fact is that every one of those public housing authorities already had long waiting lists of local families who had been waiting years for housing to become available.

That means the efforts to house Katrina victims pushed other poor families further down a long waiting list.

Those families who were pushed down the list were, in most cases, no less poor, no less desperate and, in some cases, no less homeless, than the Katrina victims. And the vast majority of them are still waiting for an available unit today.

We shouldn't be in a position where—if we respond to a disaster—our only choice is to hurt families who have been waiting years for housing.

But that's the position we find ourselves in today—and there is one reason why—years of misguided housing budgets.

And now, we're once again working on a new budget for the coming fiscal year. We should not make the same mistakes again.

Unfortunately, that's exactly what the President's budget would do.

HUD has a critical mission—to promote home ownership, ensure safe rental housing, house the homeless, rejuvenate desolate communities, and provide hope to a great many struggling Americans.

—We are talking about the impoverished elderly.

—We are talking about disabled citizens who have unique housing needs.

—We are talking about helping the working poor climb the economic ladder.

I have often said that budgets are about priorities. And it is clear that the Bush Administration's priorities are not with the missions of the Department of Housing and Urban Development.

The President's budget for the coming fiscal year proposes to increase discretionary spending by 3.2 percent. But within that total, HUD is singled out for a cut of 1.8 percent.

The Community Development Block Grant—or CDBG—program, is slated for a cut of more than a billion dollars.

All funds for the HOPE VI program—a program designed to demolish and replacing our most decrepit public housing units—is proposed for elimination in the Bush budget.

In fact, the administration's budget goes even further and calls on the Congress to eliminate the funding that we have already appropriated for this program in 2006.

Housing for the elderly is cut by 26 percent, while housing for the disabled is cut by 50 percent. These proposed cuts come at a time when every study tells us that these populations are growing—and growing rapidly.

One thing that has been clear to every American this winter is the fact that utility costs have risen dramatically. It seems that everyone knows that—except for the Bush Administration.

While utility costs have risen dramatically for public housing authorities across America, the Bush Administration wants to freeze operating funds for public housing authorities for the fifth year in a row.

Funding for the Public Housing Capital Fund—which is intended to keep over 13,000 public housing properties from falling into dilapidated, decrepit and inhumane conditions—is singled out for an 11 percent cut.

As I said earlier, the President's budget proposes to increase discretionary spending by 3.2 percent, but all of the rhetoric and public statements by the President and his OMB Director have sought to divide this budget into three separate categories:

—funding for Defense;

—funding for homeland security, and

—funding for everything else.

Their implication is clear.

In the view of the Bush Administration, programs in this third category—programs that educate our children, prevent disease, or house the underprivileged—are the least worthy of public funds.

Within this third category, the President proposes to cut overall spending by 0.5 percent. But for HUD, which falls entirely into this third category, this administration is proposing a much larger cut of 1.8 percent.

The message is clear:

—the non-defense, non-homeland security portion of the budget is a low priority for the President,

—and funding for HUD's work is an even lower priority.

It is worth noting that, while the administration is proposing to cut the HUD budget by more than \$620 million, they are proposing to boost spending for Exploration Systems in NASA by more than \$860 million.

Like many of my colleagues, I support the overall goal of space exploration. But when it comes to sending an astronaut to Mars or housing our elderly and disabled neighbors here on earth, there's no doubt where my priorities lie.

Mr. Chairman, last year, with your strong support, we were able to fend off many of the more painful cuts included in President Bush's budget for HUD.

Unfortunately we were handed an allocation by a budget resolution that I did not support that resulted in our having to accept some of his proposed cuts.

Last year, our appropriations bill did cut the Community Development Block Grant program by more than half a billion dollars. We did cut the HOPE VI program by 31 percent.

I am a member of the Budget Committee, as you used to be, Mr. Chairman. If we are presented with a budget resolution that continues to cut the Community Development Block Grant program, I am going to be the first Senator out of the box offering amendments to restore those cuts.

I hope that, together, you and I can work together toward ensuring that a budget resolution is adopted that will allow us to reject these ill-conceived proposals so that we can keep faith with the people who need HUD assistance the most.

Thank you, Mr. Chairman.

Senator BOND. Thank you very much, Senator Murray.  
Now, Mr. Secretary, if you would begin.

#### STATEMENT OF HON. ALPHONSO JACKSON

Secretary JACKSON. Thank you very much. Good morning, Chairman Bond and Ranking Member Murray, and other distinguished members of the committee. I thank you for the opportunity to be here to discuss the President's proposed budget of fiscal year 2007. It is a good budget, and I encourage you to give it your support.

The President is very concerned about helping all Americans have access to affordable housing that is decent and dignified, and his \$33.6 billion budget request for HUD demonstrates that concern.

At the same time, the President understands that fiscal restraint is necessary if we want to reduce the deficit and keep the economy growing as it has been and help everybody by creating more jobs and higher wages.

I want to highlight how the President's budget will help HUD achieve the mission Congress has assigned to us, particularly in three areas: helping more Americans own their own homes, especially folks who always thought homeownership was out of reach; helping those not ready or willing to own their own home to find decent rental housing; and reforming the way the Federal Government supports community development by better focusing block grant resources toward the most needy, while beginning to consolidate community development programs under one umbrella at HUD.

First, Mr. Chairman, is helping more Americans achieve the dream of homeownership.

If Congress will enact HUD's proposed changes to the National Housing Act, the FHA will make its mortgage insurance more flexible so that more Americans can qualify for mortgages without paying sub-prime rates. This will help more low-income families own and keep their homes.

#### FHA FORECLOSURE MORATORIUM

Speaking of FHA, I am pleased to say that HUD has just announced a further extension of the FHA foreclosure moratorium for victims of Hurricane Katrina. Borrowers with FHA loans now have

until March 31 to show that they have made long-term payment arrangements with their banks. If they do, they will have foreclosure protection until the end of June. And this is in addition to HUD's agreement to make interest-free loans to hurricane-affected families to pay their FHA-insured mortgages for a year.

#### HOME PROGRAM

The President's budget includes \$1.9 billion for the HOME Investment Partnerships program. In the past, every HOME dollar allocated has attracted \$3.60 in private sector investments.

Under that program, the President has proposed that the American Dream Downpayment Initiative, what we call "ADDI," be funded at \$100 million. Though it is a new program, ADDI funds have already assisted 13,845 low-income families to become first-time homebuyers.

#### HOMEOWNERSHIP VOUCHER PROGRAM

Another young but important program helping low-income and minority families become homeowners is the Homeownership Voucher program, which allows families on section 8 rental assistance to use their vouchers to pay a mortgage on their own home for up to 10 years. The program has already helped 5,000 low-income families own a home in the last 4 years, and we expect to have helped 3,000 more by the end of fiscal year 2007.

#### HOUSING COUNSELING

The President has proposed \$45 million for housing counseling. This is a proven method for helping low-income families to prepare themselves for the responsibilities of homeownership, avoid predatory lending practices, and avoid foreclosure. This program, in continuing partnership with many faith-based and community organizations, would be able to assist approximately 600,000 families in 2007 if the President's proposal is adopted.

Second, Mr. Chairman, is helping other low-income families find decent, dignified, and affordable rental housing.

#### HOUSING CHOICE VOUCHER RENTAL ASSISTANCE PROGRAM

HUD's largest program, at \$16 billion, is the Housing Choice Voucher Rental Assistance program. Because of unsustainable cost increases, Congress wisely changed this to a dollar-based system. But for the new system to work better, Congress needs to pass legislation to allow the PHAs to design their own rent policies. That is why the administration is asking Congress to pass Senator Wayne Allard's State and Local Housing Flexibility Act, Senate Bill 771. And I want to thank the Senator for his leadership on this important issue.

HUD continues its work to help communities remove unnecessary regulatory barriers to the development of low-income housing—through America's Affordable Communities Initiative and its Regulatory Barriers Clearinghouse.

The 2007 budget also proposes funding an additional 3,000 housing units for the elderly and persons with disabilities. All expiring rental assistance contracts are being renewed, and all construction

that is in the pipeline already is still eligible for amendment funds if their construction costs increase.

In order to help more Native Americans become homeowners, the President proposes increasing the section 184 loan guarantees program by more than 100 percent, over fiscal year 2006, to \$251 million. He also wants to increase funding to support housing for persons with HIV/AIDS to \$300 million, enough to provide assistance to an estimated 75,000 households. Our budget request includes a provision that would allow us to allocate these funds more fairly based on housing cost differences across the country.

#### HOMELESS ASSISTANCE

The administration also remains committed to helping the homeless. HUD has aggressively pursued policies to move the homeless into permanent housing. This budget proposes to increase the amount for homeless assistance to \$1.5 billion, enough to house more than 160,000 individuals.

#### CDBG

Third, Mr. Chairman, is laying the groundwork for reform of the way Federal resources are used to support community development. A key part of HUD's mission is to strengthen communities so that they can be better places to live, work, and raise families. HUD is committed to developing better performance measures for the Community Development Block Grant program, but we need a better way to target the CDBG funds to those most in need. So HUD will propose a new formula for the CDBG allocation very soon to you. Also, since the Community Development Block Grant program is staying at HUD, the President's proposed budget consolidates three other similar programs within HUD into the CDBG, laying the groundwork for further governmentwide consolidation later after HUD proves that the reforms are working well.

In conclusion, Mr. Chairman, the administration's budget provides ample resources for promoting homeownership, fair and affordable housing, and community development—the key elements of the mission that Congress has assigned to HUD.

#### PREPARED STATEMENT

This is a good budget, Mr. Chairman and ranking member, and I respectfully urge you to ask Congress to adopt it.

I thank you for this opportunity to speak before you today on the 2007 budget, and I am now available for questions that you might have.

[The statement follows:]

#### PREPARED STATEMENT OF ALPHONSO JACKSON

Chairman Bond, Ranking Member Murray, distinguished Senators of the subcommittee, the President's proposed fiscal year 2007 budget truly reflects his intent to address our Nation's housing, economic, and community development requirements. HUD's \$33.6 billion fiscal year 2007 budget seeks to build on our success and lend a compassionate hand to Americans in need, while using taxpayer money more wisely and reforming several HUD programs.

Over the past 5 years, HUD has successfully implemented the President's agenda to spur on economic and community development by promoting homeownership, particularly among the lowest-income Americans; increased access to affordable rental

housing, while combating all forms of discriminatory housing practices; and made a commitment to focus community development dollars better on those most in need by increasing local control. At the same time, HUD has improved the operational efficiency of the Department. The President's fiscal year 2007 budget request will allow the Department to build upon those successes by advancing the core mission given to HUD by Congress.

HOW HUD WILL PROMOTE ECONOMIC AND COMMUNITY DEVELOPMENT THROUGH  
HOMEOWNERSHIP

The President's vision for an ownership society correctly focuses on the reality that the ownership of private property helps human beings prosper. There is ample evidence to prove the President's assertion that ownership promotes financial independence, the accumulation of wealth, and healthier communities. Chief among the things a person can own is his own home.

Under President Bush's leadership, this administration has achieved new records in the rate of homeownership. Today, nearly 70 percent of the Nation and more than 51 percent of minorities own their homes. Despite achieving the highest homeownership rate in American history, minorities remain less likely than non-Hispanic whites to own their homes. To close this gap, President Bush challenged the Nation to create 5.5 million minority homeowners by the end of the decade, and to date 2.6 million minority families have joined the ranks of homeowners. While President Bush is pleased with the progress made, there is more to be done.

The President's proposed budget will help HUD to further that mission by transforming the Federal Housing Administration (FHA) so that it can expand homeownership opportunities for low- and moderate-income families; spur Fannie Mae and Freddie Mac to lead the market to create more affordable homeownership opportunities; help more of the lowest-income Americans make a downpayment through the HOME Investment Partnerships program (HOME) and the American Dream Downpayment Initiative (ADDI); transition more Americans from HUD assisted rental housing to homeownership through the Homeownership Voucher program; and, through our rapidly-growing partnership with faith-based and community organizations, increase the level of housing counseling that has been so useful in helping families prepare for homeownership, avoid predatory lending practices, and avoid default on their homes.

*FHA Product Transformation.*—HUD proposes to amend the National Housing Act, which was created in 1934 to create the FHA and its mortgage insurance programs. The National Housing Act has not been updated in over 70 years. Existing statutory requirements prevent FHA from updating its products; this lack of flexibility has allowed a resurgence of high-cost loans similar to those that predominated in 1934, such as interest-only and short-term balloon loans.

The original purpose of the National Housing Act was to encourage lenders to offer loans that were less risky for consumers. If Congress will enact changes to the National Housing Act to allow FHA flexibility to offer insurance for loans of different term, cash requirement, and amortization, then FHA could make it possible for additional buyers to enter the market, thus aiding both consumers and the lending industry. This is a top legislative priority for me this year and I look forward to working with Congress to see it enacted.

*Using HOME and ADDI to Help More Low-income Families Own Their Own Homes.*—For many low-income Americans, the single greatest obstacle to homeownership is the cash requirement for downpayment and closing costs.

The HOME Investment Partnerships program, the largest Federal block grant program of its kind, completed nearly 72,000 units of affordable housing in 2005, often in partnership with nonprofits, States, and local governments. The administration proposes to increase the HOME program to \$1.9 billion in 2007. Each HOME dollar allocated typically attracts \$3.60 from private sector investments.

Within the HOME allocation, ADDI funds have assisted 13,845 families to become first-time homebuyers, at an average subsidy amount of \$7,431. More than 47 percent of those assisted are minority homeowners. We have requested \$100 million for fiscal year 2007 to further enhance homeownership in America through ADDI.

*Homeownership Voucher Program.*—I am very proud to report that during this program's first 4 years, over 5,000 low-income families have been moved from the section 8 rental program rolls into the ranks of homeownership. By the end of fiscal year 2007, the program will provide homeownership opportunities for approximately 8,000 families.

*Counseling Our Way to Greater Homeownership.*—Housing counseling is an extremely important tool to help Americans purchase and keep their homes. The fiscal year 2007 budget proposes \$45 million for housing counseling in order to prepare

families for homeownership, help them avoid predatory lending practices, and help current homeowners avoid default. In partnership with faith-based and community organizations, HUD will assist approximately 600,000 families to become homeowners or avoid foreclosure in fiscal year 2007. More than ever, potential homebuyers need assistance to make smart homeownership choices. Housing counseling is the most cost-effective way to educate individuals and arm them with the knowledge to make informed financial choices and avoid high risk, high cost loans, and possible default and foreclosure.

#### HOW HUD WILL INCREASE ACCESS TO AFFORDABLE HOUSING

While homeownership is one of President Bush's top priorities, the President realizes that it is not a viable option for everyone. The largest component of HUD's budget promotes decent, safe, and affordable housing for families and individuals who may not want to become homeowners or who may not yet be ready to purchase a home.

*Promoting Local Control and Flexibility—Section 8.*—HUD's Housing Choice Voucher program is HUD's largest program at \$16 billion annually. The program provides approximately 2 million low-income families with subsidies that help them obtain decent, safe, sanitary, and affordable homes.

In response to unsustainable cost increases, Congress recently converted the previous "unit-based" allocation system to a "dollar-based" system. This made sense, but for the dollar-based system to work effectively, program requirements need to be simplified, and Public Housing Authorities (PHAs) need to be given greater flexibility.

The State and Local Housing Flexibility Act (SLHFA) introduced last year in both the House and the Senate would, among other things, give PHAs the flexibility to serve more people and better address local needs. If Congress passes SLHFA, local PHAs will be able to design their own tenant rent policies, and, in turn, they can reduce the number of erroneous payments, use their dollars more flexibly, and create incentives to work.

The administration's plan will eliminate many of the complex forms that are currently required to comply with program rules—saving both time and money. Furthermore, the administration's proposal will result in benefits and rewards for a PHA's decision to utilize good management. Enactment of this bill is one of my top priorities this year, and I stand ready to work closely with this committee and the Congress to make that happen.

*Making Improvements to Public Housing.*—For fiscal year 2007, the Department will continue its efforts to improve public housing by moving toward project-based management, and mandating financial accountability. Project-based management will provide the information on individual properties, allowing managers to compare high and low cost properties and intervene as necessary.

*Public Housing's Capital Fund Financing Program.*—The Department continues its successful implementation of the Public Housing Capital Fund Financing Program. This program allows PHAs to borrow from banks or issue bonds using future Capital Fund grants as collateral or debt service, subject to annual appropriations. In this way, PHAs are able to leverage the Capital Funds to make improvements. The President's fiscal year 2007 budget request includes \$2.2 billion for the Capital Fund, which will cover the accrual needs of PHAs. The President's budget holds the Operating Subsidy funds level at \$3.6 billion.

*Implementation of Harvard Cost Study.*—In 1998, Congress directed HUD to undertake the Harvard Cost Study, a review of public housing costs analyzing how PHAs manage their units. The Department will continue its scheduled implementation of the congressionally mandated formula for allocating subsidies for public housing operations, and will implement the formula by fiscal year 2007. The proposed State and Local Housing Flexibility Act would help PHAs' administration of public housing through its flexibility and simplification of tenant rent policies. The implementation will include transitioning the management of public housing to an asset-based model similar to how private sector multifamily housing is managed. Project based accounting is scheduled to be implemented in fiscal year 2007, and asset based management by fiscal year 2011.

*Management Accountability of Public Housing.*—The Department continues to place great emphasis on the physical condition of public housing properties, and the financial status and management capabilities of PHAs. The Department will continue providing technical assistance to PHAs and rating the effectiveness of PHAs through the Public Housing Assessment System (PHAS). PHAs with consistently failing scores may be subject to an administrative or judicial receivership. The Department will continue to utilize other tools such as Cooperative Endeavor Agree-

ments with local officials, Memoranda of Agreements, and increased oversight, in order to correct long-standing deficiencies with PHAs. Over the past 5 years, the physical condition of public housing units has improved significantly.

*America's Affordable Communities Initiative.*—Unnecessary, excessive or exclusionary Federal, State, and local regulations severely limit housing affordability by increasing costs as much as 35 percent. They also limit the ability of housing providers to build affordable multifamily housing and perform cost-effective housing rehabilitation. The Department believes that regulatory barrier removal must be an essential component of any national housing strategy to address the needs of low- and moderate-income families, and is committed to working with States and local communities to do so. The Department established “America’s Affordable Communities Initiative: Bringing Homes Within Reach through Regulatory Reform” in fiscal year 2003. This has encouraged efforts at the local level to review and reform regulatory barriers and other impediments to expanding housing affordability.

Through the Regulatory Barriers Clearinghouse, the Department maintains and disseminates important information to local governments and housing providers about regulatory barriers and new strategies developed by other communities. All proposed HUD rules, regulations, notices, and mortgagee letters are now carefully reviewed to ensure they enhance rather than restrict housing affordability.

*Indian Housing Loan Guarantee Fund.*—The U.S. Government holds much of the land in Indian country in trust. Land held in trust for a tribe cannot be mortgaged, and land held in trust for an individual must receive Federal approval before a lien is placed on the property. As a result, Native Americans historically have had limited access to private mortgage capital. The section 184 program addresses this lack of mortgage capital in Indian country by authorizing HUD to guarantee loans made by private lenders to Native Americans. The President’s budget proposes \$251 million in section 184 loan guarantees for homeownership in tribal areas, which represents a more than 100 percent increase over fiscal year 2006.

*Elderly and Persons with Disabilities.*—The fiscal year 2007 budget proposes funding for approximately 3,000 additional housing units for the elderly and persons with disabilities. While still expanding the program, the budget reflects a decrease in the rate of growth from the 2006 level, where over 7,000 new units were funded. This decrease recognizes that there are already a large number of projects in the pipeline. Importantly, however, all expiring rental assistance contracts are being renewed, and amendment funds are available for qualifying increased costs of construction projects already in the pipeline. Funds will also be available to provide supportive services through the Service Coordinator Program and for the conversion of existing elderly housing projects through the Assisted Living Conversion Program. Funds are also available to support the existing Mainstream Voucher Program fully.

HUD has constructed almost 27,000 units specifically for persons with disabilities. Including the funding for fiscal year 2005, HUD has 314 projects in varying stages of development in the construction pipeline.

HUD has constructed almost 400,000 units specifically for the elderly. Including the funding for fiscal year 2005, HUD has 342 projects (about \$1.6 billion) in varying stages of development in the construction pipeline. Moreover, HUD serves an additional 675,000 elderly families under other HUD rental assistance programs such as section 8 and Public Housing.

*Housing for Ex-offenders Returning to Society.*—Every year, more than 600,000 inmates complete their sentences and are returned to the community. Approximately two-thirds of prisoners are re-arrested within 3 years of their release and nearly half of them return to prison during that same period. Individuals released from prison face significant barriers upon re-entering their communities, such as lack of job skills and housing. To confront this problem, the President proposed a 4-year Prisoner Re-entry Initiative in his 2004 State of the Union address, designed to harness the experience of faith-based and community organizations to help individuals leaving prison make a successful transition to community life and long-term employment. The President’s 2007 budget provides a total of \$59 million for the Prisoner Re-entry Initiative, including \$24.8 million in the HUD request for housing needs for this population.

*Youthbuild.*—The President’s 2007 budget again calls for the transfer of the Youthbuild program, which supports competitive grants to train disadvantaged youth, from the HUD to the Department of Labor (DOL), as recommended by the White House Task Force for Disadvantaged Youth. On July 22, 2005, the Secretaries of Labor and HUD jointly transmitted legislation to the Congress to accomplish this transfer. Shifting this program to DOL will promote greater coordination of the program with Job Corps and the other employment and training programs the Department of Labor oversees.

*Housing Opportunities for Persons With AIDS (HOPWA).*—The HOPWA program provides formula grants to States and localities for housing assistance for low-income persons living with HIV/AIDS. The program helps maintain stable housing arrangements that improve access to health care and other needed support. The program also provides competitive grants to government agencies and nonprofit organizations. In fiscal year 2007, the President is proposing an increase in HOPWA funding to \$300 million, which will support an estimated 28 competitive grants and will provide formula funding to an estimated 124 jurisdictions. These resources will provide housing assistance to an estimated 75,025 households. In addition, the fiscal year 2007 budget request includes a proposal that would allow HUD to change the formula so that the distribution of funds is more equitable because it recognizes housing cost differences across the country.

#### HOW HUD WILL REFORM COMMUNITY DEVELOPMENT

A key component of HUD's strategic goals is to strengthen communities, ensuring better places to live, work, and raise a family. HUD is committed to producing a better means of measuring the performance of community development efforts, specifically within the Community Development Block Grant program. Allocating these funds more efficiently will help further reinvigorate our communities.

*Laying the Groundwork for Reform of CDBG, Focusing Block Grants According to Unmet Needs.*—The Community Development Block Grant (CDBG) program serves low- and moderate-income families in cities and urban counties, States, and insular areas across the United States through a variety of housing, community, and economic development activities. The fiscal year 2007 budget proposes to reform the CDBG program to contribute more effectively to local community and economic progress. Formula changes will be proposed to direct more of the program's base funding to communities that cannot meet their own needs; bonus funds will reward communities that demonstrate the greatest progress in expanding opportunity for their residents. Other Federal programs that support local development will operate in coordination with CDBG within a new, broader framework of clear goals, cross-cutting performance indicators, and common standards for awarding of bonus funding and measuring community progress. HUD programs that duplicate the purposes of CDBG—Brownfields Redevelopment, Rural Housing and Economic Development, and section 108 Loan Guarantees—will be consolidated within CDBG as part of this reform. This is another top legislative priority for me, and I look forward to working closely with you to achieve it.

*Block Grants for Native American Communities.*—The needs of this country's Native American population continue to be addressed through HUD's programs. The fiscal year 2007 budget proposes to increase the funding of the Native American Housing Block Grant program to \$626 million.

*Healthy Homes and Lead Hazard Control.*—Today, the Department estimates that 26 million fewer homes have lead-based paint compared to 1990 when the program began. Ten years ago, there was no Federal funding for local lead hazard control work in privately owned housing; today, the HUD program is active in over 250 jurisdictions across the country. The President is proposing \$115 million for this program.

*Faith-Based and Community Initiative.*—HUD continues its successful efforts to increase participation by faith-based and community organizations (FBCOs) in HUD programs. Due to a variety of efforts, more faith-based and other community organizations are extending their reach when helping society's most vulnerable citizens. The Center continues to provide outreach and technical assistance to FBCOs, through its grant writing workshops, its Unlocking Doors Affordable Housing initiative, and other outreach efforts. I am proud to report that the Center's outreach and technical assistance efforts have helped all groups compete on a level playing field for HUD assistance, regardless of whether they are faith-based or secular. According to the White House's 2004 data collection numbers, faith-based organizations have successfully competed for and won 23.3 percent of eligible HUD funding—a higher percentage than in any other department of the Federal Government.

#### HOW HUD WILL COMBAT HOMELESSNESS

In addition to pursuing other agency goals, HUD remains committed to the goal of ending chronic homelessness. The chronically homeless live in shelters or on the streets for long periods, often suffering from mental illness or substance abuse problems, and absorb a disproportionately large amount of social and medical services and expenditures. The fiscal year 2007 budget proposal includes an increase to \$1.5 billion from \$1.3 billion in 2006 for Homeless Assistance. This increase supports the administration's long-term goal of ending chronic homelessness by dedicating up to

\$200 million for the Samaritan Initiative that bolsters communities' efforts to produce supportive housing for the chronically homeless. Through the Continuum of Care grant competition, HUD has aggressively pursued policies to move all homeless families and individuals into permanent housing. This overall funding level in 2007 will house 160,000 individuals and families through this program.

This year, in addition, I am pleased to chair the U.S. Interagency Council on Homelessness, where the Federal agencies are working together toward this goal.

The administration again proposes to consolidate HUD's three Homeless Assistance Grants programs into one simplified program that will give local communities greater control to direct these funds to their priority needs.

#### HOW HUD WILL CONTINUE TO FIGHT HOUSING DISCRIMINATION

The Bush Administration is committed to vigorous enforcement of fair housing laws, in order to ensure that equal access to housing is available to every American. Fair housing enforcement activities are pivotal in achieving the administration's goal to increase minority homeownership by 5.5 million by 2010. For 2007, the President's budget proposes approximately \$45 million to support Fair Housing and Equal Opportunity activities to help ensure that Americans have equal access to housing of their choice. These activities include education and outreach, as well as administrative and enforcement efforts by State and local agencies and nonprofit fair housing organizations. Additionally, the requested amount would support the Department's ongoing efforts to address fair housing concerns in areas affected by Hurricanes Katrina and Rita. The efforts would include bilingual public service announcements, printed advertisements, and training events. The Department would provide technical assistance to builders, architects, and housing providers on accessibility requirements through Accessibility FIRST to ensure that newly constructed housing units are accessible to persons with disabilities.

#### HOW HUD WILL INCREASE ITS OPERATIONAL EFFICIENCY

HUD made significant strides in financial management this year. We are particularly proud of our achievements in:

*Financial Performance.*—Successfully accelerating the close of our operational books and audit of our financial records within 45 days of the end of the fiscal year, HUD earned an unqualified audit opinion on its 2004 and 2005 financial statements, giving the Department an unqualified or clean audit opinion on its financial statements for the past 6 consecutive fiscal years. The financial auditors also determined that HUD made significant progress in strengthening internal controls. The auditor downgraded two long-standing material weaknesses—one dating from 1990.

Continuing progress on the implementation of the final phases of the FHA Subsidiary Ledger Project contributed to HUD's ability to accelerate the preparation of auditable financial statements, and eliminate longstanding material internal control and financial systems weaknesses. HUD will complete the FHA Subsidiary Ledger Project in fiscal year 2007 and continue to pursue its goal for modernizing the Department's core financial system by fiscal year 2008, through the HUD Integrated Financial Management Improvement Project.

*Electronic Government.*—HUD continues its E-Government transformation in order to meet public expectations and government performance mandates by: increasing access to information and services using the Internet; eliminating duplicative and redundant systems by leveraging and integrating with existing Federal-wide services; acquiring or developing systems within expected costs and schedules that can be shared and used to simplify business processes; ensuring the protection of personal data; and providing increased security to guard against intrusion and improve reliability. HUD has executed plans to improve its information technology capital planning, project management, and security environment, along with modernizing HUD's IT systems infrastructure. HUD's future focus will be on modernizing its core financial systems applications and business systems applications in its largest program areas—rental housing assistance, single-family housing mortgage insurance, and discretionary grants, as well as establishing integration from our procurement data system to the Federal Procurement Data System (FPDS). In 2005, HUD successfully implemented two new systems: (1) a Human Capital support system and (2) a cross-match system with HHS to assist PHAs in verifying tenant incomes to assure eligibility for the program and accuracy in computing tenant rent contributions.

*Eliminating Improper Payments.*—HUD has reduced its gross annual improper rental assistance payments by 61 percent since 2000. In 2003, improper payments were reduced to \$1.6 billion from the 2000 level of \$3.2 billion. In 2004, improper payments were further reduced to \$1.25 billion. In October 2005, HUD provided

local PHAs with an electronic tool to verify tenants' income with the Department of Health and Human Services' National Directory of New Hires. This new tool will further improve the accuracy of eligibility determination for the rental assistance program and the proper calculation of the tenant's portion of the rent and the amount of Federal subsidy to be allocated. While the estimated improper rental housing assistance payments in fiscal year 2004 were substantially reduced from prior year estimates, they still represented 5.6 percent of total program payments. Through continuous corrective actions, HUD's goal is to reduce that improper payment rate to 3 percent of total payments during fiscal year 2007.

In conclusion, Mr. Chairman, the President's proposed fiscal year 2007 budget makes good progress toward successfully realigning Federal Government priorities according to our Nation's current needs. The HUD portion of that budget will help promote economic and community development through increased opportunities for homeownership and affordable rental housing, free from discrimination; it will also lay the groundwork for reform by focusing community development funding more carefully toward those most in need; and it will enable HUD to continue along the path to greater Departmental efficiency and effectiveness.

I thank you for the opportunity to articulate the President's fiscal year 2007 agenda for HUD. This is a good budget, Mr. Chairman, and I respectfully urge the Congress to adopt it. I am now available to answer any questions that you or other Senators may have.

Senator BOND. Thank you very much, Mr. Secretary, and as I said, we have a lot of questions. We have touched on some of them.

The PHA formula funding is flat-funded, but the estimates currently project that HUD's operating budget proposal will fund these agencies at about 80 percent of their eligibility under the formula for 2007. How can you expect agencies to operate safe and decent housing when they receive 80 cents on each dollar they expect from the Federal Government? And what kind of shortfalls is this liable to produce?

Secretary JACKSON. Mr. Chairman, that is a fair question. I think if we can pass the reforms that we have asked, that will be increased. But if we keep it at the present state that we have, you are correct. I think that the agreement that we have had with the industry is the best approach to go to asset management; that is, we have a lot of public housing authorities today that have assets that are underused, and in many cases not used at all. If we go to total asset management and those units are not used, you are paying only for the used units. Today, I think it is very important that we look at it in that manner. We have not been looking at it that way. And that was one of the reasons when we were doing the negotiation and I talked to many of the people in the industry and they were unsatisfied, I told our staff to go back to the table and try to address the needs that had been denoted to us by the people in the industry.

And I think having come out of the industry for a period of time, I am very sensitive to their needs, and I think that clearly if the reforms are passed and adopted, we will have substantial monies to cover the program. If not, then, yes, we will have a shortfall.

Senator BOND. Well, as I understand, during the negotiated rule-making the Department acknowledged that implementing the rule would require an additional \$250 million in funding, and since then, the implementation of the rule seems to have become increasingly complex and costly. You know, granted, there needs to be a new system, but how can we expect a reasonable and ordered implementation of the rule as we move to asset-based management when there is a cut and in the face of the transition costs which have been acknowledged by HUD?

Secretary JACKSON. We have acknowledged there is a concern, and, again, speaking with the industry, I sent our staff back to the table to make the transition as smooth as possible so that we would not have this kind of effect that you have just said.

We felt that we had come to an agreement, and I still think we have come to an agreement, by delaying some implementation by some housing authorities and letting others start implementation when we set the program to start.

I believe we have addressed the issues that the industry wanted to—said was very significant, and I am a little perplexed in talking to some of my industry colleagues when they say that we have not, because I specifically said to the staff, “Get in the room and resolve this”, because I, too, felt deeply that that specific issue had to be addressed.

#### ASSET-BASED MANAGEMENT

Senator BOND. Well, there is another issue that just strikes me as being a real problem. HUD is behind schedule, I gather, in developing the criteria for asset-based management, and when October 1 rolls around, PHAs scheduled to lose subsidies will not be able to use the stop-loss provisions of the rule, which would limit their loss to 5 percent, if they comply with the asset management requirements. I understand that HUD has indicated that the criteria should be completed by mid-2007, and PHAs in compliance will have their funding restored retroactively according to stop-loss rules.

But how do you do that? How do you plan for a year when you are going to get a shortfall and you are going to be shorted at the front, and you do not know what you are going to—if you are going to come out a winner in the end? It seems to me that by saying, hey, you start operating on October 1, and maybe by March 1 we will tell you how much money you are going to get, as a former chief executive of a small operation, I would have found that extremely difficult to handle.

Secretary JACKSON. I think your assessment under normal circumstances is correct, but one of the things that I think is very important is I asked the industry—because I have tried to be extremely open and accessible to the industry if that was acceptable. They said to date it was acceptable. That is why we extended the ability for the stop-loss gap to go into effect.

Now, if it is not, then I am a little baffled and surprised, and I would suggest that as chairman, you and I sit with the industry because I would not have made—I would not have gone forward with this unless clearly the industry had accepted this.

Senator BOND. I think maybe your team selects some, and our guys and gals will select some, and maybe we will have everybody sit in the same room so that they tell you the same things they are telling us, because somebody is getting the wrong story.

Secretary JACKSON. I think you are correct, Mr. Chairman. And I am a little baffled.

Senator BOND. I think this one is—

Secretary JACKSON. You know, I think—

Senator BOND. They are telling you one thing and us another. I would like to find out where the truth lies.

Secretary JACKSON. I have asked the staff to go back and make tremendous concessions, because I believe that when we did the meetings for the operation perspective, that the industry operated in good faith and down the road somewhere we stopped operating in good faith, and I sent them back to the table.

Now, I feel that—I have personally talked to the major entities in the industry, and I thought we had resolved this, and I do not question you because I have a great deal of respect—

Senator BOND. Well, it is not a question—I am not questioning what you are telling me or what my staff is telling me. But we are getting two very different signals.

Secretary JACKSON. I agree.

Senator BOND. So we need to get together and have the group that we are trying to serve tell both you and us what the truth is.

Secretary JACKSON. I would be happy to do that, sir.

#### BLOCK GRANT VOUCHERS

Senator BOND. Vouchering the block grant, as I said, I have got a minimum amount of high enthusiasm for that proposal. Maybe it could work if there is an adequate commitment of future funding and if it included special protections for extremely low-income families. But there is no guarantee of it.

I would be interested in why the Department does not include the current law requirement that 75 percent of the vouchers go to extremely low-income families at or below 30 percent of area median income. And what is your response to the claim that there would be more homeless families without this requirement?

Secretary JACKSON. Again, I think that is a fair question. I think we do adhere to that 75 percent of the vouchers should go to, at this point as the present law is written, the households below 30 percent or less of area median income. I don't think, Mr. Chairman, that in the present state of the program we can change the quality of making sure that more people have accessibility to the voucher. The extended time that people stay on that voucher has been increased tremendously since 1998. Before that, it was nearly 3 years. Today it is about 8 years. So we do not have the turnover that we had before.

I truly believe that if we give the authority to the housing authority in a block grant, as we did before 1998—we did not have unit-based costs before 1998. They gave us an allocation. And I can tell you both in St. Louis, both in the District of Columbia, and both in Dallas, I dealt with allocations and I was able to house more people at a quicker rate than we are doing today.

To me, there are no incentives for a housing authority to ask people or to help people get off section 8, because they are going to get their administrative costs regardless of what they do, whether they lease up or do not lease up those units.

So I believe that if we go back to where we were before 1998, we will see aggressive housing authorities moving, serving more people, and the voucher will turn over much quicker. And, you know, again, you know, I hear the argument that is being made by housing authorities. But I am just sorry, Mr. Chairman and ranking member, I do not buy the argument. I ran three housing authorities, and I know what it takes. And the three housing authorities

I ran all did very well, as you know, in St. Louis, and we served a lot of people. But I think we should give housing authorities incentives to serve more people and turn the vouchers over much quicker than what they are doing. And at this stage, they have no incentives to do that, and that is why the lines for section 8 vouchers are longer and longer and longer, and getting longer. And I don't know whether we are creating more homeless people, but I can tell you that the lines are getting longer.

Senator BOND. Senator Murray.

#### CDBG CUTS

Senator MURRAY. Mr. Secretary, I read through your formal opening statement, and reading that statement, you would never know that you are proposing a cut to CDBG of \$1.15 billion or about 27 percent. What your statement says is "Allocating these funds more efficiently will help further reinvigorate our communities." Can you tell us how cutting available resources by \$1.15 billion next year helps reinvigorate our communities?

Secretary JACKSON. Senator Murray, I perceive us cutting about \$635 million out of the block grant program as it stands today, not \$1.2 billion. I do believe this, that the block grant program has served a very vital purpose. That is why I was such a great advocate of it. But I am also convinced that you have very wealthy communities that have pockets of poverty that they should be taking care of. When I look at the block grant program, I think we should zero in on those communities that have been in distressed conditions, that really need our help, both economically, housing, infrastructure-wise, and gear our money toward those persons to help them move forward. And if they are moving forward, continue to help them until they come to the level that they do not need our help.

That has not been the case with the Community Development Block Grant Program, and I must admit that.

Now, to say that it has not done good in many places, I could not say that because that would be very hypocritical because I am a great proponent of it and I served as chairman of two community development agencies, but I do think the money can be zeroed in, and if the reforms are adopted, I think we have substantial money to address the needs of those communities most in need.

Senator MURRAY. I am in my 14th year here in the Senate, and I can say that I know of very few programs that have as much broad-based support as CDBG. It is supported by Members of Congress, by Governors, mayors, county supervisors, community development organizations, everywhere I go, and it is consistently supported by Democrats and Republicans alike because they go home and they hear how these funds are being used, and they know that it makes an incredible difference in their community. It seems to me like the only group that appears to be openly hostile to the CDBG Program is the Bush administration.

Last year the proposal was to combine the program with other programs and cut it by more than one-third, and this year you want to cut it by \$1.15 billion. I just want to know how the administration came to the conclusion that this program is broken and it needs to be fixed.

Secretary JACKSON. Let me say this to you. I do not think that we are hostile toward it, and I can specifically tell you that I am not. I have seen the program work, so I cannot debate about it not working—

Senator MURRAY. What is broken about it?

Secretary JACKSON. The point is, is I do not think it zeros in or zooms in on those communities most in need or those cities most in need, and I think that if we began to do that, not pockets of poverty in Palm Springs, but places like Akron, Ohio that really needs tremendous infusion of funds. I think we should clearly specify where the money should go and what is needed, and we have not done that. I think that that is a serious problem, we have not. I mean there are areas in Dallas, where I was born and raised, that receive block grant funds that should not, but if you take specific areas in St. Louis where you have almost a total community that has suffered tremendously, I think we should gear the money where it is needed.

Senator MURRAY. Okay. But right now your own budget documents say that as the program exists today, 95 percent of CDBG entitlement funds and 97 percent of State grantee funds went to benefit, today, low- and moderate-income individuals. So if every dollar of this program is already providing benefits to targeted communities, why is the administration saying we need to target it even more?

Secretary JACKSON. Again, I am not going to disagree with you, but let me say this to you. Take Dallas as an example, where I am from. Their block grant monies, a great deal is spent on housing inspection. That is a worthless waste of time of Community Development block grant money. That is what it is. But if you ask Dallas, they are going to say that they are doing that in low- and moderate-income areas, which they are, but that is a function of city government, and they should be doing it themselves. They should be using the block grant funds, if they are going to use them wisely, for the infrastructure and rebuilding of that city.

Senator MURRAY. Here in Washington, DC, are we going to look at every community and decide ourselves here, or yourself in your program, who is using the money wisely, and start doing earmarks?

Secretary JACKSON. No, that is not what I am saying, but I am saying to you that we have communities that are wealthy that can address many of these needs, and they have not been addressing these needs.

Senator MURRAY. I do not know Dallas. I did not know it was wealthy. But in your proposal, you say, so-called affluent communities are going to be eliminated. How are you going to define affluent communities? We have Bellview, that some people may say is affluent, but let me tell you, there is a growing large number of low-income people in Bellview, and they use those funds for low-income people even though Bellview may be, I do not know, within the Nation, an affluent community. I do not think so, but how are you going to define this?

Secretary JACKSON. Well, if you want to use Bellview, that is a very good example.

Senator MURRAY. It is not a good example.

Secretary JACKSON. I am very aware of it. They use a larger portion of their funds for housing inspection. They should be doing that. That should not be a function. If we are going to deal with it, we should look at the areas of the highest area of poverty to address needs.

Senator MURRAY. So are you saying CDBG funds should not be used for housing inspections?

Secretary JACKSON. Really, I do not think it should. If it should, it should come out of the administrative costs of that city. See, I think we have gotten so used to us not really addressing the needs of Community Development Block Grant funds as to what they were initially set out to do, that we think that it is okay to continue to do this. I am not saying that a portion of it should not be used, or should not come out of the administrative costs.

Senator MURRAY. How are you going to define affluent communities?

Secretary JACKSON. I think when you get our proposal that we are submitting to you, to reorganize and to look at how we can best serve communities. I think we can define affluent communities. I think Palm Beach is an affluent community. I think that, clearly, several communities that I could name are affluent. I think Bellview is affluent.

Senator MURRAY. So you are basically going to say at the Federal level, we are going to define what affluent communities are, and none of them will get any CDBG funds; is that right?

Secretary JACKSON. No, that is not what I am saying, but I think we should look at it very hard and see how we address it proportionally or whether they should receive it.

Senator MURRAY. When will we get your proposal?

Secretary JACKSON. You will have our formula within the week of what we are setting forth.

Senator MURRAY. Well, it will be very fascinating to see how you define affluent.

Secretary JACKSON. I will tell you this, I clearly believe we can define it without a doubt, and I think the formula will address that.

Senator MURRAY. Communities like Bellview have a dramatically growing number of low-income people. They are the people who work in the hotels. They are even the people who teach in our schools, and their housing needs are incredibly difficult because they live in a community where housing is even more expensive than other communities. So I see CDBG funds being incredibly important to what you may well define to us as affluent.

Secretary JACKSON. And I would say to you, I do not disagree with you on what you just said, but if the monies were going to the housing needs, that would be a different perspective. I think I would ask you to go back and look at how Bellview has been spending their money, because one of the things I did before I got here is I did look at it, and a lot of it is being spent in areas that I think you would ask them to relook at that and go spend it for just what you said.

Senator MURRAY. We will see how you define affluent and what happens with that.

Secretary JACKSON. Okay.

Mr. Chairman, Thank you very much.

Senator BOND. Thank you very much, Senator Murray.

We are very pleased to be joined by additional members of the subcommittee, and sorry you missed out on our initial very thoughtful discussions that Senator Murray and I offered.

But now we are happy to hear your questions, beginning with Senator Leahy.

STATEMENT OF SENATOR PATRICK J. LEAHY

Senator LEAHY. Thank you, Mr. Chairman. We were here prior, but we also have a massive immigration bill before Judiciary, and that is where I was.

Secretary Jackson, it is good to see you again.

Secretary JACKSON. Good seeing you, Senator.

Senator LEAHY. Welcome you to your second appearance before our subcommittee. I know that Senator Bond and Senator Murray, who do a superb job in leading this committee—I will repeat that for Senator Bond.

Senator Bond and Senator Murray, you do a superb job in leading this subcommittee.

Senator BOND. Thank you very much.

Senator LEAHY. I am concerned though about the budget, and I understand what you said to Senator Murray, but I look at cuts in affordable housing by cutting funds for public housing, weakening of the section 8 program, the President slashed funding for—I believe that CDBG is extremely helpful.

Secretary JACKSON. I agree.

Senator LEAHY. I have watched how it has been used in my State, and I see these cuts. Whether you are for or against the war in Iraq, we just get asked for billions and billions and billions of dollars more all the time to rebuild parts of Iraq, to do everything from providing for the National Guard of Iraq, while we cut money for the National Guard of the United States; for housing for Iraq, we cut it here. I believe a strong America begins at home, and that has nothing to do with whether you are for or against the war in Iraq, but if we are going to be providing for these things in Iraq, we ought to start providing for them in the United States.

Fortunately, the attempts to pay for the war in Iraq out of our domestic programs is not a wise one to do. If the war is that great an idea, then pass a tax to support it. We did this with World War II. We did it in Korea. We have always done it. Now, I think this puts a real burden on ordinary people. In my home State of Vermont, Vermonters are finding it harder and harder to find basically affordable housing. It is going to become increasingly difficult for our teachers and our police officers and our fire and rescue workers even to afford places to live in the communities they serve. We are going to see homeless families in Vermont grow.

PREPARED STATEMENT

Last weekend it was 10 degrees below zero in Vermont, not unusual this time of year. I have been in my home in Vermont when I could not tell exactly what the temperature was because the thermometer on the front porch only goes to 25 below zero. I live in a comfortable house. Many Vermonters do not. That does not be-

come a matter of discomfort, that becomes a matter of life or death. I will submit a full statement for the record, if I might, Mr. Chairman.

Senator BOND. Without objection.  
[The statement follows:]

PREPARED STATEMENT OF SENATOR PATRICK J. LEAHY

I welcome Secretary Jackson to this hearing of the subcommittee. We have much to discuss, as the President has sent a budget to Congress that ratchets down affordable housing among our budget priorities, and that would increase, not lessen, the burden put on the shoulders of our Nation's struggling low-income families. I must say that I wish it could start on a more positive note. Unfortunately the President's proposed budget for the important work of your Department is one that again invites disappointment and even incredulity, not praise.

For an unprecedented sixth year in a row, the Bush Administration has decided that affordable housing is not a national priority. The President's budget proposal says to ordinary Americans families struggling to make ends meet and needing help in affording basic housing, "Sorry, but putting a roof over your head is no longer our concern." That attitude is short-sighted, has real consequences in real communities for real people and is anything but compassionate.

At a time when Federal leadership is needed more than ever before, the Bush Administration is running in the other direction. The President has sent a budget to Congress that would hurt affordable housing programs by cutting funds for public housing and weakening the section 8 program, and he would slash funding for one of the most successful initiatives that supports economic development and affordable housing, the Community Development Block Grant (CDBG) Program.

After squandering record surpluses and converting them overnight into a record national debt through irresponsible tax and spending policies, the White House's solution is to slash funds for affordable housing programs that help hard-working Americans and their families who are stuck in a financial cul de sac, as the gap between housing costs and wages continues to widen. At the same time, the White House calls for more massive tax cuts for the wealthiest individuals and corporations. Our children and grandchildren, who cannot possibly afford such irresponsibility, will reap the true legacy of the Bush Administration's abysmal fiscal management.

In my home State, Vermonters are finding it harder and harder to find basic, affordable housing. If we fail to address this problem head on, it will become increasingly difficult for our teachers, police officers and fire and rescue workers to afford places to live in the communities where we need them. We will continue to see the ranks of homeless families in Vermont grow. This is not a problem unique to Vermont.

The budget before us signals a substantial retreat in our commitment to help provide access to safe and affordable housing for all Americans. The public housing capital fund is cut by 11 percent and the operating fund is level-funded despite the need for additional funding for the operation of public housing under the new asset-based management system, funds for housing for persons with disabilities have been cut in half, HOME formula grants have been reduced, the housing for the elderly program has been slashed, and both fair housing programs and lead-based paint grants have been cut.

Most egregious is the administration's proposal to cut the CDBG program by \$736 million, leaving funding at its lowest level since 1990. This program provides critical source of funding for affordable housing, supportive services, public improvements, and community and economic development. If the President's proposed cuts to CDBG are enacted in fiscal year 2007, then an estimated 97 percent of the more than 1,000 communities that have held entitlement status since fiscal year 2004—which was the highest level of funding for CDBG under this administration—or earlier and every State program would have their CDBG allocation slashed by at least one-third.

One of the few programs to see an increase in this budget proposal is the section 8 Housing Vouchers program, and even that increase will not be enough to restore the cuts that were made to this year as a result of inadequate funding in fiscal year 2005.

I hope to hear from you today about the vision you have for the Department of Housing and Urban Development and how you expect to run efficient and effective programs like these, when they are slowly being starved to death.

Senator LEAHY. To go back to what Senator Murray was saying on CDBG, slashing by \$736 million, that is the lowest level since 1990. The National Low-Income Housing Coalition estimates these cuts are in there, then 97 percent of the more than 1,000 communities that have held entitlement status will find it slashed by at least one-third. You have been asked questions about that. I will not keep going on that. But we see CDBG, proposed consolidation of Brownfields redevelopment grants, rural housing, economic development, and section 108 loan guarantees. If you are going to consolidate all of those programs, how are you going to do more with less? Is there some magic or are we using the same rosy assumptions we are in Iraq?

Secretary JACKSON. Well, first of all, I would not agree that it is a rosy assumption in Iraq. I believe our President—

Senator LEAHY. I have heard the administration say we would be welcomed as liberators. I have seen signs “mission accomplished,” and I heard, “Bring it on,” and I heard that this is just a momentary blip in the road as the country is spiraling, apparently, into civil war. But this is not the committee of Defense Appropriations or Foreign Operations. I am just worried that we sometimes make these projects, and they do not work very well.

Secretary JACKSON. To answer your question, Senator, if I did not think that this could work, I would not be here defending it. I think before you came in I said to Senator Murray I have the real dubious distinction of being the only HUD Secretary to run a housing authority, and to be chairman of two community development agencies. And my perspective is, is that—

Senator LEAHY. That is one of the reasons we welcome you, because of your experience.

Secretary JACKSON. Thank you, sir. My perspective is that if we implement the revised formula, which I think is very important—and I have said this almost from day one when I was Deputy Secretary—to look at how best to distribute the money to those communities most in need, and not as we have over the last 30 years. I think that when Senator Murray asked me or made a statement about the success of the program, there are so many successes. I cannot even debate that. But I think we can distribute the money much better to address those communities in 2005 that most need it, and not communities that have used it for programs that are not necessary to address the needs of what the block grant program was, from the inception, believed to accomplish.

And I say that again, yes, there is a cut, but I believe that clearly the monies that we have, if we adopt a formula that we are going to submit to you, will address the needs of what we think is very important in the block grant.

Now, if it is not adopted, I think you are absolutely correct, but I do believe that we can do a lot more with not as much money this time.

Senator LEAHY. My time is up, but I see this case every year. There are all these different holes in the budget. This subcommittee is faced with the unenviable task here for every mayor, every Governor, and just by every other group saying, “Can you put the money back in?” Again, we have worked in a very bipartisan way here, but it is somewhat difficult. We will have a further con-

versation. My time is up, but I will submit questions for the record, and maybe you and I might chat later on.

Secretary JACKSON. Yes, sir, thank you.

Senator LEAHY. Thank you, Secretary.

Senator BOND. Thank you very much for your comments and for your sympathy, Senator Leahy. This is a tough year, and we will all have a lot of work to do.

Senator KOHL.

Secretary JACKSON. Thank you very much, Mr. Chairman.

Secretary Jackson, just to plow this ground a little deeper, and once again, about section 202. The program, as you know, provides funding for local nonprofit agencies to construct and manage housing for low-income seniors. This section 202 program creates, as you know, safe and affordable communities where senior residents have access to the services that allow them to live independently, with the number of individuals over the age of 65 expected to double, as you know, in the next 24 years. How do you explain in a way that makes people understand and accept a proposal by the administration to cut funding for this program?

Secretary JACKSON. To date, Senator, we have decreased the program by \$307 million, but it is fully funded for the existing contracts that exist today, fully funded. In 2006 we funded 7,000 units of 202 and 811, and in 2007 we are funding an additional 3,000 units. So clearly, from my perspective, if the money is spent in an expeditious manner, I have no problems at all going back, saying we need more money. The program has been slow starting, and in fact, we geared the program up, since we have come in 2001, to get the backlogs of 202s, 811 that was in the backlog, and we have almost cleared it up, but not quite. And if the money continues to be funded, I think it is—I will be happy to go back and ask. I am not against 202's, 811, but I think the money must be expended very quickly.

#### HOPE VI

That is my argument even with my good friend, the chairman, about the HOPE VI. To date we still have about \$3.2 billion outstanding over 10 years in HOPE VI that has not been spent, and I do not think we should continue to fund the program unless clearly the money is spent expeditiously and wisely. To date, out of 200 allocations of HOPE VI, a little over 200, we have only had about 35 completed. That was the same situation we faced when we came in to 202. So it is not, again, that I do not think it is worthy. I think we have to look at the program and see whether it is being utilized in the best manner. If we do that, then, yes, I am the person that will defend it until the end and go ask for money.

#### CDBG

Senator KOHL. Well, we will see. CDBGs, Mr. Secretary, as you know, provide important funding to States, counties, cities and local communities for a range of projects such as housing, supportive services for seniors and disabled, improvements in public facilities, and so on. In my State, Wisconsin, the program has funded housing projects for elderly, homeless and single family housing, for low-income first-time homeowners, and a host of other projects.

It is a sort of decentralized, locally controlled program that this administration has supported. So, again, why does the budget target this program for such a significant cut? And is it going to be distributed in such a way so that communities such as Wisconsin will not be cut? Is that what you suggested earlier?

Secretary JACKSON. What I suggested is, is that we put in place a revised formula that we are going to submit to you all for you to act upon. I think that we are going to look at all of the recipients of block grant programs, look at the community as a whole, not necessarily piecemeal, and that is what I said to Senator Murray. You have very rich communities that have pockets of poverty, but clearly, those communities can address that pocket of poverty, where we could best use the monies that we have and been allocated, to address those cities of total communities that need it.

I am one, Senator Kohl, that believes block grant works. I have seen too many great projects that have been very well carried out, but I have also seen cities utilize money—and this is not something I have just said today—I have seen cities over the years utilize monies for things I did not think they should be utilizing the money for. One of the biggest problems, when I chaired the redevelopment authority here in the District, I had great fights with the council people because they had their pet projects, and I said, really, that should not be the case. We should zero in on the low- and moderate-income community, those with the most poverty, those which have the potential of developing economic development in conjunction with housing. And so I do believe that the program is valuable and worthwhile. I just think we have to redirect our energy and specifically say how this program should be used.

Senator KOHL. In doing so, cut the budget for the program. I mean, we must—

Secretary JACKSON. No, and a revised formula. Yes, the budget has been cut.

Senator KOHL. I mean, at one end you say it is a great program and you support it, you endorse it, you think it is good. On the other hand, the budget has a cut for the program and there is something there that does not connect. If you, for example, take the position, as most of us do, that there is so much that needs to be done in our country, so much, with programs like this, how you can support at the same time cutting the program is, as you can understand, to some of us hard to understand.

Secretary JACKSON. Sure.

#### BROWNFIELDS

Senator KOHL. But before my time runs out, just on Brownfields, obviously, the program, Brownfields, promotes economic development in abandoned and under-used industrial commercial facilities, as you know. It is a program that is good for the environment, good for business, and good for economic development. A number of communities in my State, including a neighborhood development initiative in Beloit, Wisconsin, have benefited from the Brownfield funding. So, can you explain why the President would propose eliminating, eliminating funding for the Brownfield redevelopment programs?

Secretary JACKSON. We have not cut it. We have consolidated the program. I think in consolidating the program, it goes back again to what I have said to the others. I think we must zero in on those communities, Senator Kohl, that most need the money. And if Beloit is one of those communities—that is one I cannot comment on—then, yes, we would zero in on that community. The question we would ask when we zeroed in on this community: “When we go in with the Community Development Block Grant Program, what effect is this going to have on the community? Has this community been devastated because of loss of jobs over a period of time? Will this invigorate the economic development, the housing development within that community?”

If it does, then it is our responsibility to go in and help Beloit become a better community. But it is not our responsibility to go into Palm Beach and help Palm Beach get richer, even though you might have pockets of poverty in Palm Beach.

Senator KOHL. Are you saying that the Brownfield program will not be eliminated in Beloit?

Secretary JACKSON. It will be part of—it is consolidated into the Community Development Block Grant Program.

Senator KOHL. Our fear, of course, as you know, is that this consolidation will result in less or no money for something like brownfields. As you know, that is what those of us on the other side of the issue are arguing, and very fearful will occur. Tell us that we are wrong.

Secretary JACKSON. Well, I can tell you as the Secretary that is not my intention when we talk about consolidation. My intention is to take a picture of what is needed in a community to bring that community to where it should be after devastation has occurred, whether industry has left, whether that has happened. I do believe that it is important to look at the community as a whole, and as I said to Senator Murray a few minutes ago, yes, there are cuts, but I am well aware of monies from block grants that have not been used for what I think they should be used for. I know people will disagree and say, “That is what you think,” and it is what I think.

I think that cities have totally taken—as my city, Dallas, I use all the time—just totally taken every housing inspector in the city off the payroll and put them on CDBG. I think that is the function of the city of Dallas. And I always want to use the city because that is the safest city for me to use, since it is Dallas. But I do not think it should be used for that.

I think it should be used for infrastructure to address issues, as the Senator just said, for rebuilding house infrastructure for low- and moderate-income people, such as fire people, police people, nurses, teachers, who find it very difficult today to be able to afford a home in this country. That is why I think we should juxtapose CDBG funds with HOME funds, with Shop funds, and help people who most need it, and in many cases that has not been the case. It has been a supplement for cities to do things that they should be required to do themselves.

Senator KOHL. Thank you so much.

Mr. Chairman, thank you.

Senator BOND. Thank you very much, Senator Kohl.

## HOPE VI

Mr. Secretary, since you wanted to talk about HOPE VI, I thought that we might talk a little bit about it, because you know how complex it is. You know how long it takes these deals to get done. Very difficult for the local governments to put all the plans together, and, frankly, from what I hear, HUD has not been as helpful as it could and should be, doing something that is absolutely the most important thing we can do, and that is to turn obsolete, unsafe, unsound, housing, which has been a festering place for crime and drugs and not good places for families, and turn them into viable communities.

Now, I can show—and I know you have seen what is going on in St. Louis, Murphy Park instead of Vaughn, the King Louis operations. This has truly revolutionized downtown St. Louis.

Secretary JACKSON. That is true.

Senator BOND. And I understand Atlanta, and Louisville, and even Chicago, which had had some very real programs, is being reborn with the money that goes into the HOPE VI operation. I am not going to be like Jim Cramer on Mad Money and tout my book, but I hope that you have read the San Francisco Chronicle article on HOPE VI, which said that it was one of the very few revolutionary programs that is making a difference in housing. And if you wanted to change it, if we want to, first of all, improve the management, administration of it, but when you are saying, well, all these needs are going to be handled through the Public Housing Capital Fund, and at the same time more than a 10 percent decrease in that, you take that into account with the proposal to eliminate HOPE VI, it seems to me that this budget turns its back on the need to help cities provide the infrastructure that is needed in many instances to clean out unsafe, unlivable housing projects into decent places for families to live.

I am just very much troubled by what the budget does to the Public Housing Capital Fund, and to HOPE VI.

Secretary JACKSON. Mr. Chairman, let me say this to you. Since 1991, when we first implemented the first HOPE VI after the recommendation of the National Committee on Severely Distressed Public Housing, which I served on, and you, and Jack Kemp were very instrumental in making sure that HOPE VI was put into law, we have demolished almost 120,000 units today around this country. So the same capital fund that was needed then is clearly not needed today. And I think, clearly, we should not have the same amount of money.

Secondly, I cannot ever question St. Louis. St. Louis has been very, very unique in a sense—so has Atlanta—because in their HOPE VI they have had developers who would leverage the money. That was the basis of the program in the first place, is to find a developer who would take the allocation from the Government, leverage it and create a community that was both socially and economically integrated.

Now, have we seen that in St. Louis with developers? I will not call any names, but it has been successful. Have we seen that in Atlanta? It has been successful. Have we seen that in Charlotte? It has been successful. Have we seen it in Dallas? It has been suc-

cessful. But those are only some examples of the 35 of over 200 applications that were funded, that were done, and done in a timely manner.

Now, if you look in the last 3 years that we have been here, we went back to the original language of the HOPE VI, where we suggested that you have a developer come in who could leverage the money that we give you. That is working, but we still have this money in the pipeline.

Now, I would be the first to say if we are recapturing part of this \$3 billion, I would say, yes, let's find some way to reallocate it to other HOPE VIs in the country, but right now, the money is standing still. And we just began, after 15 or so years in New Orleans, to get those HOPE VI off the ground. So I am saying to you, I am not saying the program in certain areas has not worked, but clearly it has not been the program that you thought about or Secretary Kemp thought about, or we thought about on the National Commission.

Senator BOND. I think we suggested recapturing some of that money, some of the unused HOPE VI money, but we understood that HUD opposed it because they did not want to be in the position of recapturing it.

Secretary JACKSON. No, no, Senator—

Senator BOND. If there are some areas where it is not being used, and other areas where it is needed, I think we ought to work together to recapture that. But you put your finger on one critical point for HOPE VI to work, there has to be a community with a developer with leverage that is going to come in and make this a truly mixed income, viable community.

Secretary JACKSON. If you recapture the money and tell us what to do with it, I will do it.

#### PUBLIC HOUSING CAPITAL FUND

Senator BOND. Well, we have about \$20 billion in public housing capital backlogs, and the budgets that have been presented by OMB do not come anywhere near meeting those. We need to get money into the Public Housing Capital Fund, and you and we need to be clear that if you are going to have HOPE VI, you need to come in with a plan, and with a developer, with the financing, with this community support, and then HUD needs to streamline its act—

Secretary JACKSON. Absolutely.

Senator Bond [continuing]. So these people can make it work. There are needs around the country for the HOPE VI funding, and if some day when you say that they are all done, I will be happy to check, and I will bet we can find some more where it is needed.

Anyhow, I took up a lot more time than I meant. Sorry.

Senator Murray.

Senator MURRAY. Thank you, Mr. Chairman.

#### PUBLIC HOUSING CAPITAL FUND CUTS

Mr. Secretary, following up on that, in your formal opening statement you said the Department continues to place great emphasis on the physical condition of public housing properties. Well, I am having a hard time reconciling that statement with the budget pro-

posal that actually cuts the Public Housing Capital Fund by more than a quarter of a billion dollars, both last year and then again this year.

Let me just share with you how those Federal capital grants have impacted a PHA in my State. King County Housing Authority has been trying for a long time, for years, to install fire prevention sprinkler systems into all their older buildings that house the elderly and house the disabled. They have had an increasing number of fires, and one of them resulted recently in a fatality.

These cuts in capital grants have meant that the installation of those safety systems are taking longer and longer and longer to get done, and it is really putting people who live there at risk.

If the Department is so concerned with the condition of public housing, why have you allowed funding for this program, the housing capital fund, to drop every year for the last 6 years?

Secretary JACKSON. Let me say this to you, Senator: We believe that the assets which King County and other housing authorities have are marketable. They can issue bonds very easily to cover any expense that they need, because, clearly, they know they are going to receive every month their monies from HUD.

The best example I can give you is what Mayor Daley has done in Chicago. He has issued bonds to the tune of almost \$350 million to address needs, plus using the capital fund. If they did not have those assets, I think the argument that you—the question you just asked, the argument you are making is legitimate.

We have gone back and said use the assets. For years, housing authorities—and I was one of them—asked to be able to issue bonds on our assets so that we could do things that we ordinarily could not do within capital funds. We have given them that authority to do it now. There is no reason why King County or anyone else cannot issue bonds to cover areas that they say are in critical need and do them very quickly. It is being done right there in Chicago. It is being done right there in Philadelphia. It is being done in other cities.

So I don't understand why they cannot address this if it is a really critical need not only through the capital funds, but also through issuing bonds.

Senator MURRAY. Well, maybe we can get you together with them, because they say this is a real challenge, and when they see those declining dollars in the future, they have to pledge their future capital grants from HUD for this purpose, and when those numbers are declining and they don't know that they are there, it is harder and harder for them to do.

Secretary JACKSON. Well, I think the key to it is that, from talking to the investment bankers, they realize—and I have had a chance to talk to them because that was a concern that was raised, a legitimate concern. I said the only way we are not going to meet the obligations of housing authorities in this country is that our Government goes bankrupt. And I do not see our Government going bankrupt, because if we go bankrupt, then we cannot meet any of our obligations.

So I allayed the fears of many of the people on Wall Street about making these bond issues. That is why they have done it in probably 15 cities today, because they know they are going to be paid

out of the income that each housing authority receives around this country.

We have to pay them. Every year they have the operating subsidy, they have the capital subsidy that we have to give. And we have to give it because it is in the budget that you allocate for us each year. So I cannot understand why they cannot do it.

#### ELDERLY DISABLED HOUSING

Senator MURRAY. Well, let me follow up on Senator Kohl's question on housing for disabled and elderly. The AARP reported that there are currently nine people waiting for every unit available, and the senior population is expected to double by 2030, from 36 million to 70 million.

Given the unmet needs and the growth in the aging population, I find it very hard to see how we can follow through on a huge cut to housing support for elderly, more than 26 percent. How do you justify that?

Secretary JACKSON. Because right now we have fully funded the existing contracts in the 202 program. We did, as I said to Senator Kohl, cut \$190 million, but for 2006, we had and still have 7,000 new units today that have not been developed. In 2007, we have an additional 3,000 units. And all of these to date are being put out through a proposal to be developed.

So I think we are addressing the needs, and if we can clear up, as we have done the pipeline before, we will be happy. That is a program that I think is absolutely important. In fact, I was talking to Chairman Bond about it. You know, I am almost there. I am near elderly. So you will have to look and see where we are in this program. But I believe that clearly right now we are addressing the needs because we have not cut out one existing contract. We have funded 7,000 units for 2006. We have funded an additional 3,000 units for 2007. And then, if necessary, we will fund again.

But I think until we develop those units again, I don't think we should just put money in the budget.

Senator MURRAY. What you were saying to Senator Kohl is there are unobligated funds in the pipeline so, therefore, you are decreasing your request. Well, we don't do that in other programs. There are a lot of unobligated funds in the NASA program, but the President is asking for an increase there because of the need. And I do not understand why the same is not true, because the need is so high, and you are doing a better job of getting the money out the door. But because the need is so high, I do not understand why we are asking—

Secretary JACKSON. Well, I cannot address what the administrator at NASA does, but I can tell you what I have suggested, and my position is that I believe that clearly we can address the needs of the elderly at this point. If I did not, I would go and—I would be the first to tell you. I really do.

Senator MURRAY. All right. Well, thank you, Mr. Chairman.

Senator BOND. Thank you, Senator Murray. I will have a number of questions to follow up on section 202 because, as I mentioned to you, we share those concerns.

## SECTION 811

I might as well get to another very serious cut, the 811, a 90 percent reduction in the 811 fund from \$155, almost \$156 million, down to almost \$16 million. How are you supposed to continue the progress toward eliminating costly institutional care that everyone agrees is outdated if 811 is eliminated as a tool for developing permanent supportive housing?

Secretary JACKSON. First of all, 811 is still fully funded. HUD has built about 27,000 units of 811, and there are about a little over 300 in the pipeline today. I still believe, again, that with the fully funded contracts, with the units built, we can address the needs. If it is clear to me that the needs further exceed what we perceive—what we have in the budget, then clearly I will come back and speak with you.

Senator BOND. Well, we are going to have some more questions about that. We will get back to you on that one.

Secretary JACKSON. Okay.

Senator BOND. Because we really think that one is serious. There are many other things I want to touch on very briefly.

## IMPROPER PAYMENTS

Improper payments. You found \$1.25 billion in 2004 in the section 8 program, losses estimated \$2 to \$3 billion a year, but under the Improper Payments Information Act of 2002, HUD plans only to target improper payments of no more than 5 percent in 2006 and 3 percent in 2007.

How do you measure and verify these numbers? And has the HUD IG verified your methodology?

Secretary JACKSON. Yes, we have—the HUD IG is involved, but also, chairman, when we came, we had really no way from our perspective of really verifying it. We have got a top-notch information technology person and we react now that we have put in place systems that we can verify for the first time. We are still working with others to even be more specific in verifying it, but I feel a lot better now with the numbers that we are giving you than I would have felt 3 years ago.

Senator BOND. Speaking of numbers, we had to rescind \$2 billion-plus from section 8 for the current year, and you told us you would find it, and now OMB has said you are going to find another \$2 billion.

How are you doing finding the \$2 billion for 2006? And where do you expect to find it from excess section 8 for the coming year?

Secretary JACKSON. I will have to give you a written response to that, Chairman.

Senator BOND. I look forward to that one.

[The information follows:]

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT,  
Washington, DC, August 31, 2006

The Hon. JOHN W. OLVER,  
Ranking Member,

The Hon. JOE KNOLLENBERG,  
Chairman,

*Subcommittee on Transportation, Treasury and Housing and Urban Development,  
The Judiciary, District of Columbia, Committee on Appropriations, U.S. House  
of Representatives, Washington, DC.*

The Hon. PATTY MURRAY,  
Ranking Member,

The Hon. CHRISTOPHER S. BOND,  
Chairman,

*Subcommittee on Transportation, Treasury, the Judiciary and Housing and Urban  
Development, and Related Agencies, Committee on Appropriations, U.S. Senate,  
Washington, DC.*

The Fiscal Year 2006 Appropriations (Public Law 109-115) Act requires the Department to notify the Committees on Appropriations if the statutory rescission of \$2.05 billion will be met from sources other than section 8. Pursuant to this requirement, the Department is submitting a list of programs that may be used to meet the rescission requirement. With the exception of Drug Elimination Grants, the funds for these programs will expire at the end of fiscal year 2006 if not obligated. The Department will make these funds available to the program offices for obligation almost through the end of September 2006. However, if by the end of September 2006, the funds are not needed then these funds will be used to meet the Department's rescission requirement for fiscal year 2006.

In fiscal year 2002, Congress terminated the Drug Elimination Grants Program. The balances remaining in this program are from recaptures. These balances will be used to meet the rescission requirement. A reprogramming is pending Congressional approval for \$14.5 million of the total \$34 million in the Public Housing Capital Fund. If Congress does not approve the reprogramming in time, then these funds may also be used to meet the rescission requirement.

If you have any questions or if I can provide additional information, please let me know.

Sincerely,

L. CARTER CORNICK III,  
General Deputy Assistant Secretary for Legislation.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT POTENTIAL SOURCES FOR FISCAL YEAR  
2006 RESCISSION

	Amount
Unobligated Funds Expiring at the End of Fiscal Year 2006:	
HOPE VI (SY 2005) .....	\$2,946,391
Housing for Persons w/Disabilities (SY 2003) .....	3,966,849
Housing for Persons w/Disabilities-TB (SY 2003) .....	118,800
Housing for Persons w/Disabilities (SY 2004) .....	3,084,243
Housing for Persons w/Disabilities-TB (SY 2004) .....	1,771,486
Housing for Persons w/Disabilities (SY 2005) .....	11,420,573
Housing for Persons w/Disabilities-TB (SY 2005) .....	2,307,920
Housing for the Elderly (SY 2003) .....	24,727,911
Housing for the Elderly (SY 2004) .....	3,942,457
Conversion to Assisted Living (SY 2004) .....	2,467,584
Service Coordinators (SY 2003) .....	288,703
Service Coordinators (SY 2004) .....	456,083
Pre-Construction Grant Demo (SY 2003) .....	4,440,662
Pre-Construction Grant Demo (SY 2004) .....	19,682,000
Working Capital Fund .....	2,843,992
Public Housing Capital Fund .....	134,810,700
Unobligated funds available until expended:	
Drug Elimination .....	796,948
Total, non-section 8 sources .....	121,273,302

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT POTENTIAL SOURCES FOR FISCAL YEAR  
2006 RESCISSION—Continued

	Amount
Section 8 Rescission .....	1,928,726,698

<sup>1</sup> Of this total amount, a reprogramming request has been submitted to Congress for \$14.5 million. If the reprogramming request is not approved by Congress before the end of the fiscal year then the entire \$34.8 million will be available to meet the fiscal year 2006 rescission.

FHA MORTGAGE INSURANCE

Senator BOND. Moving on to FHA, you have heard me raise my serious questions about the single-family mortgage program. It is competing with the private sector, and you are trying to put all kinds of bells and whistles on it to bring in wealthier homeowners to subsidize less economically strong home purchasers.

How is that going to compete successfully with the private mortgages? And how do you expect them to—what role is FHA going to provide that the private mortgage companies cannot provide?

Secretary JACKSON. Let me say this: Our regulations have been an inhibiting force for us to continue to compete with the private market. The first thing that we are doing is getting rid of those inhibiting regulations.

Second, there is a large group of people who do not fit the private market, but yet who have been using, in my mind, many predatory lenders at high interest rates to get loans. We feel deeply that that is the population we need to zero in on. And if we can be flexible in our regulations and offer them the same kind of flexibility that many private entities offer those persons who are not in this limbo area that we call it, we can address the needs.

I don't think that FHA is obsolete. I don't think it has been managed very well, and I don't think we have put our programs out publicly like we should have. We have not been proactive in any of the processes, and so when we asked Assistant Secretary Brian Montgomery to come, one of the things that we stressed with him is that we have to be more active with FHA to get part of the market back. Over the last 10 years, we have—it is the most amazing thing to see how we have lost market, but we have lost market because it is as if we really did not care about being in the market. And I think that clearly, for those persons who are in that limbo area, we should be there for them to make sure that they do not get these high usury rates.

HIGH-RISK BORROWERS

Senator BOND. Well, one of the things I am worried about—there are a number of worries I have about it. In other words, there is a risk that HUD may be taking on the risks of a number of mortgage companies who have taken on high-risk borrowers in the sub-prime market and then FHA gives them a new FHA mortgage. That is bailing out the initial lender, giving the initial lender who had the high rates in the sub-prime market, and you wind up with FHA bearing the loss that they have caused by taking out—giving a sub-prime loan with a high rate to somebody who is not a worthy borrower. So I am worried that FHA is setting itself up to be the chump in this process and leaving people with great problems in defaulted housing.

That relates to other questions, that HUD seems to be permitting nonprofits funded by a property seller to fund the downpayment so that they get the 3 percent downpayment requirement, but the seller puts money into a charity that provides and raises the price by 3 percent so the homeowner who may not be economically able to carry a mortgage has essentially a zero downpayment no-risk mortgage, which, based on the experience we have seen, is destined to be a disaster.

Now, those things worry me about what FHA is doing. Please respond.

Secretary JACKSON. Well, let me say this: You are absolutely correct. That was the posture of FHA for a period of time. That is not our posture today because we see that as unacceptable because we are creating severe problems for the prospective homeowners. And, clearly, we do not think that is what we should be doing.

That is why we are asking you to look at the Flexible bill that we are sending you today, to give us the power to cut many of the regulations so we can deal directly with this group that is right in the middle rather than having the lenders that you just spoke about dealing with that group.

So I do not disagree with you. That has been our posture, but that is not our posture today.

Senator BOND. I will come back to that after Senator Murray asks her questions.

#### HOMELESSNESS

Senator MURRAY. Thank you, Mr. Chairman.

Mr. Secretary, you noted in your testimony that you currently serve as the Chairman of the Interagency Council on Homelessness. Last year, our committee directed the Council to assess an issue that I care a great deal about, and that is the educational rights of homeless children. I have worked very hard to strengthen the protections for homeless children in the No Child Left Behind Act, the Individuals with Disabilities Act, Head Start, Higher Education Act.

Can you tell me, as Chairman of the Interagency Council, what the status and preliminary findings of your assessment are yet?

Secretary JACKSON. Honestly, Senator, I cannot, but I will find out for you. I was not Chairman—I have been Chairman now for about 4 months. I did not know that you had asked for that, but I will ask where it is and I will make sure that I get back to you directly, because I did not know you had asked for that.

Senator MURRAY. Okay. I would really appreciate that. I have been really concerned by some reports I have heard that homeless shelters may be requiring homeless children today to change schools and that certain school districts are being allowed to skirt their responsibilities to provide transportation. And I want to know exactly what is happening with that and—

Secretary JACKSON. I will get back to you.

Senator Murray [continuing]. What leadership your agency is demonstrating to make sure those homeless kids their educational rights in this country. So I will be hearing—

Secretary JACKSON. I will get back to you immediately.

[The information follows:]

## INTERAGENCY COUNCIL ON THE HOMELESS REPORTS

The House Conference Report 109–307, on page 293 of H.R. 3058, the “Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act of 2006,” enacted as Public Law 109–115, directed the Interagency Council for the Homeless to conduct an assessment of the guidance disseminated by the Department of Education, the Department of Housing and Urban Development, and other related Federal agencies for grantees of homeless assistance programs on whether such guidance is consistent with and does not restrict the exercise of education rights provided to parents, youth, and children under subtitle B of title VII of the McKinney-Vento Act. This assessment also addressed whether the practices, outreach, and training efforts of these agencies serve to protect and advance such rights. The Interagency Council for the Homeless submitted to the House and Senate Committees on Appropriations the attached interim report on May 1, 2006, and the attached final report on October 25, 2006.

[CLERK’S NOTE.—The reports referenced above have been retained in the committee files, and are also available in part at <http://www.usich.gov/slocal/EducationWebPost.html>.]

## PHAS OPERATING COSTS

Senator MURRAY. Very good.

You are, as you told us, the first Secretary of HUD who actually ran a housing authority, and I appreciate that. But I have heard from some of the larger PHAs up in the Northeast that are heating with natural gas that now they have to commit half of their Federal operating funds just to pay for those utility costs. And I was just curious if you were running one of those PHAs up there and now having to pay those tremendous costs for your utility bills, what would you do? Eliminate services for elderly? Reduce maintenance? What decisions would you make in order to pay for that?

Secretary JACKSON. You know, I cannot answer that question because to me—and I do not mean to dodge the question. That is speculation because it is very strange to me. I have not heard that yet. And I know the prices of natural gas have gone up, but no one has brought that to my attention. So if there is a large number that that is occurring—

Senator MURRAY. There is—

Secretary JACKSON [continuing]. I will be happy to look into it.

You know, let me say this to you, Senator—and I believe exactly what you just said. What bothers me tremendously is I have been very open to industry. It is amazing how they come to you with stuff, and I have been the most open Secretary and the only one that was their colleague at this level, and they do not bring it to me. And I hope they are here and they hear what I am saying, because they bring problems to me, but they do not bring other stuff to me. And if they are going to still want accessibility to me, I would much rather for them to tell me that than me be surprised today with something that you have said and they have not brought it to me.

Senator MURRAY. Okay. I am hoping they heard that.

Mr. Chairman, I have a number of other questions that I will submit for the record. Particularly, I have some on Katrina, but I understand you are coming before the committee next week to talk directly about that.

Secretary JACKSON. Yes.

Senator MURRAY. So I will save those for that time.

Secretary JACKSON. Thank you.

Senator BOND. Thank you very much, Senator Murray. I am going to close up, too, but I also am looking forward to talking with you and Mr. Donohue, the HUD IG, about Katrina, because we are being asked to put a whopping big amount in, and I kind of wonder—like Jerry Maguire, “Show me the money.” Where did it go?

But we were talking the last time about the gifts for the down-payment. Have you stopped that practice? Have you made it clear that this is not a legal practice for—

Secretary JACKSON. Have we stopped that practice?

I am sorry. We are waiting—I am sorry. I knew we had brought—we are waiting on the IRS to come with a recommendation to us because, clearly—

Senator BOND. It seems to me, the IRS or no IRS, it is a recipe for disaster, and, you know, I think you ought to be looking at the risks that are entailed with accepting this. I mean, I don’t care—

Secretary JACKSON. You are right.

Senator BOND [continuing]. What the IRS says about it. I am worried about what it does to the FHA.

Secretary JACKSON. Chairman, I agree with you, and I will do that.

#### SECTION 8 CUT

Senator BOND. And to go back to what I was saying about section 811, the budget request is a 50 percent reduction, but only about \$15 to \$16 million is going to be left for new construction. The rest will go to rental payments for current projects and vouchers, and so when I said 90 percent cut, the new construction available under the budget request for 811 is only \$15 to \$16 million, and it seems to me that there are a lot more needs out there than that.

Secretary JACKSON. Yes, sir.

#### PREDATORY LENDING

Senator BOND. All right. Predatory practices, what are you doing to reduce predatory lending? And how successful have you been?

Secretary JACKSON. I think we have been very successful. We are working extremely hard because we are concerned about that, especially in the Northeast. It is—and when I say the Northeast, I am talking everything from Washington, DC back. It has been absolutely astounding, and also—

Senator BOND. One of our very good friends from Baltimore, who is not here today, will have a lot to say about that, and on her behalf, I reiterate the concern that she has had with that practice.

Secretary JACKSON. And she has been working well with us, and we have talked to her on numerous occasions regarding that.

Senator BOND. Good. FHA multifamily, you are proposing increased mortgage insurance premiums. Again, some have suggested this could have a chilling effect on the development of multifamily housing projects. Why is the fee necessary? And have you conducted an impact analysis on the marketplace? And if so, what did you find?

Secretary JACKSON. I do not know the answer to that, Mr. Chairman. I will get back to you.

[The information follows:]

## FHA MORTGAGE INSURANCE PREMIUMS

The Department's budget stated that FHA would apply a 32 basis point increase on the FHA mortgage insurance premiums for all multifamily projects except mortgages for projects that utilize low-income housing tax credits, and GSE and HFA risk-sharing. This increase was to apply to both initial and annual premiums. In no case, however, was the resulting premium to exceed 80 basis points. The purpose of the increase was to permit continuation of the program while at the same time offsetting taxpayer liability for the program's administrative costs and any potential financial losses arising from insuring these mortgages. The proposal was prompted by the outcome of an evaluation of the program using OMB's Program Assessment Rating Tool (PART). That evaluation raised questions concerning program targeting and its overall efficiency. Since submission of the budget, HUD staff has had the opportunity to have numerous discussions with Congressional staff and the industry on this topic. Both have raised legitimate concerns about the impact such a premium increase would have on HUD's ability to foster the development of much needed rental units. The Department realizes these concerns must be addressed before any increases are made to insurance premiums. The Secretary is committed to fully discussing the proposed increase with the industry and Congressional leadership before any action is taken.

Senator BOND. All right. Finally, you are chairing the Inter-agency Council on the Homeless. How are you doing meeting your goals? How much progress has been made to meet the goal of 150,000 units of permanent housing? And when do you expect to achieve it?

Secretary JACKSON. I would prefer to speak, Mr. Chairman, to you and the Ranking Member in private about that.

## ADDITIONAL COMMITTEE QUESTIONS

Senator BOND. All right. Well, the nice thing about it is this conversation will be continued. We have lots of things to work on. I believe that that concludes it. There will be—I am sure that the ranking member and I will have several questions for the record, and if any other members of the subcommittee have questions for the record, we would ask them to get them in by the end of this week. And we will expect your replies in a timely fashion and look forward to continuing these discussions.

[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 ARLEN SPECTER

## PUBLIC HOUSING OPERATING FUND—NEW RULE

*Question.* The fiscal year 2007 budget request maintains funding at \$3.564 billion for the Public Housing Operating Fund. According to the National Association of Housing and Redevelopment Officials, this level of funding would represent only 81 percent of actual operating subsidy needed for fiscal year 2007 as housing authorities shift to asset-based management. Additionally, the implementation of the new regulations for the Public Housing Operating Fund provides a new formula for distributing operating subsidy to public housing agencies (PHAs) and establishes requirements for PHAs to convert to asset management. What is HUD's plan for assisting PHAs to come into compliance with this new approach?

*Answer.* The Department has issued a significant amount of guidance and information regarding the transition to asset management. Most of the guidance has been shared with interested PHAs and representatives of the industry groups that represent PHAs while it was in draft form to solicit input prior to finalization and publication. Since publication of the rule, the Department has held approximately 20 meetings with PHAs and the industry groups to discuss the steps required for implementation of asset management. All guidance has been shared with these groups prior to the meetings and working drafts provided for comment and recommendations.

The transition to asset management is a complex undertaking and the Department recognizes that a great deal of guidance and information for both PHAs and HUD staff will be necessary to ensure a successful transition. For that reason, the Department has been taking a phased approach at getting the guidance developed and issued, rather than issuing one set of guidance that is expected to cover all actions required over several years as PHAs transition to asset management.

On the day that the Final Rule was published, the Department met with representatives of the industry groups to provide a copy of the rule and to discuss next steps. The Final Rule was published on September 19, 2005 and in response to concerns raised by PHAs and the industry groups over the implementation of the rule in fiscal year 2006, the Department issued a revision on October 24, 2005, pushing the implementation date back to October 1, 2006. On November 2, 2005, the Department published Notice PIH 2005-34 (HA) that provided an overview regarding implementation of the Final Rule for the Public Housing Operating Fund Program. This Notice was for informational purposes only and informed PHAs of various upcoming notices and other activities tied to the implementation of the Final Rule.

On December 28, 2005, the Department published a Federal Register Notice that provided supplemental information regarding the Department's method of calculating public housing operating subsidy under the Final Rule. The Notice explained the computation of the Project Expense Level (PEL) that is one factor in the formula expenses component of the Operating Fund Formula. The Notice provided a step-by-step description of the computation of the PEL so that PHAs would understand how their PELs would be calculated.

A key component of the transition to asset management is the need for each PHA to identify their project or property groupings. Recognizing that the current project numbering system did not necessarily reflect the appropriate grouping of buildings for management purposes, the first step was to allow PHAs to self-identify their project groupings. After a series of meetings with PHAs and industry groups, the Department issued Notice PIH 2006-10 (HA) on February 3, 2006 that provided guidance and related instructions to PHAs and HUD field staff regarding the identification of projects for purposes of asset management. On February 28, 2006, and March 1, 2006, the Department held meetings with the HUD field office staff to discuss the Notice and to conduct a live demonstration of the computer screens that the PHAs would see when they entered their project grouping information. On March 8, 2006, the Department conducted a video broadcast with the PHAs and HUD field office staff on the project groupings' Notice and conducted a demonstration of the computer screens for both PHAs and field office staff. The broadcast was taped and used as a webcast on March 15, 2006 and March 23, 2006. The webcast is stored in the Department's archives of webcasts and can be accessed from its web site at [www.hud.gov](http://www.hud.gov).

On March 22, 2006, the Department issued Notice 2006-14 (HA) that provides guidance to PHAs on the criteria for asset management. This criteria is for those PHAs that want to submit documentation of successful conversion to asset management in order to discontinue their reduction in operating subsidy under the Operating Fund Program Final Rule, commonly referred to as the "stop-loss" provision. This Notice was discussed thoroughly with PHAs and representatives of the industry groups prior to publication and the industry groups provided the working drafts of the Notice to their members through their web sites and provided extensive information and comments about it through their publications.

The Department has held a series of meetings with PHAs, the industry groups and the private market vendors that offer computer assistance and software programs used by a number of PHAs. The meetings with the IT professionals and the vendors are to assure that any changes to systems and software can be done, as necessary, so that PHAs do not experience system problems as they transition their inventory to an asset management model.

The Department has also held a series of meetings with PHAs, the industry groups, Fee Accountants, Certified Professional Accountants, Independent Professional Auditors and representatives of the American Institute of Certified Public Accountants (AICPA) to discuss the necessary financial reporting changes. The Department will issue guidance to PHAs on asset-based accounting and budgeting requirements. The first group of PHAs that will have to maintain their books on an asset-based approach will be those PHAs whose fiscal year begins July 1, 2007. The Department intends to have the guidance issued prior to July 1, 2006, so that PHAs will have a full year to implement any necessary changes to their accounting systems. The last group of PHAs that will have to maintain their books on an asset-based approach are those PHAs whose fiscal year begins March 31, 2008.

*Question.* Given the anticipated shortfall, how will your budget fully implement the negotiated rule, including transitional costs?

Answer. Many PHAs have healthy levels of operating reserves. At the end of fiscal year 2005, nationwide, PHAs had approximately half a billion dollars in reserves that can be used to support the operation and maintenance of low-income housing. PHAs are allowed to retain all of the income they receive from investments and other non-dwelling rental income such as income from rooftop antennas, laundry receipts, etc. In 2005, this other income accounted for \$298 million. For purposes of subsidy calculation, rental income is frozen at 2004 levels, which means that any increase in rental income does not decrease the amount of subsidy that the PHA will receive in 2006 and 2007.

There is much to be gained through providing needed program and regulatory reforms that will give PHAs the flexibility to address their locality's housing assistance needs. By unlocking the potential that PHAs have in their assets, additional funding can be obtained to make needed improvements in housing stock or to develop an additional type of affordable housing that is self-sustaining and not wholly dependent upon Federal appropriations. PHAs will be able to make local program decisions and to focus their housing resources in a way that makes sense for their communities while seeing reduced regulatory costs. Through a variety of programs, the Department has encouraged PHAs to look at their inventory and make informed management decisions about the housing stock. Steps that PHAs have taken include demolishing the worst, and often most expensive housing stock, entering into energy performance contracts to reduce the cost of utilities, and switching to tenant-paid utilities.

#### MOVING TO WORK PROGRAM (MTW)

*Question.* MTW has enabled public housing authorities to implement federally-funded housing programs based on local needs by providing budget flexibility and regulatory relief. The fiscal year 2006 TTHUD Appropriations Conference Report provided a 3-year extension to MTW agreements that would expire on or before September 30, 2006. While we thank you for the extension, the Pittsburgh Housing Authority's MTW agreement expires 3 months after the September 30, 2006 deadline. Would you be willing to work with the Pittsburgh Housing Authority to grant them a similar extension as was received by all housing authorities expiring 3 months earlier?

Answer. The Department has agreed to grant the Housing Authority of the City of Pittsburgh (HACP) a 1-year extension to their MTW Agreement. Following subsequent communication between your office and HUD, the Department is currently considering granting HACP a 3-year extension rather than a 1-year extension.

The Department has expressed its willingness to continue and expand MTW through Title III of the proposed State and Local Housing Flexibility Act. While this bill is under consideration in Congress, the Department recognizes HACP's desire to avoid a lapse in their participation in the demonstration.

*Question.* Could you please clarify why some public housing authorities initially received MTW extensions through 2011, yet similar extensions have not been granted to other requesting housing authorities?

Answer. No current MTW housing authorities have received an extension to continue their MTW demonstration until 2011. Agreements for only three of the demonstration participants have expiration dates that occur in 2011 or 2012: Oakland, Baltimore, and Chicago. Oakland and Baltimore only recently executed their agreements and were given the now standard 7-year term. Their Agreements expire in 2011 and 2012 respectively. Due to the complexities of Chicago's Transformation Plan, their initial Agreement provided for a 10-year demonstration term, which expires in 2011.

It should be noted that the issue of extensions would not be a matter of concern under Title III of the State and Local Housing Flexibility Act (SLFHA), which is awaiting Congressional action. In Title III, the MTW Demonstration Program is made permanent and participating PHAs will meet certain performance requirements, not arbitrary time periods for participation. SLHFA would provide funding and program flexibility to PHAs; would allow agencies to develop program implementations that respond to local market conditions; would allow fungibility and flexibility needed to achieve greater cost-effectiveness in Federal expenditures; increase housing opportunities for low-income households; reduce administrative burdens; allow Federal resources to be more effectively used at the local level; and enable families to achieve economic self-sufficiency.

#### STRENGTHENING AMERICA'S COMMUNITIES INITIATIVE (SACI)

*Question.* The President's budget outlines a modified SACI (Strengthening America's Communities Initiative) proposal where only 2 of 18 economic development pro-

grams would be funded—HUD’s CDBG program, and a Regional Development Account within Commerce’s Economic Development Administration. In fiscal year 2006, Congress funded these 18 programs at a combined level of \$5.3 billion. The fiscal year 2007 budget proposes only \$3.36 billion—a reduction of nearly \$2 billion. Additionally, the fiscal year 2007 budget proposes a plan for a new CDBG funding allocation formula. Given the drastic cuts in funding to the CDBG program, altering the formula would likely result in cutting off CDBG funding to hundreds of municipalities—the expected loss in CDBG to PA is \$56.5 million. How does HUD intend to achieve the impact of these 18 programs, with a nearly \$2 billion or 37 percent reduction in funding?

*Answer.* The fiscal year 2007 budget request for CDBG is an acknowledgment that HUD and its grantees are actively working to address the current and future effectiveness of the CDBG program. With regard to the proposed CDBG formula changes, a recent study by the Office of Policy Development and Research clearly indicates that targeting to community development need has fallen dramatically since the formula was established 30 years ago. Restoring a greater degree of equity to the distribution of CDBG funds will help offset any reductions experienced as a result of reduced funding levels. The HUD budget does propose consolidation of the Brownfields, Rural Housing and Economic Development program and the section 8 Loan Guarantee program, all of which can be funded as eligible activities through the mainstay CDBG program. In addition, these are small programs compared to the scale of CDBG funding.

In addition to formula reform, the creation of a Challenge Fund will further target grants to effective efforts as high impact projects in distressed communities. Finally, the ongoing development of effective performance measurement efforts will add to the efficiency and effectiveness of the CDBG program.

*Question.* How does HUD intend to address the unmet CDBG funding needs in municipalities that will lose funding under the new formula?

*Answer.* Any proposed formula revision would not alter or restrict the list of CDBG eligible activities. CDBG will retain its hallmark flexibility and emphasis on local decision-making and, through the proposed formula reform, HUD will establish a strong foundation for the future of the CDBG program. These reforms include:

- A proposed formula change to target to need. The formula change will direct a higher proportion of resources to areas with greater need than under the existing formula and areas with similar needs will receive similar funding;
- In addition, the reform includes bonus funds to reward more effective grantees;
- Finally, there is improved performance measurement, which will lead to a more effective national program and greater local impacts.

#### ELIMINATION OF HOPE VI

*Question.* HOPE VI enhances communities by decentralizing poverty and giving families an opportunity to live in mixed-income neighborhoods with better educational and employment opportunities. I have visited HOPE VI sites throughout Pennsylvania and have discovered the critical impact that reconstruction in these public housing developments has on revitalizing neighborhoods. As HOPE VI has accomplished one of its goals of demolishing 100,000 units—which suggests to me that the program has been effective—how does HUD propose to accomplish this level of reconstruction in the future if HOPE VI is eliminated?

*Answer.* As a result of the HOPE VI program and other initiatives, the Department’s goals for demolition of the worst public housing have been met. However, the HOPE VI program has shown to be more costly than other programs that serve the same population. For example, a GAO report (GA0–02–76) stated that the housing-related costs of a HOPE VI unit were 27 percent higher than a housing voucher and 47 percent higher when all costs were included.

The Department recognizes the importance of addressing the current capital backlog within the public housing inventory and believes that this need can be more appropriately met through other modernization programs operated by the Department; e.g., the Capital Fund, Capital Fund Financing Program, non-HOPE VI mixed-finance development including leveraging private capital investment, required and voluntary conversion, section 30, and the use of tax credits. The Department will encourage housing authorities in need of this assistance to submit proposals under these programs. The Department has already approved over \$2.5 billion in 61 transactions involving 131 public housing agencies under the Capital Fund Financing Program.

## QUESTIONS SUBMITTED BY SENATOR PETE V. DOMENICI

## ELIMINATION OF SECTION 811

*Question.* This is second year in a row that the administration is attempting a deep cut to the HUD section 811 program. For fiscal year 2006, the proposal was to completely eliminate funding for new capital advance/project-based units. Congress rejected this idea in 2005—both the House and Senate Appropriations Committees restored funding. This year, the proposal is to impose another reduction to the capital advance/project-based side of the program—a 90 percent reduction, from \$155.7 million, down to \$15.84 million.

Additionally, the President's New Freedom Initiative spans numerous Federal agencies including HHS, Education, Labor and HUD. It is designed to promote integration of people with disabilities into the mainstream of community life through access to health care, education, employment and housing. It is based on the principle of life in the community as an alternative to institutional settings such as nursing homes and psychiatric hospitals. These deep reductions to the 811 program run completely against the important national goals contained in the New Freedom Initiative.

Secretary Jackson, how are States and communities supposed to continue progress toward eliminating costly institutional care if 811 is eliminated as a tool for developing permanent supportive housing?

*Answer.* The budget proposes \$119 million for the Housing for Persons with Disabilities program. Despite the section 8 funding absorbing a majority of the Department's budget, we are able to direct significant funding to the section 811 program that provides for: (1) funds to renew and amend existing contracts; (2) \$13.2 million for the construction of additional new units, and (3) continued financial support for the 27,000 units that we have already constructed and for the 314 projects (about \$400 million) in the construction pipeline.

*Question.* What resource will replace the permanent supportive housing developed by section 811?

*Answer.* We have not abandoned new construction in favor of vouchers. We believe that both forms of assistance are needed to properly serve persons with disabilities.

## QUESTION SUBMITTED BY SENATOR HERB KOHL

## CUTS TO SECTION 202

*Question.* The section 202 program provides funding for local non-profit agencies to construct and manage housing for low-income seniors. The section 202 program creates safe and affordable communities where senior residents have access to the services that allow them to live independently. With the number of individuals over the age of 65 expected to double in the next 24 years, how can you explain the proposal in the administration's budget to cut section 202 funding by \$190 million in fiscal year 2007?

*Answer.* Despite the fact that section 8 renewal funding absorbed a majority of the Department's budget, we are able to direct significant funding (\$546 million) to the section 202 program to provide for: (1) congregate services; (2) service coordinators; (3) funding to convert projects to assisted living; \$414.8 million for the construction of new units; and (4) funds to renew and amend existing contracts.

The Department has always and continues to be a proponent of housing for the elderly. We have constructed approximately 400,000 units specifically for the elderly and have 342 projects (about \$1.6 billion) in the construction pipeline. In addition, we serve an additional 675,000 elderly families under other HUD rental assistance programs.

We also are ensuring that elderly families who own homes can remain there through FHA's reverse mortgage program. In 2005, we insured 43,131 reverse mortgages and we are seeing a steady increase in this area.

## QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

## WHY CUT CDBG FUNDS?

*Question.* I met with many of the Chicago aldermen last week while they were here in Washington, and one of the first things they asked me about was Community Development Block Grants. They asked: should we just assume a 10 percent cut in CDBG funds when we plan our upcoming budgets? They went on to tell me

how devastating that would be, and how much good they can do in their local communities in Chicago thanks to those CDBG funds. So my question is this: why does the Bush Administration want to cut CDBG funds each and every year?

Answer. The administration's fiscal year 2007 budget requests more than \$3 billion in funding for CDBG. While the request is lower than the fiscal year 2006 appropriation level, the accompanying formula reforms will enable these funds to be better targeted to the Nation's most distressed communities. Over time, the program's targeting to community development need has been diffused as a result of demographic changes, development patterns and other factors. Therefore, HUD is proposing to reform the program so that it can continue to meet its objectives. Reform has four components: formula reform to restore appropriate targeting and preserve fairness in the distribution of funds; creation of a Challenge Fund that would enable effective CDBG grantees to obtain additional funding for community and economic development activities in distressed neighborhoods; consolidation of duplicative programs; and implementation of a performance measurement framework to establish clear, measurable goals of community progress to show the results of our formula programs. In addition, each CDBG grantee will retain the ability to utilize their CDBG funds as they see fit, but will have to carefully prioritize their needs in order to use those funds most effectively.

#### CAN HUD AND HHS WORK TOGETHER?

*Question.* We all share the goal of eliminating the homelessness epidemic in this country. The experts tell me that in order to do so the chronically homeless must be provided with services such as addiction treatment, mental health counseling, job training, and so forth in addition to housing, in order to keep them off the street and help them become productive members of society. Do you believe that your department can best manage the provision of these services, or should the Department of Health and Human Services handle this effort? If HHS should be doing this, how can you ensure that HUD and HHS will effectively work together to provide the complete services that these folks desperately need?

Answer. The McKinney-Vento Act authorizes the use of HUD funds for a variety of supportive services through the Department's Supportive Housing Program. As such, since enactment of the Act, HUD has provided funding for housing as well as supportive services. HUD has and continues to work closely with the Department of Health and Human Services (DHHS) and other departments that provide supportive services for homeless persons, including the Departments of Veterans Affairs and Labor. All such agencies are members of the U.S. Interagency Council on Homelessness (ICH). The ICH agencies have been working collaboratively on a number of fronts in recent years, including demonstration programs to provide needed housing and supportive services for chronically homeless persons. In these demonstrations, HUD provided resources for housing, and other agencies, including DHHS, provided needed supportive services. These demonstrations, now underway, will provide useful insights on collaborations between the Federal partners involving housing and services.

#### CAN HUD PROVIDE HOUSING DURING DISASTERS?

*Question.* We've watched in disgust as the Gulf Coast residents who lost their homes to Hurricane Katrina have been locked in sports stadiums, bused to different States, kicked out of hotels . . . and maybe, just maybe, offered a trailer in a location that is not at all conducive to finding a job or rebuilding a sense of community. FEMA has shown that it is simply not up to the challenge of providing permanent housing to such a large number of displaced families. What can HUD do to step in here on behalf of the families in the Gulf? In preparation for the next disaster, what role should HUD be prepared to play in providing both short term and long term housing to those in need?

Answer. The \$11.5 billion enacted for disaster assistance under the Community Development Block Grant program can be used by States to address the housing needs of families in the Gulf. The flexibility of the CDBG program works well in the grey area between temporary and permanent housing solutions. Each of the five States has a housing component in its action plan for disaster recovery. Mississippi and Louisiana will directly undertake programs that focus on housing. Alabama, Florida, and Texas will distribute their allocations to various units of general local government to address housing needs. In addition, Texas plans to allocate funding to councils of governments to carry out housing as part of their overall activities.

Following issuance of the report, The Federal Response to Hurricane Katrina: Lessons Learned, and at the direction of the Homeland Security Council, HUD began actively exploring options for implementing the recommendation that HUD

become the lead Federal agency for the provision of temporary housing should that transfer of responsibility occur. HUD's preparation involves consideration of comprehensive and scalable program designs, operations and logistics, program authorities, and appropriation resources for temporary disaster housing program funding, staffing, travel, training, etc.

WHY CUT FUNDING FOR THE ELDERLY AND DISABLED?

*Question.* At a time in which the President continues to push hard for making permanent the tax cuts that overwhelmingly benefit the wealthy, how can you at the same time justify cutting funding that supports the housing needs of the elderly and the disabled? What does that say about the morals and the priorities of this administration?

*Answer.* The \$1.1 billion increased cost of serving the roughly 3.4 million families currently receiving section 8 rental assistance required that the Department make some very difficult funding decisions. Our first priority had to be to families currently receiving subsidy.

However, despite the fact that section 8 renewal funding absorbed a majority of the Department's budget, we are able to direct significant funding (\$546 million) to the section 202 program to provide for: (1) congregate services; (2) service coordinators; (3) funding to convert projects to assisted living; \$414.8 million for the construction of new units; and (4) funds to renew and amend existing contracts.

In addition, proposed sufficient funding for the section 811 program provides for: (1) funds to renew and amend existing contracts; (2) \$13.2 million for the construction of additional new units; and (3) continued financial support for the 27,000 units that we have already constructed and for the 314 projects (about \$400 million) in the construction pipeline.

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QUESTIONS SUBMITTED BY SENATOR BYRON L. DORGAN

HOUSING FOR THE ELDERLY AND DISABLED PROGRAM CUTS

*Question.* A large number of North Dakotans who take part in public housing programs are elderly or disabled. Many of these folks cannot work, and if they do, cannot afford suitable housing without assistance. We are now on the front edge of the boomers turning senior and my State doesn't have housing available for the rapidly growing 30 percent of median and under portion of this group. This is a problem that the section 202 Elderly Housing Program and section 811 Disability Housing Programs were designed to address. In my opinion, these programs should be expanding not contracting. If you were in my shoes, how would you justify cutting section 202 by 25 percent and section 811 by 50 percent to my constituents?

*Answer.* Our first priority for fiscal year 2007 was to provide for the \$1.1 billion in increased costs associated with serving the roughly 3.4 million families currently receiving section 8 rental assistance. This required that the Department make some very difficult funding decisions.

However, despite the fact that section 8 renewal funding absorbed a majority of the Department's budget, we are able to direct significant funding (\$546 million) to the section 202 program to provide for: (1) congregate services; (2) service coordinators; (3) funding to convert projects to assisted living; \$414.8 million for the construction of new units; and (4) funds to renew and amend existing contracts.

In addition, proposed sufficient funding for the section 811 program provides for: (1) funds to renew and amend existing contracts; (2) \$13.2 million for the construction of additional new units; and (3) continued financial support for the 27,000 units that we have already constructed and for the 314 projects (about \$400 million) in the construction pipeline.

CUTS TO COMMUNITY DEVELOPMENT BLOCK GRANTS

*Question.* This year, the President's budget calls for a \$1 billion reduction in the CDBG program, representing a 25 percent loss in funding from last year's levels. Because of its flexibility and use in a variety of projects, local and State governments in Grand Forks, Fargo, and other North Dakota communities have come to rely on the program as the cornerstone of any new community revitalization effort. Folks at various North Dakota Housing Authorities tell me that for every \$1 of the CDBG program invested in communities, \$3 are leveraged in private funding, bringing much-needed investment, and jobs in North Dakota communities. I support this program and am pleased that Congress rejected the administration's proposal to eliminate CDBG last year. I see the proposed cuts as evidence that the administra-

tion is abandoning its commitment to America's communities in the guise of reform. How would you respond to that, Mr. Secretary?

Answer. The administration's fiscal year 2007 budget proposal is a clear statement of commitment to America's communities and of support for the CDBG program. It retains the program at HUD, funds it at a level of \$3 billion, and proposes a series of legislative initiatives that will ultimately strengthen the CDBG program. HUD is committed to seeing these reforms enacted and establishing a strong foundation for the future of the CDBG program. These reforms include:

- A proposed formula change to target to need. The formula change will direct a higher proportion of resources to areas with greater need than under the existing formula and areas with similar needs will receive similar funding;
- In addition, the reform includes bonus funds to reward more effective grantees;
- Finally, there is improved performance measurement, which will lead to a more effective national program and greater local impacts.

NATIVE AMERICAN HOUSING AND SELF-DETERMINATION ACT BILL LANGUAGE  
CONTINUATION

*Question.* The fiscal year 2007 budget requests the continuation of bill language included in last year's HUD appropriations Act that amends the Native American Housing and Self-Determination Act funding formula to require that HUD distribute funds on the basis of single-race or multi-race data, whichever is the higher amount. What is the Department rationale for including this language in fiscal year 2007, given that it generated a fair amount of controversy among the tribes and tribally designated housing entities in fiscal year 2006? Wouldn't it be preferable to consider whether changes are appropriate to the funding formula as part of the NAHASDA reauthorization process, which we will be engaged in the 110th Congress?

Answer. The fiscal year 2006 HUD Appropriations Act (2006 Act) contains a provision directing the Department to implement what is commonly known as the "hold harmless" provision. This calls for the Need component of the Indian Housing Block Grant (IHBG) formula to be calculated twice for each tribe, once using single-race data and once using multi-race data. Each tribe is then awarded the higher of those two amounts.

Until reauthorization of the Native American Housing Assistance and Self-Determination Act (NAHASDA) is addressed, and Congress determines what statutory changes, if any, it will enact during the reauthorization process, the Department has determined that the best course of action to follow is to continue the methodology Congress provided in the 2006 Act. This will ensure stability and continuity in the way that IHBG recipients receive their IHBG formula funding.

RISING UTILITY COSTS IN PUBLIC HOUSING

*Question.* Public housing and voucher program participants make a monthly housing payment that covers rent and utilities. As utility costs skyrocket, energy costs consume a greater and greater proportion of the housing payment. This means that housing authorities receive less in the form of rent for public housing. The utility over payments in the Voucher program come directly out of the fixed administrative fees allocated by HUD. In public housing, I'm told that increased utility costs could easily tap out these reserves. Under the President's proposal, there is not a utility allowance adjustment. Do you think that HUD is prepared to cover skyrocketing utility bills?

Answer. While the Department will not know the actual cost of utilities for fiscal year 2006 until PHAs submit their financial statements for the past 5 to 7 years, PHA utility costs have remained relatively stable with no dramatic spikes. Immediately after Hurricane Katrina, utility rates spiked and then came down considerably.

The 2007 Utility Expense Level (UEL) for the Public Housing Operating Fund is calculated based upon a 3-year rolling average to account for increases as well as decreases in the cost of utilities over a period of time. Although, the Department's 2007 utility expense estimate is based on actuals from a 3-year rolling base inflated by the OMB utility inflation factor of minus 1.8 percent, it is difficult to estimate the impact of utilities without actual cost data.

However, over the past 3 fiscal years (2003–2005), PHAs have been able to retain over \$100 million in excess utility payments made to them, which are available as a part of their operating fund reserves to cover operational and maintenance costs of their program. Also, to reduce the cost of utilities, the Department encourages PHAs to enter into energy performance contracts, and to also switch to tenant-paid utilities. Switching to tenant-based utilities does not shift the cost of utilities to the

persons needing the assistance because the tenant's rent is lowered by the amount of the standard utility allowance, and the tenant becomes responsible for the entire utility cost, above or below what the standard utility allowance was before the change in policy. This will encourage personal responsibility of tenants in conserving energy and reducing utility consumption and will reduce, or at least make predictable, the utility expense of the PHA and the Department. In addition, the Energy Policy Act allows for energy performance contracts to run for up to 20 years instead of 12 years. This should allow PHAs and HUD greater certainty in planning their utility expenses, and responding to unexpected variations in consumption or price.

The Housing Choice Voucher program assists families with the gross rent, which is not only the rent due to the owner, but also includes applicable utility allowances for any tenant supplied utilities. The individual PHA establishes the utility allowances for its program. These allowances must be based on the typical cost of utilities and services paid by energy-conservative households that occupy housing of similar size and type in the same community. In accordance with 24 CFR 982.518(c), the PHA must review its schedule of utility allowances each year, and must revise its allowance for a utility category if there has been a change of 10 percent or more in the utility rate since the last time the utility allowance was revised. Funding to cover these allowances is part of the Housing Assistance Payment (HAP) subsidy amount provided by HUD for rental assistance; it is not part of the administrative fee provided to a PHA to manage the program. Starting in fiscal year 2005, Congress has provided funding to PHAs based on a budgetary formula and has directed PHAs to manage all increases in HAP costs, including increases in utility allowances, within that budgetary allocation.

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QUESTIONS SUBMITTED BY SENATOR PATRICK J. LEAHY

CUTS TO COMMUNITY DEVELOPMENT BLOCK GRANTS

*Question.* This is the second year that the President's budget seeks drastic cuts and changes to CDBG. The request would slash CDBG by over \$1 billion, leaving funding at its lowest level since 1990. This program is a critical source of funding for affordable housing, supportive services, public improvements, and community and economic development.

The National Low Income Housing Coalition estimates that if further cuts to CDBG are enacted, then an estimated 97 percent of the more than 1,000 communities that have held entitlement status since fiscal year 2004—when we reached the highest level of CDBG funding under this administration—or earlier would have their CDBG allocation slashed by at least one-third. Each State would also see its allocation reduced by at least a third compared to the fiscal year 2004 funding level.

Secretary Jackson, your Department is principally responsible for housing and community development. How do you justify a budget that slashes funding for this most successful initiative that supports economic development and affordable housing?

*Answer.* The fiscal year 2007 budget of \$3.032 billion for CDBG reflects a reduction of approximately \$700 million from the enacted fiscal year 2006 level. The administration's fiscal year 2007 budget proposal recognizes the value of the CDBG program to local community development efforts in two ways. First, it maintains the CDBG program at HUD as opposed to consolidating or transferring it to another agency. Second, the budget requests funding for the CDBG program at a level of more than \$3 billion. In addition, the fiscal year 2007 budget proposal improves the effectiveness of the program in several significant ways. The proposal is as follows:

- proposed formula change will direct a higher proportion of resources to areas with greater need than under the existing formula and areas with similar needs will receive similar funding;
- bonus funds will be established to provide additional funds to more effective grantees; and
- improved performance measurement will lead to a more effective national program and greater local impacts.

CUTS TO COMMUNITY DEVELOPMENT BLOCK GRANTS

*Question.* Is it the President's intention to focus this program solely on job creation and economic development? If so, why don't we call this what it is—the elimination of community development as part of HUD's core mission?

*Answer.* The proposed reforms of the CDBG program will not alter or restrict the list of CDBG eligible activities. Thus, grantees will continue to make their own decisions as to the activities they will fund with their CDBG dollars—be it public serv-

ices, infrastructure, housing or economic development. The reforms will achieve three goals—CDBG formula reform, improved performance measurement standards for CDBG and implementation of a challenge grant to provide targeted development grants to high impact projects in distressed communities.

#### CONSOLIDATION OF HUD'S SMALLER COMMUNITY DEVELOPMENT PROGRAMS

*Question.* I noted that the President's proposal from last year for the "Strengthening America's Communities Initiative" remains alive in the fiscal year 2007 budget request. The administration was soundly beaten back by Congress last year on its proposal to consolidate and slash funding under this initiative for several smaller economic and community development programs with larger programs like CDBG.

The administration pursues this misguided goal for fiscal year 2007 with a proposed consolidation of CDBG with Brownfields Redevelopment grants, Rural Housing and Economic Development, and section 108 Loan Guarantees. It again proposes no funding for these smaller programs and would fund CDBG at 20 percent less than this year.

Since the fiscal year 2007 budget request would fund CDBG at substantially less than this year, as well as consolidate it with those other programs, how do you magically propose to do so much more with so much less?

*Answer.* The key will be reform of the CDBG formula. A recent study by the Office of Policy Development and Research found that one of the problems with the CDBG formula is that some communities with little need for CDBG funds have received much more on a per capita basis than many communities with much greater needs. Restoring a greater degree of equity to the distribution of funds will help offset any reductions experienced as a result of reduced appropriations levels. The budget does propose consolidation of the Brownfields Economic Development Initiative (BEDI), Rural Housing and Economic Development Program, and the section 108 Loan Guarantee Programs under CDBG. In almost every case, the activities eligible for assistance under these programs can be funded through the CDBG program. This point is demonstrated by the fact that the section 108 and BEDI programs are authorized through the CDBG statute and utilize the CDBG eligible activities list to define their eligible activities.

#### CUTS TO HOUSING PROGRAMS

*Question.* I was pleased to see an increase this year for the section 8 voucher program in fiscal year 2007. Finding an affordable place to live is becoming increasingly difficult for many working families in Vermont and the section 8 program often helps bridge the gap for families who are struggling to make ends meet.

Unfortunately due to inadequate funding in fiscal year 2005, local housing agencies budgets continue to be cut this year. Some estimate that 80,000 fewer families may be served by the voucher program as a result, over 200 of those in Vermont. The increase in the fiscal year 2007 budget is enough to undo about half of these reductions—and I thank you for that—but it still falls short of the money needed to restore the cuts we have seen over recent years.

In other areas of the budget we see additional rollbacks. The public housing capital fund is cut by 11 percent, the operating fund is level-funded despite the need for additional funding for the operation of public housing under the new asset-based management system, funds for housing for persons with disabilities have been cut in half, HOME formula grants have been reduced, housing for the elderly programs have been slashed, and both fair housing programs and lead-based paint grants have been cut.

Mr. Jackson, each year the administration submits a budget for HUD that is littered with bullet holes—one year it is section 8, the next it is public housing, the next it is CDBG—and each time the subcommittee is left holding the bag. Can you offer me any assurances that this will not continue in future years?

*Answer.* While some, including the Center for Budget and Policy Priorities (CBPP), forecasted that approximately 80,000 fewer families would be able to be assisted given the administration's funding request for fiscal year 2005, this has turned out not to be so. In fact more families were assisted in fiscal year 2005 than the previous year and the CBBP has retracted its initial fiscal year 2005 projections in a footnote to its 2006 report. The Department has not been made aware of a single family in the State of Vermont displaced as a result of the fiscal year 2005 budget for the Housing Choice Voucher Program.

HUD has been consistent in its support for the section 8 program. The administration agrees with the appropriators in that the most effective way to deliver section 8 rental assistance is through a fixed budget that allows public housing agencies to properly plan their operations. In support of that approach the President's

budget request currently being debated, includes a \$380 million budgetary increase over 2006 funding levels coupled with a number of key legislative proposals aimed at further improving the efficiency of the Housing Choice Voucher Program. HUD will continue to actively engage in communication with Congress to ensure these important reforms are enacted. By measuring outcomes and aligning incentives, these important programs will be even better.

CUTS TO PROPOSED HOUSING PROGRAMS

*Question.* How do you expect to run a Department whose core programs are being eroded away bit by bit?

*Answer.* By appropriately prioritizing resources and proposing reforms to key Departmental programs, including section 8 and CDBG, HUD can continue the advances for the good of the low-income community. Those programs that are not able to drawdown all of its funds or are simply inefficient, must be reformed. HUD will continue to work with Congress to ensure these key reforms are enacted.

SUBCOMMITTEE RECESS

Secretary JACKSON. Thank you.

Senator BOND. Thank you very much. The hearing is recessed.  
[Whereupon, at 11:04 a.m., Tuesday, March 2, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

**DEPARTMENTS OF TRANSPORTATION, TREASURY, THE JUDICIARY, HOUSING AND URBAN DEVELOPMENT, AND RELATED AGENCIES APPROPRIATIONS FOR FISCAL YEAR 2007**

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**THURSDAY, MARCH 16, 2006**

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

The subcommittee met at 9:35 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Christopher S. Bond (chairman) presiding.

Present: Senators Bond, Bennett, Cochran, Murray, Durbin, Dorgan, and Leahy.

**DEPARTMENT OF TRANSPORTATION**

**OFFICE OF THE SECRETARY**

**STATEMENT OF HON. NORMAN Y. MINETA, SECRETARY**

**OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND**

Senator BOND. Mr. Secretary, if you are ready, we will welcome you. I didn't want to start until you got organized, but Senator Murray and I have some words, we hope, of wisdom, at least of concern, that we would like to share with you to begin.

The Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, HUD and Related Agencies will come to order. It is a pleasure to welcome our good friend, Secretary Mineta, and thank him for appearing today to testify on the Department's 2007 budget. This is the first of two hearings we have scheduled for the review of the budget request, especially Amtrak and FAA, both of which are facing significant policy decisions over the next several years.

Our hearing today will focus on the overall budget request for the Department of Transportation and then we will have a second panel that will take a closer look at the state of Amtrak in the 2007 budget. In April, we are planning to have our second DOT-related hearing, where we will focus on the FAA and labor issues facing FAA.

Mr. Secretary, we look forward to your comments on the overall budget picture for all modes of transportation and we will welcome now the second panel on Amtrak, FRA Administrator Joe

Boardman, David Hughes, President and CEO of Amtrak, Mr. David Laney, Chairman of the Board, and Mr. Mark Dayton, Senior Economist, Department of Transportation for the OIG.

The 2007 budget for DOT would provide \$65.64 billion in gross budgetary resources, basically, a flat budget from last year's 2006 \$65.51 billion budget. The budget, I regret to tell you, is deceiving because not all modes are treated equally. There are bright spots in the budget for some modes within the Department, like FHWA and the Federal Transit Administration, FTA. Unfortunately, there are significant shortfalls for other modes, like FAA and Amtrak.

Since we will be holding a separate hearing on FAA, I am not going to focus significantly on the FAA. Our April hearing will include issues related to the resolution of a labor contract with the air traffic controllers, a significant reduction to the Airport Improvement Program, and the proposed open skies aviation treaty.

First, having worked for better than 2½ years as chairman of the Senate Subcommittee on Transportation and Infrastructure to pass SAFETEA, I am pleased to see that this year, the administration has fully embraced the historic funding levels achieved under the law. Although I regret some things that those crazy authorizers did, we will now try to clean up the mess in our appropriations process.

This year marks the 50th anniversary of the Dwight D. Eisenhower System of Interstate and Defense Highways, a landmark commitment to the transportation and commercial needs of the Nation. Our interstate highway system has had a profound impact on our Nation's economy, keeping communities and families connected to one another and serving as the primary system for moving goods and products that are the life blood of our economy. The 2007 budget would provide \$3.4 billion, a boost in needed investment funding for our Nation's highways and bridges. Over \$2 billion of this funding increase was called for by SAFETEA.

An additional \$842 million is also made available by the Bond-Chafee Revenue Aligned Budget Authority, or RABA, begun under TEA21 and continued in SAFETEA. Some people in Washington call it the Chafee-Bond proposal, since Senator Chafee was chairman of the committee, but I am taking the liberty of changing the alignment of names. These additional funds will allow an increased investment in key highway and transportation projects which will complement and assist the continuing growth of the U.S. economy.

I commend the administration for its commitment to increasing important highway spending when receipts into the Highway Trust Fund are higher than projected. Unfortunately, this is where the good news ends, and permit me to explain our subcommittee's unmet budgetary needs in the current budget.

As I stated in our March 2 hearing on HUD, this year's budget request is lacking for many of the programs under our jurisdiction. Many widely supported programs within HUD, such as CDBG, public housing capital funding, HOPE VI, Section 202 elderly, Section 811 housing for the disabled have been slashed in the 2007 budget. Even more troubling, the 2007 HUD budget includes a \$2 billion rescission of excess Section 8 funds, which I don't think are available. They also assume, without any justification whatsoever, a wide range of fees that the Congress will not approve and rescis-

sions which Congress will not approve. This makes the decisions posed by the 2007 budget especially troubling.

The subcommittee will also have to face substantial shortfalls in many other accounts, for example, a shortfall of some \$400 million in proposed Amtrak funding level for fiscal year 2007 and some \$1.557 billion for AIP and F&E. The proposed Amtrak funding of \$900 million is clearly not enough to support Amtrak's funding needs, and I am not even sure that flat funding will meet the anticipated expenses in 2007.

Last year, to avoid a veto which the administration proposed, we added reform language with necessary funding to support Amtrak's need for 2006. Consistent with this reform legislation, I expected the administration to have a vision for reform and be prepared to implement this vision. That was an empty hope. Nothing has happened. Reducing the budget for Amtrak makes no sense unless and until the administration is prepared to implement a reform strategy which can be supported by the budget request.

Let me be clear. As many people here know, when I was Governor of Missouri, I supported and signed into law annually millions of dollars in subsidies to keep Amtrak running in our State. But let me be equally frank that we cannot continue to see costs rising beyond the available revenues with many areas of expenditure apparently unjustified. Consequently, Mr. Secretary, I expect you and our second panel to justify the Amtrak budget and I expect the Amtrak panel to explain where we are, where we are going, and what it is going to cost. Anything less would be a big disappointment for us and the people who depend upon Amtrak.

In particular, I am troubled that while the administration seems to press for Amtrak reforms and accountability in its budget submissions, it has yet to exercise the substantial authority it has sought and received from Congress to maintain greater control over the Federal funds provided to Amtrak.

Mr. Secretary, we provided you with sole authority to approve or disapprove Amtrak's requests for funds to cover capital needs and operating losses. To date, I am not aware of a single instance in which you have denied funding to Amtrak. In particular, DOT and Amtrak must be able to account for its expenditures in budget submissions with long-term plans for individual capital improvements similar to State TIPS or Transportation Improvement Plans. If detailed Transportation Improvement Plans were provided by Amtrak, we would be better able to understand what unmet needs are out there and we could then decide whether or not we agree with providing additional funds for passenger rail service.

I am concerned the budget submission does not include any funds for Amtrak for debt service payments. These payments are necessary and will have to be paid, whether through a line item for debt service added by this subcommittee or through the \$500 million provided in the capital costs budget for Amtrak included in your budget submission. One cannot ignore the fact that the debt is there and that there is an immediate and legal obligation to repay it, even if you do not agree with the manner in which the sizeable debt was incurred. Until a reform bill is enacted, we would expect the Amtrak Board to step up to the plate, make such re-

forms that are needed and necessary consistent with the current budget and the budget request.

Finally, among other issues, the 2007 budget requests a total of \$13.8 billion for FAA, a \$500 million decrease from the current year. While the FAA's operational activities in the budget would see a 5 percent increase over the amount provided last year, the budget would impose a dramatic cut in airport construction and investment.

This subcommittee is once again left to fill in the gaps of underfunded Federal responsibilities for our Nation's airports, including a reduction of some \$765 million for AIP from what was provided for this year. As the administration should know, this program is critical to the future of commercial aviation in the Nation. Nevertheless, this cut would be used to increase funding for salaries and expenses and the hiring of air traffic controllers and safety inspectors at the expense of funding needed for airport investment improvements under AIP. If the administration were to follow the blueprint of Vision 100, the authorizing legislation for aviation, in the same manner in which they funded needed highway improvements under SAFETEA, the AIP number for 2007 would be \$3.7 billion rather than the \$2.7 billion provided.

Let us be clear. Over the next 15 years, passenger boardings on airplanes are expected to grow by some 15 percent and include a 30 percent growth in air transport and commercial operations. At the 35 busiest airports in the Nation, total operations are expected to grow by more than 34 percent by 2020. While I know the administration is expected to propose new ways to fund the Aviation Trust Fund, we cannot afford to shortchange our commercial air needs in the meantime.

We need answers to all these issues, but more importantly, we need adequate funding. We need to protect the future of commercial aviation, and absent a substantive explanation of the budget, I consider the proposed funding level a failure of leadership. In other words, we need to understand the justification for this funding and how the administration intends to maintain a world class, indeed a world first commercial aviation industry.

#### PREPARED STATEMENT

Mr. Secretary, we appreciate your willingness to work with us in being here today and it is my pleasure to turn to my ranking member and partner on the subcommittee, Senator Murray.

[The statement follows:]

#### PREPARED STATEMENT OF SENATOR CHRISTOPHER S. BOND

The Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, HUD and Related Agencies will come to order.

We welcome Secretary Mineta and thank him for appearing before us today to testify on the Department of Transportation's budget submission for fiscal year 2007. This is the first of two hearings that we have planned to review the fiscal year 2007 DOT budget submission.

Our hearing today will focus on the overall budget submission for the Department of Transportation, followed by a second panel that will take a closer look at the state of Amtrak in the fiscal year 2007 budget. In April, we are planning to have our second DOT related hearing where we will focus in on the Federal Aviation Administration and labor issues facing the FAA.

Mr. Secretary, I look forward to your comments on the overall budget picture for all of the modes of transportation within the Department. I also welcome our second panel witnesses on Amtrak: FRA Administrator Joseph Boardman; Mr. David Hughes, President and CEO, Amtrak; Mr. David M. Laney, Chairman of the Board of Amtrak and Mr. Mark Dayton, Senior Economist, Department of Transportation Office of the Inspector General.

The proposed fiscal year 2007 budget for DOT would give the department \$65.64 billion in gross budgetary resources. This is basically a flat line from last year's fiscal year 2006 \$65.51 billion appropriation for the Department of Transportation. The fact that this is a flat line budget is deceiving because all modes are not treated equally. There are bright spots in this budget for some modes within the Department, like the Federal Highway Administration (FHWA) and the Federal Transit Administration (FTA), and unfortunately there are black holes for other modes like the FAA and Amtrak.

Having worked for over 2½ years as the Chairman of the Senate Subcommittee on Transportation and Infrastructure to pass SAFETEA-LU, I am pleased to see that this year the administration has fully embraced the historic funding levels achieved under the law. This year marks the 50th anniversary of the Dwight D. Eisenhower System of Interstate and Defense Highway. No one can deny that our interstate system has had a profound impact on our Nation's economy, keeping communities and families connected to one another and serving as the primary system for moving goods and products that are the lifeblood of our economy.

The fiscal year 2007 budget will provide a \$3.4 billion boost in needed investment for our Nation's highways and bridges. While over \$2 billion of this funding increase was called for by SAFETEA, an additional \$842 million is also made available by what I call the Bond-Chafee Revenue Aligned Budget Authority (RABA) begun under TEA-21 and continued in SAFETEA. I commend the administration for continuing its commitment to allowing spending to increase when receipts into the highway trust fund are higher than had been projected.

Unfortunately, this is where my good news report ends, and I begin with our subcommittee's unmet budgetary needs provided under the fiscal year 2007 budget speech.

As I stated at our March 2 hearing on HUD, this year's budget request for HUD proposes some \$33.65 for fiscal year 2007, a decrease of some \$621 million, or some 2 percent from the fiscal year 2006 funding level of \$34.27 billion.

This request does not reflect the true extent to which many other important housing and community development programs are compromised. In particular, because of needed increases to section 8 funding, funding for many widely supported programs, such as CDBG, Public Housing Capital funding, HOPE VI, Section 202 Elderly and Section 811 housing for the disabled, has been slashed. The fiscal year 2007 HUD budget also includes a \$2 billion rescission of excess section 8 funds which are unlikely to be available.

In addition to the very difficult decisions posed by the HUD fiscal year 2007 budget, this subcommittee will also have to face substantial shortfalls in many other accounts including, for example, a shortfall of some \$400 million in the proposed Amtrak funding level for fiscal year 2007. This proposed level is clearly not enough to support Amtrak's funding needs and I am not sure that even flat funding will meet Amtrak's anticipated expenses in fiscal year 2007. Why was \$900 million chosen instead of the approximately \$1.315 billion provided for Amtrak in fiscal year 2006? Is \$900 million really sufficient to keep Amtrak afloat?

If the administration wants Congress to be serious in its efforts to pass reform legislation, the administration must be more serious in its budget submissions. I am troubled that, while the administration seems to press for Amtrak reform and accountability in its budget submissions, it has yet to exercise the substantial authority that it has sought and received from Congress to maintain greater controls over the Federal funds provided to Amtrak. The Secretary of Transportation now has sole authority to approve or disapprove Amtrak's request for funds to cover capital needs and operating losses. To date, I am not aware of a single instance in which the Secretary has denied funding to Amtrak because Amtrak's grant request would not be the most efficient use of Federal funds.

As we all know, this year's budget proposal of \$900 million is better than the black hole provided for Amtrak in fiscal year 2006, however the \$900 million reflected in the budget does not come with sufficient budgetary justification to draw any conclusions as to what \$900 million will get us? I think that Amtrak should have to account for its expenditures and budget submissions with long term plans for individual capital improvements, similar to state TIPs, or transportation improvement plans. If detailed transportation improvement plans were provided by Amtrak, we would be better able to understand what unmet needs are out there,

and we could then decide whether or not we agree with providing additional funding for passenger rail service.

I am concerned that the budget submission we have before us for Amtrak does not include any funds for debt service payments. These payments are necessary and will be paid, whether through a line item for debt service added by this subcommittee, or through the \$500 million provided in the capital costs budget for Amtrak provided in your budget submission. One can not ignore the fact that the debt is there and that there is an immediate and a legal obligation to repay it, even if you do not agree with the manner in which this sizeable debt was incurred.

Finally, the budget requests a total of \$13.8 billion for FAA, a \$500 million decrease from fiscal year 2006. While the FAA's operational activities under the budget would see a 5 percent increase over the amount provided last year, the budget would impose a dramatic cut in airport construction investment.

This subcommittee is left once again to fill in the gaps of under-funded Federal responsibilities for our Nation's airports to the tune of \$765 million for AIP below what was provided in fiscal year 2006. This cut would be used to increase funding for salaries and expenses and hiring of air traffic controllers and safety inspectors at the expense of funding needed airport investment improvements under the AIP program. If the administration were to follow the blueprint of VISION-100, the authorizing legislation for aviation in the same manner in which they funded needed highway improvements under SAFETEA, the AIP number for fiscal year 2007 would be \$3.7 billion, rather than the \$2.75 billion provided.

Mr. Secretary, I appreciate your time today. I now turn to my ranking member and partner on this subcommittee, Senator Murray.

#### STATEMENT OF SENATOR PATTY MURRAY

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

Just a few months ago, Congress passed the SAFETEA-LU highway, transit and safety authorization bill. That law settled many of the major questions about transportation policy and funding for the next few years. Normally, this would be a relatively quiet period on transportation policy, but instead, this year is going to be anything but quiet when it comes to the challenges facing us in transportation.

We already hear voices of concern that the revenues to the Highway Trust Fund will not be adequate to actually fund the SAFETEA-LU bill through 2009, and we will be presented with proposals this year to dramatically restructure the way we finance our national aviation enterprise, including the operations of the FAA.

One of the biggest cost drivers in the FAA's budget is the need to pay for our hard working and highly capable air traffic controllers. Yet there are many rumors floating around that the Bush administration would rather let Congress settle the contract dispute with air traffic controllers than settle the issue at the bargaining table. I hope that is not the case. Last night, I received word that the FAA has asked the mediator to extend the negotiations in the hope that more progress can be made, and I take that as a positive sign. I hope Secretary Mineta will instruct his team to get back to the bargaining table and stay there until a contract is negotiated. This is not something that should be thrown in the laps of Congress.

Now, as I review the Department of Transportation's budget for the coming fiscal year, it is clear that there are three huge and controversial funding holes in the President's budget. One is the 30 percent funding cut proposed for Amtrak. Another is the proposal to cut in half the essential air service subsidies necessary to maintain air service to our rural communities. The last is the adminis-

tration's proposal to cut more than \$750 million from our capital investments in our Nation's airports.

I am pleased that Chairman Bond has agreed to have special hearings so we can review those issues in detail. Following our discussion with Secretary Mineta this morning, we will have a panel that will specifically address Amtrak, and we also have a hearing with the FAA Administrator on May 4.

Another challenge we face is the need to adequately fund the transportation needs of the gulf coast recovery. Last year, this subcommittee provided \$2.75 billion for emergency relief for highways. Now, it is becoming clear that several of the major highway and bridge replacement projects in Louisiana and Mississippi will be more expensive than anticipated. This is an issue I hope we address in the supplemental, Mr. Chairman, if we are to ensure that the Gulf region has the kind of infrastructure that will allow its economy to rebound, and we must not ignore the other emergency relief projects from other disasters that have been awaiting reimbursement for many months or, in some cases, years.

So, as I said, these will not be quiet times for transportation policy and this subcommittee will be right in the middle of the debate.

Other than the three large funding holds that I cited, the Department of Transportation is clearly one of the winners in the administration's budget proposal. Secretary Mineta, you did quite well with funding for the Transportation Department, which is rising almost 5 percent, and I am sure that didn't come without a fight. And I am sure there will be more funding fights as this year continues.

The budget resolution currently being debated on the floor endorses the President's overall funding for discretionary spending. While funding for the DOT in the President's budget may be increased by 5 percent, funding for the Department of Housing and Urban Development is cut by almost 2 percent. Funding for the Department of Health and Human Services is down 2.3 percent. And funding for education is cut almost 4 percent. That is the universe in which transportation programs will have to do battle this year.

Since I often spend time during these statements complaining about what is not included in the agency's budget, I do want to take a minute to commend the Secretary for some initiatives that are included in this budget.

Most notably, within the FAA, \$80 million is included for the ADS-B program and \$24 million is requested for the SWIM program. I will spare my colleagues an explanation of those acronyms, but those two programs really hold the promise of allowing us to break away from an air traffic control system that is dependent on dated radar technology. Those are the kinds of investments that we should have been making over the last several years, and instead, those initiatives were crowded out of the budget because the administration had insisted on cutting the funding for air traffic control modernization for each of the last 2 years. These technologies will allow us to get greater productivity out of our limited airspace with an even greater margin of safety. So I want to commend Secretary Mineta and Administrator Blakey, as well, for insisting that these initiatives be funded in the budget this year.

Our second panel today will be on Amtrak, and we want to welcome our new Federal Railroad Administrator, Joe Boardman, as a witness today. During the time that Mr. Boardman's position was vacant, the DOT General Counsel served as the Secretary's lead on passenger rail policy. Those were not the responsibilities for which the Senate confirmed the General Counsel, so I am glad Mr. Boardman is now prepared to take over. We hope and expect that he will shortly be serving as the Secretary's designee on the Amtrak Board of Directors.

During our discussions this morning with Mr. Boardman and our witnesses from Amtrak and the Inspector General's office, I hope to pursue precisely what choices would face us if we are forced to live within the President's proposed 30 percent cut in funding. I expect that we will find, as we have in prior years, that with Amtrak's existing debt levels and its statutory responsibility to its employees, there is no way the railroad will be able to shed roughly \$400 million in costs during the fiscal year starting this coming fall without lapsing into bankruptcy.

That is why I expect the Amtrak Board of Directors has submitted a budget to us seeking \$1.6 billion for 2007. Despite the fact that every member of Amtrak's Board of Directors has now been appointed by the Bush administration, that Board is seeking an appropriation that is some \$700 million more than the Bush administration is supporting. Apparently, those Bush appointees know something about Amtrak's costs and the national rail network that the ideologues at OMB and DOT do not.

As part of our discussion with the second panel, I want us to have an honest dialogue about Amtrak's real costs. For too long, the Amtrak trains that serve the vast majority of States in this country, the States outside of the Northeast, have been castigated as Amtrak's main budget problem while the trains operating in the Northeast Corridor are held up as the flagship of efficiency.

When you look into the realities of where Amtrak's annual subsidies are going, however, you find that this is far from the whole truth. Due to the extraordinary capital needs of the Northeast Corridor and the debt service costs associated with that corridor, the fact is that a vast amount of Amtrak's annual appropriation must go straight into that corridor. Those subsidies are needed not just to continue Amtrak's service, but also to ensure the continuation of all the community railroads that operate over that corridor every day.

Over the last 4 years, Amtrak's appropriation has increased by \$244 million, and over the same time, Amtrak's annual investment in the Northeast Corridor has increased by roughly the same amount. So put another way, the Northeast Corridor has absorbed just about every dollar of the increased appropriation this subcommittee has provided over the last few years.

Now, I am not saying that those investments are not necessary. In fact, they are long overdue. What I am saying is that the service in the Northeast Corridor, including the local commuter services that operate on the corridor, are no less dependent on annual subsidies from this subcommittee as Amtrak services across the rest of the country.

Amtrak just reached a record number of riders for its third consecutive year. It is noteworthy that ridership over the Northeast Corridor grew by only 1 percent, while trains around the rest of the country grew at faster rates. Let us just look at the trains that are serving my State and Chairman Bond's State.

The Empire Builder is a train that provides service between Seattle and Spokane in my State, and that train continues on to serve the States of several other subcommittee members, including Senator Burns, Dorgan, Kohl, and Durbin. Ridership on the Empire Builder grew by 9 percent last year. Ridership on the Cascades service that runs from Vancouver, B.C. all the way to Eugene, Oregon, grew by almost 6 percent. In the chairman's State, service between Kansas City and St. Louis grew by almost 7 percent, while service between St. Louis and Chicago grew by almost 14 percent just last year.

#### PREPARED STATEMENT

My point here is that while there is a growing level of pressure on the railroad to eliminate or terminate these services, their popularity among the traveling public is rising. I, for one, am not going to support a policy where we leave thousands of passengers across the entire country without rail service solely because the capital needs of the Northeast Corridor have gotten too expensive.

Thank you, Mr. Chairman.

[The statement follows:]

#### PREPARED STATEMENT OF SENATOR PATTY MURRAY

Thank you, Mr. Chairman.

Just a few months ago, Congress passed the SAFETEA-LU highway, transit and safety authorization bill. That law settled many of the major questions about transportation policy and funding for the next few years.

Normally, this would be a relatively quiet period on transportation policy. But instead, this year is going to be anything but quiet when it comes to the challenges facing us in transportation.

We already hear voices of concern that the revenues to the Highway Trust Fund will not be adequate to actually fund the SAFETEA-LU bill through 2009.

And we will be presented with proposals this year to dramatically restructure the way we finance our national aviation enterprise including the operations of the FAA.

One of the biggest cost drivers in the FAA's budget is the need to pay for our hard working and highly capable air traffic controllers. Yet there are many rumors floating around that the Bush Administration would rather let Congress settle the contract dispute with air traffic controllers than settle the issue at the bargaining table.

#### THREE FUNDING HOLES

As I review Department of Transportation's budget for the coming fiscal year, it is clear that there are three huge and controversial funding holes in the President's budget.

—One is the 30 percent funding cut proposed for Amtrak.

—Another is the proposal to cut in half the Essential Air Service subsidies necessary to maintain air service to our rural communities.

—The last is the administration's proposal to cut more than \$750 million from our capital investments in our Nation's airports.

I'm pleased that Chairman Bond has agreed to have special hearings so we can review these issues in detail.

Following our discussion with Secretary Mineta this morning, we will have a panel that will specifically address Amtrak. We also have a hearing with the FAA Administrator on May 4th.

## GULF COAST

Another challenge we face is the need to adequately fund the transportation needs of the Gulf Coast recovery. Last year, this subcommittee provided \$2.75 billion for Emergency Relief Highways.

Now it's becoming clear that several of the major highway and bridge replacement projects in Louisiana and Mississippi will be more expensive than anticipated.

This is an issue we must address in the Supplemental, Mr. Chairman, if we are to ensure that the Gulf region has the kind of infrastructure that will allow its economy to rebound.

And we must not ignore the other emergency relief projects from other disasters that have been awaiting reimbursement for many months or, in some cases, years.

So, as I said, these will not be quiet times for transportation policy, and this subcommittee will be right in the middle of the debate.

## DOT'S BUDGET

Other than the three large funding holes that I cited earlier, the Department of Transportation is clearly one of the winners in the administration's budget proposal. Secretary Mineta did quite well with funding for the Transportation Department rising almost 5 percent. I'm sure it did not come without a fight.

And there will be more funding fights as the year continues. The Budget Resolution currently being debated on the Floor endorses the President's overall funding for discretionary spending.

While funding for the DOT in the President's budget may be increased by 5 percent—

—funding for the Department of Housing and Urban Development is cut by 2 almost percent;

—funding for the Department of Health and Human Services is down 2.3 percent;

—and funding for Education is cut by almost 4 percent.

That is the universe in which transportation programs will have to do battle this year.

## AIR TRAFFIC CONTROL MODERNIZATION

Since I often spend time during these statements complaining about what is not included in the agency's budget, I want to take a minute to commend the Secretary for some initiatives that are included in the budget.

Most notably, within the FAA, \$80 million is included for the ADS-B program and the \$24 million is requested for the SWIM program. I will spare my colleagues an explanation of these acronyms. But these two programs hold the promise of allowing us to break away from an air traffic control system dependent on dated radar technology.

These are the kind of investments that we should have been making over the last several years. Instead, initiatives like these were crowded out of the budget because the administration insisted on cutting the funding for air traffic control modernization for each of the last 2 years.

These technologies will allow us to get greater productivity out of our limited air space with an even greater margin of safety. So, I want to commend Secretary Mineta and Administrator Blakey for insisting that these initiatives be funded in the budget this year.

## AMTRAK

Our second panel at today's hearing will be on Amtrak. We welcome our new Federal Railroad Administrator, Joe Boardman, as a witness.

During the time that Mr. Boardman's position was vacant, the DOT General Counsel served as the Secretary's lead on passenger rail policy.

Those were not the responsibilities for which the Senate confirmed the General Counsel, so I am glad Mr. Boardman is now prepared to take over.

We hope and expect that he will shortly be serving as the Secretary's designee on the Amtrak Board of Directors.

During our discussions this morning with Mr. Boardman and our witnesses from Amtrak and the Inspector General's office, I hope to pursue precisely what choices Amtrak would face if it is forced to live within the President's proposed 30 percent cut in funding.

I expect that we will find, as we have in prior years, that with Amtrak's existing debt levels and its statutory responsibilities to its employees, there is no way that the railroad would be able to shed roughly \$400 million in costs during the fiscal year starting this coming fall without lapsing into bankruptcy.

That is why, I expect, the Amtrak Board of Directors has submitted a budget to us seeking \$1.6 billion for 2007.

Despite the fact that every member of Amtrak's Board of Directors has been appointed by the Bush Administration, that Board is seeking an appropriation that is some \$700 million more than the Bush Administration is supporting.

Apparently, these Bush appointees know something about Amtrak's costs and the national rail network that the ideologues at OMB and DOT do not.

#### AMTRAK'S REAL COSTS

As part of our discussion with the second panel, I want us to have an honest dialogue about Amtrak's real costs.

For too long, the Amtrak trains that serve the vast majority of States in this country—the States outside of the Northeast—have been castigated as Amtrak's main budget problem while the trains operating in the Northeast Corridor are held up as the flagship of efficiency.

When you look into the realities of where Amtrak's annual subsidies are going, however, you find that this is far from the whole truth.

Due to the extraordinary capital needs of the Northeast Corridor and the debt service costs associated with that corridor, the fact is that a vast amount of Amtrak's annual appropriation must go straight into that corridor.

Those subsidies are needed not just to continue Amtrak service, but also to ensure the continuation of all the commuter railroads that operate over that corridor every day.

Over the last 4 years, Amtrak's appropriation has increased by \$244 million. And over the same time, Amtrak's annual investment in the Northeast Corridor has increased by roughly the same amount.

Put another way, the Northeast Corridor has absorbed just about every dollar of the increased appropriations this subcommittee has provided over the last few years. I am not saying that those investments are not necessary. In fact, they are long overdue.

What I am saying is that the service in the Northeast Corridor—including the local commuter services that operate on the Corridor—are no less dependent on annual subsidies from this subcommittee as Amtrak's services across the rest of the country.

#### AMTRAK'S RISING RIDERSHIP

Amtrak just reached a record number of riders for its third consecutive year.

It is noteworthy that ridership over the Northeast Corridor grew by only 1 percent while trains around the rest of the country grew at far faster rates.

Let's just look at the trains serving my State and Chairman Bond's State. The Empire Builder is a train that provides service between Seattle and Spokane in my State. The train continues on to serve the States of several other subcommittee members including Senator Burns, Dorgan, Kohl and Durbin.

—Ridership on the Empire Builder grew by 9 percent last year.

—Ridership on the Cascades Service that runs from Vancouver, BC all the way to Eugene, Oregon grew by almost 6 percent.

In Chairman Bond's State, service between Kansas City and St. Louis grew by almost 7 percent while service between St. Louis and Chicago grew by almost 14 percent just last year.

My point is that, while there is a growing level of pressure on the railroad to eliminate or terminate these services, their popularity among the traveling public is rising.

I, for one, am not going to support a policy where we leave thousands of passengers across the entire country without rail service solely because the capital needs of the Northeast Corridor have gotten too expensive.

Thank you, Mr. Chairman.

#### PREPARED STATEMENT

Senator BOND. Thank you very much, Senator Murray. Senator Leahy has also submitted a statement which will be included in the record.

[The statement follows:]

## PREPARED STATEMENT OF SENATOR PATRICK J. LEAHY

Thank you, Mr. Chairman, for holding this important hearing today. On the heels of last year's passage of the transportation reauthorization bill and significant managerial changes at Amtrak, it is very timely to hold this hearing on the budget requests for the Department of Transportation and Amtrak.

I am very concerned that Congress will not be able to fund our Nation's multifaceted transportation system adequately if Congress accepts the President's budget request. The President shortchanges Amtrak and public transit programs, and he drastically cuts funding for the Essential Air Service program that brings air service to small communities, like Rutland, Vermont. Without this program, air passenger service to dozens of small communities across the country will end.

I look forward to hearing the testimony from today's witnesses about the future direction of the Transportation Department and Amtrak. Thank you.

Senator BOND. Now, Mr. Secretary, your statement, please.

## STATEMENT OF SECRETARY NORMAN Y. MINETA

Secretary MINETA. Mr. Chairman and members of the subcommittee, thank you again for this opportunity to appear before you today to discuss the President's fiscal year 2007 budget for the Department of Transportation.

Our transportation network is the backbone of the strongest and most dynamic economy in the world, and President Bush is proposing a \$65.6 billion plan to keep America moving safely, reliably, and efficiently.

I will touch on a few highlights, and at this time, I request unanimous consent that my full written statement be made a part of the record.

Senator BOND. Without objection.

## SURFACE TRANSPORTATION PROGRAMS

Secretary MINETA. The President's 2007 budget request, Mr. Chairman, reflects the funding level authorized in SAFETEA-LU, which provides a record investment of \$286 billion through fiscal year 2009. Now, this investment reflects a strong commitment to transportation in what we all recognize is a very tight budget environment. However, we have reached a juncture where our focus must be on modernizing financing as well as infrastructure.

I know that this committee is aware that the balances in the Highway Trust Fund are on a downward slope and there is a growing consensus that we will need to look beyond traditional gasoline taxes to finance 21st century transportation needs. So the President's budget sets aside \$100 million for States that want to test alternatives to the gasoline fuel tax on a broad scale.

The Open Roads Financing Pilot Program will allow us to see how the public accepts fees, tolls, and other approaches and how well they raise revenue, and whether they are, indeed, more effective in reducing traffic congestion. The lessons that we learn through these demonstrations, as well as the work done by the congressionally-created Commission on the Future of the Highway Trust Fund, will help form future decisions on surface transportation policies.

## FEDERAL AVIATION PROGRAMS

Aviation financing also is in need of modernization, and after consultation with the stakeholder community, we are developing a

forward-looking plan which we expect to submit shortly. In the meantime, the President's 2007 budget provides \$13.7 billion for the Federal Aviation Administration from a combination of trust fund revenues as well as general fund revenues. Of the requested amount, \$8.4 billion will address the FAA's operational needs and support hiring the needed safety inspectors and air traffic controllers per the Congressional plan.

An additional \$2.75 billion is provided for the Airport Improvement Program, otherwise known as AIP. The airport construction grant request for 2007 is sufficient to address the construction needs for all currently planned runways and to meet our goal for improving runway safety.

Looking to the future, the Department's budget provides \$122 million for the next generation Air Transportation System Initiative. Early progress in this multi-agency effort is encouraging and our fiscal year 2007 budget invests in key building blocks for transforming the way that America flies, including the ADS-B, the Automatic Dependent Surveillance-Broadcast program, which ultimately will move us from the ground-based to a satellite-based air traffic control system.

#### INTERCITY PASSENGER RAIL

The budget also promotes continued transformation of intercity passenger rail. First, I want to express my appreciation to Chairman Bond and Senator Murray and this committee for delivering a clear message to Amtrak that it must address its money-losing services. We are confident that management and the Board are committed to turning the company around, and we will use the oversight authority that you gave us to ensure that this happens.

In recognition of the progress to date, and with the expectation that we will see much more by the end of fiscal year 2006, the President requests \$900 million to help Amtrak make the transition to a new and better model of intercity passenger rail. Five-hundred million dollars of that request is for capital needs and maintenance. The remaining \$400 million would be available as Efficiency Incentive Grants tied directly to continued activities that support reformed railroad operations.

#### SAFETY INITIATIVES

Now, over the past 5 years, we have also gained important momentum when it comes to safety, and roughly one-fourth of the Department's total resources in the 2007 budget will pay for safety initiatives. As fiscal year 2007 approaches, we face the twin challenges of modernizing our transportation infrastructure and bringing financing mechanisms that support them into the 21st century.

I look forward to working closely with all of you and with the entire Congress as we make sure that America continues to have a transportation system that is the envy of the world.

#### PREPARED STATEMENT

Thank you again for this opportunity to testify today and I will be pleased to respond to any questions that you may have.

Senator BOND. Thank you very much, Mr. Secretary.

[The statement follows:]

PREPARED STATEMENT OF NORMAN Y. MINETA

Mr. Chairman, members of the subcommittee, thank you for the opportunity to appear before you today to discuss the administration's fiscal year 2007 budget request for the U.S. Department of Transportation. The President's request totals \$65.6 billion in budgetary resources, which will support major investments in transportation nationwide that are vital to the health of our economy and the American way of life.

Nearly \$16 billion, or more than 24 percent, of the total request for the Department will support transportation safety—my top priority. Statistics show our past safety efforts are paying off. Our early estimates show in 2005 the highway fatality rate reached an historic low of 1.43 fatalities per 100 million vehicle-miles traveled. Still, annual highway deaths continue to hover around 43,000—a number that is still too high.

Our transportation network is the backbone of the strongest and most dynamic economy in the world. The President's budget request continues record investments in our Nation's transportation infrastructure, as well as supporting research and technology. At the same time, the budget reflects the recognition that our funding mechanisms are outdated. There is a growing consensus that traditional gasoline taxes and airline ticket taxes are not adequate to the task of supporting 21st century transportation needs. We must explore new and innovative ways to provide more reliable transportation services while focusing on costs. Consequently, the 2007 budget introduces alternative financing ideas that may provide possible funding options for our resource needs in the future.

SURFACE TRANSPORTATION PROGRAMS

Last summer, the "Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users" (SAFETEA-LU) reauthorized our surface transportation programs through fiscal year 2009, providing a record \$286 billion investment and a continued focus on improvements in highway safety. The President's 2007 budget plan for the Federal Highway Administration, the Federal Transit Administration, the Federal Motor Carrier Safety Administration, and the National Highway Traffic Safety Administration reflects the funding envisioned in SAFETEA-LU. The budget provides \$815 million for the National Highway Traffic Safety Administration, along with \$521 million for the Federal Motor Carrier Safety Administration, to improve safety on our Nation's highways. The budget also proposes a record \$8.9 billion Federal investment in public transportation. This funding for the Federal Transit Administration will help achieve common-sense transit solutions, especially for the elderly, persons with disabilities, and in rural areas where 40 percent of counties have no public transportation.

Even though SAFETEA-LU has just recently passed, we are already thinking about new ways to fund surface transportation programs in the future. That is why the 2007 budget plan proposes a \$100 million pilot program to evaluate innovative ways to finance and manage major portions of highway systems. Grants under this pilot program will allow the Federal Government to partner with up to five States that want to test fees, tolls, and other approaches on a broad scale—either statewide or across an urban area and its suburbs. We will see how the public accepts these approaches, how well they raise revenue, and whether they are indeed more effective in reducing traffic congestion. The lessons learned from this pilot program, as well as the work done by the Congressionally created commissions on the future of the Highway Trust Fund, will help inform future decisions on financing surface transportation needs. The timing is important. By the end of the 2007 budget year, only 2 years will remain before SAFETEA-LU expires.

FEDERAL AVIATION PROGRAMS

Approaching even more quickly is reauthorization of the Federal Aviation Administration (FAA) and the taxes that finance the Aviation Trust Fund, which expire at the end of fiscal year 2007. Currently, our primary funding source for the FAA is tied to the price of an airline ticket. But there is general consensus that our growing aviation system needs a more stable and predictable revenue stream—one that creates a more direct relationship between revenues collected and services provided. Soon, the Bush Administration will propose a reauthorization plan that will include a solid, forward-looking financing proposal for the Aviation Trust Fund.

The President's 2007 budget plan provides \$13.7 billion to fund aviation. Of this request, \$8.4 billion will address the FAA's operational needs and support hiring

needed safety inspectors and air traffic controllers. The President's budget also includes nearly \$2.8 billion for Airport Improvement Program (AIP) grants, which were instrumental in helping restore service last year to several Gulf Coast airports shut down by Hurricanes Katrina and Rita. The 2007 AIP request is sufficient to address construction needs for all currently planned runways.

The demand for air transportation continues to rise, placing more burdens on our current systems. To address future needs, the FAA is partnering with other Federal agencies in planning for the Next Generation Air Transportation System (NGATS). This multi-agency effort is exploring new ways to manage air transportation through the use of modern technology. As a first step, the 2007 budget provides funding for this effort, including \$80 million to support FAA's deployment of Automatic Dependent Surveillance-Broadcast (ADS-B). ADS-B will replace current radar systems and provide more accurate surveillance coverage. In addition, the budget provides \$24 million for System Wide Information Management, which will make a network-enabled air traffic system possible, improving safety, efficiency, and security. These are the building blocks of the Next Generation initiative, which will transform the way that America flies.

#### INTERCITY PASSENGER RAIL

The budget also promotes continued transformation of intercity passenger rail in America. In last year's budget, the administration demanded reform. America needs a sustainable framework for convenient, high-quality passenger rail service, and over the past year both Amtrak and the Congress have responded. Amtrak developed a strategic reform plan that seeks to restructure the company and introduce route competition. Through the fiscal year 2006 appropriation, Congress included measures to address Amtrak's money-losing sleeper car and food and beverage services, among other efficiency measures. Together, these reforms will help Amtrak realize meaningful savings this year, and therefore reduce its need for Federal subsidies.

In recognition of this progress—and with the expectation that we will see much more by the end of fiscal year 2006—the President's fiscal year 2007 budget requests \$900 million to help Amtrak make the transition to a new and better model of intercity passenger rail. Of this amount, \$500 million will provide for capital needs and maintenance of existing infrastructure, including the Northeast Corridor. The remaining \$400 million will fund new "Efficiency Incentive Grants" tied directly to continued progress toward reform. In addition, our plan assumes continuation of the legislative initiative begun in 2006 that would assess fees for capital investment and maintenance costs by transit agencies for their use of the Northeast Corridor. We recognize that this budget will require Amtrak to accelerate its efforts to address its costs, but we believe the recommendations recently made by the Government Accountability Office and the Department of Transportation Inspector General, as well as the company's own strategic plan, provide a roadmap for success. While much work remains to address Amtrak's serious and well-documented problems, we believe the fiscal year 2007 budget will encourage progress and promote efforts to move to a more sustainable system.

#### MARITIME PROGRAMS

The President's plan includes \$154 million to fully fund the Maritime Administration's Maritime Security Program. This fleet of 60 active, militarily useful vessels manned by U.S. mariners is critical to the support of our troops abroad. The President's budget also includes \$62 million for the U.S. Merchant Marine Academy, of which \$15 million is for capital investment improvements at the Academy.

#### RESEARCH, PIPELINES, AND HAZARDOUS MATERIALS SAFETY

Approximately 15 months ago, Congress enacted the Department of Transportation's reorganization proposal to create the Pipeline and Hazardous Materials Safety Administration (PHMSA) and the Research and Innovative Technology Administration (RITA).

PHMSA is responsible for the safety of almost one-third of all products shipped each year and two-thirds of all energy products consumed. This includes the packaging, shipment, and handling of all hazardous materials by highway, rail, water, and air, as well as the movement of energy products by pipeline. The 2007 budget provides \$149 million for PHMSA's operations, including \$75.7 million for pipeline safety, \$27.2 million for hazardous materials safety, and \$28.2 million for emergency preparedness grants.

RITA has brought new energy and a focus on the Department's research efforts, and is working to expedite the implementation of cross-cutting, innovative transpor-

tation technologies. The President's 2007 budget request includes \$8.2 million in direct funding, plus an additional \$27 million from the Highway Trust Fund for the Bureau of Transportation Statistics, to continue these efforts. In addition, RITA will undertake over \$300 million in transportation-related research, education, and technology application on a reimbursable basis.

#### DEPARTMENT OF TRANSPORTATION HEADQUARTERS BUILDING

Finally, I want to highlight the fiscal year 2007 President's budget request of \$59.4 million for the new Department of Transportation headquarters building project. The goal is to complete the consolidation of the Department's headquarters' operating functions, excluding the FAA, into a facility at the Southeast Federal Center in fiscal year 2007. The requested funds will cover DOT's tenant-related costs, including security and telecommunications equipment and the infrastructure to support it. The end result will be a facility that provides modern office technology, enhanced communications, a quality work environment, and updated security systems for more than 5,000 Federal workers.

The President's budget request reflects a fiscally responsible plan for the Department of Transportation to help America meet its 21st century transportation needs. To ensure that the Department is exercising sound stewardship over the financial resources entrusted to us, we continue to focus on program performance to maximize efficiency and create a results-oriented Government. Together with the Congress, and with our public- and private-sector partners, we are revolutionizing transportation to keep America moving.

Thank you again for the opportunity to testify today. I look forward to working closely with all of you, and with the entire Congress, as you consider the fiscal year 2007 President's budget request. I will be pleased to respond to any questions you may have.

#### FREIGHT TRANSPORTATION

Senator BOND. We are going to have to do a quick round and move on to the FRA, but one of the first things I have is a growing concern about freight transportation capacity. Your Bureau of Transportation Statistics estimates freight volumes in tons will increase by 70 percent by 2020. We have roughly the same highway miles and we have 40 percent fewer rail miles. We are watching our inland water infrastructure become obsolete, inefficient, and outdated. How much concern do you have that in the decades ahead, if we don't plan and do something more for transportation, there will be a straightjacket on our economy, frustrating competitiveness, growth, and job creation?

Secretary MINETA. There is no question that the increase in trade in the next 20 years is going to be a very large impact on the transportation system, and that is why the Safe, Accountable, Flexible, Efficient, Transportation Equity Act; A Legacy for Users (SAFETEA-LU) legislation is so important. It brings back what we started in the Intermodal Surface Transportation Efficiency Act of 1991 (ISTEA), and that was the I, intermodal. Today, we know that given the large inflow of transport into the country through maritime trade, loads go onto rail and onto the highway. What we are trying to do through SAFETEA-LU is make sure that the intermodal freight gateway connection is coordinated.

Given limited financial resources, SAFETEA-LU includes financing mechanisms other than the traditional Highway Trust Fund that we rely on, such as the Transportation Infrastructure and Innovation Act (TIFIA), State Infrastructure Banks (SIBs), private activity bonds, and other financing mechanisms where we want more people to come to the table with public-private partnership programs.

Senator BOND. As more intermodal freight becomes available and increases that burden, you are looking at taking the overseas shipments and putting them on rail and highways, which are overcrowded. Given the fact that one single medium-size barge tow can carry the freight of 870 trucks, shouldn't we be looking at the increasingly important option to maintain the efficiency, relieve congestion, conserve fuel, and reduce air emissions by bringing our inland waterways up to speed?

Secretary MINETA. Absolutely, and that was one of the first things I undertook when I became Secretary of Transportation in 2001. We already had the Wendell H. Ford Aviation Investment and Reform Act (AIR-21) to take care of aviation. We had the Transportation Equity Act for the 21st Century (TEA21) as it related to surface transportation needs. One of the things we proposed was a SEA-21 program to deal with short-sea shipping on the east, west, gulf coasts and the inland waterway system. That program is now before the Office of Management and Budget (OMB) and we are hoping that we will be able to get that out, because it is part of our total marine transportation system.

#### INTERCITY PASSENGER RAIL SYSTEM

Senator BOND. I would hope, Mr. Secretary, with your broad understanding of transportation that we can mark you down as a supporter of the Water Resources Development Act, which OMB treats like an illegitimate child at a family reunion.

I wish to address one Amtrak question. I would like to know how you see your responsibility for Amtrak. I am concerned about the debt. I am concerned about reforms that will require elimination or cut-back. What do you see as your role and what do you expect to achieve in your position as the Secretary of Transportation with overall responsibility for the area?

Secretary MINETA. First of all, there is a need for an intercity passenger rail system. What the administration and I are trying to do is give a long-term, sustainable future to intercity passenger rail. The present model can't do it. You recognize that when you see first-class sleeper service being subsidized to the extent that it is, and in terms of some passenger rail services where the subsidy may be \$450 to \$500 per passenger. There are areas like food services, first class sleeper services, and other areas where they do need change.

What we are trying to do is bring reform that will give long-term financial sustainability to an intercity passenger rail system. Last year, we requested no funding for Amtrak. We submitted our reform measure in 2003, 2004, and 2005, but no action was taken on the reform measure. So OMB said, okay, let us get their attention. We will request zero funding for fiscal year 2006 until we get reform. We got Congress' attention.

We attempted a three-prong approach: the authorizing committees; the Appropriations Committee; and the Board of Directors. The House authorizing committee provided a \$2 billion a year, 6-year program, but no reforms. In the Senate, we got an \$8 billion package over 5 years, or \$1.6 billion per year for 5 years; it had some reforms in it. The proposal went on the budget reconciliation

bill, but then it got pulled in conference and that reform effort failed.

So then we were dependent on the Appropriations Committees. You folks did come back with reforms, plus the actions of the Board brought about sufficient reform. OMB recognized this effort and we included \$900 million in this year's budget. We are looking for further reforms, and for that there will be additional monies forthcoming.

Senator BOND. Mr. Secretary, thank you very much. You may have had a black and blue spot on your jaw, but we lost a pound of flesh in this subcommittee, and so to follow up on these questions, I believe that Senator Murray may have some questions to ask.

Senator MURRAY. I certainly will, and unfortunately, our time is limited, but I know well that the Secretary, as a former member, knows that the authorization committee has to make those rules, not the Appropriations Committee, and I think the Secretary has a pretty strong history in the House of ensuring that that occurred, so I hope that is where you are leaning, Mr. Secretary.

Secretary MINETA. Well, you are right, absolutely right. We will keep trying.

#### FEDERAL AVIATION ADMINISTRATION

Senator MURRAY. Let me ask you about the FAA because the FAA expects 73 percent of its air traffic controllers to retire over the next 10 years, and as part of last year's appropriations bill, we fully funded your request to hire an additional 595 air traffic controllers and we provided an extra \$12 million that you did not request to try to fill some of those vacancies in the ranks of the aviation safety inspectors. These are perhaps the most critical safety positions in the entire FAA, and unfortunately, as you know, the across-the-board cut was imposed in the defense appropriations bill that impacted that funding somewhat.

But it is now the middle of March. We are almost halfway through this fiscal year, and ever since the new year began, our subcommittee has been trying to find out how many new air traffic controllers and safety inspectors you will actually be hiring this year. Your Department has not been able to give us a straight answer to address that issue and I can't help but be concerned that if your Department doesn't have a plan yet halfway through this year for dealing with this critical safety question, that we are either endangering safety or you are incapable of managing your people.

So, Mr. Secretary, can you tell this committee precisely how many air traffic controllers and how many air safety inspectors you will be hiring this year?

Secretary MINETA. We are adhering to the congressional plan. As I recall, the plan was for 1,129 air traffic controllers.

Ms. SCHEINBERG. I believe it was originally 1,249.

Secretary MINETA. I am sorry, the plan was originally for 1,249 air traffic controllers, and there is no plan for inspectors. But in any event, we are geared toward the congressional plan.

Senator MURRAY. Well, how many—

Secretary MINETA. The 1 percent across-the-board rescission has impacted the FAA, plus the fact that we have to absorb pay raises from within the budget. In fiscal year 2006, as I recall, we have to absorb close to 1 percent of the pay raise.

Senator MURRAY. We actually gave you 12——

Secretary MINETA [continuing]. Two-point-two——

Senator MURRAY. We gave you \$12 million more than you requested——

Secretary MINETA. It was a 3.1 percent pay raise——

Senator MURRAY [continuing]. So even with the across-the-board cut and with the other factors that you put in place, we should be on a road to do this? I am deeply concerned that we have not yet been able to get from your office the workforce plan. You have to hire these critical safety inspectors that we need on the ground, so when our public flies, they know their planes have been inspected, and air traffic controllers, who, as you know, are retiring at a much higher rate than you are now hiring.

Secretary MINETA. Well, our plan on air traffic controllers was 1,249 and the number of inspection for flight standards and aircraft certification personnel Congress funded to be hired is 238. That is the congressional plan that was——

Senator MURRAY. If you could get back to us within the next week here how many you have actually hired and exactly, over the course of the next few months, how many you are in the process of hiring——

Secretary MINETA. Absolutely.

Senator MURRAY [continuing]. I think it is important for us to know.

Secretary MINETA. We will do that for the record.

[The information follows:]

With regard to air traffic controllers, in December 2004, the FAA published “A Plan for the Future: The Federal Aviation Administration’s 10-Year Strategy for the Air Traffic Control Workforce.” This document outlined the agency’s plans to hire and train controllers based on actual results and changes in traffic forecasts since 2004. In the December 2004 report, FAA estimated the need to hire 1,249 controllers in fiscal year 2006 with estimated losses of 654 controllers for a net gain of 595 controllers. This estimate was based on traffic forecasts produced in March of 2004. Based on the March 2005 forecasts, FAA reduced the number of planned hires in fiscal year 2006 from 1,249 to 1,129. Since that time, in March 2006 new aviation forecasts were released resulting in further reductions to the number of planned hires in fiscal year 2006 from 1,129 to 930 controllers with losses of 800 for a net increase of 130 controllers in fiscal year 2006.

Unlike the air traffic controllers, there is no FAA staffing plan for hiring safety personnel. For fiscal year 2006, FAA requested funding for 97 additional safety personnel in flight standards and aircraft certification. Congress increased funding for FAA safety personnel to a total of 238 in fiscal year 2006, or a net increase of 141 personnel from the FAA request. As a result of the 1 percent rescission and unfunded pay raise in fiscal year 2006 (\$13.9 million), FAA planned to hire only 87 additional safety personnel. However, in keeping with the Congressional desires to increase safety personnel above the FAA requested level, the Department submitted a reprogramming request to Congress to use lapsed funds in fiscal year 2005, in addition to transfers from other lines of business, to fund an additional 84 staff in safety surveillance oversight in fiscal year 2006. FAA anticipates hiring a net increase of 171 safety personnel in fiscal year 2006, or 67 less than the level requested by Congress.

## FAA REAUTHORIZATION

Senator MURRAY. All right. The authorization of the Aviation Trust Fund, as you know, expires at the end of fiscal year 2007 and we have not yet heard the administration's views on the future of aviation financing. The Air Transport Association supports a plan that would charge a fee to every user of the air traffic control system. The general aviation community responded quickly opposing user fees. We were told to expect the administration's plan to be released sometime this month, in March, and as I said, this month is half over. Can you tell us when we are going to see the administration's new proposal for aviation financing?

Secretary MINETA. We have submitted it to OMB. I don't think it will be out by the end of this month. I would say within a month, it will be completed.

Senator MURRAY. Well, what is your—

Secretary MINETA. So I would say by the—I am sorry.

Senator MURRAY. Since you have submitted it to OMB, can you give us your general response to the proposals that have been put forward by the Air Transport Association?

Secretary MINETA. Until OMB approves the plan, I am not able to say where we are going on it.

Ms. SCHEINBERG. Senator Murray, our proposal has significant changes to the current financing of the FAA, and as a result, OMB has put the proposal through interagency clearance. There are significant issues that the Department of Treasury and other agencies are contemplating. This is not a single-agency review; we have been talking with these other agencies and trying to iron out the plan.

Senator MURRAY. Okay. Well, let me ask you one very specific question. The proposal of the Air Transport Association appears to eliminate the role of this committee in overseeing the FAA as well as directing Federal funds for the operation and modernization of the FAA.

Secretary MINETA. I am sorry, the ATA—

Senator MURRAY. The ATA proposal appears to eliminate this committee's oversight of the FAA and I want to know whether your proposal is going to change the role of this committee.

Secretary MINETA. No, not at all.

Senator BOND. Thank you very much, Senator Murray. This committee goes by the FIFO rule, but since we have been joined by the distinguished chairman of the full committee, I might ask, since he has multiple responsibilities, if he would like to go next.

## STATEMENT OF SENATOR THAD COCHRAN

Senator COCHRAN. Mr. Chairman, thank you. I appreciate the opportunity to join you and the other members of the subcommittee in welcoming the distinguished Secretary of Transportation and his Chief Financial Officer to our committee hearing. We appreciate your good assistance as you carry out your duties. Over the last 5 years, you have demonstrated a great amount of competence and you have devoted an enormous amount of effort to helping to protect and expand our Nation's transportation assets. We appreciate your very outstanding work.

Secretary MINETA. Thank you.

Senator COCHRAN. I might add, too, we thank you for your timely assistance to the airports in the gulf coast region, which suffered enormous damages as a result of Hurricanes Katrina and Rita. We are recovering. We are rebuilding. But it wouldn't be possible without the strong support of you personally and the other members of this administration. We appreciate that help very much.

Secretary MINETA. Thank you very much, sir.

Senator COCHRAN. Thanks, Mr. Chairman.

Senator BOND. Thank you very much, Chairman Cochran.

Senator Bennett.

#### STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

Mr. Secretary, I would be remiss if I did not once again thank you and commend your Department for all of the support you have given to public transportation in the State of Utah. I sit on the Banking Committee, which authorizes public transportation and mass transit, and it is always fun, as the Senator from a State perceived to be a rural State—actually, we are one of the most urbanized States in the Nation—to hear Senators on the Banking Committee from Eastern States always talk about urban transit and say, why can't we do it as well everywhere as we are doing it in Salt Lake City?

That always makes me feel good and it is because of the partnership that has been built with the people in Utah and the staff at FTA. I need to continually thank you and them for the cooperative way in which we have worked on that. We like being the example that people point to.

My favorite story, Mr. Chairman, there is still a hard-core group in Utah that opposes mass transit and they held a rally in downtown Salt Lake City, and in the notice for the rally, they said, this will take place during rush hour, so if you want to be sure to get there on time, take mass transit in order to be there.

#### INTERCITY PASSENGER RAIL

Mr. Secretary, do you really think we have got a shot at making Amtrak finally work? It has been around for so long. I have heard so many stories over the years about, well, this is the year that we are going to get Amtrak under control. This is the year that Amtrak is going to finally deal with its debt burden. It is going to finally get its service where it ought to be. I hear your optimistic statements and I read them. I have been reading through the material that is available to us. It all sounds good. Just give me your gut reaction as to where we are in Amtrak.

Secretary MINETA. Amtrak reform is not going to be done in a short period of time. As an example, in our reform measure we asked that the Northeast Corridor assets be turned over to the Department of Transportation. We would then take 6 or 7 years to bring it up to a good state of affairs. In the meantime, we would form a consortium of the Northeast Corridor States to which we would then be able to turn back those assets. The other part of the program would be 50 percent capital partnership with the States on capital improvements.

It is a journey that starts at some point. That point is going to be when we get the reform measures in place on the structure of Amtrak, based on the principles in our reform measure. It requires those principles to be embraced in legislation, or in terms of Board practices, and laid out over a number of years to transform Amtrak into a sustainable, well-functioning intercity passenger rail system.

Senator BENNETT. I agree absolutely that we have to have a functioning intercity rail passenger system in those parts of the country where it makes sense. Every year at these hearings, I say this, and every year at these hearings, or after these hearings, there are nasty letters to the editor about me in the Salt Lake papers.

The Northeast Corridor Amtrak rail passenger service, absolutely essential. We could not sustain the impact of dumping that many passengers on the highway or trying to cram them into airplanes. I think the total number of people who debark Amtrak in Salt Lake City is less than a dozen a week. Now, I may be off by an order of magnitude. It may be 120 a week. But the cost of maintaining that kind of service over those kinds of distances simply doesn't make sense to me.

I see the Senator from Illinois is here. It may make sense from New York to Chicago. That is outside of the Northeast Corridor. It may make sense from Los Angeles to San Francisco. But I hope as we look at the Amtrak long-term, we recognize that in order to have, paraphrase it just a little, in order to have mass transit make sense, you have to have the mass that needs to be transited.

Given the distances we have in this country, intercity passenger service in the Northeast Corridor or perhaps between New York and Chicago, you do have the mass that needs to be transited, but the mass coming from, let us say, Denver to Salt Lake City that is currently handled by train is not enough to justify the kinds of expenditure that the taxpayers are being called upon to provide.

Thank you, Mr. Chairman.

Secretary MINETA. You are absolutely correct, Senator, and the No. 1 principle, as I recall, in our reform proposal is to make economic sense and congestion sense. Yes, sir.

Senator BOND. Thank you very much, Senator Bennett.

Senator Durbin.

#### INTERCITY PASSENGER RAIL

Senator DURBIN. Thank you, Mr. Chairman.

Secretary Mineta, thank you for being here. You have given a lifetime to public service as a mayor and Member of the House of Representatives and in the President's Cabinet and I thank you for that.

Secretary MINETA. Thank you.

Senator DURBIN. I am happy to count you as a friend. But I want to ask you some questions following up on Senator Bennett's questions.

I can't figure out where this administration is when it comes to Amtrak. Last year, you zeroed it. Congress came back and said, no. We passed an authorization bill for Amtrak in the Senate by a vote of 93 to 6 and an appropriation bill of \$1.3 billion, which we felt might be adequate to keep Amtrak functioning.

Six days after we passed the authorization bill, Mr. Gunn was dismissed as the head of Amtrak. I think that was a serious mistake. I think he has been one of the most level-headed administrators in the history of that operation. He was totally apolitical, as I saw it, and maybe that is what cost him his job. He has not been replaced, as I understand it, as of today, which is a sad commentary on Amtrak's administration and management. If the administration is clearly dedicated to reforming Amtrak, then you need an engineer in that locomotive and you don't have one at this moment.

Secondly, the budget request this year just leaves me cold. It is as if someone is drowning 50 feet offshore and you throw them a 25-foot rope. That is what has happened this year with this \$700 million request. We know, I think reliably so—I am sorry, \$900 million request. We know, reliably so, that Amtrak needs about \$1.6 billion to maintain operations and to make critical investment, to conform with the Americans with Disabilities Act and other legal requirements. Absent that kind of basic capital investment, there is no way they can maintain schedules and ridership.

In my State, it is personal. We are deeply committed to Amtrak. The State of Illinois has made a commitment of \$12 million-plus to Amtrak on an annual basis because we value it so much. So it isn't as if we are begging from the Federal Government or asking without coming up with something locally. It is essential to us in terms of the passengers that are served when we have, I think, 2.5 million passengers in the course—yes, 2.5 million passengers ticketed through Chicago on Amtrak in the year 2005.

So my basic question to you, Mr. Secretary, is this. Is it the administration's intent before they leave office to let Amtrak slowly wither and die on the vine, or are you willing to work with people of good faith and good will who are trying to make the necessary investments so that Amtrak has a future? I can't argue for Senator Bennett's situation in Utah because I don't know it, but I do know the situation in Illinois. Amtrak is essential to down-State residents as well as those in the Chicagoland region, and we are fearful that the administration's goal is to close down Amtrak as we see it, or to diminish the investment in Amtrak that is necessary for its future. I would like to ask you to comment, please.

Senator BENNETT. Senator, I have been trying to give our Amtrak dollars to you for years.

Senator DURBIN. We are still willing to take them, too.

Secretary MINETA. We are very committed to an intercity passenger rail system, but the present structure isn't going to give us a long-term, viable intercity passenger system that is sustainable. That is why people say, "Mineta, why are you trying to kill Amtrak?" Frankly, if I wanted to kill Amtrak, I would do nothing. But we are working to formulate a financial and public policy to deal with Amtrak in the long-term.

I wish we could get over the hump of other people saying we are trying to kill Amtrak. Rather, we are trying to build Amtrak, or some kind of an intercity passenger rail system, for the future. That is why in our proposal, we commit to a 50 percent capital improvement program partnership with the States. As examples, there are Oregon and Washington with service to British Columbia,

the California system, and the Northeast Corridor. There are also the States themselves, as former Governor Kit Bond talked about his commitment to rail in the State of Missouri.

Today, there is a Midwest Railroad Initiative made up of Michigan, Illinois, Wisconsin, Minnesota, Iowa, Indiana, Ohio, Missouri, and Kansas. Those States are putting into their rail operation, as I recall, somewhere around \$30 million. They are doing that totally with State money. We are willing to work with the States and come up with a 50–50 partnership for their capital programs.

In our reform package, we are trying to follow the model currently used to finance transit, highway and airport capital projects. Those are all partnership programs.

Senator DURBIN. Mr. Secretary, if I could just—I know my time is up, and I don't want to prevail on the committee any longer other than to suggest that Illinois has already invested \$250 million in upgrading Amtrak. We have made a commitment. We are not just there with our hands up to the Federal Government. And a \$12 million annual commitment to the operating expenses of Amtrak in our State. We believe it is essential for our economy.

I don't believe we can have a realistic and cogent energy policy in America that does not include mass transit and rail transit, including Amtrak, in circumstances like Illinois. To put more cars on the road is not going to in any way reduce our addiction to oil in this country. So I hope that the administration will work with us in Congress to try to find the right funding level so that Amtrak doesn't just survive another year, but starts to build for a more successful future.

Secretary MINETA. Well, I think—

Senator BOND. Thank you very much, Senator Durbin, and regrettably, since we do want to get this next panel up and have them testify, because our votes are starting, I am going to stay here as long as I can, I want to hear what the Amtrak panel has and I will submit a whole bunch of questions on AIP, why you took the \$100 million out of existing funds, what are the other options that States may pursue on Amtrak and Open Skies.

But thank you very much, Mr. Secretary, and we will be continuing our dialogue with you and now we would like to invite the second panel.

#### ADDITIONAL COMMITTEE QUESTIONS

Secretary MINETA. We will submit for the record responses to the questions sent by the members. Thank you very much, Chairman Bond and members of the committee.

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

#### QUESTIONS SUBMITTED TO THE DEPARTMENT OF TRANSPORTATION

##### QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND

##### TRANSIT SMALL STARTS

*Question.* Mr. Secretary, in light of the Advanced Notice of Proposed Rulemaking issued by FTA last month regarding Small Starts, how will you ensure that the Small Starts program has the right balance between oversight and flexibility of funds? This program could be a great resource for small transit authorities or those

that are lacking the financial resources to devote to large scale mass transit projects. However, my concern is that if the Department creates too much bureaucratic red tape, it may defeat the purpose of providing a grant program for smaller transit projects.

Answer. The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU) provides Small Starts funding to projects with total costs not exceeding \$250 million and New Starts funding of less than \$75 million. Each project must conduct an alternatives analysis and be approved to enter project development based on requirements in a reduced set of criteria for Small Starts project justification compared to traditional New Starts projects.

The Advanced Notice of Proposed Rule Making (ANPRM) issued January 30, 2006, addresses both reduced requirements on grantees and the need for projects to be well justified. The requirements are scaled to the size and complexity of the project so that simple projects at lower cost require less effort to demonstrate their worthiness for funding while larger projects are required to perform more analysis. To highlight these differences in justification the Federal Transit Administration (FTA) has proposed a category of projects that are justified for funding by virtue of their physical characteristics, cost limitations and existing ridership. This category is called "Very Small Starts." Projects that qualify for this category also rate well for each of the project justification criteria in SAFETEA-LU; therefore, no detailed assessment of transportation benefits is necessary, saving project sponsors significant time and costs for analysis. The specific project characteristics for Very Small Starts have been defined in FTA's proposed interim guidance for Small Starts that was issued on June 9, 2006.

Additional reductions in requirements for Small Starts funding are for alternatives analysis studies and for effort to produce information for evaluation. It is anticipated that alternatives analysis studies will be simpler than those for traditional New Starts because areas considering smaller projects will have a limited number of alternatives that need to be examined and the settings for the projects could involve less analysis. The tools needed to forecast transportation benefits could also be simpler to develop and apply as described in the ANPRM. These efforts are aimed at reducing Federal "red tape" while ensuring project benefits and financial capacity can be met so that only meritorious projects go forward.

#### BUS RAPID TRANSIT

*Question.* Mr. Secretary, in terms of providing more cost-effective solutions to traffic congestion, Bus Rapid Transit appears to be a great alternative to the expensive capital costs associated with building or expanding light and heavy rail mass transit systems. Are there any new ideas coming from the Department to make Bus Rapid Transit more efficient in terms of operating? Is anything being done to make BRT more attractive to transit authorities throughout the country?

Answer. While each transit mode has its place, Bus Rapid Transit (BRT) generally offers an attractive solution where there are dedicated or segregated travel lanes, well-designed bus stations with level boarding, multiple doors for entry and egress onto large platforms, and less frequent stops as opposed to minimally equipped and frequent bus stops, off-board fare collection, transit signal priority and queue jumping at intersections, timely and appropriate customer service information, and large comfortable buses that project a unique identity of the service.

The new Small Starts program makes available an additional source of funding for BRT projects, both with and without fixed guideways. Under the Small Starts category, certain "corridor-based bus capital projects" are eligible for funding. Projects are limited to those with proposed Capital Program funds of less than \$75,000,000 and a total project cost of less than \$250,000,000. The Proposed Interim Guidance and Instructions for Small Starts has been released recently for public comment. The project justification criteria are simplified, focusing on three criteria: cost-effectiveness, public transportation that is supportive of land use policies, and the effect on local economic development. The criteria for local financial commitment have been simplified to focus only on a shorter term financial plan. The project development process for Small Starts is a three-step process: alternatives analysis, project development, and construction, rather than the four steps for the more elaborate New Starts projects.

In cooperation with the National Bus Rapid Transit Institute, FTA has launched several information-gathering and outreach activities to promote BRT as a cost-effective alternative. FTA has been conducting several public outreach seminars and workshops to inform both transit agencies and the public on the attributes and benefits of BRT. FTA has also launched a program to update the document "Characteristics of Bus Rapid Transit for Decision Making" that was released in 2004 to add

advances made in BRT systems. The update is slated for release in late 2007. FTA has initiated cooperative working relationships with the U.S. Conference of Mayors and several non-profit organizations that are promoting BRT to share data and to extend the reach to more organizations, thereby resulting in greater interaction with the public in finding solutions for congestion mitigation in metropolitan areas.

FMCSA PARTNERSHIP WITH THE STATES IN IMPLEMENTING SAFETEA-LU PROVISIONS

*Question.* Mr. Secretary, as you well know, as a result of SAFETEA-LU, the modal Administrations in your Department that oversee surface transportation have a considerable job to do in implementing many of the provisions in that legislation in both a regulatory and grant framework.

In many cases, this requires a close working relationship and partnership with existing organizations representing State and local governments. It also requires the leveraging of resources and meeting venues with these groups. For example, this is accomplished in FHWA through its partnership with AASHTO. In public transit, it is FTA's partnership with groups such as APTA. In automobile safety, it is NHTSA's partnership with groups such as the Governor's Highway Safety Association.

With respect to motor carrier safety, it is my understanding that one group that the Federal Motor Carrier Safety Administration (FMCSA) should be working closely with is the Commercial Vehicle Safety Alliance (CVSA) whose membership consists of State motor carrier safety enforcement agencies and those in Canada and Mexico.

I have learned that FMCSA has chosen not to participate in one of the two international meetings that CVSA holds each year and that it has decided not to allow States to use MCSAP funds to attend CVSA meetings. This is troubling since FMCSA has a huge task in implementing SAFETEA-LU State motor carrier safety grant programs as well as the constant need to deal with safety and security issues at both our Northern and Southern borders. It is critical that FMCSA continue to maintain a consistent motor carrier safety and security policy throughout North America and involve the States in helping to make critical decisions since they are delivering the bulk of the motor carrier safety programs.

In light of this, Mr. Secretary, can you tell me why FMCSA is not better leveraging taxpayer dollars and meetings with those of CVSA?

*Answer.* The Federal Motor Carrier Safety Administration (FMCSA) and the Commercial Vehicle Safety Alliance (CVSA) have always worked closely and cooperatively to advance motor carrier safety on the Nation's highways. Through its Annual Spring Conference and the Fall Workshop, CVSA has provided a regular forum for State and Federal enforcement personnel and industry representatives to address critical issues confronting motor carrier safety. FMCSA values this relationship and will continue to participate in these forums. FMCSA leadership and staff will continue to work with State and industry members on CVSA's committees and will continue to participate on CVSA's Executive Committee at the Associate Administrator level. FMCSA is also meeting with CVSA's executive staff monthly to address immediate safety concerns and define issues for scheduled CVSA membership meetings.

Over the past few years, DOT has focused increasingly on being an effective steward Federal grant funds. As a result, FMCSA has taken a more direct leadership role with its State partners to ensure grant funds are being applied with the highest safety benefit. On February 1, 2006, FMCSA sent a letter to each State outlining the use of Motor Carrier Safety Assistance Program (MCSAP) funds for CVSA meetings. The letter stated fiscal responsibility dictates that grant funds could be used for two national meetings with our State partners each year—a CVSA conference and an FMCSA Annual MCSAP Conference. The effective date of the new policy was delayed until fiscal year 2007 to provide CVSA with an adequate planning period. In May 2006, FMCSA conducted its MCSAP Conference. Invitations were issued to the director of each State's lead agency in order to build a more effective working relationship with policy-level decision-makers. During the 2-day meeting, presentations focused on SAFETEA-LU provisions and guidance to the States on implementation of the new congressional requirements. The feedback received from that meeting indicates an overwhelmingly favorable response for continuance which FMCSA intends to do annually.

Nearly half of FMCSA's budget is dedicated to grant programs to fund vital State enforcement and educational efforts. For that reason, FMCSA also works with other critical groups such as the American Association of Motor Vehicle Administrators (AAMVA), the International Association of Chiefs of Police (IACP), and the American Association of State Highway and Transportation Officials (AASHTO) to advance commercial motor vehicle safety.

## OPEN ROADS FINANCING PILOT PROGRAM

*Question.* I am glad to see the administration's fiscal year 2007 budget adheres to the guaranteed highway funding levels called for in SAFETEA-LU. I feel strongly that we need to adhere to the commitments made to our States in that bill.

Along those lines, I am intrigued by your proposed Open Roads Financing Pilot Program. First of all, I am wondering why the administration did not suggest this concept while we were in negotiations on last year's highway bill. More fundamentally, I am concerned that you are in effect proposing to divert \$100 million that has been dedicated to surface transportation improvements to fund a series of initiatives that will not focus on infrastructure. I fully agree that we must begin to prepare for the transportation financing challenges of the future, and I look forward to seeing what the administration proposes in the way of revenue proposals for the aviation trust fund sometime this year.

If the Open Roads Financing Pilot Program is such a priority for the administration, then why aren't you proposing an additional \$100 million for this initiative rather than suggesting cuts elsewhere?

*Answer.* During the preparation of the fiscal year 2007 budget, the concept of the Open Roads Financing Pilot Program was developed to allow States to better leverage the resources provided in SAFETEA-LU and to inform the next reauthorization debate. The \$100 million in funding proposed for the program will assist up to five States in evaluating innovative ways and to demonstrate the benefits of more efficient methods of charging for the use of major portions of their highway systems. Successful alternatives will include innovative mechanisms that can augment existing sources of State (not Federal) highway funding, enhance highway performance, and reduce congestion. The administration believes the activities for this program should be funded within the guaranteed levels enacted in SAFETEA-LU.

## AIRPORT IMPROVEMENT PROGRAM

*Question.* The administration's budget proposes a \$765 million reduction in funding for the Airport Improvement Program. I recall that you requested a \$500 million AIP cut in last year's budget, which this subcommittee rejected. While I am concerned that we are going down this road again, I have a more substantive question about this proposal.

You have previously stated that your \$2.75 billion AIP recommendation would be sufficient to fund all currently planned airport construction projects. At the same time, your agency is forecasting passenger air travel will increase 45 percent from 738.6 million enplanements in 2005 to almost 1.1 billion in 2017. Given this dramatic growth in estimated travel, doesn't it make sense to begin expanding aviation infrastructure capacity right now to prepare for the future, rather than simply attempting to cover the minimum amount of investment needed today?

*Answer.* The decision to request an Airport Improvement Program (AIP) funding level of \$2.75 billion reflects the tough realities of the present budgetary climate. We took a hard look at the level of AIP funding that would be needed to meet our highest priorities and to keep the national airport system safe, secure and efficient.

At the proposed \$2.75 billion funding level, the Federal Aviation Administration (FAA) will be able to fund all high priority safety, capacity, and security projects. The FAA will be able to: fund all of its current and anticipated letter of intent commitments; improve runway safety areas; help airports meet their Part 1542 security requirements; and, continue work on phased projects.

For the longer term, the FAA is reviewing the current and future structure and level of AIP in the context of reauthorization. AIP provides 20–25 percent of airport capital funding needs nationally. Therefore, the FAA is working to develop an AIP funding proposal that assures sufficient Federal funds to meet high priority airport capital funding needs that cannot be met through other sources.

## RULEMAKING ON SINGLE OCCUPANCY HYBRID ELECTRIC VEHICLE ACCESS TO HOV FACILITIES

*Question.* What is the status of DOT's rulemaking on single occupancy hybrid electric vehicle access to HOV facilities? Has DOT consulted with EPA to determine vehicle criteria and requirements for single occupancy hybrid electric vehicle access on High Occupancy Vehicle lanes? Has EPA provided DOT vehicle certification, and guidelines and procedures for vehicle comparison and performance calculations, as required by the law? How is DOT enforcing State compliance with the HOV facility provisions in the new Federal highway law? What is DOT advising States like California and New York that have established HOV lane single occupancy vehicle exemptions in violation with Federal law?

Answer. Section 1121 of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU) adds section 166 to title 23 of the United States Code. Section 166(e) requires the Environmental Protection Agency (EPA) to issue regulations concerning the certification and labeling requirements for low emission and energy-efficient vehicles and to establish guidelines and procedures for making the fuel efficiency comparisons and performance calculations described in new section 166(f). Section 166(f) establishes the minimum percentage gains in fuel efficiency that vehicles must achieve in order for States to be able to allow them to use an HOV facility. EPA certifies the percentage gain in fuel economy that qualifies vehicles under this subsection. A State may require a higher percentage gain in fuel economy than the Federal minimum. The Federal Highway Administration (FHWA) is working with EPA on this rulemaking.

The statute is effective immediately, but the EPA rulemaking is not expected to be completed until the end of 2006. Thus, FHWA has granted conditional approval to States that demonstrate reasonable compliance with the SAFETEA-LU requirements. To date, conditional approvals have been provided to New York and California. FHWA recently clarified that both California and New York must ensure that more stringent fuel economy standards are based on a percentage gain in fuel efficiency and that these States must work toward correcting any inconsistencies with this requirement. Other States that wish to allow low emission and energy-efficient vehicles to use HOV facilities now may request a conditional approval on a similar basis. The programs that are conditionally approved may have to be changed to comply with the EPA final rule when that rule is issued.

#### NPRM AND OPEN SKIES

*Question.* Secretary Mineta, one contentious issue that has emerged in a number of areas of late is the question of ownership and foreign control. Can you please explain for me the relationship between the notice of proposed rulemaking (NPRM) on "actual control" and the status of the Open Skies agreement between the United States and the EU?

Answer. The goal of the NPRM proceeding is to realize the commercial and public benefits obtained by providing the airline industry with greater access to global capital markets, while ensuring that U.S. citizens remain in actual control of U.S. airlines. We are proposing to modify our interpretation of "actual control" because a change in the historic interpretation appears to be long overdue and in the best interests of the U.S. airline industry and the American public. The European Union has made it clear that it will not move forward on the agreement until it has the opportunity to assess the final outcome in DOT's "actual control" proceeding. However, this rulemaking was initiated, and is being pursued, based on its own merit.

#### AMTRAK

*Question.* Why does Amtrak not have a detailed multi-year financial plan? Wouldn't this planning document, similar to a TIP, or transportation improvement plan, help Amtrak identify year-to-year, what priorities for improvements are necessary to be made and help in the budget process?

Answer. Amtrak has regularly developed multi-year investment plans in the past. The problem is that these plans have been developed in isolation, without involvement from the States, who are key drivers in planning for other modes of transportation. In addition, these plans have been built on unrealistic assumptions, not the least of which is that the Federal Government would fund whatever Amtrak asked for regardless of efficiency and/or effectiveness of Amtrak's proposed investments. In recognition of the need for meaningful plans, the Federal Railroad Administration (FRA) has made as a condition of its grant agreement with Amtrak the development of an infrastructure investment plan with substantial involvement of the States and other users of the infrastructure. FRA has also directed Amtrak to develop plans for improving the financial performance of long-distance trains and for identifying its equipment needs. If these requirements are satisfied, they can become a major part of the foundation for the detailed multi-year financial plan that is needed.

*Question.* Realizing that Amtrak needs approximately \$295 million to address its mandatory debt service, and zero is provided in this year's budget proposal, how would you propose to address the debt?

Answer. The Federal Government does not guarantee the repayment of any of Amtrak's current debt. In this, Amtrak is the same as any other private company. Amtrak needs to look to its own resources, including the repayment of mandatory debt service.

## QUESTIONS SUBMITTED BY SENATOR MIKE DEWINE

## AIR TRAFFIC CONTROLLERS

*Question.* In 1999, the FAA cut the number of Air Traffic Control Supervisors by 700 positions. Since this reduction in supervisor staffing, the number of operational errors and runway incursions has increased, prompting safety concerns documented by the Department of Transportation (DOT) Inspector General in reports in 2000 and in 2003.

Reports accompanying the fiscal year 2004 and fiscal year 2005 transportation appropriations measures directed the FAA to increase supervisory staffing levels by 120 positions per year to a floor of 1,846 on September 30, 2005. Unfortunately, recent reports indicate that the FAA has not hired enough permanent supervisors to meet this floor. Finally, and most importantly, there appears to be a strong correlation between the number of supervisors and operational errors. The FAA's own fact book shows that as the FAA began to hire more supervisors in fiscal year 2004 and fiscal year 2005 in response to the committee's directions, the increase in the number of errors dropped significantly. The FAA Fact Book shows there were only 1,710 supervisors on April 1, 2005. Moreover, it is my understanding that when the FAA made efforts to reach the 1,846 floor by the end of the fiscal year 2005, it did so with temporary promotions of controllers into supervisory ranks rather than permanent hires.

Secretary Mineta, I have long been concerned about adequate supervisory staff for our air traffic control system, and the impact a lack of full-time supervisors has had on the safety of the flying public. In the past, this subcommittee has noted that as numbers of supervisors decreased serious operational errors and runway incursions have increased. We addressed this issue via committee reports in fiscal years 2002, 2003, 2004 and 2005. To fix the problem, Congress has mandated that the FAA have at least 1,846 supervisors on hand by September 30, 2005. What was the exact number of air traffic control supervisors on that date? Of this number how many were air traffic controllers temporarily appointed to supervisory positions? How many supervisors were in place on March 1, 2006? Were any of these supervisors temporary appointments? If so, how many?

*Answer.* The FAA believes the need to hire supervisors should be based on organizational requirements tied to the operation. FAA is facing several years of anticipated controller retirements and its source of hires for supervisors comes from existing controller ranks. FAA calculates the number of controllers it needs based on traffic volumes and other criteria. The number of supervisors is tied to the number of controllers, and traffic volumes, which have been down for the past few years. FAA's Controller to Supervisory Ratio on September 30, 2005 was 8.07:1 and is consistent with industry best practices.

On September 30, 2005, the FAA had 1,801 Operations Supervisors on board. Of this total, 72 air traffic controllers were temporarily appointed to supervisory positions during that month. On March 1, 2006, there were 1,749 Operations Supervisors on board. There were 9 temporary appointments to supervisor position in February 2006. On April 25, 2006 the FAA had 1,794 Operations Supervisors, an increase of 45 over the March 1st total. The controller-to-supervisor ratio on April 25th was 8.1:1.

*Question.* Secretary Mineta, the Department of Transportation's Inspector General Mead has repeatedly said that lack of adequate numbers of air traffic control supervisors has resulted in a dangerous rate of increase in controller operational errors and runway incursions. What is the FAA doing to fix this problem? Has the Department instituted a freeze on hiring/promoting new air traffic control supervisors, and if so, what has prompted this decision?

*Answer.* There has not been any decision to freeze hiring or promoting of new air traffic control supervisors. The FAA is continuing to monitor all causal effects of operational errors and runway incursions in its facilities.

## QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

## FAA'S TELECOMMUNICATIONS INFRASTRUCTURE

*Question.* I understand that the FAA's Telecommunications Infrastructure (FTI) management of the Air Traffic Controller communications system has been plagued with significant problems. For example, there have been three outages at O'Hare on 11 telecommunications lines between O'Hare and Elgin, two of which occurred in March of 2006.

The DOT Inspector General will soon release a report on the FAA's management of the FTI contract. To help put the findings and recommendations of that report in the proper context, please answer the following questions regarding the Air Traffic Control elements of that contract.

The current "Leased Interfacility NAS Communication System" (LINCS) uses TDM technology. Will FTI create a new network for Air Traffic Control to replace LINCS using modern packet-based technology? Will the Air Traffic Control part of the FTI system be more reliable than the existing LINCS system? If not, why spend more than \$300 million on a new system?

Answer. FTI implements a multi-services platform that provides a wide range of service offerings and enables the FAA to meet a range of challenges. FTI uses Time-Division Multiplexing (TDM) technology for services supporting critical Air Traffic Control operations. FTI uses packet-based technologies for non-critical Air Traffic Management applications to support the broad distribution of data required by those applications. Packet-based technologies provide a highly cost-effective means for enterprise-wide distribution of data because they are based on "postalized" pricing that is not distance sensitive. This type of capability is not available through the LINCS network.

FAA requirements for the FTI network call for six levels of service availability in contrast to the two levels of service availability provided by LINCS. The highest service availability level provided by the FTI network exceeds the highest specified availability level for the LINCS network.

Finally, it should be noted that the basis for the \$300 million capital investment is not solely to improve service availability, rather, it is to replace services provided by: (1) leased service contracts (e.g., LINCS) that are expiring; and (2) FAA-owned networks that are reaching the end of their economic lifetimes.

*Question.* Does the FTI contractor get paid when it installs FTI system elements, or when those elements have been tested and actually go into service?

Answer. The FTI contractor can bill for network infrastructure once it has been successfully tested and demonstrated its readiness to support the implementation of telecommunications services. There is a separate billing for individual services that takes place after they have been successfully tested and demonstrated as ready for FAA use. It is an FAA responsibility to cutover the service to actual use.

*Question.* Are the Department of Defense and Department of Homeland Security satisfied that the FTI currently meets the security and reliability standards for the DOD and DHS portions of the ATC communications network?

Answer. Yes. The FTI network complies with all current certification standards to include the latest versions of Federal Information Processing Standards (FIPS) 199 standards and National Institute of Standards and Technology (NIST) guidelines. When the FAA establishes a memorandum of understanding with other government agencies to provide telecommunications services, the specific guidelines and standards are identified by name to ensure a common security posture on the interfaces with those agencies. The FAA is already providing FTI services to DOD facilities and there have not been any issues with information security.

*Question.* An effective way to measure progress under the contract is by the number of LINCS switches and circuits which have been disconnected. From the beginning of the contract through February, 2006, what is the average number of disconnects per month? What is the highest number of disconnects in a given month? The FAA is still saying that the FTI transition will be completed by December 2007. From March, 2006 forward, how many disconnects per month need to occur in the LINCS system to finish the contract before the FAA's stated completion date?

Answer. The transition of services did not begin immediately upon contract award; rather, it began after the FAA achieved the In-Service Decision (ISD) milestone for the program in December 2003. In addition, it should be noted that the FAA's transition approach called for the program to trial run its procedures at two pathfinder sites. As a result, transition activities did not begin in earnest until the first quarter of fiscal year 2005. From that point to February 2006, there were an average of 78 disconnect orders issued per month. The highest number of disconnects in a given month occurred in the most recently completed month (March 2006) when 255 disconnect orders were issued. The number of disconnect orders per month has increased by more than 60 per month over the past 3 months. As of the end of March 2006, there were a total of approximately 1,550 legacy service disconnect orders issued since the FTI transition began.

While the number of legacy service disconnects is one measure of progress, it does not capture the full scope of the work effort. For example, while the transition of legacy services has proceeded, the FAA has also implemented over 800 new services directly onto the FTI network thereby avoiding additional investments in the legacy network infrastructure.

Finally, it should be noted that service disconnects are rate-limited by the number of legacy services transitioned to the FTI network and the number of service cutovers completed by the FAA. In recent months, the FTI contractor (Harris) has increased monthly service implementation rates by nearly 250 percent since the start of fiscal year 2006. In addition, the FAA has implemented a number of process improvements that resulted in an increase of 100 more service cutovers for each of the past 3 months.

As of the beginning of March 2006, there were approximately 13,000 LINCOS circuits remaining in operation. Based on this quantity, an average of approximately 590 services would have to be disconnected per month over the remaining 22-month period to achieve the planned completion of December 2007.

*Question.* When will the expected savings from the FTI contract recoup all the transition costs and first show net savings? Is that date before or after the end of the original 10-year contract in 2012? What will be the total net savings, after factoring in all the transition costs, over the first 10 years of the FTI contract, through mid-2012?

*Answer.* To clarify, there has been no change to the duration of the FTI contract. When the FAA first released the Screening Information Request to initiate the FTI procurement, the contract duration was set at 15 years. It has not been changed. With respect to the expected savings, the FAA projects that it will recoup all of the transition costs and reach the breakeven point by 2012. However, by as early as fiscal year 2008, it is projected that the FAA's total telecommunications service costs will be less than they would have been if the FAA had not implemented the FTI network.

Because the breakeven point occurs roughly in mid-2012, the total net cost savings will essentially be zero at that point. However, it should be noted that the FTI business case projects that FAA operating costs for telecommunications services will be \$129 million less in fiscal year 2012 than they would have been if the FAA had not implemented the FTI network.

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QUESTIONS SUBMITTED BY SENATOR PATRICK J. LEAHY

AMTRAK

*Question.* The most recent grant request from Amtrak indicates that the struggling railroad needs \$1.5 billion next year for capital and operational expenses. The President's budget request, though, only seeks \$900 million in total funding. Since we have heard the administration proclaim that it is dedicated to passenger rail nationwide, how does this budget request add up to that commitment?

*Answer.* It is important to separate the form of transportation—intercity passenger rail—from the provider of that service. The administration supports intercity passenger rail service as a component of this Nation's transportation system where it has the potential to enhance the mobility of our citizens. Unfortunately, the business model we use today to provide that service—Amtrak—is so flawed that that potential has not been realized. The administration is willing to invest in passenger rail service but not in an unreformed Amtrak. The \$900 million request reflects the administration's view that there has been progress in reforming intercity passenger rail service but much more progress is needed.

*Question.* My small State of Vermont has two State-sponsored trains—the Vermonter and the Ethan Allen Express. The State of Vermont paid \$2.65 million to cover the operating losses this year and is slated to pay \$4 million next year as Amtrak ramps up the share paid by the States. The Department of Transportation and Amtrak have said that they intend to develop public-private partnerships for the corridor service. How closely are you working with the individual States to improve equipment and service on these trains?

*Answer.* As part of this year's grant agreement, Amtrak was required to initiate a pilot through which a State, or States, could assume the responsibility for parts of the service they deem important to help assure that such service was provided with the highest quality and in the most cost-effective manner as possible. The Federal Railroad Administration (FRA) has been in contact with Vermont as it developed its response to this request for proposals which will result in improved service over the route of the Vermonter. Specifically, FRA anticipates that Vermont will soon apply for a loan under the Railroad Rehabilitation and Improvement Financing program to acquire new equipment that will provide more cost effective and frequent service. But this is just a pilot. For the long-term, the U.S. Department of Transportation (DOT) believes that a reformed system of intercity passenger rail service would work best if it is modeled after the successful partnerships between

the USDOT and the State DOTs that implement the highway and transit programs. In these programs, the States assume the lead for the planning and implementation of transportation projects they believe are most important. USDOT is a partner in these efforts, providing support for capital investments.

*Question.* I am also concerned about the lack of presidential nominations to the Amtrak Board of Directors. With three open seats on the seven-member Board and with the current Board members all holding the same party affiliation, what is the status of the President's process in filling the empty slots? I do not think any of us want to see a repeat of the secretive action that the partisan Board took last September to authorize splitting off the Northeast Corridor from the rest of Amtrak's operations.

*Answer.* The President has attempted to fill the vacant seats on the Amtrak Board. However, the Senate has not chosen to act on his nominations. In 2004, the President nominated four highly qualified persons to the Board including two who do not share his political affiliation, yet the Senate chose not to vote on the confirmation of any of these four. Currently, the President has nominated four highly qualified persons for the five existing vacancies on the Amtrak Board. Of these one does not share the President's political affiliation. I hope that the Senate will act timely on these nominations.

Also, to clarify, the Amtrak Board's vote last September did not authorize splitting off of the Northeast Corridor (NEC) from the rest of Amtrak's operations. Rather, the Board authorized an evaluation of structural options to segment the finances of the NEC so that Amtrak could better understand the revenues and expenses associated with those operations, which are significantly different than the rest of Amtrak's operations.

#### ESSENTIAL AIR SERVICE

*Question.* The President's budget requests only \$50 million for the Essential Air Service program—less than half of the \$110 million that was appropriated to the program by Congress last year. Since over 60 of the communities currently receiving EAS funding would be dropped from the program under the administration's proposal, the \$50 million funding level is clearly insufficient to meet EAS communities' needs. How do you believe that the Essential Air Service program can survive with only \$50 million in direct funding? How do you expect small communities around the country, like Rutland, Vermont, to be able to meet the 10–15 percent match you envision?

*Answer.* We are proposing a fundamental change in the way the government supports transportation services to rural America. The EAS program subsidizes scheduled air service to communities that received scheduled service at the time of deregulation in 1978. There have been tremendous changes in the industry since then, but the program has remained static. Many communities benefiting from this program have done little to help make the service successful. Requiring a modest contribution from these communities may energize civic officials and business leaders at the local and State levels to encourage use of the service.

For the most isolated communities, those more than 210 driving miles from the nearest large or medium hub airport, we propose to continue to subsidize air service to the extent of 90 percent of the total subsidy required. The least isolated communities, quantified as those that are within: (a) 100 driving miles of a large or medium hub airport; (b) 75 miles of a small hub; or (c) 50 miles of a non-hub with jet service would not qualify for subsidy for air service; however, they would qualify for a Federal subsidy of 50 percent of the total cost for surface transportation. At all other subsidized EAS communities, we would offer an array of options, including paying for 75 percent of the cost of the traditional EAS-type scheduled service.

In addition, we would work with the communities and State transportation departments to procure charter service, single-engine, single-pilot service, regionalized service, or ground transportation in cases where those options seem to be more responsive to communities' needs. Finally, our experience with the Small Community Air Service Development Program has been that small communities have been able to raise matching funds. In that regard, we note that the funds do not have to come from the city budget. Rather, the funds can come from the chamber of commerce, individual businesses, or even from the State. With these reforms, the Department's \$50 million budget request would keep the most isolated communities connected to the national air transportation system.

QUESTIONS SUBMITTED TO THE OFFICE OF INSPECTOR GENERAL, DEPARTMENT OF  
TRANSPORTATION

## QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND

*Question.* Why does Amtrak not have a detailed multi-year financial plan now? Wouldn't this planning document, similar to a TIP, or transportation improvement plan, help Amtrak identify year-to-year, what priorities for improvement are necessary to be made and help in the budget process?

*Answer.* We have previously indicated that Amtrak needs to do a better job setting priorities for its capital dollars. For example, in our Assessment of Amtrak's 2003 and 2004 Financial Performance and Requirements, issued November 18, 2004, we made this point and stated further, "For instance, programming millions of scarce capital dollars for fixing long-distance sleeper cars when bridges that Amtrak owns are beyond their functional and economic lives and must be refurbished or replaced is unacceptable."

Amtrak does produce lists of planned capital projects both for the upcoming year and for a 5-year period. The relative priorities among the projects on the lists are not clearly and explicitly stated. We believe it would be beneficial for Amtrak to publicly release a prioritized list of its capital projects, similar to a TIP, and, thereby, explicitly consider the tradeoffs among and competing demands for its limited capital resources.

*Question.* Realizing that Amtrak needs approximately \$295 million to address its mandatory debt service, and zero is provided in this year's budget proposal, how do you propose to address the debt?

*Answer.* The Department of Transportation is best able to provide the rationale underlying its budget proposal.

*Question.* What are you doing in terms of renegotiating your debt service rates?

*Answer.* Amtrak is best able to describe its activities in this area.

*Question.* The Inspector General's Office within the Department of Transportation has indicated that Amtrak's operating subsidy baseline is \$586 million. Amtrak's fiscal year 2006 operating appropriation is \$490 million. What specific savings has Amtrak identified to live within this amount?

*Answer.* Our third quarterly assessment of Amtrak's savings from operational reforms, dated July 13, 2006, provides a detailed description of Amtrak's planned operational reforms, their progress to date in implementing those reforms, and their progress to date in closing the gap between Amtrak's operating subsidy baseline and its fiscal year 2006 appropriation. (A copy of that report is enclosed.)

Amtrak has identified 15 operational reforms aimed at reducing its long-term operating losses. Amtrak has begun to implement five of these 15 reforms in the areas of food and beverage service, train operations, corporate overhead, long-distance train service and Northeast Corridor operations. Amtrak has saved \$46.3 million from these reforms through May 2006.

Amtrak has realized another \$52.7 million in savings from revenue increases, lower labor costs and other expense reductions.

*Question.* What options, if any, are available for Amtrak to outsource its first class services? Under what scenario would Amtrak consider outsourcing its first class service on its long-distance routes?

*Answer.* In our July 2005 report, "Analysis of Cost Savings on Amtrak's Long-Distance Services", we identified the cost of providing food service as a major driver of Amtrak's losses on its long-distance service, including first class sleeper service. Under current law and its existing labor contracts, Amtrak can outsource food and beverage services. Employee protections written into law limit the practicality of outsourcing other services associated with long-distance trains. We would encourage Amtrak to evaluate and pursue options for outsourcing its food and beverage service as a possible means of reducing costs on long-distance trains. Outsourcing these services could reduce the cost of both coach and first class sleeper service on long-distance trains.

*Question.* Amtrak has indicated that it will update labor contracts to enhance customer service and provide greater efficiencies. I understand that currently, more than 80 percent of Amtrak's passenger revenues are consumed by labor and benefit costs alone. What are Amtrak's specific goals as it looks to update its labor contracts?

*Answer.* Amtrak is best able to describe its goals in its labor negotiations.

## QUESTIONS SUBMITTED BY SENATOR PATRICK J. LEAHY

*Question.* The most recent grant request from Amtrak indicates that the struggling railroad needs \$1.5 billion next year for capital and operating expenses. The President's budget request, though, only seeks \$900 million in total funding. Since we have heard the administration proclaim that it is dedicated to passenger rail nationwide, how does this budget request add up to that commitment?

*Answer.* The Department of Transportation is best able to provide the rationale underlying its budget proposal.

*Question.* My small State of Vermont has two State-sponsored trains—the Vermonter and the Ethan Allen Express. The State of Vermont paid \$2.65 million to cover the operating losses this year and is slated to pay \$4 million next year as Amtrak ramps up the share paid by the States. The Department of Transportation and Amtrak have said that they intend to develop public-private partnerships for the corridor service. How close are you working with the individual States to improve equipment and service on these trains?

*Answer.* The Department of Transportation and Amtrak are best able to describe their activities in this area.

## AMTRAK

Senator BOND. My apologies to the witnesses. I would ask that you all make your statements very briefly. We will accept the full statements for the record. Senator Murray and I will have a couple of questions before we have to race for a vote that should be starting now.

Mr. Laney, welcome.

**STATEMENT OF DAVID M. LANEY, CHAIRMAN, AMTRAK BOARD OF DIRECTORS**

Mr. LANEY. Thank you, Mr. Chairman and members of the subcommittee. I appreciate the opportunity to appear before you today to discuss Amtrak fiscal year 2007 funding needs and I will make it very brief.

First of all, before I summarize the 2007 request, I would ask that the grant and legislative request to Congress and the full statement be included in the record of this hearing.

Senator BOND. Without objection.

Mr. LANEY. Thank you. In short, I will make it very brief. Amtrak's Board and management are aggressively ushering in significant change at Amtrak. Every organization likes to consider itself an agent of change and progress, and I know you have heard it before from earlier incarnations of Amtrak, that there would be a new and improved railroad at hand. There have even been past projections or predictions of profitability.

What I want to outline today is a step in the direction of material, tangible progress at Amtrak, and I will be the first to say that the jury is still out, but I have very good and reliable reasons to be optimistic. The indications are very encouraging and early results are already reflected in our operating budget.

For Amtrak, change, as far as the Board is concerned, cannot come quickly enough. This year and next year are absolutely pivotal years for Amtrak in its implementation of strategic reform, but to continue and ultimately finish the job we started, we will need your continued support, especially in 2007.

The 2007 grant request is essentially a first installment on our promise to deliver on these goals. We have made progress in simplifying and reducing the cost of food and beverage service. We are pursuing efficiencies in our mechanical operations, as well as our

stations and call center functions that could include the closing or consolidation of some facilities. We are reevaluating our fleet management practices. We are aggressively pursuing revenue growth through a top-to-bottom focus on improving customer service. We will look at ways to improve our service reliability where we can control the infrastructure and work with our railroad partners to the extent possible where we don't control it.

We have also begun a long overdue and comprehensive review of our long-distance trains that includes establishing a set of metrics to measure, rank, and improve performance. This year, we will also reevaluate our entire long-distance route network with an eye to possible restructuring and reconfiguration.

And ultimately, we have to reach agreement with our labor unions, some of which have been without new contracts for 6 years. The key to that success is changes in work rules, some of which date to the steam engine era.

As we said in our grant and legislative request, Amtrak has never in its history instituted so pervasive a reform effort so aggressively. The strategic reform initiatives are detailed in the legislative request and we will continue to update you on our progress, but let me make a couple of statements about the levels without going into detail as to capital, operating and debt service. To the extent you have questions, either I will answer them here or will be glad to respond to questions.

As a point of reference, our fiscal year 2006 appropriation is about \$1.3 billion. Amtrak's fiscal year 2007 grant request is \$1.598, or rounded to 6. This amount would fund basic capital, operating and debt service needs. Our 2007 request for operating support is essentially flat to the 2006 appropriation and over \$40 million less than last year's request. Our 2007 capital request has increased, however, principally because of investments we consider essential to our strategic reform program, large and critical infrastructure projects, legal mandates, and compliance, a first installment, in effect, with ADA requirements.

We have also requested minimal working capital for critical liquidity needs throughout the year, and without these large capital projects, or strategic reform funding requests, or working capital requests, our fiscal year 2007 grant request would be essentially flat to our 2006 appropriation. And again, I won't go into detail with respect to the various elements.

What I would say, though, that what shapes the urgency and the direction of our reform efforts is our strategic plan, not the budget, not reports from the GAO or DOT or DOT IG, and I should say that I think for the first time since I have been on the Board, we have the most constructive, complementary partnership with the DOT, the FRA, and the DOT IG office that I think we have ever had.

But to concentrate our energy and resources on the reform efforts, adequate funding will be essential so that we are not fighting a rear guard action to fend off liquidity crises or even insolvency.

#### PREPARED STATEMENT

So in closing, let me just say that adequate funding for 2007 is critical in terms of our continuing to be effective at implementing

our strategic reform initiatives, and I would add how important it is, and I think you have heard it from Secretary Mineta, how important it is for Congress to pass a reauthorization for Amtrak that contains a capital match program which will bring States to the table with financial support for passenger rail, and I am sure it will.

Thank you, Mr. Chairman.

Senator BOND. Thank you very much, Mr. Laney. We look forward to seeing your strategic plan.

[The statement follows:]

PREPARED STATEMENT OF DAVID M. LANEY

Mr. Chairman and members of the subcommittee, I appreciate the opportunity to appear before you today to discuss both the current and future state of Amtrak and our fiscal year 2007 funding needs.

While I will briefly summarize our fiscal year 2007 request in a few moments, I would ask that our Grant and Legislative Request to Congress be included in the record of this hearing.

In short, Amtrak's Board and management are aggressively ushering in change at Amtrak. Every organization, of course, likes to consider itself an agent of change and progress. I know you have even heard it before from earlier incarnations of Amtrak that a "new and improved" railroad would soon become more efficient, that service would improve, and that expenses would fall. Someone in the not too distant past, I believe, even predicted profitability. What I briefly want to outline for you today is a step in the direction of material, tangible progress at Amtrak. I'll be the first to tell you that the jury is out; and until the results are in I am not about to assume a successful outcome. But I am optimistic. The indications are very encouraging—early results are already reflected in our operating budget.

In its long history, the railroad industry has developed its own culture, uniquely resistant to change in many ways. As a result, changing settled practices is neither simple nor quick. But change has to come, and for Amtrak it cannot come quickly enough to satisfy our Board. You may recall in 2002 Amtrak survived its closest brush with insolvency. Since then the company has reorganized, begun to rebuild the plant and equipment and stabilized to a point where I believe we can now begin to address fundamental change aggressively in a number of areas. This year and next are truly pivotal years for Amtrak in its implementation of strategic reform.

The fiscal year 2007 Grant Request is essentially the first installment on our promise to deliver on these goals.

- We have made progress in simplifying and reducing the costs of the delivery of food and beverage service on our trains.
- We are now exploring outsourcing options and looking at the delivery of food and beverage from every angle.
- We are also pursuing efficiencies in our mechanical, stations and call center functions through a number of initiatives that could include the closing and consolidation of some facilities and outsourcing functions similar to what is being done in the industry.
- We have begun the reevaluation of our fleet management practices and fleet utilization efficiencies; I expect significant improvement in that area.
- We are aggressively pursuing ridership and revenue growth through a top-to-bottom focus on improving customer service.
- We will look at ways to improve our service reliability where we control the infrastructure, and work with our railroad partners where we don't.
- We have also begun a long overdue, comprehensive review of our long-distance trains, establishing a set of metrics by which we will measure, rank and improve performance, and a reevaluation of our entire long distance route network, with an eye to possible restructuring and reconfiguration.
- Finally, we hope to reach agreement with our labor unions, some of which have been without new contracts for almost 6 years. Key to the success of our labor negotiations must be changes to work rules, some of which date to the steam engine era.

Let me emphasize that our goal is to improve our customer service, to become more efficient at what we do, to reduce our unit operating costs while growing revenue, and to prepare ourselves for what we hope is a more competitive future environment for passenger rail.

The initiatives I have described are discussed in more detail in the Grant and Legislative Request. Through our regular reports to Congress, the Federal Railroad Administration, the Department of Transportation's Inspector General and the Government Accounting Office, we will continue to update you on the progress we are making on each of these initiatives. It is the Board's intention to help lead and guide management in this process and to make certain that we do not slacken the pace of reform.

One final comment, Mr. Chairman before I move to the grant request. Some of the challenges confronting Amtrak and passenger rail ultimately may be more in your court than ours. We are basically hemmed in on three sides: (1) I have mentioned labor—our current cost structure will impede the development of a competitive passenger rail industry and forestall any prospects for growth; (2) without a Federal capital matching grant program, States will remain very reluctant to invest in passenger rail—with such a program States will invest in passenger rail in areas where it is most needed; and finally, (3) capacity: outside the NEC we operate on the increasingly limited capacity of private freight lines—port and highway efficiency is dependent on adequate freight rail capacity; so is Amtrak.

Now, let me turn to our grant request. As a point of reference, our fiscal year 2006 appropriation is about \$1.3 billion. Our fiscal year 2007 Grant Request for operating support is essentially flat to the fiscal year 2006 appropriation, and over \$40 million less than last year's request. Our fiscal year 2007 capital request has increased, however, principally because of investments we consider essential to our strategic reform program, large and critical infrastructure projects, legal mandates, and compliance with Americans with Disabilities Act requirements. We have also requested minimal working capital support for critical liquidity needs throughout the year. Without such capital projects or working capital requirements, our fiscal year 2007 Grant Request would be essentially flat to our fiscal year 2006 appropriation.

This year, Amtrak's Grant Request is \$1.598 billion. This amount would fund basic capital, operating, and debt service needs as well as minimal working capital. As I mentioned, also included in this amount are the capital investment funds needed to accelerate implementation of our reform initiatives.

In addition, the grant request includes a discussion on other investment options that would bring benefits well beyond Amtrak—options related to station accessibility issues mandated by the American's with Disabilities Act, network reliability improvements, the beginning of a modest Federal-State corridor development matching fund, and initial restructuring of Amtrak's debt. The inclusion of these items highlights the urgent need for Congress to complete work on an Amtrak reauthorization, which expired 3½ years ago.

#### CAPITAL PROGRAM

The fiscal year 2007 capital grant request of \$730 million continues Amtrak's investment in rolling stock and infrastructure, along with high-return strategic business initiative investments. While this request represents an increase in funding from the current fiscal year 2006 level of \$495 million, it includes investment in our reform initiatives—all with near-term payoffs in operating efficiency—as well as investment in long deferred and now critical infrastructure projects. For example, the fiscal year 2007 request includes, in addition to ongoing state-of-good-repair needs, funding for the replacement of the nearly 100-year-old Thames River Bridge lift span and the upgrade of traffic control and signal systems.

#### *Infrastructure*

Amtrak owns or maintains 730 route miles of passenger rail right of way nationwide, including 400 miles of high-speed main line between Boston and Washington. Critical areas that must continue to be addressed include:

- Wood ties on main tracks and through switches and interlockings are costly to maintain in a high-traffic environment and must be replaced with more durable concrete ties;
- The catenary system dating from the early part of the last century must be fully rehabilitated or replaced; and
- Major portions of the power supply systems are reaching the end of their useful lives and must be replaced to avoid outages and address increased power demand.

#### *Rolling Stock*

Amtrak's passenger fleet ranges in age from 5 to over 50 years old. Because of financial constraints in the late 1990's through 2002, investment in major overhaul work on much of Amtrak's 1,700 car passenger fleet was deferred. Predictably, the

reliability of Amtrak services declined as en-route failures mounted due to deferred investment.

While much work has been done to improve fleet reliability, Amtrak's goal for fiscal year 2007 is to continue the major fleet overhauls that we initiated in 2003 to improve train comfort and reliability.

#### OPERATING BUDGET

Amtrak's request for operating support in fiscal year 2007 is \$498 million, which represents less than one-fifth of our total operating budget. By achieving efficiencies and increasing revenues we have first contained, then reduced our operating loss. It is important to note that Amtrak's operating requests have decreased over the past 3 years from \$768 million in fiscal year 2004, to \$570 million in fiscal year 2005, to a projected \$540 million in fiscal year 2006.

The fiscal year 2007 estimated operating budget will embody the first full year of benefits of revenue enhancement and cost reduction associated with a variety of the strategic initiatives. In total, these initiatives are expected to reduce total annual operating needs by over \$40 million next year, and increasing amounts in subsequent years.

This request of \$498 million is an aggressive goal for us, leaves little room for error and heightens the acute importance of our working capital request. However, we are mindful that one measure of success in our reform efforts is a continued reduction of the need for Federal operating support.

#### WORKING CAPITAL

Included in our grant request is \$75 million for working capital, which amounts to about 2.5 percent of the company's annual operating budget. Seventy-five million dollars also represents about 7 days of cash requirements. No company the size or complexity of Amtrak would responsibly allow its cash balances to decline below that level without assured prospects of new funding. As I am sure you recognize, too little liquidity poses high-risks for all Amtrak stakeholders. Last year's operating problem with the Acela braking system, for instance, jeopardized the company's cash position, and we certainly know from that and other experiences that Amtrak should have at least a minimal level of working capital for unanticipated business risks. Amtrak's need for cash reserves is in part dictated by the fact that the company has no access to a working line of credit to cover unexpected short term costs.

#### DEBT SERVICE

The amount requested for debt service, \$295 million, is needed for fiscal year 2007 debt service payments, including some contractually required lease buyouts. In addition, we have proposed an optional restructuring program for certain long-term equipment leases which, if you choose to fund it, would reduce future debt payments. While we carry a sizeable amount of debt, it is worth noting that we have reduced it by about \$300 million during the last 3 years, and since 2002 there has been no new borrowing.

That, in summary, is our Grant and Legislative Request. In closing, let me say that all of us at Amtrak believe that the service we provide is increasingly valuable to the many regions and communities we serve. Our job is to continue to build Amtrak's credibility from your standpoint and Amtrak's attractiveness as a transportation option from our passengers' perspective. We will continue to press forward with our strategic initiatives, but we will absolutely need your continued support to finish the job.

Finally, I cannot emphasize enough how important it is for Congress to pass a reauthorization for Amtrak this year that contains a capital match program which brings States to the table with financial support for passenger rail.

## DEPARTMENT OF TRANSPORTATION

### FEDERAL RAILROAD ADMINISTRATION

#### STATEMENT OF JOSEPH H. BOARDMAN, ADMINISTRATOR

Senator BOND. Now, Mr. Boardman, the FRA Administrator.

Mr. BOARDMAN. Mr. Chairman, Ranking Member Murray, Senator Bennett, I won't repeat the numbers that the Secretary put on the table, but the Department has been and continues to be con-

sistent in believing that Amtrak's business model is flawed and must be reformed.

Amtrak does not yet have effective budget discipline. They are not subject to the rigors of the need to turn a profit and they do not prepare a public budget in the tradition of a city, a county, or even a transportation authority. By falling into a unique in-between category of existence, Amtrak has managed to avoid discipline that normally governs either public or private corporations.

While the present Board of Directors—and I like David—has made the first tentative steps in developing discipline, much more needs to be done. Improvements to date have only occurred because the demand for reform by this administration and support for that reform by this committee. We need to be steadfast in fiscal year 2007 and following years if a true change in the Amtrak culture is to be achieved. There have been too many false starts and empty promises. Amtrak must do better and we should be partners in making sure that they do.

This committee embraced the spirit of that reform last year with its provision that the Secretary shall determine and assess fees on commuter railroads operating in the Northeast Corridor. They would cover the capital and maintenance costs attributable to those same commuter railroads. This idea would promote fair and equitable access for all operators. The committee's leadership in reforming this aspect of a very complex Amtrak picture has been accepted and embraced by the administration as a significant opportunity to develop a key principle of the administration's approach to reforming intercity passenger rail service.

With the assessment of the commuter fees, the States should have a strong incentive to partner with the Federal Government in establishing both policy standards and service warrants, along with investment policies, that would maintain the infrastructure at a maintenance level that meets the needs of business travelers, commuters, tourists, and freight operators. This kind of policy-level attention will help to strengthen and extend the economic opportunities provided by the mobility and reliability of rail service in the Northeast Corridor and continue to enhance the region's globally competitive advantages in the financial, insurance, and real estate industry.

By combining those levies with the Department's proposed \$500 million capital budget for Amtrak and including State and Federal policy and planning goals for infrastructure investment in the Northeast Corridor, this new partnership will benefit intercity passenger rail for all interested stakeholders. This then opens up opportunities, as have been expressed by Secretary Mineta, that with the right Amtrak reforms, this administration will not only support infrastructure improvements in the Northeast Corridor, but could assist State partners that are ready to improve intercity passenger rail services in other areas.

We are at a point in this administration, together with Congress, that we can demonstrate both a significant progress in reforming Amtrak and a major progress in advancing goals for improved intercity passenger rail, even in Utah.

Amtrak must find new ways to operate competitively. Even from the earliest times of discussion and debate over several administra-

tions and several congressional periods, there have been both general and specific suggestions made to improve Amtrak's operational performance. Amtrak's core business is to provide a safe, clean, efficient transportation service that is on time and placed in the appropriate market at the right time to provide a connected and reliable service to fair-paying customers.

With that clear focus, Amtrak can be successful and competitive. Amtrak's internal reform must progress quickly to allow a clear operating focus with effective financial discipline. The Department and the States must progress quickly to find success in forming a partnership in the Northeast Corridor infrastructure and operation and this committee has opened that opportunity for us to do that.

PREPARED STATEMENT

The public demands real accomplishment in this partnership, not only in the Northeast, but in the South, Midwest, and far West. Intercity passenger rail, when delivered in partnership and focused on being effective and seamless, has the potential to improve our environment and strengthen our economy. As Federal Railroad Administrator, I will work with this committee, other committees, Amtrak, the States, and stakeholders to make that happen. Thank you very much.

Senator BOND. Thank you very much, Mr. Boardman.

[The statement follows:]

PREPARED STATEMENT OF JOSEPH H. BOARDMAN

Chairman Bond, Ranking Member Murray and other members of the subcommittee, it is my pleasure today to represent Secretary of Transportation Norman Y. Mineta to discuss the Bush Administration's budget request for fiscal year 2007 as it relates to subsidies for the National Railroad Passenger Corporation, better known as Amtrak.

As Secretary Mineta has already stated, the budget promotes continued transformation of intercity passenger rail. The President requests \$900 million to help Amtrak make the transition to a new and better model of intercity passenger rail. Five hundred million dollars of that request is for capital needs and maintenance. The remaining \$400 million would be available as Efficiency Incentives tied directly to continued reform.

The Department has been and continues to be consistent in believing that Amtrak's business model is flawed and must be reformed. Amtrak does not yet have effective budget discipline. They are not subject to the rigors of the need to turn a profit, and they do not prepare a public budget in the tradition of a city or a county, or even a transportation authority. By falling into a unique in-between category of existence, Amtrak has managed to avoid the discipline that normally governs either private or public corporations. While the present Board of Directors has made the first tentative steps in developing discipline, much more must be done. Improvements to date have only occurred because of the demand for reform by this administration and support for that reform by this committee. We need to be steadfast in fiscal year 2007 and following years if a true change in the Amtrak culture is to be achieved. There have been too many false starts and empty promises. Amtrak must do better, and we should be partners in making sure that they do.

This committee embraced the spirit of that reform last year, with its provision that the Secretary shall determine and assess fees on commuter railroads operating on the Northeast Corridor (NEC) that would cover the capital and maintenance costs attributable to those same commuter railroads. This idea would promote fair and equitable access for all operators. The committee's leadership in reforming this aspect of the very complex Amtrak picture has been accepted and embraced by the administration as a significant opportunity to develop a key principle of the administration's proposed approach to reform of intercity passenger rail service.

With the assessment of the commuter fees, the States should have a strong incentive to partner with the Federal Government in establishing both policy standards and service warrants, along with investment policies that would maintain the infra-

structure at a maintenance level that meets the needs of business travelers; commuters; tourists; and freight operators. This kind of policy level attention will help to strengthen and extend the economic opportunities provided by the mobility and reliability of rail service on the NEC, and continue to enhance the region's globally competitive advantages in the financial, insurance and real estate industry. By combining those levies with the Department's proposed \$500 million capital budget for Amtrak, and including State and Federal policy and planning goals for infrastructure investment on the NEC this new partnership will benefit intercity passenger rail for all interested stakeholders. This then opens up opportunities as have been expressed by Secretary Mineta that with the right Amtrak reforms, this administration will not only support infrastructure improvement on the NEC, but could assist State partners that are ready to improve intercity passenger rail services.

We are at a point where this administration, together with Congress can demonstrate both significant progress in reforming Amtrak, and major progress in advancing goals for improved intercity passenger rail. Amtrak must find new ways to operate competitively. Even from the earliest times of discussion and debate over several administrations, and several Congressional periods, there have been both general and specific suggestions made to improve upon Amtrak's operational performance. Amtrak's core business is to provide a safe, clean, efficient transportation service that is on-time and placed in the appropriate market at the right time to provide a connected and reliable service to fare paying customers. With that clear focus Amtrak can be successful and competitive.

Amtrak's internal reform must progress quickly to allow a clear operating focus with effective financial discipline. The Department and the States must progress quickly to find success in forming a partnership on the NEC infrastructure and operation this committee has opened an opportunity for us to do that. The public demands real accomplishment in this partnership, not only in the Northeast, but in the South, and Midwest and far West. Intercity passenger rail—when delivered in partnership and focused on being effective and seamless—has the potential to improve our environment and strengthen our economy. As Federal Railroad Administrator I will work with this committee; other committees; Amtrak; States; and Stakeholders to make that happen.

Mr. Chairman, thank you for this opportunity. I would be happy to answer any questions at this time.

#### OFFICE OF INSPECTOR GENERAL

#### STATEMENT OF MARK R. DAYTON, SENIOR ECONOMIST

Senator BOND. Mr. Dayton, we are going to call on you for the rest of the story and then we will have opportunities for one question each. I turn to my colleague, Senator Murray, for the first one after Mr. Dayton.

Mr. DAYTON. Thank you, Mr. Chairman and members of the subcommittee.

Senator MURRAY. They have called, so we are in a very short time frame here.

Mr. DAYTON. Once again, as with last year, the work of this subcommittee and your colleagues in the House will be the key to maintaining fiscal discipline at Amtrak. In fact, the provisions established by this committee this year are having an impact. Amtrak's Board and management seem committed to reform and Amtrak is beginning to realize some reductions in the need for operating subsidies.

But the heavy lifting has just begun. Commitment to these reforms will need to be sustained for many years. Indeed, it will be several years before we see most of the financial benefits from current initiatives.

Without a fundamental restructuring of the company through reauthorization, the Appropriations Committees will need to continue to pressure Amtrak for reform, specifically by limiting the funds

made available to subsidize its operating losses, and by making Federal support contingent upon further restructuring.

The bottom line is this. Just to maintain the system as it is currently configured, in a steady state of repair, and assuming that current reform efforts will begin to pay off, Amtrak would need an appropriation in fiscal year 2007 of about \$1.4 billion. This would include \$485 million for operating losses, \$600 million for capital spending, and \$295 million for debt service. These amounts would continue the pressure for reform but would not yield any significant improvement in the overall state of good repair.

This 2007 appropriation would be nearly 7 percent over what was enacted last year, but would be a very tight budget that leaves little or no margin for error in either operations or investment. If an operating problem were to arise that affected revenue or expenses—like the Acela brake problem; or an unexpected capital expense—like a bridge failure on the Northeast Corridor, Amtrak could face insolvency.

Private companies of Amtrak's size generally have access to lines of credit or maintain sufficient cash reserves to reduce the risk associated with such events. Amtrak has no such safety net.

A separate working capital appropriation of \$125 million would help address these risks, but if Congress were to provide such support, the funds should be subject to controls that prevent Amtrak from using them for ordinary business activities. One approach would be to use a constraint similar to that in this year's Efficiency Incentive Grants that would require approval by the Secretary before the year-end level of working capital could fall below \$125 million.

This 2007 funding picture depicts the fundamental dysfunction we face with Amtrak: just to maintain the current state of repair, without addressing the backlog of infrastructure needs, without investing in short-distance corridors that have been discussed today, and without recapitalizing the equipment fleet, would require nearly a \$100 million increase in Amtrak funding in fiscal year 2007. And to avoid an increased risk of insolvency would require more than a \$200 million increase in that funding.

So what are the solutions? As we have testified before, the current system needs to be fundamentally restructured. This will require new authorizing language for Amtrak programs. We see three key goals for successful reform of intercity passenger rail. First, continuous improvements in the cost effectiveness of services provided. Second, devolution of the power to determine those services to the States. And third, adequate and stable sources of Federal and State funding.

Absent reauthorization, the appropriations process can provide necessary fiscal discipline over Amtrak's operating losses. In 2006, the Appropriations Committee established a process to achieve operational reforms. We believe this process is of considerable value and strongly encourage you to continue it in 2007.

Specifically, the 2006 bill directed Amtrak to achieve savings through operating efficiencies, including changes to its food and beverage service. The bill also reduced Amtrak's operating subsidy, applying further pressure to cut its costs. The committee also re-

quired our office to report quarterly on Amtrak's progress to this end.

As part of our oversight effort, we have seen that Amtrak is beginning to show improvement. For example, the company has made strides in reforming its food and beverage service, which could become a break-even or even marginally profitable in the next 5 to 6 years.

Much work remains, however, to eliminate the losses on first class sleeper service. I would emphasize, we continue to find any Federal subsidy for first class passengers unacceptable and have yet to see plans for even pilot programs aimed at restructuring these services. Outsourcing of reservation and maintenance services has become widespread in the transportation sector and Amtrak has only begun to scratch the surface on assessing their potential.

#### PREPARED STATEMENT

Congress should mandate accelerated efforts in these areas as a condition to taxpayer support in any fiscal year 2007 appropriation, particularly if the funding approaches this \$1.5 billion level. Such a requirement—

Senator BOND. Thank you, Mr. Dayton.

Mr. DAYTON. Okay.

Senator BOND. Your statements will be included in full in the record.

[The statement follows:]

#### PREPARED STATEMENT OF MARK R. DAYTON

Mr. Chairman and members of the subcommittee, we appreciate the opportunity to present the views of the Office of Inspector General on Federal funding for Amtrak in fiscal year 2007.

Once again, as with last year, the key to maintaining fiscal discipline at Amtrak will be the work of this subcommittee and your colleagues in the House. We can report today that the provisions the committee put in place for this fiscal year are having an impact: the Amtrak Board of Directors and current management seem committed to reform, efficiency improvements are beginning to be implemented, and some reductions in required operating subsidies are being realized. But the heavy lifting has just begun and current reform efforts will require many years of sustained commitment. Indeed, much of the financial benefits in the form of significant operating loss savings will not occur for several years.

Absent a fundamental restructuring of the company through reauthorization, it will fall to the Appropriations Committees to continue the pressure for reform, specifically by limiting the funds made available to subsidize operating losses and by making Federal support conditional upon further operational restructuring.

*The Bottom Line.*—To maintain the currently configured system in a steady state of repair and after accounting for the reform efforts already underway, the fiscal year 2007 appropriation for Amtrak would need to be about \$1.4 billion. This includes \$485 million for cash operating losses, \$600 million for capital spending, and \$295 million for debt service. The operating subsidy amount would continue the pressure on Amtrak for reform put in place by Congress last year, the capital amount would simply keep the system from falling into further disrepair, and the debt service amount is Amtrak's fixed costs for repayment of principal and interest.

Despite this being almost a 7 percent increase over the fiscal year 2006 enacted level, it is a tight budget that would leave little or no margin for error in neither operations nor investment. If an operating problem arose that affected revenue or expenses, such as the Acela brake problem, or if an unexpected capital expense arose, such as a bridge failure on the Northeast Corridor (NEC), Amtrak could face insolvency, particularly if the problem were to occur late in the fiscal year after the majority of funds had been spent or committed. Private companies of Amtrak's size often have access to lines of credit to reduce the risk associated with these unfore-

seeable events or maintain cash reserves in an order of magnitude larger than that typically held by Amtrak.

Working capital of \$125 million would help address the risks Amtrak faces from these unforeseeable events. To ensure these funds are used to cover fluctuations in operations and not for ordinary course expenditures, appropriate controls should be established. One approach for dealing with this problem is to impose the same constraints on use of these funds as those in this year's Efficiency Incentive Grants whereby approval of the Secretary would be required before the year-end level of working capital could fall below \$125 million. Alternatively, a unanimous vote of the Board of Directors could be required in the same event. In either case, if Congress were to provide these funds, additional funds would not be needed for this purpose in future years.

These funding requirements illustrate the fundamental dysfunction that we face with Amtrak: just to maintain the current state of repair—not to address the backlog of infrastructure needs, not to invest in short-distance corridors around the country, not to recapitalize the equipment fleet—requires an \$86 million increase in Amtrak funding in fiscal year 2007 and an increase of over \$200 million to avoid increased risks of insolvency, should Congress decide to provide \$125 million for working capital.

*How Did We Get Here?—*Amtrak's funding requirements actually have not changed appreciably over the past 9 years—only the source of those funds has changed. External funding to Amtrak (in addition to revenue and State support) totaled \$11.6 billion from 1998 through 2006 or almost \$1.3 billion per year.<sup>1</sup> Therefore, the current \$1.4 billion estimate of requirements is in line with past years. It differs, however, in that now all of it must come from direct appropriations, whereas in past years some came from borrowing and some from the Taxpayer Relief Act of 1997. Because debt service increased significantly during this same time period, the \$1.4 billion actually provides less funding for operations and investment than prior year average subsidies.

*What Are the Solutions?—*As we testified previously, the current system needs to be fundamentally restructured. Such a restructuring requires new authorizing language for Amtrak programs and funding support. We have enumerated three key goals for successful reform of intercity passenger rail service: (1) continuous improvements in the cost-effectiveness of services provided, (2) devolution of the power to determine those services to the States, and (3) adequate and stable sources of Federal and State funding.

These goals can be achieved through six programmatic changes: formula grants to States for capital and operating costs of intercity passenger services, restoration of the forward-going system to a state of good repair, capital matching grants to States for corridor development, establishment of adequate Federal and State funding, resolution of the legacy debt issues, and resolution of NEC ownership and control.

Until a reauthorization is forthcoming, there is much that Amtrak management and its Board can do to achieve these goals and program changes, assisted by this committee. The company has made strides in reforming its food service provision and may have in place process that will achieve break-even or marginally profitable provision of food service on its trains in the next 4 to 5 years, if it follows through on these initial steps.

Much work remains, however, to eliminate the losses on first class sleeper service. We continue to find unacceptable any Federal subsidy for first class passengers and have yet to see plans for pilot programs to restructure these services. Outsourcing of reservation and maintenance services has become widespread in the transportation sector, but Amtrak has only begun to scratch the surface on assessing its potential. As a condition to taxpayer support in any fiscal year 2007 appropriation, particularly at levels approaching \$1.5 billion, accelerated efforts in these areas should be mandated. Such requirements for fiscal discipline from this committee and the Congress will keep Amtrak moving in the right direction so that when a reauthorization is finally enacted, the company will be poised to provide better, more efficient services for the country.

I will now discuss these issues in greater detail.

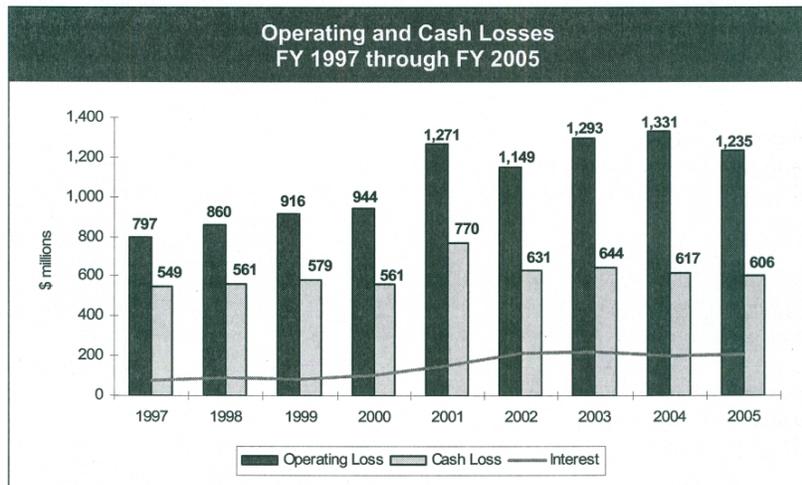
<sup>1</sup>This consists of \$7.7 billion in Federal appropriations; \$2.2 billion in capital funds from the Taxpayer Relief Act of 1997; and \$1.7 billion in net, non-defeased (that is, not pre-funded) borrowing.

AMTRAK'S FINANCIAL CONDITION REMAINS PRECARIOUS BECAUSE IT HAS NOT  
STRUCTURED ITS SERVICES TO MATCH AVAILABLE FUNDING

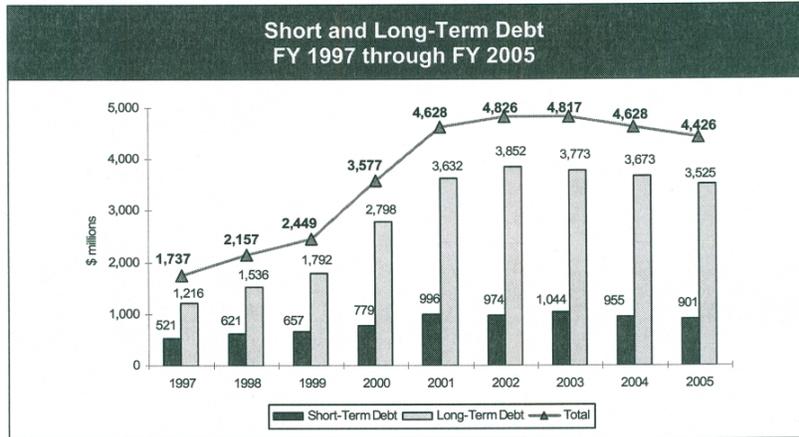
The current model for providing intercity passenger service continues to produce financial instability and poor service quality. Despite multiple efforts over the years to change Amtrak's structure and funding, we have a system that limps along, is never in a state-of-good-repair, awash in debt, and perpetually on the edge of collapse. In the end, Amtrak has been tasked to be all things to all people, but the model under which it operates leaves many unsatisfied.

*Operating Losses.*—Amtrak continues to incur substantial operating losses. It ended fiscal year 2005 with an operating loss of \$1.235 billion. On the positive side, during the first 4 months of fiscal year 2006, Amtrak's net operating loss was \$49 million less than last year and its cash operating loss, excluding interest and depreciation, was \$74 million less than the same period last year. It remains to be seen if these improved financial results can be sustained for all of fiscal year 2006. In fact, Amtrak has indicated that operating within the \$485 million operating subsidy for this year will likely require some one-time actions in spite of its performance to date.

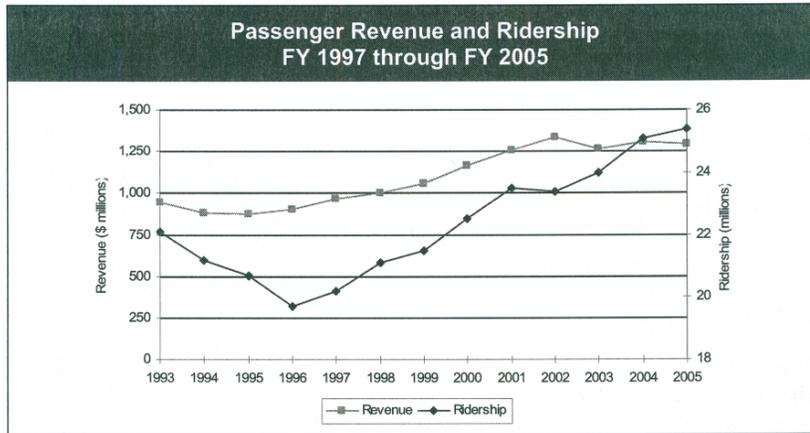
Putting these results in perspective, the system continues to suffer operating losses on all but a handful of routes. Operating losses on long-distance trains, excluding interest and depreciation, were \$529 million in fiscal year 2005. Losses on some long-distance trains (excluding depreciation and interest) exceed \$400 per passenger. For the last 5 years, annual cash losses have exceeded \$600 million, though their persistence at this level primarily is attributable to increased interest expense. Amtrak has made some progress in controlling its cash operating loss, excluding interest.



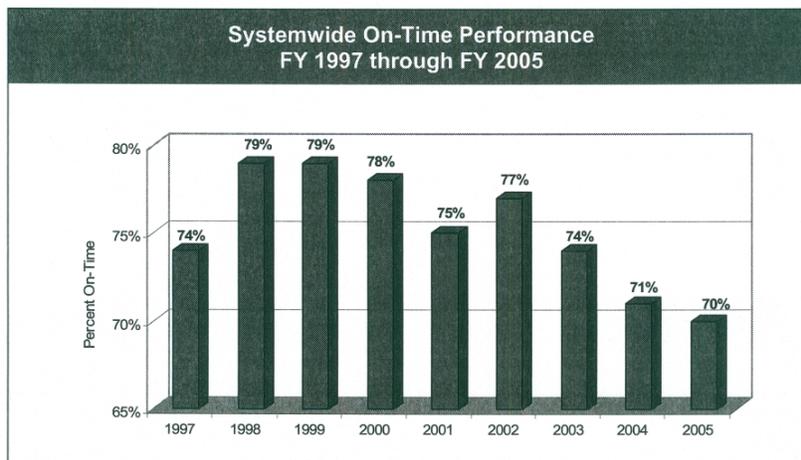
*Debt Burden.*—Amtrak is carrying a large debt burden. Its total debt peaked at \$4.8 billion in fiscal year 2002 and has declined only slightly in the past 2 years. For the foreseeable future, Amtrak's annual debt service will approach \$300 million.



*Revenue and Ridership.*—While ridership increased to 25.4 million in fiscal year 2005, passenger revenues declined to \$1.292 billion, and remain below the \$1.340 billion achieved in 2002. For the first 4 months of fiscal year 2006, passenger revenues were \$31 million higher than the same period in fiscal year 2005, mainly due to fare increases. Ridership growth during this period was less than 1 percent.



*On-Time Performance.*—On-time performance fell from 74 percent in fiscal year 2003 to 70 percent in fiscal year 2005, with even Amtrak’s premier service—Acela Express—achieving on-time performance of only 76 percent. On-time performance for long-distance trains averaged 41.4 percent last year, with the poorest performing train, the Sunset Limited, having an on-time performance of only 7 percent. System-wide on-time performance through January 2006 was 66 percent, compared to 72 percent for the first 4 months of fiscal year 2005.



**ABSENT REAUTHORIZATION, THE APPROPRIATIONS PROCESS CAN PROVIDE NEEDED  
FISCAL DISCIPLINE OVER AMTRAK'S OPERATING LOSSES**

The system needs to be fundamentally restructured through a reauthorization. In the absence of a reauthorization last year, the Appropriations Committee established a process in fiscal year 2006 to achieve meaningful, but incremental, operational reforms. We believe this process is not a substitute for reauthorization, but it is of considerable value nonetheless; and we strongly encourage Congress to continue it in fiscal year 2007.

The fiscal year 2006 Appropriations bill specifically directs Amtrak to achieve savings through operating efficiencies, including, but not limited to, modifications to food and beverage service and first-class service. The bill also exerts pressure on Amtrak to reform by reducing Amtrak's operating subsidy from the fiscal year 2005 level of \$570 million to \$495 million. (A 1 percent rescission, \$4.95 million, and a designation of \$5 million for the development of a managerial cost accounting system, combined to reduce the funds available to subsidize ongoing operations to \$485 million.) In addition, \$31.7 million was made available for an efficiency grant program aimed at providing additional capital investments if Amtrak reduces operating costs to live within its fiscal year 2006 Federal operating subsidy.

The fiscal year 2006 Appropriation bill also requires our office to report quarterly to this committee and its counterpart in the House on whether or not and to what extent Amtrak has achieved savings as a result of operational reforms. We must certify whether or not Amtrak has achieved such savings by July 1, 2006 if Amtrak is to continue its use of fiscal year 2006 appropriated funds to subsidize the net losses from food, beverage, and sleeper car service on any Amtrak route.

In our January 5, 2006 report to this committee, we set Amtrak's overall operating subsidy baseline at \$586 million. This baseline represents Amtrak's fiscal year 2006 projected operating loss after accounting for anticipated costs and revenue adjustments. It also reflects the savings resulting from initiatives implemented in fiscal year 2005 and fiscal year 2006 prior to our issuing the report.

This fiscal year, Amtrak will need to achieve \$101 million in savings from the \$586 million operating loss baseline to operate within its Federal subsidy. In addition to sustainable operational reforms, Amtrak plans to rely on one-time actions, and revenue increases to meet its end of year budget goals. One-time actions will not be considered as part of our July certification process. It is our opinion that Congress intended us to consider only those savings from sustainable, structural reforms when we decide in July whether or not Amtrak has achieved enough savings from operational reforms to warrant certification.

**AMTRAK NEEDS TO RESPOND AGGRESSIVELY TO THE APPROPRIATIONS BILL  
REQUIREMENTS AND SEE THESE INITIATIVES THROUGH TO COMPLETION**

To address needed savings from operational reform, Amtrak has developed an implementation plan for 15 new initiatives. These include a plan for restructuring its

food and beverage service and dining and lounge car operations over several years; adopting a reliability-centered maintenance approach to increase fleet maintenance efficiencies; consolidating maintenance facilities and reducing maintenance overtime; outsourcing and reducing staff at stations; improving fuel efficiency; renegotiating labor agreements to eliminate outsourcing and work rule restrictions; and reducing outside legal fees. Other initiatives such as restructuring long-distance train services, improving financial management systems, and improving service reliability on the Northeast Corridor are only in the beginning planning stage. Our Quarterly Reports will examine Amtrak's reform efforts to determine whether Amtrak is fully addressing potential reform opportunities and whether planned initiatives are meeting their stated goals and are sustainable over the long-term.

The initial focus of Amtrak's reform efforts is its food and beverage service. The company has made strides in reforming its food service provision and may have in place a process that will achieve break-even or marginally profitable provision of food service on its trains. Amtrak plans to implement its strategic initiatives, including food and beverage service, over a 6-year period, with some not fully implemented until fiscal year 2012. Once fully implemented, Amtrak projects savings of \$190 million a year from these initiatives.

Our preliminary analysis of Amtrak's operating savings for the first 4 months of fiscal year 2006 indicate that only about \$20 million in such savings can be expected this fiscal year. These savings amount to only 20 percent of the savings Amtrak must achieve to live within its fiscal year 2006 Federal operating subsidy. Amtrak plans to close the remaining gap with one-time actions and budget adjustments, spending the remaining fiscal year 2005 year-end cash reserves, and better-than-projected revenue performance.

These short-term gap-closing actions will not reduce Amtrak's need for subsidies in fiscal year 2007 or beyond. In addition, Amtrak initially planned to rely on the \$31.7 million Efficiency Incentive Grant to make ends meet in fiscal year 2006 and reduce the need for further operational savings. As we stated in our January Quarterly Report, we do not believe it would be appropriate to anticipatorily count these discretionary grants toward achieving the required savings. Congress should require a business plan from Amtrak that does not rely on these savings and specifically identifies all the savings required to operate within its fiscal year 2006 resources. Congress should also continue the pressure on Amtrak to be expansive and aggressive in the scope and pace of implementing long-term, structural operating reforms.

As mentioned earlier, Amtrak needs to address the cost of providing long-distance service, and, in particular, first-class sleeper service. In July 2005, we reported that Amtrak could save between \$75 million and \$158 million in annual operating costs by eliminating sleeper car service, outsourcing food and beverage service, and eliminating other amenities on long-distance trains. The plan Amtrak is preparing on how to improve the operational and financial performance of these trains needs to fully address these areas for potential significant savings.

#### REAUTHORIZATION IS A BETTER COURSE FOR REFORMING INTERCITY PASSENGER RAIL SERVICE

Incremental operating savings over the next 5 or 6 years will not be sufficient to fund the significant increases in capital investment required to return the system to a state-of-good-repair and promote corridor development. This mismatch of funding sources and needs requires a long-term solution that can be achieved only by changing the model for intercity passenger rail.

To create a new model for intercity passenger rail, a comprehensive reauthorization that provides new direction and adequate funding is needed. The problem with the current model extends beyond funding—there are inadequate incentives for Amtrak to provide cost-effective service; state-of-good-repair needs are not being adequately addressed; and States have insufficient leverage in determining service delivery options, in part because Amtrak receives Federal rail funds, not the States.

Reauthorization should establish meaningful reforms that ensure greater cost-effectiveness, responsiveness, and reliability in the delivery of passenger rail transportation. Three central themes will drive successful reform.

—*Improvements in Cost-Effectiveness.*—Amtrak, as the sole provider of intercity passenger rail service has few incentives, other than the threat of budget cuts or elimination, for cost control or delivery of services in a cost-effective way.

—*States Need a Larger Voice in Determining Service Requirements.*—The current model for providing intercity passenger service does not put States in a position to decide upon the best mix of service for their needs—what cities are served, schedules and frequency of service, and what amenities should be provided.

Those decisions are made by Amtrak, and they are not always in the best interests of the States served. Intercity passenger rail would be better served with State-led initiatives as to where and how intercity passenger rail service is developed. States are best able to determine the level of passenger rail service required to meet their strategic transportation needs and State sponsorship will become increasingly important as they will be asked to provide increased operating and investment support. Capital funding decisions, as with mass transit, should ultimately reside with the Department of Transportation, based on congressional direction and in partnership with the States.

—*Adequate and Stable Federal Funding is Essential.*—None of the corridors around the country, including the Northeast Corridor, can provide the type of mobility needed without significant capital investment. In the NEC, this means bringing the existing facilities to a state-of-good-repair with no match requirement. In other corridors around the country, it means creating the infrastructure for high-frequency services in partnership with freight railroads and commuter authorities. A robust Federal program of capital matching grants will be essential if these corridors are to be developed. In addition, long-distance services that provide connections between corridors require recapitalization if they are to be run efficiently and are to provide the high quality services their passengers deserve. None of this, however, implies giving more money directly to Amtrak, especially under the current model.

In our view, a framework for reauthorization requires the incorporation of six core elements.

*Formula Grants to States for Capital and Operating Costs.*—This program would address the needs of areas served by long-distance routes that have little corridor development potential, while simultaneously creating incentives for States to encourage operating efficiencies from the service operator. Formula funds can be used for operating expenses, capital maintenance, and/or capital improvements at the discretion of the States and have no match requirement.

*Restoration of the Forward-Going System to a State-of-Good-Repair.*—This program would provide Federal funds, with no match required, to address the accumulated backlog of deferred investment and maintenance on the NEC and in fleet and facilities outside the NEC. After a state-of-good-repair has been achieved, capital funds with a reasonable State match would be available for capital maintenance.

*Capital Matching Grants to States for Development of Corridor Services.*—This program would give States the ability to improve and expand routes and service on their supported corridor routes through a Federal capital funding program with a reasonable State match requirement.

*Setting Federal and State Funding of These Programs at Adequate Levels.*—Federal funding levels, along with State contributions have not been sufficient to subsidize operations, address deferred capital needs, and significantly improve service along the existing rail network. It will require minimum Federal funding of \$2.0 billion a year to restore the system to a state-of-good-repair and provide funding for new corridor development.

*Resolution of the Legacy Debt Issue.*—This element would give the Secretary the authority to evaluate Amtrak's debt and to take action in the best interest of intercity passenger rail that is economically advantageous to the United States Government.

*Resolution of Northeast Corridor Ownership.*—The NEC is of considerable interest in reauthorization. Unlike the rest of the passenger rail system, Amtrak owns the infrastructure between Boston and Washington, DC. The Federal Government may decide to take on the responsibility of restoring the NEC to a state-of-good-repair, and its debt—if it is determined to be in the public's interest to do so. Once the NEC is returned to a state-of-good-repair, the States can take a larger responsibility in directing and managing ongoing operations and maintenance. In return for fully funding the corridor, the Federal Government may decide to take title to Amtrak's assets. Although Amtrak may very likely remain the operator for NEC, we will be in a better position to decide what is the best use and ownership structure of NEC assets by the end of the reauthorization period.

This framework would require cost efficiencies as Federal funds available to cover operating losses would decline over the 5-year reauthorization period. Specifically, it would give States greater responsibility for passenger rail investments with oversight of capital investment vested in the Department. Additionally, it would focus Federal funding on stable and robust capital investment programs that would bring the system to a state-of-good-repair, maintain it in that condition, and provide for the development of corridors throughout the country.

Mr. Chairman, that concludes my statement. I would be happy to answer any questions at this time.

Senator BOND. My sincere apologies, but this is the way the Senate functions. I turn to Senator Murray for her questions.

Senator MURRAY. I would just say that this presents us a great dilemma because Mr. Laney has said we need a \$300 million increase in order to enact reforms. Mr. Boardman has said we need to cut it by \$400 million to make reforms happen. And Mr. Dayton says that we are in a tight budget with no margin for error at \$1.4 billion. So in writing, I would like back from each one of you how you explain your thesis on this, because we need to understand that and it is clear it is very controversial.

But I would like to ask the one question I have for Mr. Dayton. Your testimony appears to be advocating different treatments for States depending on whether those States are in the Northeast Corridor or in other regions of the country. The taxpayers of my State provide a lot of revenue to maintain the Cascadia service, and in fact, on a per passenger basis, provide the highest State subsidies of any in the country. There are plans to improve the rail corridor between Vancouver and Eugene that will even add to that.

You say that capital contributions from the Federal Government to improve rail corridors should require a State match, but your testimony says that billions of dollars are needed to bring the investment in the Northeast Corridor up to a good state of repair, but the States along the Northeast Corridor should not be required to put up a match. Well, the people I represent are asking why we should be required to have a Federal match and the Northeast Corridor should not. I would like a short answer from you and a longer one in writing on whether or not the States in the Northeast Corridor should be required to make some kind of contribution, considering the fact that 46 percent of the train miles used on that corridor are used by commuter rail agencies of the States and not by Amtrak.

Mr. DAYTON. Clearly, all States should be contributing to the capital portion of their services. I would say that the Northeast Corridor actually does produce an operating profit and that profit does go to cover some of the losses on the short-distance corridors around the country and the long-distance corridors. And so to the extent that Amtrak reduces or eliminates those losses through, as we have said, eliminating sleeper service and reforming food and beverage service. The reason that we advocate those is to free up funds that can be put into capital.

Senator MURRAY. I am sorry, you say they have an operating profit, but I know that they have millions of dollars in capital costs and that they are in deficit. So how do you say that?

Mr. DAYTON. There is an operating profit in terms of just the cost of operations, but you are right, the capital investment in the Northeast Corridor is greater than that operating profit. That is true. If that operating profit were not covering losses elsewhere, it could be reinvested in the corridor itself, so that the passengers in those States that are using the corridor would, in fact, be supporting the capital investment.

Senator MURRAY. I know my time is short. That wouldn't even come close to dealing with the dilemma that I think we need to understand, and I would appreciate a long answer from you since we are unfortunately short on time.

Mr. DAYTON. We will provide it.

Senator BOND. Thank you very much, Senator Murray.

I understand that the IG in November 2005 reported that the Amtrak Board of Directors indicated in writing that they would be launching a number of pilot projects, including reforms to first class service on its long-distance routes that would enable Amtrak to achieve savings. I gather that has not been—no pilot projects have come forward. I would like to ask Amtrak where those pilot projects are. What do you contemplate in this area?

Mr. LANEY. Senator, we have pilot projects in the works, I think, on a State basis and I believe they are scheduled for presentation to the Board in our April Board meeting, which is the first week of April, unrelated to the first class service.

First class service is a little more difficult. It is an essential piece of the puzzle for overnight travelers, and a lot of our trains are overnight trains. But we, at least I share with the IG the concern about any Federal dollars subsidizing first class passengers, because there are losses, significant losses, involved in that. We have looked at some opportunities and been a little frustrated by some labor cost structure difficulties in bringing in alternatives to Amtrak's providing that service. But we have got a ways to go and we have not wrestled that to the ground.

Senator BOND. Mr. Laney, Mr. Boardman, Mr. Hughes, Mr. Dayton, our sincere apologies. We would invite your further comments in writing. We will look forward to continuing these discussions. I may even have some options that, while they may be distasteful, they may be effective and I would like to discuss those with you.

We thank our witnesses.

#### ADDITIONAL COMMITTEE QUESTIONS

Senator LEAHY. I just wanted to submit a couple of questions for the record.

Senator BOND. Senator Leahy will be submitting questions for the record, and obviously, we would like you to take those questions, as well. Thank you very much.

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

#### QUESTIONS SUBMITTED TO AMTRAK

##### QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND

*Question.* Why does Amtrak not have a detailed multi-year financial plan now? Wouldn't this planning document, similar to a TIP, or transportation improvement plan, help Amtrak identify year-to-year, what priorities for improvements are necessary to be made and help in the budget process?

*Answer.* Amtrak has a multi-year plan for capital improvements and also a multi-year projection of funds required for debt service. In connection with the company's "Strategic Reform Initiatives and Fiscal Year 2006 Grant" request, the company also provided its first 5-year projection of operating funds required. This document did describe the yearly priorities for improvement, as well as the legislative changes required, to achieve the target numbers.

*Question.* Realizing that Amtrak needs approximately \$295 million to address its mandatory debt service, and zero is provided in this year's budget proposal, how would you propose to address the debt?

*Answer.* Debt service must be honored each year to avoid default. Accordingly, the company would have to curtail its capital expenditures and/or reduce its net operating loss by \$295 million. To reduce capital expenditures by this magnitude will

jeopardize the system state of good repair: to reduce the net operating loss by this magnitude will likely require significant curtailment of existing services.

*Question.* What are you doing in terms of renegotiating your debt service rates?

*Answer.* Some small debt obligations have provisions for early repayment and, if the penalties are not onerous, the company is exercising these early payment options (when cash is available). However, there is no opportunity to renegotiate the interest rates on existing debt without (1) a “stick” that threatens the lenders unless they co-operate and reduce rates or (2) a “carrot” that gives lenders some incentive to reduce rates. We have been unsuccessful in urging Congress to selectively grant Amtrak debt a “full faith and credit” guarantee (a meaningful carrot) in return for financial concessions from lenders.

*Question.* The Inspector General’s Office within the Department of Transportation has indicated that Amtrak’s operating subsidy baseline is \$586 million. Amtrak’s fiscal year 2006 operating subsidy baseline is \$586. Amtrak’s fiscal year 2006 operating appropriation is \$490 million. What specific savings has Amtrak identified to live within this amount?

*Answer.* We believe we will be able to fully fund operations with the \$490 million appropriation because of: (1) better than expected ridership that is the result of increases in automobile gasoline prices, (2) lower wages, salaries and benefits expense that is the result of slower rates of hiring for replacements (i.e. working with higher vacancy rates and lower actual headcount), (3) realized improvements in the financial results of our food and beverage business activity, (4) lower than expected professional fees and (4) lower FELA and liability claims costs.

*Question.* What options, if any, are available for Amtrak to outsource its first class services? Under what scenario would Amtrak consider outsourcing its first class services on its long-distance routes?

*Answer.* Under current law, Amtrak may outsource food and beverage services. Outsourcing of other services, such as sleeping car services on long-distance trains, requires negotiations with Amtrak’s labor unions under the Railway Labor Act if the outsourcing would result in the layoff of Amtrak employees. See Public Law No. 105–134, sec. 121.

Subject to applicable law, Amtrak will consider outsourcing services if it appears that outsourcing will reduce the cost and/or improve the quality of the services without adversely impacting safety or customer service.

*Question.* Amtrak has indicated that it will update labor contracts to enhance customer service and provide greater efficiencies. I understand that currently, more than 80 percent of Amtrak’s passenger revenues are consumed by labor and benefit costs alone.

What are Amtrak’s specific goals as it looks to update its labor contracts?

*Answer.* Amtrak’s specific goals with every union that has not had an agreement through December 31, 2004 are to achieve health care cost containment and premium contribution, work rule changes to improve productivity and lower costs and, in return, a fair increase if the those goals are met. Three unions representing approximately 35 percent of the employees represented at Amtrak have entered such agreements with the company.

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#### QUESTIONS SUBMITTED BY SENATOR CONRAD BURNS

*Question.* Mr. Laney, a lot of attention has been focused recently on the improvements and upgrades to long-distance trains, in order to increase ridership. We have seen the benefits of those commitments on the Empire Builder, and I wonder if you could discuss what steps you plan to take to continue this process.

*Answer.* In August 2005, the Empire Builder was relaunched with upgraded equipment, enhanced on board amenities, improved customer service and a renewed marketing focus. The improvements have been well received by passengers, who are paying the planned higher fares for a perceived better valued product. As a result, ticket revenues (October through May) are up 18 percent versus last year, and sleeping car revenues are up 28 percent. Year-to-date ticket revenues are favorable to the budget by \$1.8 million. With just 10 months’ experience, the project is on track to improve the train’s bottom line by about \$4.8 million by the end of fiscal year 2007. In conjunction with the restructuring of its long-distance services, Amtrak is looking for additional opportunities to provide enhanced services on other long-distance routes where there is the potential for a positive financial contribution.

*Question.* As you know, I was very disappointed in the decision to fire David Gunn. I am sure the Board had its reasons, but I am concerned that part of the impetus to push him out the door was his understanding that long-distance trains

are an essential part of the Amtrak network. Can you give me a sense of the Board's commitment to preserving long-distance trains, especially in communities where public transportation options are so limited?

Answer. The Board has stated publicly its commitment to a responsible and systematic evaluation of Amtrak's long-distance network, focusing on all facets of long-distance service, including service quality, function, optimal network configuration and economics. The fact that long-distance train operations are valued by many communities in which transportation options are more limited will invariably be factored into the Board's evaluation process. Mr. Gunn's departure was unrelated to his positions regarding long-distance trains.

*Question.* You mention in your testimony a concern about freight rail capacity issues. I share those concerns. Do you believe that capacity issues require more rail to be laid down, or can improved technology and better management accomplish those goals?

Answer. Increased rail line capacity can come from many sources other than laying more rail. Some examples:

- Additional locomotives;
- Additional crews;
- Additional yard capacity to keep trains from backing up on main lines;
- Signal and operating rule changes allowing running both directions on existing multiple track lines, allowing trains to operate closer together (shortening signal spacing), or allowing greater dispatcher control (Centralized Traffic Control);
- Improved dispatching systems, possibly broken into regions rather than large centralized systems;
- Changed dispatching practices, including less turnover among dispatchers and more dispatcher training trips to create familiarity with physical territory;
- Positive train control systems;
- Directional running on parallel lines;
- More frequent crossovers or sidings, or reconfigured crossovers and signals allowing movements at higher speeds;
- Better maintenance of existing lines reducing slow orders;
- Better maintenance of existing signal systems reducing signal failure delays;
- Better maintenance of locomotives and cars to avoid failures;
- Better train handling practices to avoid failures; and,
- Realignment of existing lines or curvature elevation to increase speeds or make speeds more uniform.

Generally, a railroad will choose adding more rail lines as the least desirable, last resort to add capacity, since new rail lines are expensive and cannot be easily redeployed if traffic patterns shift.

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QUESTIONS SUBMITTED BY SENATOR PATRICK J. LEAHY

*Question.* The most recent grant request from Amtrak indicates that the struggling railroad needs \$1.5 billion next year for capital and operational expenses. The President's budget request, though, only seeks \$900 million in total funding. Since we have heard the administration proclaim that it is dedicated to passenger rail nationwide, how does this budget request add up to that commitment?

Answer. If the actual grant to Amtrak were reduced to \$900 million, it would inevitably require a reduction in capital expenditures, a curtailment of existing services or both. From any appropriation, Amtrak's first legal obligation is to make debt service (principal and interest) payments amounting to almost \$300 million. If only \$600 million in Federal funds remained, they would be insufficient to fund the necessary capital maintenance program and support the existing level of services: each of these activities will require almost \$500 million during the current fiscal year.

*Question.* My small State of Vermont has two State-sponsored trains—the Vermonter and the Ethan Allen Express. The State of Vermont paid \$2.65 million to cover the operating losses this year and is slated to pay \$4 million next year as Amtrak ramps up the share paid by the States. The Department of Transportation and Amtrak have said that they intend to develop public-private partnerships for the corridor service. How closely are you working with the individual States to improve equipment and service on these trains?

Answer. Amtrak works closely with the 13 States that provide funding for State-supported services operated by Amtrak. For example, Amtrak is currently working with Vermont on an initiative to improve food service quality and reduce food service costs borne by the State.

In May, Amtrak solicited proposals from States that fund Amtrak services for a pilot trial of State and/or private participation in the provision of some of the services required for the operation of their State-supported services. Federal funding in the amount of \$2.48 million is available for a pilot project that can be demonstrated to reduce the cost of providing the services at issue. Amtrak received responsive proposals from a number of States that fund State-supported services, including Vermont. Amtrak expects to make selection(s) from among these proposals for the pilot project by the end of July.

SUBCOMMITTEE RECESS

Senator BOND. The hearing is recessed.

[Whereupon, at 10:54 a.m., Thursday, March 16, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

**DEPARTMENTS OF TRANSPORTATION, TREASURY, THE JUDICIARY, HOUSING AND URBAN DEVELOPMENT, AND RELATED AGENCIES APPROPRIATIONS FOR FISCAL YEAR 2007**

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**THURSDAY, APRIL 6, 2006**

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

The subcommittee met at 9:37 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Christopher S. Bond (chairman) presiding.

Present: Senators Bond, Murray, and Dorgan.

DEPARTMENT OF THE TREASURY

OFFICE OF THE SECRETARY

**STATEMENT OF JOHN W. SNOW, SECRETARY**

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Good morning. The Subcommittee on the Appropriations Committee on Transportation, Treasury, Judiciary, HUD and Related Agencies will come to order.

This morning, the Senate committee will conduct its budget hearing on the fiscal year 2007 budget on the Department of the Treasury. In addition, due to the important role of the Treasury in fighting the war on terrorism, today's hearing also will focus on the Treasury's Office of Terrorism and Financial Intelligence. Senator Murray is on the way, but her staff has graciously agreed to allow me to proceed, even though she will miss part of my opening statement. I will promise to give it to her in full when she gets here later on. But because of the schedule, and we have a vote scheduled at 10:30, Mr. Secretary, if it is all right with you, we would like to finish up your part of the testimony by 10:15. I am going to wield the gavel so we can have the second panel testify before we have to go to the vote. If you don't mind, we will try to keep it short and get you out of here at 10:15 to accommodate our schedule.

As I said, we have two panels. On the first panel, Treasury Secretary John Snow, and we welcome Secretary Snow back, and we look forward to hearing his views on the accomplishments and challenges facing Treasury. After Secretary Snow, we will hear

from a second panel of high-level Treasury officials who help lead the Department's efforts on combatting terrorists' financing. Specifically, we will hear from Under Secretary for Terrorism and Financial Intelligence Stuart Levey, and Assistant Secretary for Intelligence and Analysis Janice Gardner.

I have had the great pleasure of getting to know both Mr. Levey and Ms. Gardner through my work on the Senate Select Committee on Intelligence. Both have done an outstanding job of bringing together the unique capabilities and resources of the Treasury Department in intelligence gathering and analysis. The result has made the Department a key player and a true asset in the intelligence community and in the war on terrorism.

A lot has changed at the Treasury since our hearing last year, Mr. Secretary. One year ago, the Department was floundering due to a vacancy overload at its most senior-level positions. Now most of these vacancies have been filled and the Department is currently playing a much more significant and visible role in many important areas, especially having reestablished its role as a leader in combatting illicit financing with regard to money laundering and terrorist financing.

Mr. Secretary, I congratulate you and the President for responding to our concerns and filling these important positions. I am pleased by the Treasury's commitment to these important challenges, and I am especially impressed with the quality of leadership at the Office of Terrorism and Financial Intelligence, TFI. If anybody can follow all of these acronyms during the discussion, you are a little bit quicker than I am, but I have a cheat sheet to read them from.

That said, I remain concerned about the Department's ability to handle its management responsibilities, particularly in the IT area since the Office of Inspector General continues to cite management as a major challenge area, especially due to the recent failure of the BSA Direct Information Technology Project. It is a critical system, intrinsic to the success of the Financial Crimes Enforcement Network, or FinCEN's mission, and I am very frustrated that it did not receive greater oversight and support prior to and during its development. I intend to ask the GAO and the Inspector General, or the OIG, to review this issue and to provide some specific recommendations for preventing this kind of problem.

I acknowledge your current management team is relatively new, and to some degree they are still getting their feet wet. However, on your watch, Mr. Secretary, BSA Direct and other large capital-investment projects like the Treasury Building and Annex repair and restoration, HR Connect and the Treasury Communications Enterprise have experienced significant problems.

In terms of the latest failure, BSA Direct, I am fully committed to working with FinCEN's director Bob Werner in fixing these problems, and I credit the Director for taking action. However, we need to understand why your team did not act sooner, or at least ask questions on why milestones were being missed and costs were exceeding the original award amount. Senator Murray and I expect answers, Mr. Secretary, not excuses.

We also want your commitment, Mr. Secretary, to assist Director Werner in ensuring that these types of problems do not happen

again. Finally, this subcommittee expects a clear action plan designed to address these IT management issues. The action plan should be submitted no later than 45 days of this hearing, but I expect, because I know this is a high priority for you, as it is for us, that it will be sooner than that.

Let us be clear, we expect better management, better oversight, and better accountability from the Department or else the chairman, and I believe I speak for my ranking member, will be reluctant to appropriate any additional funds for IT projects at the Treasury or Treasury priorities. This is that important to us.

Turning to the Treasury's budget request, the administration requests some \$13.1 billion for the Department for 2007. About \$11.6 billion falls under the purview of this subcommittee. For the THUD account, the budget requests a \$24.7 million or 0.2 percent increase over the 2006. Most of the Treasury's budget and the budget increases are for the Internal Revenue Service, which comprises some 92 percent of the Department's budget under the THUD Subcommittee—a significant budget request in a very tight budget year. We will not be rubber-stamping any budget proposals because we do not have the money to do it. Instead, a budget anchored by a demonstrated commitment and comprehensive justification is expected. Because of the budget emphasis and the importance of the IRS, the subcommittee plans to hold a separate hearing on the IRS later this month, and we will focus on the IRS at that time.

There are a couple of IRS items, Mr. Secretary, I want to bring to your attention. First, the IRS budget request is disappointing. While the administration proposes an \$18.1 million increase for IRS in 2007, the increase is, frankly, insufficient in taking a serious bite out of the \$340 billion tax gap. Further, the budget request is filled with a number of budget gimmicks, which, if unattained, could result in significant cuts to IRS programs and core services in both taxpayer service and enforcement.

I also raise our serious concern with the proposed cut to the IRS's Business Systems Modernization, or BSM, program. BSM still has its challenges and risks, but led by the new Associate CIO and his team, BSM is beginning to show results, and for the administration to propose reductions to BSM now makes little sense to us. In fact, cutting BSM greatly damages the momentum built up over the past 2 years. This is a classic example of punishing good behavior.

The second point we raise is with IRS proposed regulations on disclosure and use of taxpayer information. There appears to be growing concerns about taxpayer privacy being compromised by the proposed regulation. Some concerns seem to be based on misunderstandings, whereas others are legitimate issues regarding the disclosure of confidential taxpayer information. It is a complex issue, filled with a lot of land mines. Nevertheless, I hope that Treasury and the IRS can balance out the needs and problems to ensure the maximum confidentiality of all taxpayer information to the greatest extent possible.

The last point I raise is on taxpayer service. The 2006 THUD appropriations laid out some clear directives that restrict the IRS from reducing taxpayer services until a plan for adequate alternative services is provided, and the Treasury Inspector General for

Tax Administration, TIGTA, to offer another acronym, provides a review. I understand the IRS is complying with his directive, and I am optimistic that we will not have problems in the future.

My strongest area of interest within Treasury is in its activities in fighting the war on terror, and in particular, terrorist financing. The Treasury has a long and storied history of successfully combatting organized crime from the Al Capone days, to the Nazis in World War II, and more recently, to the drug lords of Central America. These past and ongoing experiences have helped the Treasury develop a unique set of skills in understanding, deterring, and eliminating a wide variety of illicit funding. For example, the Treasury's Office of Foreign Assets Control, or OFAC, and its predecessor organizations, have had a long history of administering and enforcing economic and trade sanctions beginning with the War of 1812, through the Civil War, and the First and Second World Wars.

In modern times, OFAC has helped combat intelligence narcotics traffickers, and now as a key operational component of TFI, it is also taking on terrorists and WMD proliferators. Due to the Treasury's long experience and its unique role, Congress authorized the creation of the Treasury Office of Terrorism and Financial Intelligence, or TFI, not just to recognize the Treasury's expertise or reorganize existing intelligence, but to take the Treasury with its unique experience to a new level to play a greater role in the war on terror.

As a part of TFI, Congress created the Office of Intelligence and Analysis, or OIA, which is charged with analyzing intelligence and financial information, producing high-level products for administration and Treasury officials, for, as we all know too well from past experiences, there is a lot of information available. The problem is being to put the information together, or connecting the dots.

Since its creation, TFI and OIA are beginning to show some real results. In fact, last December, the 9/11 Commission graded various aspects of the Federal Government on fighting the war on terrorism and gave an A-minus in the area of combatting terrorist financing. That is a pretty good score compared with what everybody else got, and TFI and the Treasury Department deserve a lot of credit. TFI deserves credit and recognition for its strong role in combatting financing due to the excellent work in support of the Department's efforts to designate terrorist entities, shut down financial flows, to individuals from rogue regimes, and uncover clandestine financial networks.

In 2005, the Department designated a number of banks and foreign officials in troubling areas like Syria, North Korea, and Iran. Last December, the Department designated Banco Delta Asia under section 311 of the PATRIOT Act. It is a powerful new tool authorizing the Department to designate various foreign and financial institutions as a primary laundering concern, and to impose sanctions. Under Secretary Levey stated that, "Banco Delta Asia has been a willing pawn for the North Korean government to engage in corrupt financial activities through Macau, a region that needs significant improvement in its money laundering controls. By invoking our USA PATRIOT Act authorities, we are working to

protect U.S. financial institutions, while warning the global community of the illicit financial threat posed by Banco Delta Asia.”

This bank was a key hub, and having made visits to our officials and our resources in that area, I can tell it has had a major impact from the people doing the job in that area. They are telling me how important and significant this was. The DRPK under Kim Jong-il has bemoaned the action, stating to the President of China that, “The regime might well collapse under the weight of U.S. sanctions.” It would be a shame, wouldn’t it?

TFI has also been able to assist foreign governments in taking their own actions. It is creating a new unit to tackle terrorists financing in innovative ways. Last year we funded the Joint DOD/Treasury Finance Cells. The pilot cell in Baghdad, known as the Iraq Threat Finance Cell, ITFC, enhances collection, analysis, and dissemination of intelligence. Since I serve on both Appropriations and Intelligence, I am very encouraged to see OIA is up and running strong within the government. I believe it is key to winning the war on terror. It is a focal point for the Department for compartmented intelligence analysis and support, and the critical intelligence it is providing during weekly targeting meetings is very important. It is going to deal with the use of hawalas. Those are the traditional Arab money-transfer and changing organizations. They are now too often being used by terrorist organizations. We need to know how they work and how to regulate them. The Office of Terrorist Finance and Financial Crime, TFFC, is looking at the use of hawalas by terrorist organizations and is working with other Federal agencies and international counterparts, for example, in tackling illicit financial flows associated with Afghan narcotics.

I am pleased with the TFI’s progress, but it has to adapt to the continually changing efforts to defeat our efforts. Now, the financing is fragmented into a constellation of small entities, transferring smaller amounts. The experts tell us the 9/11 attacks cost \$500,000, the March 11 bombings in Spain cost about \$15,000, and the recent attacks in London last July cost the terrorists as little as \$2,000. Therefore, combatting terrorist financing has to remain front and center. It is going to be a critical part of our counterterrorism efforts. We have to anticipate the imagination of terrorists because they will go through any means to cause chaos.

One final point before I close. The Committee on Foreign Investment in the United States, or the CFIUS process, in regard to the recent Dubai Ports World controversy: my strong opinion is that DPW was treated very badly since a perfectly legitimate company owned by one of our closest allies in the Middle East was slapped in the face. I can tell you from visiting with foreign officials that that has not only affected our allies in the UAE, but our allies around the world. There are definitely some significant questions about the CFIUS process, they are already being addressed, and I think that some of the intelligence concerns can be addressed by OIA within Treasury. Congress is going to be working on updating that, and I am pleased that the Senate Banking Committee is taking on this issue and has recently passed legislation to reform CFIUS. Notwithstanding any legislation, I believe that Treasury needs to develop a better system of communicating to the Hill on the deals it is considering. Mr. Secretary, we saw a classic example

of that wonderful process on DPW of ready, fire, and aim. Perhaps some additional information to Congress would allow Congress to aim before firing, and I hope we can do that in the future.

Now with apologies, I turn to my colleague, Senator Murray.

STATEMENT OF SENATOR PATTY MURRAY

Senator MURRAY. Thank you very much, Mr. Chairman. Today we are joined by Treasury Secretary John Snow, and I want to welcome him here this morning.

Most Americans view the Treasury Secretary as the leading Cabinet official for our Nation's fiscal policy. Indeed, the Treasury Secretary plays a critical role on overseeing our financial markets and coordinating policy with our international partners. The Secretary is responsible for taking the lead on tax policy and overseeing the collection of tax revenues.

As members of this subcommittee, we have a special obligation to look at another important role of the Treasury Secretary, namely, as the administrator of the funds appropriated by this subcommittee. We have the job of evaluating whether the tax dollars we have appropriated have been well spent, and whether taxpayers have gotten value for their money. In that regard, the record of this Treasury Department is deeply disturbing. Time after time, this subcommittee has been required to sound the alarm about misguided, multimillion-dollar initiatives that have resulted in lengthy delays and massive cost overruns. At this hearing last year, I talked about the unfortunate history of the TBARR program—the Treasury Department's building modernization project. That program is now nearing completion, but not before it spent almost \$100 million more than initially budgeted, and taking 3 years longer than we were promised when we made our initial appropriation.

Last year we also talked about Treasury's so-called HR Connect program, an initiative to modernize the human resources information system at the Treasury Department. That initiative has also been plagued with costly delays and cost overruns.

As we observe the Treasury Department's performance over the last year, we are faced with still more examples of mismanagement and waste. The Treasury Department has been attempting to launch a Treasury Communications Enterprise, or TCE, initiative. As far as we can tell, absolutely nothing has gone right with this program since its inception. The GAO found fault with the competition process, so the Treasury Department decided to terminate its contract and procure services through the General Services Administration. The Treasury Department then reversed its decision and decided to launch a separate competition process for the TCE initiative, despite the fact that the GSA system will have the services Treasury needs at a lower cost. The Treasury Inspector General found that the entire project was fraught with poor planning and execution. The Treasury IG also observed that there was little evidence of adequate senior management oversight of the project.

Even more disturbing have been the missteps that directly affect services to taxpayers, and our ability to combat terrorist financing. Last year, Secretary Snow's IRS Commissioner proposed to eliminate more than 60 Taxpayer Assistance Centers across the country.

I opposed that initiative. He intended to close those centers in order to free up money for enhanced tax law enforcement. Now, while I support efforts to collect the taxes that are owed, I do not believe that enhanced enforcement should come at the cost of services to taxpayers. Despite my opposition and that of many legislators, the IRS Commissioner persisted. In the end, we included bill language prohibiting him from closing these Taxpayer Assistance Centers until the Inspector General could review the methodology and data that he used to determine which centers to close.

We now have the results from the Inspector General. He found that the IRS was using faulty data or data that was not the most current data. He also found that the IRS did not have the necessary management information systems to interpret this data. Had this been allowed to go through, the Commissioner would have, quite possibly, been closing the wrong Taxpayer Assistance Centers, leaving taxpayers who need help in the lurch.

Finally, when it comes to the area of terrorist financing, we have the deeply troubling efforts of Treasury launching its new computer communications system for administering the Bank Secrecy Act, known as BSA Direct. As recently as February 17, 2006, the Treasury Department maintained that this new IT system would be a critical and essential new tool to provide greater access and analytical capability. Indeed, our subcommittee attached such importance to this initiative that we provided \$5 million that the Treasury Department did not request to expedite the deployment of this critical new system. Now, just this past March, a new agency head was put in charge. He found numerous problems surrounding this initiative and issued a stop-work order. It remains to be seen whether BSA Direct should be continued and will add any real value to our efforts to combat terrorist financing. It might make sense for Treasury to use the IRS's new BSA data management system that is already up and running at a fraction of the BSA Direct.

The bottom line is this: just because the Treasury Department prints the Nation's money and collects the Nation's tax dollars, it does not give the Department the right to waste those dollars. This Department has an obligation to learn from its mistakes, and as far as I can tell, these mistakes with major procurements are happening over, and over, and over again. The Treasury Secretary is responsible for many critical matters of international finance. He is also responsible for every dollar we appropriate to his Department. I hope and expect that he will have clear answers for us today about why we continue to encounter these repeated management failures and waste of taxpayer dollars in the Department.

Finally, Mr. Chairman, I want to thank you for scheduling a separate panel of witnesses so that we can deal with the matter of terrorist financing. There is certainly no greater calling on the part of this agency than its effort to cut off the financial lifeline from those terrorists who wish to do us harm. It is one of the reasons that I am so disturbed by the Department's failure in the BSA Direct program. Thank you, Mr. Chairman.

Senator BOND. Thank you very much, Senator Murray. Now Mr. Secretary, we have outlined a few areas of concern. We would welcome your comments.

## SUMMARY STATEMENT OF JOHN W. SNOW

Secretary SNOW. I thank you, Mr. Chairman, and Senator Murray. It is always a privilege and a pleasure to appear before you, to hear your comments, exchange views and get your insights and have an opportunity to talk to you about these important issues. You have raised a lot of good issues, both you and Senator Murray. We put in place, I think, a set of processes that are going to get at these issues more effectively.

First of all, we have identified a pretty good team. I appreciate some of your good comments, frankly, on that team. It is encouraging to hear that from the chairman of this committee. So getting the right team in place, you know, you are right, a year ago we had vacancies across the board, and today, virtually all of those vacancies are filled, and filled with really top-flight people.

On the IT issues, we recognize we have got to do better. We know that, again, getting the right people in place and the right management structures. I have had a lot of experience, Senator Murray and Mr. Chairman, over the years, probably at least as much as you have, in overseeing and managing IT systems. The Government's IT systems are more complex than any you ever see in the private sector, and when it comes to something like BSA, go to your corner software store and you can't pick it up off the shelf. You got to develop these systems on your own, and they are inherently very, very complex. I am not making excuses. We are going to do better. We have realigned the CIO under the Assistant Secretary for Management. We are going to apply the lessons that we have learned from past mistakes.

One of those lessons is you put in place real project management and you understand going in what you are trying to accomplish. You know your requirements. You lay out your requirements. You have milestones. You follow the success in achieving those milestones, all those things that are good management, and providing better coordination across all the functions. I am confident that we are going to do better on that score.

Let me say, you know this Department has changed enormously over the few years that I have been here. When I came in, it was going through that massive restructuring to create Homeland Security. We did not have the TFI functions fully developed, and I want to thank you for your support in helping us put in place this strong TFI function.

What is Treasury all about? It has an important role, as Senator Murray said, in trying to keep the American economy on the right path, and in dealing with counterparts in the global economy. I think we do that pretty well. The American economy today you know is performing very well. We are growing at close to 4 percent for the last nearly 3 years since the Jobs and Growth Bill went into effect, 5 million new jobs, and I think we are going to continue on that good path. The Treasury Department's counsel with the President and putting in place the Tax Program of 2003 I think has a lot to do with that. So I hope Congress will move to extend those reductions on dividends and cap gains, and do it soon.

We also have an important role in securing our country from terrorist threats. You have alluded to that and I will not go into it

except to say it is a top priority with me, and I think we have the right people in place to drive those efforts.

The Treasury stands at the center of the national and the global fiscal policy issues, the Current Account issues, global growth issues, all of those. We participate in the G-7 and the G-20 and APEC, and we lead this country's efforts at the World Bank and the IMF, all critically important functions. Senator Murray, I take seriously your comments about the deficit. We are a voice for restraining spending and keeping the economy strong to get revenues coming in, and revenues, of course, are now at an all time high for the United States Government, and on a path as a percent of GDP to achieve their historic level.

You have raised other issues that I will look forward to getting into in the Q and A. On the 7216 question, that regulation, Mr. Chairman, you are right, that has been grossly misperceived in the press. It is actually a tightening of the rules on privacy, not a weakening of those rules. We can get into that later.

#### PREPARED STATEMENT

Again, I very much value the close working relationship with this committee and your excellent staff. We take seriously their comments, we take seriously the GAO's comments, and working together, I think we will continue to make good progress at the Department. I thank you.

[The statement follows:]

#### PREPARED STATEMENT OF JOHN W. SNOW

Chairman Bond, Senator Murray, and members of the subcommittee, I appreciate the opportunity to appear before you today to discuss the President's fiscal year 2007 budget for the Department of the Treasury.

The President's budget for Treasury in fiscal year 2007 reflects the Department's dedication to promoting economic opportunity, strengthening national security and exercising fiscal discipline. The budget supports activities that help ensure all Americans will have the opportunity to live in a Nation that is more prosperous and more secure.

The Treasury appropriations request for fiscal year 2007 is \$11.6 billion, slightly above the fiscal year 2006 enacted budget. This request is consistent with the President's overall goal of cutting our deficit in half by 2009. The Treasury Department is committed to fiscal austerity and to the most efficient and effective use of taxpayer dollars while at the same time boosting revenues through continued economic growth.

Mr. Chairman, we have provided the committee with a detailed breakdown and justification for the President's fiscal year 2007 budget request for Treasury. I would like to take the opportunity today to highlight portions of our request and then I would be happy to take any questions you may have.

#### PROMOTING A PROSPEROUS AND STABLE U.S. ECONOMY

The Treasury Department plays a predominant role in the development and implementation of the President's goals for domestic and international economic growth, and the communication of his agenda. To reach our greatest potential, the economy must increase its rate of growth and create new, high quality jobs for all Americans.

The legal and regulatory framework must also support this growth by providing an environment where businesses and individuals can grow and prosper without the burdens and costs of unnecessary taxes and regulations. In addition, the role of the tax system in supporting economic growth is critical. The economic indicators since the President signed the Jobs and Growth Act in May 2003 provide validity to this notion. Since that time, we have seen 11 straight months of positive business investment; nearly 5 million jobs have been created; the unemployment rate stands at a remarkable 4.8 percent; and now we are also seeing a rise in American's income and

wealth. What's also impressive is the fact that tax revenues are surging; Federal revenues for fiscal year 2005 totaled \$2.15 trillion—the highest level ever.

The budget addresses the need to consider the economy when considering tax policy with the proposed creation of a new Dynamic Analysis Division within Treasury's Office of Tax Policy. Understanding the full range of behavioral responses to tax changes, including how tax changes affect the size of the economy and, eventually, tax revenues, is critical to designing meaningful, effective tax policy, and tax reform. This small expenditure will have a substantial pay-off for the American taxpayer.

Treasury's Office of International Affairs also plays a key role in supporting growth by advancing our Nation's interests in an increasingly complex world economy. The office improves access to foreign markets for U.S. financial service firms, promotes domestic demand-led economic growth abroad, and fosters economic restructuring and stability. These activities contribute to rising standards of living in both the United States and other countries.

As globalization has progressed, Treasury's on-the-ground presence in international finance and economic centers has steadily receded. The \$9.4 million requested to increase Treasury's overseas presence will enable the Department to carry out its international mission in the global economy more effectively. Treasury attachés will work in tandem with the Office of International Affairs and the Office of Terrorism and Financial Intelligence to build relationships with foreign officials and work with local U.S. industry and agency representatives to advance U.S. interests. They will also provide much-needed intelligence and expertise to U.S. officials in Washington formulating policy on international economics, trade, finance, and terrorist finance.

The budget also seeks \$7.8 million for the Community Development Financial Institutions (CDFI) Fund to administer the New Markets Tax Credit and manage the existing loan portfolio. The budget proposes to consolidate CDFI's remaining programs into the Strengthening America's Communities Initiatives (SACI) within the Departments of Commerce and Housing and Urban Development.

#### FIGHTING THE GLOBAL WAR ON TERROR AND SAFEGUARDING OUR FINANCIAL SYSTEMS

While promoting financial and economic growth at home and abroad, Treasury performs a critical and far-reaching role in homeland security. The Department battles national security threats by coordinating financial intelligence, targeting and sanctioning supporters of terrorism and proliferators of weapons of mass destruction (WMD), improving the safeguards of our financial systems, and promoting international coordination to attack the financial underpinnings of terrorist and other criminal networks. To support these efforts, the President requests \$388.7 million for fiscal year 2007.

The Office of Terrorism and Financial Intelligence (TFI) supports Treasury's national security efforts by safeguarding the U.S. financial systems against illicit use. TFI provides financial intelligence analysis, develops and implements anti-money laundering measures, administers the Bank Secrecy Act, and enforces economic and trade sanctions. In addition, TFI provides policy guidance for the Internal Revenue Service's (IRS) Criminal Investigation staff. IRS special agents are experts at gathering and analyzing complex financial information from numerous sources and applying the evidence to tax, money laundering, and Bank Secrecy Act violations. These agents support the national effort to combat terrorism and participate in the Joint Terrorism Task Forces and similar interagency efforts focused on disrupting and dismantling terrorist financing.

Financial intelligence exposes the infrastructure of terrorist and criminal organizations. It provides a roadmap for investigators to find those who help facilitate criminal activity. These investigations lead to the recovery and forfeiture of illegally obtained assets and create broad deterrence against criminal activity. Treasury plays a crucial role in linking law enforcement and intelligence communities with financial institutions and regulators. To support these efforts, Treasury requests an increase of \$16.9 million for the Financial Crimes Enforcement Network to improve coordination with State and local regulators, strengthen regulatory training and outreach, and enhance Bank Secrecy Act collection, retrieval, analysis, and sharing.

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 the terrorists' ability to function. Treasury's actions include:

- Freezing the assets of terrorists, drug kingpins, and support networks;

- 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 2007 President's budget requests \$7.8 million to enable Treasury to continue to enhance its abilities to identify, disrupt, and dismantle the financial infrastructure of networks of terrorists, proliferators of WMD, narco-traffickers, criminals, and other threats. Treasury will also improve its analytical capabilities, to provide actionable intelligence and to target, designate and implement sanctions against the financiers of WMD proliferation.

This budget request funds Treasury's national and homeland security mission at a level that provides increasingly effective support to the war on terror. Treasury will enhance this support with an increased international presence funded in this request. Treasury attachés located at critical embassies throughout the world will enable close liaison with the international financial institutions and foreign governments to promote the national and economic security interests of the United States.

#### COLLECTING TAXES AND MANAGING THE GOVERNMENT'S FINANCES

Treasury's strategic goal to manage the U.S. Government's finances effectively is the largest part of the President's fiscal year 2007 request for the Department. The budget request of \$10.9 billion—the majority of which is for the Internal Revenue Service—underscores Treasury's commitment to provide quality service to taxpayers and enforce America's tax laws in a balanced manner.

The Internal Revenue Service (IRS) provides taxpayers with top-quality services by helping them understand and meet their tax responsibilities through a commitment to integrity and fairness. The IRS supports the administration's goal of reducing the Federal deficit by increasing tax receipts collected through taxpayer services, enforcement compliance, and identifying improvements that will reduce the cost of revenue collection. Treasury's enforcement efforts yielded a record \$47.3 billion in enforcement revenue in fiscal year 2005. The fiscal year 2007 budget will provide funding to continue the IRS's dedication to service and maintain efforts to improve the enforcement of tax laws.

Increasing compliance with the tax code is at the heart of the Treasury's enforcement programs. The IRS will continue to expand enforcement efforts by targeting its casework and enforcement activities to deliver results more effectively. The IRS will continue to analyze tax information and data from compliance research studies to better understand and counter the methods and means of those taxpayers who fail to report or pay what they owe. The IRS is focusing on discouraging and deterring non-compliance such as corrosive activity by corporations and high-income individual taxpayers. In order to ensure funding for tax enforcement, the administration is again proposing a program integrity cap adjustment. I am pleased that the Senate Budget Committee included this adjustment in their Budget Resolution.

To reinforce this effort, the budget proposes new tax legislation that will improve the ability of the IRS to identify underreporting and collect unpaid taxes, while minimizing the burden on those who comply with the tax code. These legislative proposals strategically target areas where research reveals the existence of substantial compliance issues. The improvements will burden the taxpayers as little as possible, and the changes support the administration's broader focus on identifying legislative and administrative changes to increase compliance with the tax code.

The IRS continues to make progress with the Business Systems Modernization (BSM) program. BSM aims to modernize the tax system by providing real business benefits to taxpayers and IRS employees through new technology. In fiscal year 2006 and continuing in fiscal year 2007, BSM is revising its modernization strategy to emphasize the incremental release of projects to deliver business value sooner and at lower risk.

The Treasury Inspector General for Tax Administration (TIGTA) continues to partner with the IRS in increasing compliance with the tax code by ensuring that the IRS can pursue the effective administration of Federal tax laws without hindrance from internal and external attempts to corrupt the tax system. TIGTA serves to highlight opportunities for cost savings in IRS operations, protect taxpayer rights and privacy, and generally promote the economy, efficiency and effectiveness of tax administration.

The Alcohol and Tobacco Tax and Trade Bureau (TTB) also works to ensure that taxes due become taxes collected. TTB is the Nation's leader on regulating alcohol,

tobacco, firearms, and ammunition excise taxes. The bureau is responsible for the collection of approximately \$15 billion annually. TTB ensures that alcohol beverages are labeled, advertised, and marketed in compliance with the law. TTB's efforts assure the public that alcohol and tobacco products reaching the marketplace are unadulterated, thereby providing marketing and sales value to the industry. The budget proposes to establish user fees to cover a portion of the costs of these regulatory functions.

Treasury also works to disburse, manage, and account for the Nation's monies as it distributes payments, finances public services, and balances the government's books.

The Financial Management Service (FMS) is the government's financial manager and as such administers the government's payments and collections systems. In fiscal year 2005, FMS issued over 952 million non-defense payments valued at \$1.5 trillion, of which 76 percent were made electronically. The President's budget includes proposed legislation that would enhance non-tax debt collection opportunities, including allowing FMS to collect an estimated \$3.8 billion in past due unemployment compensation debts over the next 10 years.

The Bureau of the Public Debt (BPD) facilitates Treasury's debt financing operations by issuing and servicing Treasury securities. BPD will continue its goals of increased efficiency and achieve its mission to borrow the money needed to operate the Federal Government and to account for the resulting debt.

#### STRENGTHENING FINANCIAL INSTITUTIONS

Treasury, through the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS), maintains the integrity of the financial system of the United States by chartering, regulating, and supervising national banks and savings associations. Ongoing supervision and enforcement ensure that each national bank or saving association is operating in a safe and sound manner, which enhances the reliability of the U.S. financial system. In fiscal year 2005, OCC and OTS oversaw assets held by these insured depository institutions totaling \$7.3 trillion.

The United States Mint and the Bureau of Printing and Engraving (BEP) share the responsibility of meeting global demand for the world's most accepted coins and currency. Neither the U.S. Mint nor the BEP receive any appropriated funds from Congress. In fiscal year 2005, the Mint returned \$775 million to the Treasury's General Fund. The U.S. Mint continues its work to streamline operations and remain highly effective, while providing coins for circulation and numismatic purposes. BEP continues its work of developing new methods of designing our currency to guard against counterfeiting. The bureau plans to release the redesigned \$100 dollar bill later this year.

#### MANAGING TREASURY EFFECTIVELY

The President has requested \$219.8 million to ensure proper stewardship of the Department. Treasury is committed to using the resources provided by taxpayers in the most efficient manner possible.

The Departmental Offices and Department-wide Systems and Capital Investments Program (DSCIP) account funds technology investments to modernize business processes throughout Treasury, helping the Department improve efficiency. In fiscal year 2007, the President's budget requests \$34 million for ongoing modernization and critical information technology projects and to invest in other new technologies that will improve efficiency and service. Included in this request is \$21.2 million to complete the redesign and modernization of Treasury's Foreign Intelligence Network (TFIN), a Top Secret/Sensitive Compartmented Information system critical to the support of Treasury's national security mission.

Included in this budget request is \$17.4 million to fund the Department's Office of Inspector General (OIG) audit and investigative programs. The budget also includes \$136.5 million for the Treasury Inspector General for Tax Administration (TIGTA) and its efforts to oversee the Nation's tax administration.

The Treasury Franchise Fund, recognized as a Financial Management Center of Excellence, is a self-supporting business-like entity that provides common administrative services to other Federal agencies on a fully reimbursable basis. The Fund will continue to support Treasury's stewardship of the Department by promoting excellence in its management and increase competition for government and financial services.

## TREASURY AND THE PRESIDENT'S MANAGEMENT AGENDA

Treasury is meeting the President's challenge to improve the management of the Department's people and resources. On the most recent President's Management Agenda (PMA) scorecard, the Department achieved a Green progress score in five out of six initiative areas, indicating that plans are in place and implementation is progressing to accomplish the PMA objectives.

The Office of Management and Budget's Program Assessment Rating Tool (PART) is intended to improve program performance. Treasury made a strong commitment to improve its program performance, and PART scores subsequently have improved. Currently, 70 percent of Treasury's PART evaluations have scored "adequate" or better and Treasury has set a target of 76 percent scoring "adequate" or better in fiscal year 2006.

Treasury will continue to work closely with the Office of Management and Budget and other stakeholders to make improvements in implementing the initiatives set forth in the President's Management Agenda.

## CONCLUSION

Mr. Chairman, I look forward to working with you, members of the committee, and your staff to maximize Treasury's resources in the best interest of the American people and our country as we move into fiscal year 2007. We have hard work ahead of us and I am hopeful that together we can work to make the Treasury a model for management and service to the American people, and continue to generate economic growth, increase the number of jobs for our citizens, and keep our financial systems strong and secure.

Thank you again for the opportunity to present the President's budget for the Treasury Department today. I would be pleased to answer your questions.

## INFORMATION SYSTEMS

Senator BOND. Mr. Secretary, thank you very much. Let's get right to the questions.

We have talked about BSA Direct, raising serious questions about the Treasury's ability to procure, manage and oversee IT. Can you give me your personal commitment that high-risk projects like the Treasury Financial Intelligence Network, critical for the TFA analysts to perform their jobs, will not experience the same problems as BSA Direct? How can you assure us that there will be the necessary support and resources for TFIN and other IT projects based on the lessons learned?

Secretary SNOW. There are lessons learned here. I think the major lesson learned is get those requirements well specified in advance, and have somebody with knowledge about IT matters watching it closely. I have asked the Assistant Secretary for Management to make that a priority, and I have asked her, working with the CIO, to make sure they keep me regularly posted on these IT projects. There are a number of them, TFIN and others, that will get my personal attention. They will be managed by people who know a lot more about the management of IT than I do, but as somebody who has been in this world for a long time, I think I can see problems, spot problems, and help keep us on the right track. I pledge to you I am going to do everything I can.

## INCREASED OVERSEAS PRESENCE

Senator BOND. Thank you, sir. As you know, I have supported the major expansion of the Overseas Attaché Program. Can you describe your short-and long-term goals for it, how it will help the American people, and describe the coordination efforts between the Office of International Affairs and the Office of Terrorism and Financial Intelligence in this program?

Secretary SNOW. Absolutely, Mr. Chairman, and I appreciate the chance to do so.

Treasury today has attaché posts at a limited number of places, Baghdad, I think Kabul, Afghanistan, and Tokyo. At one point we had many more, and we see a real need to expand the number to go to critical places on the globe. The attachés would have a dual role. It would be advancing the objectives of good economic policies in those countries, but also the TFI objectives of coordinating on terrorist finance issues, coordinating on issues of putting place better regulatory regimes in many countries. The United States is way ahead of most of the rest of the world in having the PATRIOT Act and 311 and 326 and the various rules we have that allow us to freeze, block and get at terrorist monies. Augmenting the effort to fight terrorists' finances will be a big part of these attachés' roles as well. And they are going to critical places in the Middle East as well as to financial centers around the world.

Senator BOND. I am delighted to see that you are looking at Southeast Asia where I think there are lots of problems, and I would also suggest you look at Pakistan where there could be some real challenges.

#### IRS 7216 REGULATIONS

Moving very quickly to 7216, do you think the proposed regulations adequately address consumer-protection issues? And how are they stronger than current regulatory protections?

Secretary SNOW. Thank you very much, Mr. Chairman. They are much stronger than current law. Current law does not prescribe the form of a warning, and 7216 does prescribe the form of a warning, a much stronger warning. It also puts time limits on the period through which the third party can use that data of 1 year. It had been open-ended. I think the testimony of the fact that this protects taxpayers better is that Nina Olson, the National Taxpayer Advocate, has supported the issuance of these regulations. So I think there was a miscommunication, and the real facts are this tightens privacy with respect to use of taxpayer information.

#### OFFICE OF DYNAMIC ANALYSIS

Senator BOND. Mr. Secretary, the budget proposes \$500,000 to create a new Dynamic Analysis Office within the Treasury. What types of analysis would this office conduct that is not being conducted now? I have a personal feeling about the need for this, but what is the long-term plan for the office in terms of funding and staffing?

Secretary SNOW. When we come to you, Mr. Chairman, with tax proposals, you have the right to say to us: "What will that do to GDP? What will that do to growth? What will that do to macroeconomic variables?" The Dynamic Analysis Office will develop models to enable us to answer those questions so that when we come forward with major tax analyses, major tax proposals, we will have analyses behind those proposals to answer questions about the broad macroeconomic effects.

Senator BOND. I think we have seen it demonstrated that strict, static budget analysis leads to some very bad guesses about future performance.

## TAX GAP

Finally, I would like to ask you about the tax gap, a \$345 billion tax gap. That is the amount of money estimated that is owed and that is not collected. That means those of us who are sweating as hard as we can to pay the taxes we owe by April 15 are carrying the burden for some slugs who are out there not paying the \$345 billion. How can we take a bite out of that with the reduction in the money for the IRS?

Secretary SNOW. Mr. Chairman, the budget proposal includes five new specific legislative proposals that I think would help. The Commissioner I think you know is keen on strengthening enforcement and has done a good job of doing so, with more audits, more enforcement activity, more focus on the enforcement side. We always have to get that balance right, though, between enforcement and taxpayer service. We are just going to continue to do the best we can, and in Commissioner Everson we have somebody who is absolutely dedicated to this purpose.

Senator BOND. Thank you very much, Mr. Secretary. Senator Murray.

## TAX PREPARATION ERROR RATES

Senator MURRAY. Mr. Secretary, let me start by addressing some of the problems that exist at our major tax preparation companies. Just 2 days ago the GAO reported that there may be some serious problems with the accuracy of the tax returns prepared by many of the private tax preparation companies. The GAO found that these companies often prepared returns that were incorrect, with tax consequences that were sometimes significant. Some of these mistaken returns could have exposed taxpayers to penalties for things like negligence and willful or reckless disregard of tax rules. What are you doing now to rectify that situation?

Secretary SNOW. This is a recurring issue, Senator, as you know. I think every year about this time we see newspaper accounts of this. I do not think it is an intent to defraud anybody. I think the problem that you are talking about is the result of the bewildering complexity of the Code itself. You can get 15 tax people of impeccable credentials looking at one tax return and coming up with 15 different results. I think that that is fundamental in the nature of the Code, and we have to address the complexity of the Code.

Senator MURRAY. That could be, but still we have people who go to a tax preparer and believe that they know what they are doing, and I think it is of serious consequence if we do not have an aggressive agency that is doing something to help regulate these tax preparation companies.

Secretary SNOW. Senator, to put this in a little perspective, the IRS itself gives differing interpretations, so that the issue here, and I think it is really a serious one, is not an effort to defraud anybody. It is a reflection of the inherent complexity.

Senator MURRAY. People in your agency give different interpretations? Is that not a problem in itself?

Secretary SNOW. It is a problem of how complex the Code is. My wife is a volunteer to the IRS to help elderly people and poor people prepare their tax returns. She came back to me after a session

recently and said, "John, you cannot imagine how bewildering and confusing the Tax Code is. How do you expect people to comply with the Tax Code when I, a reasonably intelligent person who has had a course in taxes, can hardly figure it out myself?" I think that is a common refrain.

Senator MURRAY. I have to disagree with you a little bit. It may be a complex Tax Code, but when we have private tax preparation companies and an IRS that has a function to make sure that they have the correct information, we cannot just say that that is an excuse for giving taxpayers penalties for being negligent. I think we have to do our job better, I think your agency has to do its job better, and I think we have to manage these tax preparation companies and have aggressive oversight with them. Do you disagree with that?

I will tell you if a math teacher gives a complex question to a bunch of high school students and they come back and say: "Gosh, it is complex", I do not think you would accept it, and I know I would not.

Secretary SNOW. Senator, every year your local newspaper and local newspapers all over the country go out with one tax return, take it to acknowledged tax experts, and the tax experts differ themselves on what the amount owed is. Albert Einstein said, and he was a pretty smart fellow, the one thing that he ever encountered that was entirely incomprehensible to human intelligence was the Internal Revenue Code. If it is tough for Einstein, you can see why it is tough for the rest of us.

#### IRS 7216 REGULATIONS

Senator MURRAY. Mr. Secretary, I do not think anybody would disagree that the complexity of the Tax Code is a challenge for all of us, but it is a challenge we have to aggressively be on top of. Following-up on the chairman's question on the proposed regulations on revising section 7216, I heard you say that some of that improves protection of taxpayer information. That may well be true, but it also very clearly loosens some of the tax preparer companies' obligations and may very easily by just someone accidentally swiping their pen in the wrong place, they lose their private information. I would like to know from you if you are going to follow-up on that, if you are going to take a look at those regulations, take into concern that this has opened up the real question of whether or not taxpayers' private information may accidentally be used without their knowledge?

Secretary SNOW. Senator, absolutely. We have a duty to protect the information of taxpayers, and I pledge to you that we are going to take those responsibilities with the utmost seriousness. This particular regulation was actually an effort on the part of the IRS and the Commissioner to tighten up this regulation.

Senator MURRAY. And I am going to be asking him about it next week, I assure you.

Secretary SNOW. The rulemaking is still open. We invite comments, we invite your comments and others to comment on it.

Senator MURRAY. This has raised serious alarms.

Secretary SNOW. Right.

Senator MURRAY. Since you oversee that division, I wanted you to be aware of it. I want to know that you are aware of it and I want to know that you are following up on it.

Secretary SNOW. And I align myself with your comments on it. It is very important that we protect taxpayer information.

#### TAXPAYER ASSISTANCE CENTERS

Senator MURRAY. I just have 1 minute left here, and I want to ask about the reference that I made in my opening comments to closing some Taxpayer Assistance Centers, and we found out that that was based on faulty data. I would like to find out from you whether we should just accept the IRS's arguments on other recommendations, or should we now be questioning all of those? Since that was based on faulty data, that gives us a lot of concern.

Secretary SNOW. I think you have important oversight responsibilities, and we benefit from your challenging us and raising questions.

Senator MURRAY. Has your Department now abandoned any of your plans to close any of the Taxpayer Assistance Centers?

Secretary SNOW. Yes, there will be no reduction in service contemplated in this budget.

#### BSA DIRECT

Senator MURRAY. Let me just comment in my last 10 seconds here on the BSA Direct program, and I heard your comments to the chairman. With all due respect, I really do appreciate your commitment to do better on those procurements, but it is what we heard last year. So I would like to follow up with you, I know I am out of time, but hear from you what we are going to do to make sure we are not sitting here year after year hearing the same story on these complex procedures.

Secretary SNOW. Senator, the new Director, Mr. Werner, came in and looked at the program and saw that it was missing milestones and put a pause on it.

Senator MURRAY. Right.

Secretary SNOW. As he follows through on his analysis, I will keep the committee fully posted on what we think should be done.

Senator MURRAY. Thank you very much, Mr. Secretary.

Senator BOND. Mr. Secretary, I said we were going to suspend your testimony at 10:15, but Senator Dorgan has come in. Senator, I apologize. We are trying to get the second panel on, but if you would like to take 2 minutes for your statement-question-presentation, and then we will come back after the vote to question the second panel.

Senator DORGAN. Mr. Chairman, that is fair. Senator Burns and I have been running another Appropriations subcommittee just across the hall.

Senator BOND. I hope you are doing good things for us. We have some ideas.

Senator DORGAN. We have the Missouri provision in our bill, so we think it is going to go pretty well.

I will be very brief and just make two points to the Secretary. I understand the point has already been made about the sale of taxpayer information by private preparers to third parties. I have

sent you a letter about that. Despite the explanations of it, I think it is a horrible idea. I think we ought to have a pretty aggressive public discussion about whether tax preparers under any condition ought to sell taxpayer information that they glean in preparing tax returns to third parties. I understand that that has been raised.

#### TAX SHELTERS

I want to show you a picture. This is, Mr. Secretary, a picture of a building on Church Street in the Cayman Islands. It is called the Uglund House. You may be familiar with it. The Uglund House on Church Street is the official residence, according to David Evans who did a story at Bloomberg News, for 12,748 corporations. I know they are not in there, but it's what they claim to be their official residence. Why would they claim that? There is one purpose, to avoid paying U.S. taxes. This is a real crisis. I do not think we have the ability, resources or capability at this point to nearly begin to address this.

Here we are in 2006 with 12,748 companies claiming this one building as their residence. Trying to force these companies to pay taxes is like connecting the ends of two plates of spaghetti. The way the IRS goes about it is pretty incompetent in my judgment. Second, the law by-and-large favors and gives opportunity to companies to do this.

I hope very much that we will at the Treasury Department decide to blow a hole in this kind of practice because it is costing us a great deal of lost revenue. It is also unfair to ask working families to pay their taxes and then have these companies park their address simply for residence purposes at a building in the Caymans to avoid paying taxes.

Secretary SNOW. Senator, I look forward to a chance to have a good discussion with you on that. The IRS has tried to tighten up its enforcement activities in this area, but I think, as you said, this also reflects the state of the law, and I would hope is part of the broad-based tax reform efforts we would look at these issues very, very closely. I agree with you.

Senator DORGAN. It is both the law and enforcement. Maybe you and I should just fly down to Church Street at the Caymans and park in the lobby there and see who comes and goes from that building. Thanks, Mr. Secretary.

Secretary SNOW. Thank you, Senator.

Senator BOND. Senator Dorgan, I think there is some good fishing down there, so maybe we could spend a couple hours down there and then see about the other resources.

Mr. Secretary, thank you very much for being here. Now we will call Mr. Levey and Ms. Gardner, and do as much as we can before the vote starts.

Senator BOND. Thank you very much, and we will begin with Mr. Levey. Sir.

## OFFICE OF TERRORISM AND FINANCIAL INTELLIGENCE

## STATEMENT OF STUART LEVEY, UNDER SECRETARY

## ACCOMPANIED BY:

**JANICE GARDNER, ASSISTANT SECRETARY, OFFICE OF INTELLIGENCE AND ANALYSIS**

**ROBERT W. WERNER, DIRECTOR, FINANCIAL CRIMES ENFORCEMENT NETWORK**

Mr. LEVEY. Thank you, Mr. Chairman, Senator Murray, and Senator Dorgan. Thank you for the opportunity to speak before you today about the President's 2007 year request for the Office of Terrorism and Financial Intelligence at the Treasury Department. And thank you especially, Mr. Chairman, for all the kind remarks you made in your opening statement. I hope we can live up to them.

The funding that is in the President's budget will provide us with the resources needed to support the Department's essential and growing terrorist financing, money-laundering, WMD proliferation, narco-trafficking, and economic sanctions programs, as well as the intelligence capabilities that are critical to the success of those programs.

Treasury has continued, with the strong support of this committee, to build much needed resources for the Office of Terrorism and Financial Intelligence, and we have achieved some important successes. I attribute those successes to the unbelievably dedicated work force that I have been blessed with, and an extraordinary management team that I work with, including Assistant Secretary Gardner, as well as Assistant Secretary O'Brien who is here today, the Director of FinCEN, Bob Werner who is here, and the Acting Director of OFAC, Barbara Hammerle who is also here today, they make my job a very easy one.

Over the past year alone, TFI has designated and financially isolated front companies, nongovernmental organizations, and facilitators supporting terrorist organizations such as al Qaeda, Jemaah Islamiyah, and Egyptian Islamic Jihad. We have implemented targeted financial sanctions under a new Executive Order aimed at North Korean, Iranian, and Syrian facilitators of WMD proliferation, and we have struck a deep blow to North Korea's illicit conduct and ability to abuse the international financial system to facilitate that conduct. Those accomplishments are only the tip of the iceberg, but they demonstrate without question not only that our resources are being put to good use, but that the Treasury Department is fulfilling its vitally important role.

On terrorist financing, as you note, Mr. Chairman, the 9/11 Commission's Discourse Project awarded its highest grade, an A-, to the U.S. Government's efforts to combat terrorist financing. This praise truly belongs to the dedicated individuals not only in the Office of Terrorism and Financial Intelligence, but our partner agencies around the government who aggressively track and combat this threat.

As you know, Mr. Chairman, from your service on the Intelligence Committee, it is very hard to measure success in an area like terrorist financing. The meaningful indicators of our success are typically complex and not readily quantifiable, such as anecdotal reporting about terrorist cells having difficulty raising money

or paying operatives. We focus on those intelligence reports, even though they are often fragmentary, and try to identify the difficulties that the terrorists are having raising or moving money and adjust to it. In recent months we have seen at least one instance of what we look for most, a terrorist organization indicating that it could not pursue sophisticated attacks because it lacks adequate funding.

We have also seen success, in my view, in preventing terrorist financing by deterring would-be donors. In my opinion, if we are going to succeed in our fight against terrorist financing, we need potential donors to know that responsible governments will treat them as the terrorists that they are. Those who reach for their wallets to fund terrorism must be pursued and punished in the same way as those who reach for a bomb or a gun.

This requires cooperation from other governments, and in that regard, I was heartened by a recent statement by the Saudi Arabian Foreign Minister, Prince Saud al-Faisal, who publicly called for those who support terrorism to be held to account. If Saudi Arabia and others in the region see this commitment through, it will send a powerful message of deterrence to would-be terrorist financiers.

In other areas of this fight, to be honest, we are not where we need to be. State sponsors of terrorism like Iran and Syria present a very difficult problem, providing not only money and safe haven to terrorists, but also financial infrastructure through which terrorists can move, store, and launder their funds. Secretary Rice had it right when she referred to Iran in particular as the "central bank of terror."

While this is a daunting challenge we face, the impact of our actions over the past year with respect to Syria show that we can make progress in isolating state sponsors of terrorism. Among other things, we finalized the designation of the Commercial Bank of Syria under section 311 of the PATRIOT Act in part because of the risk of terrorist financing posed by a bank owned and controlled by an active and defiant state sponsor of terror like Syria.

Success in all of our efforts depends on cooperation from responsible financial institutions both in the United States and abroad. The recent announcement by UBS that it would cut off all business with Iran and Syria provides a notable example of a financial institution making clear that the business of terrorist states is just not worth the risk. Other financial institutions are similarly reviewing their business arrangements and taking special precautions to ensure that they do not permit terrorist financiers or WMD proliferators, which are increasingly able to identify and combat using our new authorities, access to the global financial system. On WMD proliferation, Mr. Chairman, the exposure of a WMD proliferation network headed by A.Q. Khan provided the world with a window into one of the most frightening scenarios that we face.

The U.S. Government is doing everything in its power to deter, disrupt and prevent the spread of weapons of mass destruction and ensure especially that they do not fall into the hands of terrorists, and the reason for this is that proliferators, just like terrorists, require a substantial network to support them. And by cutting off the supply lines of that network, we can isolate the individual

proliferators, paint a clear picture of how and with whom they operate, and erode the infrastructure that supports them.

In June 2005, the President issued a new Executive order which allows us to do just that, essentially to apply the same tools that we do against terrorist financiers to WMD proliferators. A designation under this Executive order cuts the target off from access to the U.S. financial and commercial system, and puts the international community on notice about the threat it poses. Thus far, we have designed a total of 20 entities for proliferation related to Iran, Syria, and North Korea. Our efforts to prepare additional designation packages are ongoing, and will continue through the end of this year and next. One of our major initiatives in the President's budget is a request for 10 additional analysts to work on this program.

As you noted also, Mr. Chairman, in September 2005, we exercised a new authority under the PATRIOT Act, section 311 of the PATRIOT Act, to list Banco Delta Asia as a primary money-laundering concern. The regulatory action against this bank that was facilitating a range of North Korean illicit activity has dealt a blow to North Korea's ability to engage in illicit conduct and obtain financial services to facilitate that conduct. As a result of that 311 action against this bank, and our office's subsequent and continuing outreach efforts, a number of responsible jurisdictions and institutions have taken steps to ensure that North Korean entities engaged in illicit conduct are not receiving financial services. In fact, press reports indicate that some two-dozen financial institutions across the globe have cut back or terminated their financial dealings with North Korea, thereby constricting the flow of dirty cash to Kim Jong-il's regime.

#### PREPARED STATEMENT

If there is time in the questions and answers, I would like to explain to the committee how that worked in more detail.

Mr. Chairman, I look forward to working closely with you and your staff, and thank you again for the opportunity to testify today. [The statement follows:]

#### PREPARED STATEMENT OF STUART LEVEY

Chairman Bond, Ranking Member Murray, and other distinguished members of the subcommittee, thank you for the opportunity to speak before you today about the President's fiscal year 2007 request for the Office of Terrorism and Financial Intelligence (TFI) at the Department of the Treasury. This funding will provide us with the resources needed to support the Department's essential and growing terrorist financing, money laundering, WMD proliferation, narco-trafficking, and economic sanctions programs, as well as the intelligence capabilities that are critical to the success of these programs.

As you know, TFI is a relatively new office. It was created in 2004 to oversee the Treasury Department's enforcement and intelligence functions aimed at severing the lines of financial support to international terrorists, WMD proliferators, narcotics traffickers, and other criminals. The office consolidates the policy, enforcement, regulatory, and analytical functions of the Treasury and adds to them critical intelligence components by bringing under a single umbrella the Office of Intelligence and Analysis (OIA), the Office of Terrorist Financing and Financial Crimes (TFFC), the Financial Crimes Enforcement Network (FinCEN), the Office of Foreign Assets Control (OFAC), and the Executive Office for Asset Forfeiture. TFI also works closely with the IRS-Criminal Investigative Division in its anti-money laundering, terrorist financing, and financial crimes cases.

Together, we leverage a wide range of tools to pressure obstructionist regimes. Using various authorities, we also have the ability to freeze the assets of terrorists, proliferators, and other wrongdoers. We use regulatory authorities to help banks and other institutions implement systems to detect and halt corrupt money flows. And, diplomatically, we work with other governments and international institutions, urging them to act with us against threats and to take critical steps to stem the flow of illicit finances.

#### KEY ACHIEVEMENTS

As Treasury has continued—with your support—to build much-needed resources for this new office, we have achieved some important successes. Over the past year alone, TFI has designated and financially isolated front companies, non-governmental organizations, and facilitators supporting terrorist organizations, such as al Qaeda, Jemaah Islamiyah, and Egyptian Islamic Jihad; implemented targeted financial sanctions under a new Executive order against North Korean, Iranian, and Syrian facilitators of WMD proliferation; and struck a deep blow to North Korea's illicit conduct and ability to abuse the international financial system to facilitate that conduct. These efforts have required a contribution from all of TFI's components, as well as the hard work of other Departments and agencies.

These accomplishments are only the tip of the iceberg, but they demonstrate without question not only that our resources are being put to good use, but that the Treasury Department is fulfilling its vitally important role to play in deterring and defending against our country's greatest national security challenges. Our financial authorities complement other national security instruments, providing policymakers with a range of options for isolating and pressuring hostile regimes, terrorists, and proliferators of weapons of mass destruction. When we are confronted with a foreign threat that is not susceptible to diplomatic pressure, financial authorities are among the rare tools short of military force that we can use to exert leverage.

I would like to highlight some of TFI's key achievements in greater detail.

#### *Terrorist Finance*

The 9/11 Commission's Public Discourse Project awarded its highest grade, an A-, to the U.S. Government's efforts to combat terrorist financing. This praise truly belongs to the dozens of intelligence analysts, sanctions officers, regional specialists, and regulatory experts in the Treasury's Office of Terrorism and Financial Intelligence (TFI) who focus on terrorist financing, along with their talented colleagues in other agencies—law enforcement agents who investigate terrorism cases, Justice Department prosecutors who bring terrorist financiers to justice, foreign service officers in embassies around the world who seek cooperation from other governments and many others from the intelligence community. You will not find a more talented and dedicated group of people, with a complete focus on the mission.

Teamwork across agencies has translated into effectiveness. We have continued to improve our ability to track key targets and to take the most appropriate action against the terrorist target. Sometimes that means that the Treasury will take public action, sometimes it involves persuading another country to take action, and sometimes we decide to continue to quietly collect intelligence to better map out the terrorist network. From the formation of TFI, we have been committed to that philosophy, resisting the application of metrics to our activities that would distort our incentives, for example, by emphasizing the number of terrorism designations.

The meaningful indicators of our success are typically complex and not readily quantifiable, such as anecdotal reporting about terrorist cells having difficulty raising money or paying salaries or benefits. In recent months, we have seen at least one instance of what we look for most—a terrorist organization indicating that it cannot pursue sophisticated attacks because it lacks adequate funding.

Typically, though, the information we receive is not as clear. As an example, one interesting trend that we have witnessed is a decrease in the average amount of transactions that we learn about. Obviously, we are only privy to a subset of the total transactions, but this observation carries across various financial conduits and terrorist organizations and we have no reason to believe that it is unrepresentative. Interpreting this indicator is more difficult. It could reflect an overall decrease in the amount of money moving to and from terrorists. Just as easily, it could indicate that terrorists are breaking their transactions out into smaller sums, fearing interception. Alternatively, the trend could be an outgrowth of a movement by terrorist organizations away from banks towards less formal mechanisms, like cash couriers. These couriers may offer concealment, but some get caught and some get greedy, and so it is very risky to entrust them with large sums of money. Any of these alternatives would indicate that our efforts are having an impact and this trend may bear out our assessment that terrorists who fear using the banking system do not

have a ready and reliable alternative for moving large sums of money. We will continue to monitor developments, but I hope this provides a sense of how complex a task it is to assess the overall impact of our efforts to combat terrorist financing.

In specific areas, we can point to more concrete indicators of success. We have made dramatic progress in combating terrorist abuse of charities. Prior to 9/11 and even afterwards, terrorists used charities as safe and easy ways to raise and move large sums of money. Al Qaeda and Hamas, in particular, relied on charities to funnel money from wealthier areas to conflict zones with great success. Through a combination of law enforcement and regulatory actions against several corrupt charities, both at home and abroad, we have taken out key organizations and deterred or disrupted others. In tandem, active engagement with the legitimate charitable sector has succeeded in raising transparency and accountability across the board.

We have thus far designated more than 40 charities worldwide as supporters of terrorism, including several U.S. charities such as the Holy Land Foundation, the Global Relief Foundation, the Benevolence International Foundation, the Al Haramain Islamic Foundation, and the Islamic African/American Relief Agency (IARA). The impact of these actions is serious, and sometimes decisive. IARA once provided hundreds of thousands of dollars to Osama bin Laden. More recently, IARA country offices have experienced increased pressure and its leaders have expressed concern about the organization's future.

Our most recent action targeted KindHearts, a purported charity in Ohio that was supporting Hamas. In that instance, we took coordinated action with DOJ prosecutors and the FBI, which executed a search warrant at the moment that we froze the group's assets. Although we generally do not disclose specific blocked asset information, KindHearts has stated that over \$1 million of its assets were blocked. Overall, engagement with the charitable sector combined with enforcement actions against bad organizations have radically altered the dynamic, leaving dirty charities isolated and imperiled.

Another important measure of our progress is an increase in the number of countries approaching the U.N. Security Council to seek the designation of terrorist supporters. This global designation program, overseen by the U.N.'s 1267 Committee, is a powerful tool for global action against supporters of al Qaeda. It envisages 191 U.N. Member States acting as one to isolate al Qaeda's supporters, both physically and financially. Increasingly, countries have begun to look to this committee, and administrative measures in general, as an effective complement to law enforcement action. In 2005, 18 Member States submitted names for the Committee's consideration, many for the first time, and we will continue to support this process and encourage others to do so as well.

In other arenas of this fight, however, we are not where we need to be. State sponsors of terrorism, like Iran and Syria, present a vexing problem, providing not only money and safe haven to terrorists, but also a financial infrastructure through which terrorists can move, store, and launder their funds. While this is a daunting challenge, I believe that the Treasury Department's tools, combined with cooperation from responsible financial institutions, can make a difference. In the past year, for example, we have designated top Syrian officials, including the then-interior minister Ghazi Kanaan and the head of Syrian Military Intelligence, Assaf Shawkat, in part for their support to terrorist organizations. Also, on March 9, we issued a final rule under Section 311 of the PATRIOT Act confirming that the Commercial Bank of Syria (CBS) is a "primary money laundering concern" and forbidding U.S. financial institutions from holding correspondent accounts for CBS. Among our reasons for that action was the risk of terrorist financing posed by a significant bank owned and controlled by an active and defiant state sponsor of terror like Syria.

We have ample reason to believe that responsible financial institutions around the world pay close attention to such actions and other similar indicators and adjust their business activities accordingly, even if they are not required to do so. A recent example of interest was the announcement by the international bank UBS that it intended to cut off all business with Iran and Syria. Other financial institutions are similarly reviewing their business arrangements and taking special precautions to ensure that they do not permit terrorist financiers or WMD proliferators—which we are increasingly able to identify and combat using a new authority—access to the global financial system.

#### *WMD Proliferation*

The exposure of the WMD proliferation network headed by A.Q. Khan—father of Pakistan's nuclear bomb and, more recently, nuclear technology dealer to Libya, Iran, and North Korea—provided the world with a window into one of the most frightening scenarios that we face. The U.S. Government is doing everything in its

power deter, disrupt, and prevent the spread of weapons of mass destruction and ensure that they do not fall into the hands of terrorists. Treasury plays a key role in this effort.

Proliferators, like terrorists, require a substantial support network. By cutting off the support lines of that network, we can isolate individual proliferators, paint a clearer picture of how, and with whom, they operate, and erode the infrastructure that supports them. In June 2005, the President issued Executive Order 13382, which allows us to do just that.

This Executive Order authorizes the Treasury and State Departments to target key nodes of WMD proliferation networks, including their suppliers and financiers. A designation under this Executive Order cuts the target off from access to the U.S. financial and commercial systems and puts the international community on notice about the threat it poses. Based on evidentiary packages prepared primarily by OFAC, the President initially designated a total of eight entities in North Korea, Iran, and Syria. Continuing investigations by OFAC resulted in the subsequent designation of eight additional North Korean, and two additional Iranian, entities. And, just last week, Treasury designated two more proliferators, Kohas AG and its president, Jakob Steiger. Kohas AG, a Swiss company, acts as a technology broker in Europe for the North Korean military and has procured goods with weapons-related applications. Nearly half of the company's shares are owned by a subsidiary of Korea Ryonbong General Corporation, a previously-designated North Korean entity that has been a focus of U.S. and allied efforts to stop the spread of controlled materials and weapons-related goods, particularly ballistic missiles.

OFAC's efforts to prepare additional designation packages—with the support of the Office of Intelligence and Analysis—are ongoing and will continue throughout fiscal years 2006 and 2007. In fact, one major OFAC initiative for 2007, which I will discuss shortly, relates directly to the WMD program.

This new authority provides a powerful tool to combat the financial underpinnings of WMD proliferation and also underscores the President's commitment to work with our international partners to combat this threat. We hope our program can provide a model for other governments to draw upon as they develop their own laws to stem the flow of financial and other support for proliferation activities, as called for in U.N. Security Council Resolution 1540 and by the G-8 at Gleneagles.

The Treasury and State Departments have been engaged in aggressive international outreach in order to promote this important concept. Assistant Secretary Pat O'Brien, Deputy Assistant Secretary Daniel Glaser, and I have met with our counterparts in a number of countries in Europe, Asia, and the Middle East to urge them to ensure that U.S.-designated proliferators are not able to do business in their countries and to develop their own 13382-like authorities.

Although our WMD program is in its early stages, and while I am limited in what I can say in this public forum, I am pleased to be able to assure you that, through cooperation with both governments and the private sector, we are already seeing an impact on our targets. Indeed, this program has significantly enhanced the U.S. Government's overall counterproliferation efforts.

#### *Section 311 Designation of Banco Delta Asia SARL*

In September 2005, not long after the President signed this new WMD Executive Order, the Treasury Department used a separate authority—Section 311 of the USA PATRIOT Act (PATRIOT Act)—to list Banco Delta Asia SARL (BDA) as a "primary money laundering concern." This regulatory action against a bank facilitating a range of North Korean illicit activities has dealt a blow to Pyongyang's ability to engage in illicit conduct and obtain financial services to facilitate that conduct. Along with our offensive targeting of several entities under E.O. 13382 for supporting North Korea's WMD and missile proliferation-related activities, it has frustrated North Korea's efforts to conduct proliferation-related transactions.

Section 311 authorizes the Secretary of the Treasury—in consultation with the Departments of Justice and State and appropriate Federal financial regulators—to find that reasonable grounds exist for concluding that a foreign jurisdiction, institution, class of transactions, or type of account is of "primary money laundering concern" and to require U.S. financial institutions to take certain "special measures" against those jurisdictions, institutions, accounts, or transactions. Potential measures include requiring U.S. financial institutions to terminate correspondent relationships with the designated entity. Such a defensive measure effectively cuts that entity off from the U.S. financial system. It has a profound effect, not only in insulating the U.S. financial system from abuse, but also in notifying financial institutions and jurisdictions globally of an illicit finance risk.

The success of the BDA action offers an instructive case study of the impact of this authority. BDA provided financial services for over 20 years to North Korean

government agencies and front companies, some of which were engaged in illicit activities, including currency counterfeiting, narcotics trafficking, production and distribution of counterfeit cigarettes and pharmaceuticals, and the laundering of the associated proceeds. We also know that North Korean entities engaged in WMD proliferation, including Tanchon Bank—the primary financial facilitator of North Korea’s ballistic missile program—held accounts at BDA. BDA tailored its services to the needs and demands of North Korean entities with little oversight or control. In fact, bank officials intentionally negotiated a lower standard of due diligence with regard to the financial activities of these clients.

—BDA helped North Korean agents conduct surreptitious, multimillion dollar cash deposits and withdrawals without question for the basis of those transactions.

—BDA knowingly accepted counterfeit currency from North Korean companies. In that regard, it is worth noting that the U.S. Secret Service has been investigating North Korean counterfeiting since 1989, and, over the past 16 years, has seized more than \$48 million in high quality U.S. currency, or “supernotes.”

—A well-known North Korean front company that has been a client of BDA for over a decade has conducted numerous illegal activities, including distributing counterfeit currency and smuggling counterfeit tobacco products. In addition, the front company has also long been suspected of being involved in international drug trafficking.

Treasury’s ongoing investigation of BDA has not only confirmed our original concerns about BDA’s complicity in facilitating this type of conduct, but has shed additional light on the wide spectrum of North Korea’s corrupt and dangerous activities, as well as its vast illicit financial network.

As a result of the 311 action against BDA and TFI’s subsequent and continuing international outreach efforts, a number of responsible jurisdictions and institutions have taken proactive steps to ensure that North Korean entities engaged in illicit conduct are not receiving financial services. Press reports indicate that some two dozen financial institutions across the globe have cut back or terminated their financial dealings with North Korea, constricting the flow of dirty cash into Kim Jong Il’s regime.

Treasury’s efforts with respect to Banco Delta Asia, specifically, and combating North Korea’s illicit activities, more generally, are ongoing. The Internal Revenue Service—Criminal Investigation Division is leading an investigation to exploit underlying North Korean account information at Banco Delta Asia provided by the Macau authorities. This investigation will allow the United States to gain an even greater understanding of the illicit activities highlighted in our Section 311 designation, and to uncover additional leads regarding DPRK entities of concern. Additionally, TFI officials continue international outreach efforts to raise awareness of North Korea’s illicit conduct, explain the actions that Treasury has taken, and encourage governments and institutions to not to do business with individuals and entities engaged in illicit conduct. By all accounts, that outreach is working.

#### OVERVIEW OF THE FISCAL YEAR 2007 TFI REQUEST

The 2007 request of \$135.2 million for TFI, including \$89.8 million for the Financial Crimes Enforcement Network, provides critical funding to expand TFI’s ability to combat terrorist financing and other key national security challenges. It will allow us to continue and build upon these past achievements and current efforts. I know the members of the subcommittee are aware of this request in detail, so I will just touch on a few important highlights of new initiatives.

#### *Office of Intelligence and Analysis*

TFI’s Office of Intelligence and Analysis (OIA) was created to focus expert analytical resources on the financial and other support networks of terrorists, WMD proliferators, and other key national security threats. Over the past year, OIA has assumed an increasingly important role in the Treasury’s efforts to combat key national security threats in Iran, Syria, and North Korea. OIA’s top strategic priority is to provide policymakers with relevant intelligence and expert analysis to support policy formulation and carry out the Treasury’s role in the war on terror. Other OIA strategic priorities include providing intelligence support to senior Treasury officials on the full range of economic and political issues and communicating with other members of the Intelligence Community.

As Assistant Secretary Janice Gardner will describe shortly, the 2007 request provides funding for OIA to continue its efforts to build Treasury’s intelligence capabilities by improving its key infrastructure and adding to its analytic breadth and expertise.

*Office of Foreign Assets Control*

The Office of Foreign Assets Control (OFAC) administers and enforces economic and trade 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. Since receiving expanded designation authority in 2001, the United States has designated 428 terrorist-related individuals and entities; 320 of those designations have been carried out in coordination with our allies and designated at the United Nations. The fiscal year 2007 budget provides additional resources for OFAC to monitor and update existing designations and track the development of new support structures and funding sources. It includes:

- Ten additional positions to continue to implement and administer the new Executive Order 13382, combating the proliferation of weapons of mass destruction.
- Fifteen additional positions to monitor and update existing terrorist designations. This is critical given that Specially Designated Global Terrorists and their support networks continuously seek new ways of evading U.S. and international sanctions by changing the names and locations of front companies and altering their financing methods.

*Office of Terrorist Financing and Financial Crime*

As the policy development and outreach office for TFI, the Office of Terrorist Financing and Financial Crime (TFFC) collaborates with the other elements of TFI to develop policy and initiatives for combating money laundering, terrorist financing, WMD proliferation, and other criminal activities both at home and abroad. TFFC works across the law enforcement, regulatory and intelligence communities and with the private sector and its counterparts abroad to identify and address the threats presented by all forms of illicit finance to the international financial system. TFFC advances this mission by promoting the transparency of the financial system and by developing and facilitating the global implementation of targeted financial authorities to identify and intercept those illicit actors that operate within the financial system. TFFC's efforts focus on:

- developing and facilitating the implementation of global anti-money laundering and counter-terrorist financing standards, primarily by working with and through the Financial Action Task Force the various regional bodies, including the IMF and World Bank and each of the regional development banks;
- promoting the development of effective targeted financial sanction regimes and the use of other targeted financial authorities through the G7, G20, FATF, United Nations, European Union, and bilaterally with countries of strategic importance;
- addressing financing mechanisms of particular concern by developing AML/CFT protective measures, initiatives, and best practices in vulnerable sectors such as charities, alternative value transfer systems and emerging payment systems; and
- conducting direct outreach to the domestic and international private sector to facilitate and improve development and implementation of sound AML/CFT controls.

In all of these areas, TFFC relies on and works closely with other elements of TFI, the Treasury Department, the interagency and international communities to effectively combat the threats that illicit finance presents to the international financial system. Recently, for example, TFFC worked closely with 16 Federal bureaus and offices from across the law enforcement, regulatory, and policy communities to produce the U.S. Government's first-ever Money Laundering Threat Assessment. This working group pulled together arrest and forfeiture statistics, case studies, regulatory filings, private and government reports, and field observations. The report analyzes more than a dozen money laundering methods and serves as a first step in a government-wide process to craft strategic ways to counteract the vulnerabilities identified.

The fiscal year 2007 request continues the administration's support of TFFC's important efforts.

*Treasury Overseas Presence*

Treasury attachés serve as the U.S. Treasury's representatives in key economies overseas. Because of their technical expertise, Treasury attachés enjoy unique access to foreign Ministries of Finance and Central Banks. This access provides the U.S. Government with a direct channel to key decisionmakers on economic policy issues, including foreign exchange policy and financial service regulatory policies. Working in tandem with TFI and Treasury's Office of International Affairs, Treas-

ury attachés will be working to prevent the abuse of the international financial system for terrorist finance, money laundering, or other illicit purposes.

—Treasury proposes to increase its overseas presence from 5 attachés to 18 attachés in fiscal year 2007.

*Financial Crimes Enforcement Network*

TFF's Financial Crimes Enforcement Network (FinCEN) helps to safeguard the U.S. financial system from the abuses of financial crime, including terrorist financing, money laundering, and other illicit activity. This is accomplished primarily through the Bank Secrecy Act, which requires financial institutions to report financial transactions, such as suspicious activities that may be indicative of financial crimes. FinCEN also supports law enforcement, intelligence, and regulatory agencies through sharing and analysis of financial intelligence, and building global cooperation with financial intelligence units (FIUs) in other countries. The fiscal year 2007 request provides additional resources to FinCEN to streamline data processing and enhance its e-filing capabilities to increase the ease of compliance with regulations and improve its abilities to track users' needs. It includes:

—Enhancing components of the BSA Direct Umbrella System, including electronic filing and secure access components. Although FinCEN has entered a stop work order with respect to development of the data storage and retrieval component of the BSA Direct system in order to permit it to assess delays in deploying this component, both the electronic filing component and secure access components are presently operational and need to be upgraded to allow direct input of the BSA filings into the collection system and meet expanded user base.

—Development funding for FinCEN's Cross-Border Wire Transfer System Initiative. The authorizing language (Section 6302 of the Intelligence Reform Act of 2004 (S. 2845 Public Law 108–458)) presents the Bureau with two tasks: (1) a feasibility study to be completed as soon as practicable; and (2) the implementation of enabling regulations and a technological system for receiving, storing, analyzing, and disseminating the reports, to be completed by December 2007. The feasibility study will address whether it is possible to complete the development and implementation of the system by the statutory deadline of December 2007. We anticipate delivery of the study to the Secretary of the Treasury by late spring 2006.

CONCLUSION

Mr. Chairman, the Treasury Department—working closely with other Departments and agencies across the U.S. Government—is playing a key role in deterring and defending against the greatest threats to our security. Indeed, we have achieved some important successes in our 2-year history. I look forward to working closely with you, other members of the committee, and your staff to ensure that TFI has the resources it needs in fiscal year 2007 to build upon that success. Together we can work to maximize the Treasury Department's ability to protect the American people.

Thank you again for the opportunity to testify today.

Senator BOND. Thank you, Mr. Levey.

STATEMENT OF JANICE GARDNER

Ms. GARDNER. Good morning, Chairman Bond and Ranking Member Murray. I thank you for the opportunity to testify today on the budget for the Office of Intelligence and Analysis.

I would like to request a copy of our report for fiscal year 2006 to 2008, our Strategic Direction, to be entered into the record. We produced this report for your committee in response to the conference report accompanying the fiscal year 2006 appropriations bill. The report defines our mission, establishes strategic objectives, and outlines OIA's priorities and direction for the next several years.

Senator BOND. Without objection.

[The information follows:]



REPORT FOR SENATE &  
HOUSE APPROPRIATIONS  
COMMITTEES

MARCH 01 2006



OFFICE OF INTELLIGENCE AND ANALYSIS  
OFFICE OF TERRORISM AND FINANCIAL INTELLIGENCE

Office of Intelligence  
and Analysis

# Strategic Direction

Fiscal Years (FY) 2006-2008

Office of Intelligence and Analysis  
Strategic Direction  
Fiscal Years (FY) 2006-2008

**Operational Charter**

The Office of Intelligence and Analysis (OIA) was established by the Intelligence Authorization Act for FY 2004. The establishment of OIA is codified at Title 31, United States Code, Section 311. The Act specifies that OIA shall be responsible for the receipt, analysis, collation, and dissemination of foreign intelligence and foreign counterintelligence information related to the operation and responsibilities of the Department of the Treasury. The Act established the Assistant Secretary for Intelligence and Analysis as the head of OIA.

On April 28, 2004, Secretary of the Treasury John Snow established the Office of Terrorism and Financial Intelligence (TFI) by Treasury Order 105-17. The Order placed OIA within TFI, and the Assistant Secretary for OIA reports directly to the Under Secretary for TFI. The Order also placed the Office of Terrorist Finance and Financial Crime (TFFC), the Office of Foreign Assets Control (OFAC), Financial Crimes Enforcement Network (FinCEN) and the Treasury Executive Office for Asset Forfeiture (TEOAF) within TFI. The Order specifies that:

- OIA will build a robust analytical capability on terrorist finance by coordinating and overseeing work involving intelligence analysts

in all Treasury components. OIA will focus on the Department's highest priorities, as well as ensuring that the existing intelligence needs of OFAC and FinCEN are met.

- OIA also will provide intelligence support to senior Treasury officials on a wide range of international economic and other relevant issues. OIA will serve in a liaison capacity with the Intelligence Community (IC) and represent the Department in various intelligence-related activities.

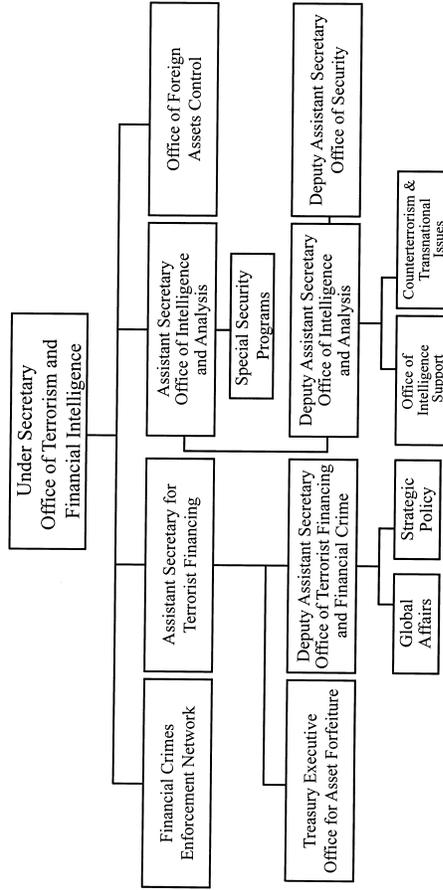
**TFI mission**

*TFI marshals the Department's unique policy focus, financial intelligence, global network, regulatory responsibilities, tools and authorities to safeguard the financial system and counter the financial underpinnings of national security threats.*

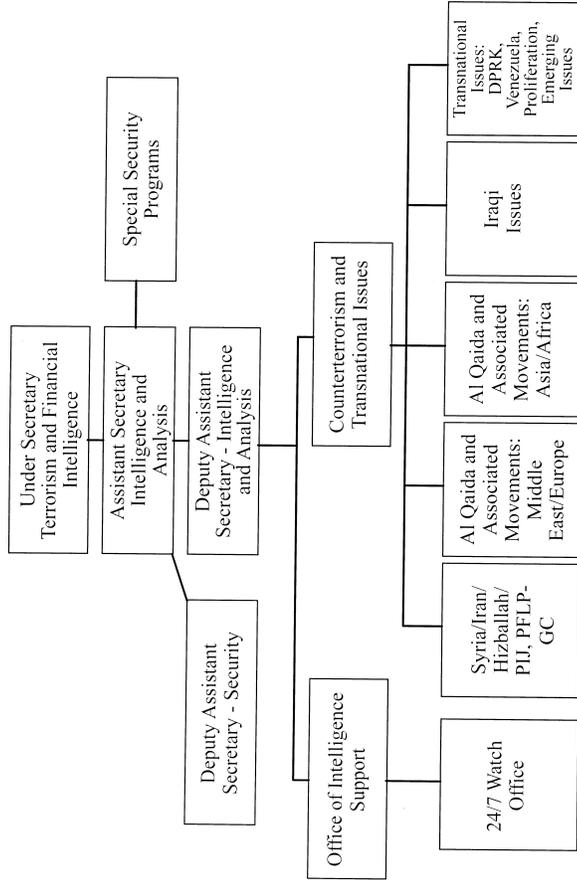
**TFI Priority Areas**

- Terrorism Financing
- Proliferation
- Rogue Regimes
- Money Laundering/Narcotics

### Treasury TFI Structure



### Office of Intelligence and Analysis Structure



**OIA Mission Statement**

Support the formulation of policy and execution of Treasury authorities by providing:

- Expert analysis and intelligence production on financial and other support networks for terrorist groups, proliferators, and other key national security threats
- timely, accurate, and focused intelligence on the full range of economic, political, and security issues

**OIA Operating Principles**

- Objective, unbiased, and expert analysis on the financial and other support networks for terrorists, proliferators and other key national security threats.
- Communication among workforce and across TFI.
- Development of human capital.
- Acquisition of up to date analytic tools and information technology systems
- Priorities in line with those of Treasury, the National Security Council, and the Intelligence Community.

**OIA GOALS**

**Goal 1.** Support the formulation of policy and execution of Treasury authorities by providing expert analysis and intelligence production on financial and other support networks for terrorist groups, proliferators, and other key national security threats.

This goal will remain OIA's top overall priority in FY 2006-2008. The primary responsibility for fulfilling this goal will fall to OIA's Counterterrorism and Transnational Issues section (CTI). OIA's analytic component. As part of their "all source" analysis, CTI's analysts regularly review a broad range of information from the IC, including human and signals intelligence reports, other agencies' analytic assessments, as well as open source information.

OIA's role in this regard is to ensure that the current intelligence information and analysis are incorporated into all aspects of policy deliberations. To accomplish this, OIA will provide decision makers in TFI with strategic targets and policy options in a form that facilitates Departmental action. OIA will also serve as the central focal point for the Treasury Department to fuse financial data

from OFAC, FinCEN, TFFC, as well as the IC.

Since OIA was created in 2004, it has made significant progress in building the robust intelligence and analytic program which enables it to provide this type of support to policymakers. OIA was greatly enhanced in FY 2005 by the detail—which is now a permanent transfer—of 23 analysts from OFAC's Foreign Terrorist Division (FTD). Moving the FTD analysts to OIA has helped transform Treasury from a passive consumer of analytic and intelligence products to a full member of the IC. OIA has been using the expertise of these FTD analysts as a foundation for a true center of expertise on material support to terrorist organizations and proliferators. The additional personnel that OIA is planning to hire in FY 2006 will allow OIA and Treasury to further improve its analytic coverage and expertise in priority areas, such as insurgency funding, terrorist financing, and proliferation financing. This will enable OIA to continue to improve its ability to provide policymakers with the relevant intelligence and expert analysis that they need to make policy decisions.

**TRANSLATING INTELLIGENCE INTO POLICY:  
TFI TARGETING MEETINGS**

In 2005, OIA initiated weekly targeting sessions led by TFI's Under Secretary, which includes senior officials from OFAC and FinCEN as well. At these sessions, based on a review of the relevant intelligence, potential targets are presented and discussed. The participants assess the full range of potential Treasury actions, including designation, and decide on follow up direction and assignments. OIA will continue to host and participate in these sessions in FY 2006-2008, which have proved to be an effective mechanism for translating intelligence information into policy action.

**Objective 1:** Provide timely and insightful intelligence analysis that is focused on supporting Treasury authorities.

- Provide intelligence analysis that supports Treasury's designation of persons pursuant to economic sanctions imposed by Executive Order, statute, and/or UN Security Council resolution.
- Provide intelligence analysis on proliferation financing to support OFAC and other Treasury entities in their efforts to target WMD proliferators.
- Provide intelligence analysis that supports Treasury's engagement of foreign authorities to set appropriate standards to safeguard the international financial system, such as Treasury's participation in the Financial Action Task Force and similar fora.
- Coordinate and oversee intelligence analysis that supports designation of foreign jurisdictions, financial institutions, classes of financial transactions, or types of accounts pursuant to Section 311 of the USA PATRIOT Act.
- Provide intelligence analysis that supports the identification and repatriation of assets looted by corrupt foreign officials.

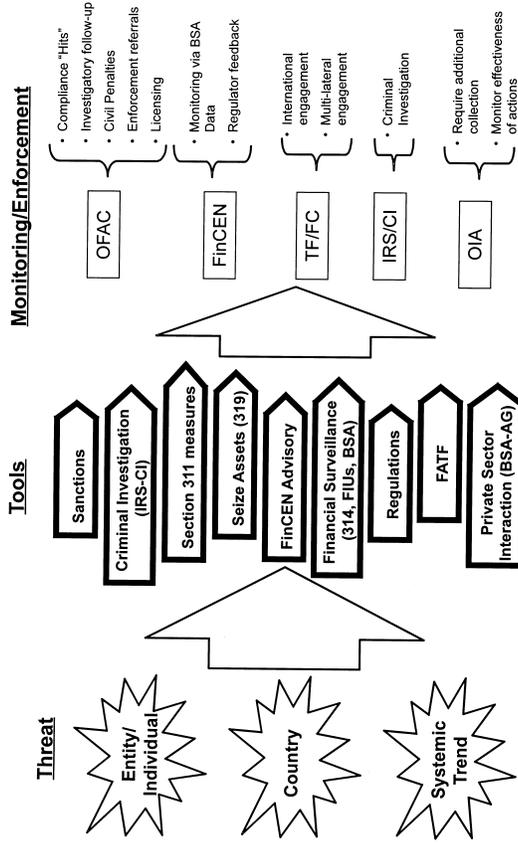
**Objective 2:** Provide current intelligence analytical support.

- Rapidly alert senior Treasury policymakers to breaking developments affecting their areas of responsibility, and identify opportunities for Treasury Department action associated with those developments.
- Respond to questions from senior Treasury policymakers regarding breaking developments and provide rapid, accurate responses.

**Objective 3:** Provide strategic intelligence analysis that supports long-term policy development by Treasury regarding the nature and extent of threats to, and abuse of, the financial system.

- Conduct broad, comprehensive analysis of the financial networks of terrorists, proliferators, and other criminals, evaluating their vulnerability to interdiction under existing and potential Treasury authorities.
- Identify financial modalities or techniques used, or potentially used, by terrorists, proliferators, and other criminals; assess the threat they pose to the US and international financial system; and evaluate the effectiveness of existing and potential Treasury authorities to interdict them.

# Action Flow-chart



### FY 2006 Strategic Analysis Priority Areas

In FY 2006, OIA analysts will be completing strategic research papers, on high priority terrorist and proliferation financing topics. OIA has completed a research and production plan for FY 2006, to help guide OIA's activities during the upcoming year. The plan was coordinated with OIA's primary customers, including TFFC, OFAC, and FinCEN, and is consistent with IC, NSC, and Treasury priorities.

- **Terrorist Financing:** Over the past several years, the terrorist threat has become far more decentralized in nature, and many terrorist groups affiliated with al Qa'ida now pose a serious threat to US national security. In FY 2006, OIA will continue to develop its analytic expertise and expand its analytic coverage on the financial and other support networks of the various terrorist groups and networks bent on attacking the U.S. and its allies.
- **Insurgency Financing:** OIA will attempt to improve its understanding of the insurgency financing in FY 2006, primarily through the Baghdad-based Iraq Threat Finance Cell (ITFC) for which Treasury serves as the co-lead with Department of Defense. ITFC was established to enhance the collection, analysis and dissemination of intelligence to combat the Iraqi insurgency. Such intelligence is critical to support and strengthen U.S., Iraqi and Coalition efforts to disrupt and eliminate financial and other material support to the insurgency.
- **Rogue Regimes/Proliferation Financing:** Over the past year, OIA has assumed an increasingly important role in Treasury's effort to combat other national security threats, including rogues regimes involved in WMD proliferation, such as Iran, Syria, and North Korea. In FY 2006, OIA will continue to build on its nascent effort in this critical area.

**Goal 2.** Provide timely, accurate and focused intelligence support to the Department on the full range of economic, political, and security issues.

Prior to the creation of OIA, the Office of Intelligence Support (OIS) was Treasury's sole intelligence component. The intelligence support provided by OIS to the senior leadership in the Department had dwindled in recent years, leaving only a minimum viable liaison function and a 24/7 Watch Office. OIS, which is now an office within OIA, is attempting to remedy this situation, by providing enhanced support to the Secretary, Deputy Secretary, Undersecretary for International Affairs, and other senior Departmental officials outside of TFI. OIS has been particularly focused on improving the level of support for Department senior leadership for National Security Council meetings and meetings with foreign leaders. It is crucial that Treasury officials are fully prepared to participate in these forums. Intelligence provides

an essential element of this preparation, providing unique insights into context, conditions, and personalities surrounding key national security issues. In FY 2006-2008, OIA will strive to increase both the depth and breadth of intelligence provided to the Department.

**Objective 1:** Better integrate intelligence support into policymaking process.

- Conduct zero-based review of current intelligence support; identify and address shortfalls through creation of new products/ dissemination means.
- Formalize and expand process for supporting senior officials' requirements with an emphasis on "just-in-time" support for foreign travel, NSC/NEC policy meetings, and meetings with foreign officials.

- Explore means to deliver more intelligence to a wider audience.
- Develop and enhance methodology for providing current intelligence to senior leadership.

**Objective 2:** Improve integration and collaboration with IC, to foster better IC support to Treasury on economic, financial, and political issues.

- Review, update, and submit Treasury's collection, production, and dissemination requirements to appropriate IC agencies.
- Develop mechanisms to alert IC to Treasury issues of concern.
- Provide regular feedback to IC on quality and focus of their support to Treasury.

**Objective 3:** Upgrade warning and current intelligence functions.

- Shift focus of Watch Office from information control/distribution and communications support to intelligence operations center.
- Review and reengineer Watch Office processes to expand capabilities and improve effectiveness.

**Goal 3.** Establish Treasury as a fully integrated member of the IC.

The December 2004 Intelligence Reform and Terrorism Prevention Act (IRPTA) has made this goal particularly critical, as the act places a premium on information exchange and collaboration within the IC. Over the past several years, due to resource constraints, the Department has not effectively engaged with the rest of the community, resulting in the lack of communication and missed opportunities for cooperation. As one of the 15 components of the IC (and the smallest), OIA needs to play a more active role in the community. The newly created

position of Assistant Secretary for Intelligence and Analysis has put OIA specifically, and Treasury more generally, in a better position to effectively interact with the IC, particularly with respect to the Director of National Intelligence (DNI).

During its short tenure, OIA has already made great strides in integrating Treasury into the IC, and will continue to build on these efforts in FY 2006-2008. For OIA, an important initial step in improving its integration into the IC was ensuring that OIA's priorities are closely aligned with those of the IC, writ large. As is discussed at greater length below, OIA priorities and direction are closely aligned with those set forth by the Director of National Intelligence in the National Intelligence Strategy. OIA's goals and direction align with key DNI objectives in a number of areas, including: strengthening analysis, WMD proliferation, keeping policymakers informed, and building an integrated intelligence capability. (*See Appendix A*).

In addition, for the first time in FY 2005, Treasury's intelligence office produced all source intelligence analytic products, which were disseminated to the IC, on terrorist financing and other important national security issues. For example, OIA produced a finished piece on the activities of an important Non-Governmental Organization (NGO), which may be providing support to terrorist organizations. TFI's Under Secretary passed a diplomatic note--based on this finished piece--to the foreign government where this NGO is based, demanding that this government take action against the NGO. In addition, OIA disseminated over 50 cables to the IC in 2005. These cables provide valuable information to other IC members on the financial activities of known or suspected terrorists and their networks.

In 2005 OIA analysts also participated in the drafting and coordination on a variety of IC analytic products. These include: National Intelligence Estimates, CIA studies, Senior Executive Intelligence Briefs and Presidential Daily Briefs. The additional personnel OIA is hiring will allow OIA to further increase its contributions to IC products, and to produce additional finished intelligence pieces, for dissemination to the IC.

OIA has also established detail arrangements with various intelligence, law enforcement and military agencies, in an effort to improve information sharing and coordination. These detail assignments include:

- **Military:** OIA has analysts detailed to 3 of the military commands—CENTCOM, PACOM, and EUCOM—and a military officer from CENTCOM is assigned to OIA. OIA also has an established liaison relationship with SOUTCOM.
- **Law Enforcement:** The FBI has detailed an intelligence analyst to OIA.
- **Intelligence:** A representative from NSA is assigned to OIA to provide support to senior Treasury officials, and an analyst from CIA is detailed to OIA to support OIA's counterproliferation efforts.

As OIA grows in size, we plan to expand the scope of our detail assignments with U.S. intelligence, law enforcement and military agencies. For example, in FY 2006, OIA will be integrating a SOCOM detailee into OIA. In addition, over the next several years, OIA also intends to explore the possibility of detailing an OIA analyst to the CIA; working with NSA to detail an additional officer to OIA; and, arranging a temporary assignment of an OIA analyst to the National Counterterrorism Center (NCTC). In FY 2006-2008, OIA is also planning to engage in both formal and informal analytic exchanges with its intelligence and law enforcement partners. For example, the FBI and OIA have agreed to work on several joint analytic projects during the upcoming year. This type of collaboration with FBI will continue in FY 2007-2008.

OIA has also been involved in the efforts by the DNI and the National Security Council/Homeland Security Council to transform the information sharing environment. OIA represents Treasury on the Information Sharing Council and on the Information Sharing Policy Coordinating Committee.

**Objective 1:** Increase Treasury representation in IC forums and provide Treasury input to IC assessments and plans.

- Increase participation in IC collection and production boards.
- Reinvigorate relationship with National Intelligence Council.
- Provide senior-level input into the production and reviews of IC plans and assessments.
- Increase participation in DNI and NCTC Working Groups and Task Forces.

**Objective 2:** Develop formal and informal mechanisms for the dissemination of Treasury intelligence products to appropriate IC members.

- Refine and expand process for producing Treasury cables and other formal products, including finished intelligence pieces.
- Develop Intelink and SIPRNet websites.
- Explore possible mechanisms to make information gathered by Treasury officers through overseas travel and contact with foreign officials available to the IC.

**Objective 3:** Increase Treasury's timely access to relevant IC information.

- Expand analytic details and exchanges with other IC agencies.
- Increase collaboration with other IC agencies on analytic projects.
- Participate in DNI and HSC/NSC Information Sharing Initiatives.

**Objective 4:** Develop bilateral relationships with key foreign partners through the DNI's office.

- Identify several key potential foreign intelligence/law enforcement partners.

- Develop strategy and objectives for bilateral partnership.

**Goal 4.** Coordinate and oversee intelligence throughout the Department, including OFAC's and FinCEN's intelligence analysis.

OIA is responsible for coordinating and overseeing intelligence analysis within the Department. As part of these duties, OIA will review all finished intelligence products drafted by individual TFI components and circulate them throughout TFI in order to produce an integrated product for senior policymakers. OIA will also serve as the central coordinating point for the intelligence collection requirements process. An important aspect of this process will involve working with FinCEN to feed collection requirements for the Department of the Treasury to the Financial Intelligence Units (FIU) worldwide. Moreover, OIA will also oversee the Department's intelligence analysis by providing input into performance evaluations of appropriate analysts within TFI.

In 2005, OIA hired a full time Requirements Officer, who is aggressively submitting requirements and evaluations on behalf of all Treasury entities, including OFAC and FinCEN, to the IC. In these requirements submissions, Treasury includes comprehensive background information as well as a detailed statement of Treasury's intelligence gaps to help focus the IC on Treasury's needs. In response to these detailed requirements, Treasury has received a greatly increased level of tailored support from the IC. OIA will attempt to further improve its integration into the IC requirements process in FY 2006-2008.

**Objective 1:** Drive intelligence analysis throughout the Department and provide guidance on intelligence-related products.

- Prepare target lists, share them with other TFI components, and coordinate prioritization of targets.
- Facilitate regular coordination/information exchanges between OFAC, FinCEN, and OIA analysts, as well as communication with IC.

- Serve as Point of Contact (POC) for tasking from interagency forums dealing with terrorism issues, such as the Terrorist Financing Policy Coordinating Committee or Deputies Committee in order to tap intra-departmental resources in a coordinated, comprehensive manner from the inception of a new project.

**Objective 2:** Develop efficient and transparent process for execution of common functions.

- Serve as TFI conduit for submission of collection requirements to the IC in order to deconflict and prioritize collection requirements generated by TFI components.
- Establish a common process for submitting downgrade/declassification requests to the IC, including compiling guidance on relevant components at other USG agencies responsible for processing downgrade/ declassification requests. Serve as primary POC to the IC dealing with deliberations regarding modifying the existing declassification process.
- Maintain a library of finished intelligence to be provided to other TFI components in support of ongoing projects.

**Objective 3:** Serve as the Senior Official of the IC (SOIC), with all DCI Directive-related responsibilities including managing Sensitive Compartmented Information (SCI).

- Appoint and supervise the officers for the handling and protection of SCI, including the Cognizant Security Authority (CSA), Special Security Officer (SSO), and Designated Accrediting Authority (DAA).
- Oversee the secure, timely distribution of all national intelligence and SCI and ensure it is handled in accordance with all applicable directives, plans, and procedures; provide training as appropriate.

- Approve all billets for SCI access, maintain Department-wide security clearance records, and ensure that accurate clearance information is passed to other agencies.
  - Oversee the approval, accreditation, and continued security compliance of all Sensitive Compartmented Information Facilities (SCIFs) throughout the Department.
  - Ensure appropriate counterintelligence (CI) policies and procedures are in place to protect the Department's sensitive capabilities, to include technical support and travel/threat briefings for senior Treasury officials.
- Treasury's SOIC providing oversight, began the process of stabilizing TFIN to meet Treasury's current intelligence needs. When the project is complete, TFIN will have:
- New network hardware – servers, routers, firewalls, switches, and workstations
  - Up-to-date network software – Operating System and anti-virus tools
  - IC CIO Enterprise Architecture compatibility
  - Advanced analyst tools
  - Complete disaster recover and business continuity capability

**Strategic Goal 5.** Invest in people and Information Technology.

In order to fulfill its mission, the Department will need to make a significant investment in OIA's future, particularly in its human resources and analytical tools necessary to get the job done. The office has conducted a zero-based review of its personnel needs, and is working with HR to recruit talented staff with analytical skills. It is also expanding its organizational structure, which will allow for maximum flexibility in meeting the changing priorities of key customers in TFI and International Affairs. Under this structure, the OIA analytic units will be more narrowly focused/tailed than they have been in the past. OIA will also retain the flexibility to "surge" analysts and other resources towards immediate, high priority requirements. OIA will be working to ensure that the new analysts hired in FY 2006 are fully integrated into the units, receive adequate and appropriate training, and have access to the basic analytic tools necessary to identify trends, patterns, and "connect the dots."

OIA will also be working to upgrade TFIN - the only system used by the Department of the Treasury authorized for Top Secret/Sensitive Compartmented Information (TS/SCI) – which is at risk of catastrophic failure. In FY05, Treasury's Office of the Chief Information Officer, with the

Ultimately, TFIN will interact seamlessly within the IC and provide Treasury analysts with the common software tools used throughout the Community to allow timely and efficient collaboration with other intelligence analysts in the IC, other government departments/agencies, and the DoD.

**Objective 1:** Recruit and hire a high quality workforce.

- Identify the appropriate skills mix to build an agile and highly responsive intelligence analytical unit and intelligence liaison function.
- Develop relationships with outside entities, including universities and other outside experts, to identify potential candidates for recruitment.
- Work with Security to expedite clearance process and get new hires on board.

**Objective 2:** Retain OIA personnel through career development.

- Develop and implement a training plan for OIA workforce for both analytical training and expertise building, leveraging CIA University,

Joint Military Intelligence College, State Department Foreign Affairs Training Center, and other government and non-government education resources.

- Provide opportunities for career development and promotion through expanding variety of assignments, including forward-deployed analysts to the Combatant Commands, National Counterterrorism Center, and details to other agencies.
- Ensure each employee has a career development plan outlining opportunities for training and other assignments.

**Objective 3:** Recapitalize SCI network and provide analytical tools.

- Provide state-of-the-art analytical environment for OIA personnel and acquire analytical tools such as link analysis and data mining to support the office's ability to conduct in-depth, strategic analysis.
- Develop capability to store, retrieve, and manipulate large quantities of data.
- Rebuild SCI network to provide maximum interoperability with other IC agencies in line with E.O. 13356 and rebuild SCI network to be compatible with the Department of Defense's Defense Messaging System network.
- Develop disaster recovery capability to protect vital electronic records and analytical products.

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**OIA Human Resources Strategy**

OIA is developing a hiring strategy to ensure that it is recruiting a high quality work force with the appropriate skill mix. The addition of the new personnel will enable OIA to take significant steps towards building the robust intelligence and analytic program necessary to fulfill its critical mission.

**RECRUIT:**

OIA will take advantage of a number of different recruiting fora for its hiring effort. These include:

- IC Job Fairs
- Presidential Management Fellow Job Fairs
- Recruiting fairs at select universities

OIA will also be using a variety of federal recruiting programs, including:

- Presidential Management Fellows Program
- Federal Career Intern Program
- Student Career Experience Program
- Federal Career Fellows

**HIRE:**

- **Analysts:** OIA will be hiring all source analysts with a variety of experience, ranging from very junior analysts directly out of graduate school to senior analysts with years of relevant experience. OIA will be targeting analysts with prior IC and financial sector experience, as well as relevant regional/area expertise.
- **Economists:** OIA will be targeting economists in its FY 2006 hiring efforts. The Treasury Department has made significant strides over the past several years designating terrorism—and more recently proliferation—targets. Developing a better impact of the economic impact of the sanctions is essential in assessing whether Treasury is focusing on the appropriate types of targets. OIA economists will work closely with the other all source analysts to analyze the likely effect of future designations.
- **Information Officer:** As OIA expands, its IC administrative needs will increase as well. OIA will be hiring an officer, who will facilitate OIA's downgrade/declassification requests. These types of request are essential for Treasury's designations and for its diplomatic outreach efforts.

**OIA Hiring Strategy, Continued****TRAIN:**

- Develop and implement a training plan for entire OIA workforce.
- Appoint a Point of Contact for all training-related matters.
- Ensure that analysts of all experience levels receive appropriate training, including courses on: analytic tradecraft, analytic briefing/presentation, relevant regional/subject areas, and analytic tools.
- Ensure each employee has a career development plan outlining opportunities for training and other assignments.
- Leverage existing US Government training courses, including CIA University, Joint Military Intelligence College, State Department Foreign Affairs Training Center, as well as non-government education resources.

**RETAIN:**

- Provide opportunities for career development and promotion through expanding variety of assignments, including at the Combatant Commands, National Counterterrorism Center, CIA, and other agencies.
- Raise promotion potential for both managerial and analytic positions, in light of evaluation of current responsibilities.
- Provide the analysts with opportunities to frequently brief senior level Treasury and IC officials, as well as Congressional oversight committees.
- Provide opportunities for both overseas and domestic travel to continue development of expertise and skills.

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#### **Measuring OIA's Performance**

- OIA has identified a number of potential metrics, against which we will collect data that will permit us to evaluate our current and future performance. As OIA evolves, we will conduct a continuous internal review to ensure that we are using appropriate performance measures. We may find the need to modify both the baselines and the performance measures themselves as a result of this evolution and evaluation.
- OIA's metrics -- which are aligned with the DNI's strategic objectives -- are designed to ensure that OIA is fulfilling the objectives outlined in this plan. They include:
  - Contributions of OIA analysts to IC products
  - Customers' satisfaction with timeliness, accuracy, and relevance of OIA's products
  - Integrating the new analytic hires into OIA by providing them with adequate and appropriate training, mentoring and analytic tools
- We are also in the process of developing additional metrics as well.
- We anticipate that this performance management process will be particularly valuable for OIA in judging our progress in the technological arena. In FY 2006, for the first time, we will be closely tracking the TFIN system's performance to establish a baseline. We plan to measure our progress, in large part, by measuring the system's performance in future years against the baseline we establish this year. We hope to see that our efforts to upgrade the system will result in far fewer system failures than we are currently experien

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**OIA Goals Closely Aligned with those Established by the DNI**

OIA's priorities for FY 2006 are closely aligned with those of the DNI, as outlined in the DNI's October 2005 National Intelligence Strategy.

- **Informed Policymakers:** One of the DNI's top mission objectives is to "anticipate developments of strategic concern and identify opportunities as well as vulnerabilities for decision-makers." OIA's top strategic goal to "provide policymakers with relevant intelligence and expert analysis to support the formulation of policy and execution of Treasury authorities" is consistent with this objective. OIA's increased focus on strategic intelligence analysis in FY 2006 will also help OIA identify emerging issues relevant for policymakers.
- **Analytic Expertise:** Transforming OIA into a center of analytic expertise on financial and other support networks for terrorist groups, proliferators, and other key national security threats, is in line with one of the DNI's top enterprise objectives, which is to "strengthen analytic expertise, methods, and practices; tap expertise wherever it resides; and explore alternative analytic views."
- **WMD Proliferation:** The Treasury Department's ability to target proliferators of weapons of mass destruction was enhanced in June 2005 with the issuance of Presidential Executive Order 13382. This order applies the same tools Treasury has used to successfully block the assets of terrorist supporters to those who aid in the spread of weapons of mass destruction. OIA's increased focus on this issue is aligned with the DNI's objective of preventing and countering the spread of weapons of mass destruction.
- **Integrated Intelligence Capability:** The DNI's top enterprise objective is to "build an integrated intelligence capability to address threats to the Homeland..." Two of OIA's strategic goals are in line with this DNI objective. OIA's efforts to enhance the Treasury Department's relations with the IC will help the DNI achieve this broader objective. OIA is also responsible for building an integrated intelligence capability within Treasury, with its responsibility for coordinating and overseeing intelligence throughout the Department. Unifying and strengthening Treasury's intelligence efforts will also help the Department build stronger ties to the IC.

### OIA Goals Align with Key DNI Enterprise Objectives

DNI Enterprise Objective 1	DNI Enterprise Objective 2	DNI Enterprise Objective 3	DNI Enterprise Objective 4
Build an integrated intelligence capability to address threats to the homeland, consistent with US laws and the protection of privacy and civil liberties	Strengthen analytic expertise, methods and practices; tap expertise where ever it resides; and explore alternative analytic views	Rebalance, integrate, and optimize collection capabilities to meet current and future customer and analytic priorities	Attract, engage, and unify an innovative and results-focused Intelligence Community workforce

OIA Goal 1	OIA Goal 2	OIA Goal 3	OIA Goal 4	OIA Goal 5
Develop actionable intelligence by analyzing all-source intelligence and information collected by the Treasury Department	Enhance intelligence support to the Department on the full range of political and economic issues	Coordinate and oversee intelligence throughout the Department, including OFAC's and FinCEN's intelligence analysis and the analysts forward deployed to the military commands and the National Counterterrorism Center (NCTC)	Enhance the Department's relations with the Intelligence community	Invest in people and Information Technology

### OIA Goals Align with Key DNI Mission Objectives

<p><b>DNI Mission Objective 1</b></p> <p>Prevent and counter the spread of weapons of mass destruction</p>	<p><b>DNI Mission Objective 4</b></p> <p>Develop innovative ways to penetrate and analyze the most difficult targets</p>	<p><b>DNI Mission Objective 5</b></p> <p>Anticipate developments of strategic concern and identify opportunities as well as vulnerabilities for decision-makers</p>
<p><b>OIA Goal 1</b></p> <p>Develop actionable intelligence by analyzing all-source intelligence and information collected by the Treasury Department</p>	<p><b>OIA Goal 2</b></p> <p>Enhance intelligence support to the Department on the full range of political and economic issues</p>	<p><b>OIA Goal 3</b></p> <p>Coordinate and oversee intelligence throughout the Department, including OFAC's and FinCEN's intelligence analysis and the analysts forward deployed to the military commands and the National Counterterrorism Center (NCTC)</p>
<p>Invest in people and Information Technology</p>	<p>Enhance the Department's relations with the Intelligence community</p>	<p>Invest in people and Information Technology</p>

Ms. GARDNER. In addition, it describes the role that OIA plays in the Treasury Department's intelligence activities, and expands on OIA's efforts to better integrate the office with the rest of the Intelligence Community.

As you know, OIA was established by the intelligence authorization bill in 2004, and prior to the creation of OIA, Treasury did not have an in-house dedicated intelligence analytical element. Our mission is to support the formulation of policy and execution of Treasury's authorities, and it is twofold. One is to support TFI in providing expert analysis of intelligence on financial and other support networks for terrorist groups, proliferators, and other key national security threats. But also to provide timely, accurate and focused intelligence on the full range of economic, political, and security issues for the Secretary, the Deputy Secretary, and the Office of International Affairs.

While we are still a fairly new entity, we have taken a number of significant steps in 2005 toward building the robust intelligence and analytical program necessary to fulfill our mission. We are trying to transform Treasury from a passive consumer of analytical and intelligence products, to becoming a full member of the Intelligence Community, and we are building a foundation to become a true center of expertise on material support to terrorist organizations.

The funding allocated by Congress for fiscal year 2006 is allowing us to make significant additional improvements in a number of areas. For example, we have completed a research and production plan for fiscal year 2006 to help guide our activities during the upcoming year. The plan was coordinated with our primary customers including within TFI, but also the entire Intelligence Community and the National Security Council to ensure that our priorities are aligned with the administration.

In particular, we are trying to improve our understanding of insurgency financing in fiscal year 2006 primarily through the Baghdad-based Iraq Threat Finance Cell that you had mentioned, Mr. Chairman, for which Treasury serves as the co-lead with CENTCOM at DOD. ITFC was established to enhance the collection, analysis, and dissemination of intelligence to combat the Iraqi insurgency, and that kind of intelligence is really critical to support and strengthen U.S. and Iraqi coalition efforts to disrupt and eliminate financial and other material support to the insurgency. In fact, the Treasury's presence in Iraq on ITFC is already paying some dividends. More and better detailed information on the insurgency financing issues is becoming available. In addition, the financial intelligence analysts have provided great support to the military in identifying trends and patterns in insurgency financing in the context of a cash-based economy like Iraq.

The funding request for fiscal year 2007 will enable OIA to continue its efforts to build our intelligence capabilities by improving key infrastructure and adding to our analytical breadth and depth on terrorist financing and the financial underpinnings of other national security threats.

Let me just briefly mention the initiatives that we have. The first one was one that you had mentioned, the Treasury Foreign Intelligence Network, which is the sole source of top secret information

into the Treasury Department. When TFI was created, our counterterrorism-related responsibilities were expanded dramatically, and the current system has not been modified or updated to keep pace with changes in either intelligence user or technological requirements. The operating system is no longer supported, and our frequent crashes have been preventing senior Treasury officials from receiving intelligence in a timely manner. What we will be doing in response to some of your concerns on the IT management, we have tried to leverage the expertise of the Intelligence Community, so they are helping us so that we are not reinventing the wheel, and we are taking off-the-shelf software and hardware. We are also using the CIA to help do the project management for us, so we have two levels of oversight. We have asked the DNI's office, the Director of National Intelligence, to also take a look. They have a new CIO, and they are coming also to take a look at us to make sure that we are on the right track. So we are ensuring that we do have the proper project management discipline in place that the Secretary has mentioned.

In addition to TFIN, we have an initiative for All Source Analysis Capability. As Under Secretary Levey mentioned, over the past year as OIA has grown, policy makers both at Treasury and at the White House have become more aware of Treasury's capabilities, and OIA has increasingly been tasked with addressing the most pressing national security issues. Given our small size, we have gone from zero analysts in the beginning of fiscal year 2005, to 53 analysts, and will hopefully have 15 more. Bringing these new analysts on board as quickly as possible is essential to our continued success, and these additional positions will allow us to engage in increased analytical exchanges with other national security and Intelligence Community agencies, and this also includes our effort to sustain the effort in Baghdad.

#### PREPARED STATEMENT

Finally, one more initiative that is important is our secure space. As you know, OFAC also is going to be growing in terms of its terrorism and WMD designation programs, and together we are going to try to make sure that we have the secure space available to house these new analysts.

Thank you very much for your continued support, and for your comments this morning.

[The statement follows:]

#### PREPARED STATEMENT OF JANICE GARDNER

Chairman Bond, Ranking Member Murray, and members of the subcommittee, I thank you for the opportunity to testify today on the Office of Intelligence and Analysis' 2007 budget request. The Department of the Treasury greatly appreciates the committee's support to this point for our efforts to establish and build the Office of Intelligence and Analysis (OIA).

I request that a copy of OIA's report on its fiscal year 2006-2008 strategic direction be entered into the record. We produced this report for your committee in response to the conference report accompanying the fiscal year 2006 appropriations bill. OIA was required to submit a report that detailed "how OIA will implement the purpose of the Office as intended by the Congress." OIA's report defines its mission, establishes strategic objectives, and outlines OIA's priorities and direction for the next several years. In addition, it describes the role that OIA will play in the Treasury Department's intelligence activities, and expands on OIA's plans to better integrate the office into the Intelligence Community (IC). We hope that the com-

mittee members will find the report to be helpful as they consider OIA's 2007 budget request.

I will discuss a number of the themes covered in the OIA report in my prepared remarks today. I will provide some background on our office, provide an overview of the significant progress we made in fiscal year 2005, update you on where we stand with our fiscal year 2006 efforts, and explain how we would plan to use the funds we have requested in fiscal year 2007.

#### BACKGROUND ON OIA

OIA was established by the Intelligence Authorization Act for fiscal year 2004. The Act specifies that OIA shall be responsible for the receipt, analysis, collation, and dissemination of foreign intelligence and foreign counterintelligence information related to the operation and responsibilities of the Department of the Treasury. Prior to the creation of OIA, Treasury did not have an in-house intelligence analytic element.

On April 28, 2004, Secretary of the Treasury John Snow established the Office of Terrorism and Financial Intelligence (TFI) by Treasury Order, which placed OIA within TFI. As the Assistant Secretary, I report directly to Under Secretary Levey, who heads TFI.

OIA's mission is to support the formulation of policy and execution of Treasury authorities by:

- Producing expert analysis of intelligence on financial and other support networks for terrorist groups, proliferators, and other key national security threats, and
- Providing timely, accurate, and focused intelligence on the full range of economic, political, and security issues.

#### SIGNIFICANT PROGRESS IN FISCAL YEAR 2005

While OIA is still a fairly new entity, it took a number of significant steps in 2005 towards building the robust intelligence and analytic program necessary to fulfill its critical mission. Moving the OFAC Foreign Terrorist Division (FTD) analysts to OIA was instrumental in transforming Treasury from a passive consumer of analytic and intelligence products to a full contributing member of the IC. OIA has been using the expertise of these analysts—as well as that of the new hires—as a foundation for a true center of expertise on material support to terrorist organizations. As a result, OIA has considerably improved its analytic coverage and capability in priority areas, such as Iraqi insurgency funding.

OIA's top priority, as we mentioned in our report to your committee, is to help translate intelligence into policy. OIA analysts conduct "all source" analysis, regularly reviewing a broad range of information from the IC, including human and signals intelligence reports, other agencies' analytic assessments, as well as open source information. OIA's role in this regard is to then ensure that the current intelligence information and analysis are incorporated into all aspects of policy deliberations. OIA took several steps in 2005 to address this objective.

- Perhaps most significantly, OIA initiated weekly targeting sessions, which are led by Under Secretary Levey and include officials from OIA, OFAC, and FinCEN as well. At these sessions, potential targets are presented and discussed. The participants assess the full range of potential Treasury actions, including designation, and then assign follow up action.
- OIA also began producing analytic papers for Under Secretary Levey, primarily on nongovernmental organizations (NGOs), which may be providing support to terrorists. Under Secretary Levey has passed a number of these papers to the foreign governments where these NGOs are based, asking them to take appropriate action. He has then followed up to ensure that the governments are taking the necessary steps to put a halt to this activity.

In addition to these diplomatic papers, in 2005 Treasury's intelligence office prepared a number of other all source intelligence analytic products on terrorist financing and other national security threats. In fact, OIA has disseminated over 50 cables to the IC over the past year. OIA analysts also participated in the drafting and coordination on a variety of IC analytic products. These include:

- National Intelligence Estimates;
- CIA studies; and
- Articles for senior administration officials, such as the Senior Executive Intelligence Brief.

There were two key reasons why OIA was able to improve its capability to produce all source intelligence analytic products. First, Treasury—through OIA—is becoming far better integrated into the IC than it has been in the past. In 2005,

OIA hired its first full time Requirements Officer, who has played a key role in bringing OIA into the IC. This officer is sending in specific questions and inquiries on behalf of all Treasury entities, including OFAC, to the IC. In these “requirements submissions” Treasury includes comprehensive background information as well as a detailed statement of Treasury’s intelligence gaps to help focus the IC on Treasury’s needs. In response to these detailed requirements, Treasury has received a greatly increased level of tailored support from the IC.

Second, OIA has also built its analytic expertise and improved its access to intelligence information by establishing detail arrangements with various intelligence, law enforcement and military agencies. These detail assignments include:

—*Military*.—OIA has analysts detailed to 3 of the military commands—CENTCOM, PACOM, and EUCOM—and a military officer from CENTCOM is assigned to OIA. OIA also has an established liaison relationship with SOUTCOM. SOCOM is also preparing to assign an officer to OIA.

—*Law Enforcement*.—The FBI has detailed an intelligence analyst to OIA.

—*Intelligence*.—A representative from NSA is assigned to OIA to provide support to senior Treasury officials.

In 2005, OIA also began to build its analytic expertise and coverage in another key area—proliferation financing. The Treasury Department’s ability to target proliferators of weapons of mass destruction (WMD) was enhanced in June, 2005 with the issuance of Executive Order 13382. This order applies the same tools Treasury has used to successfully block the assets of terrorist supporters to those who aid in the spread of WMD. OIA analysts were integrally involved in supporting OFAC in developing the designation targets listed in the annex of the Executive Order, and continue to assist OFAC investigators in identifying intelligence reporting that may be useful to support future designations.

#### BUILDING ANALYTIC COVERAGE AND DEPTH IN FISCAL YEAR 2006

The funding allocated by the Congress for fiscal year 2006 is allowing OIA to make significant additional improvements in a number of areas this year. For example, the additional personnel and the infrastructure improvements funded in fiscal year 2006 are enabling OIA to increase its analytic coverage and to further develop its expertise on the financial aspects of key threats to U.S. national security, including terrorism and WMD proliferation.

In fiscal year 2006, OIA analysts will be completing strategic research papers on high priority terrorist and proliferation financing topics. OIA has completed a research and production plan for fiscal year 2006 to help guide OIA’s activities during the upcoming year. The plan was coordinated with OIA’s primary customers, including TFFC, OFAC, and FinCEN, and is consistent with IC, NSC, and Treasury priorities.

—*Terrorist Financing*.—Over the past several years, the terrorist threat has become far more decentralized in nature, and many terrorist groups affiliated with al Qaida increasingly pose a serious threat to U.S. national security. In fiscal year 2006, OIA will continue to develop its analytic expertise and expand its analytic coverage on the financial and other support networks of the various terrorist groups and networks bent on attacking the United States and its allies.

—*Insurgency Financing*.—OIA will attempt to improve its understanding of the insurgency financing in fiscal year 2006, primarily through the Baghdad-based Iraq Threat Finance Cell (ITFC) for which Treasury serves as the co-lead with Department of Defense. ITFC was established to enhance the collection, analysis and dissemination of intelligence to combat the Iraqi insurgency. Such intelligence is critical to support and strengthen U.S., Iraqi and Coalition efforts to disrupt and eliminate financial and other material support to the insurgency. —In fact, the Treasury presence in Iraq on the ITFC is already paying dividends. More and better detailed information on the insurgency finance issues is becoming available. In addition, the financial intelligence analysts have provided great support to the military in identifying trends and patterns in insurgency financing in the context of a cash-based economy.

—*Rogue Regimes/Proliferation Financing*.—Over the past year, OIA has assumed an increasingly important role in Treasury’s effort to combat national security threats, including rogues regimes involved in WMD proliferation, such as Iran, Syria, and North Korea. In fiscal year 2006, OIA is continuing to build on its nascent effort in this critical area.

To accommodate its rapid growth, and to achieve the ambitious goals that have been laid out for OIA, we have developed a hiring strategy to ensure that we are recruiting a high quality work force with the appropriate skill mix. OIA has been

taking advantage of a number of different recruiting fora and using a variety of Federal recruiting programs, such as the Presidential Management Fellows Program. In terms of our analytic hires, OIA is hiring all source analysts with a variety of experience, ranging from junior analysts directly out of graduate school to senior analysts with years of relevant experience. OIA is also targeting analysts with prior IC and financial sector experience, as well as relevant regional/area expertise.

OIA is also targeting economists in its fiscal year 2006 hiring efforts. The Treasury Department has made significant strides over the past several years designating terrorism—and more recently proliferation—targets. Developing a better assessment of the economic impact of the sanctions is essential in determining whether Treasury is focusing on the appropriate types of targets. This kind of analysis is extremely valuable not only for Treasury policymakers, but for policymakers elsewhere in the government as well. It can help shed light on what policy tools the U.S. Government should use—and are likely to be effective—against particular countries or targets.

In sum, we believe that we are on track to succeed with our rapid expansion, and that we will make—and are already making—major strides in fiscal year 2006 to continue transforming OIA into a center of analytic expertise on the issue of financial and other support networks for terrorist, proliferators, and other key national security threats.

#### FISCAL YEAR 2007 BUDGET REQUEST

The funding request for fiscal year 2007 would enable OIA to continue its efforts to build Treasury's intelligence capabilities by improving its key infrastructure and adding to its analytic breadth and expertise.

Our key initiatives in our fiscal year 2007 request include:

*TFIN.*—The modernization of Treasury's Foreign Intelligence Network (TFIN), the sole information technology system in the Department authorized for Top Secret information. With the creation of Treasury's Office of Terrorism and Financial Intelligence (TFI) and OIA, the Department's counterterrorism-related responsibilities were expanded dramatically. A new information technology architecture was required to support this broader, Congressionally-mandated mission. The current system is unstable and has not been modified or upgraded to keep pace with the changes in intelligence, user, or technological requirements. The operating system is no longer supported and the entire system is at risk of catastrophic failure. The frequent system crashes have been preventing senior Treasury officials from receiving intelligence reporting from other agencies in a timely manner. In addition, the system's performance issues have been hampering the ability of Treasury's intelligence analysts to perform their jobs.

Ultimately, the upgraded TFIN system will allow Treasury to interact seamlessly within the IC and provide Treasury analysts with the common software tools used throughout the Community. It will allow timely and efficient collaboration with other intelligence analysts in the IC, other government departments/agencies, and the Department of Defense.

*ITFC.*—Our request will allow Treasury to sustain its co-lead role in the Baghdad-based ITFC. Two Treasury officers have already been assigned temporarily to Iraq, where they conducted the initial assessment or "Phase I". "Phase II," which calls for the assignment of Treasury personnel to Iraq on an ongoing basis to bolster the all-source intelligence analysis on the insurgency, is now in progress. Improving the U.S. Government's understanding of the insurgency funding is a key goal for our office, and I as mentioned earlier, this interagency initiative is already paying important dividends.

*All Source Analysis Capability.*—The additional analysts OIA is requesting in fiscal year 2007 will allow OIA and Treasury to further increase the depth and breadth of its analytic coverage and expertise in priority areas, such as terrorist financing, and proliferation financing. Over the past year, as OIA has grown and policymakers—both at Treasury, in the White House and elsewhere—have become more aware of its capabilities, OIA has been increasingly tasked with addressing the most pressing national security issues. Given its small size and increasing importance, bringing new analysts on board as quickly as possible is essential for OIA's continued success. These additional positions would also allow OIA to engage in increased analyst exchanges with other national security and IC agencies, in accordance with the Intelligence Reform and Terrorist Prevention Act of 2004.

*Secure Space.*—As the committee is aware, in addition to the proposed OIA growth, the Office of Foreign Assets Control (OFAC) is expanding its terrorism and WMD designations programs. Both OIA and OFAC's expansion is necessary, in part, as a result of the June 2005 Executive Order, giving the Treasury Department addi-

tional authority to target proliferators of WMD. The highly classified work of these expanding units can only be accomplished in specially constructed secure areas, known as Sensitive Compartmented Information Facilities (SCIFs). Once the fiscal year 2006 hires have been assigned their work spaces in existing SCIFs, there will be no available SCIF space remaining in the Department. Both OIA and OFAC are requesting additional positions in fiscal year 2007; the Secure Space Initiative is directly linked to that request. Given the lack of remaining available SCIF space in the Treasury Department, we will have to build additional SCIF space to accommodate any fiscal year 2007 OIA and OFAC hires. Adequate security infrastructure is critical to protecting the intelligence and national security functions of the Department. Approval of this initiative will ensure Treasury personnel have the required secure workspaces to support the mission of disrupting and dismantling the financial infrastructure of the terrorists and isolating their support networks.

#### CONCLUSION

Thanks again for your continued support for OIA and TFI. We appreciate the confidence that your committee has shown in our office to this point. We believe that the resources that we requested in fiscal year 2007 will enable OIA to take the next steps in building the type of robust intelligence capability that Congress envisioned when you created our office.

That concludes my prepared remarks. I would be happy to answer any questions.

#### TFI AUTHORITIES

Senator BOND. Thank you very much, Ms. Gardner. Mr. Levey, I am delighted to hear that our allies are now saying that we ought to hold financiers to account. You may know I am from Missouri which is called the "Show Me" State. A lot of times I keep thinking about that old country music song, "I Want a Lot Less Talk and a Whole Lot More Action." Would you please tell us when you start seeing the action? Words are nice.

Let me ask you to explain in a little more detail how TFI has had an impact on combatting terrorist financing and what new powers you have that Treasury could not do before TFI was created, and what additional resources you may need from this committee or from the Intelligence Committee.

Mr. LEVEY. I think maybe we should do that by discussing the initiatives that we have asked for, in addition to the ones that Assistant Secretary Gardner laid out for our Intelligence Office which are critical in order to answer the increased demand. I want to highlight one thing that she said, which is that success breeds demand in this. People are seeing that the actions that we take in terms of looking at the financial system and trying to both make it impervious to illicit activity on the one hand, but also to target illicit activity within it on the other to identify the bad actors and call them out and get financial institutions to say they are going to stop doing business with them. People are seeing that that is really valuable, and so they are asking us to do more and more on different important issues, both with respect to WMD proliferation and terrorism.

In order to do that, one of the most important things we need is the intelligence capability to support it. We need to be able to come up with the analysis, identify the right targets, know the right networks, so that we can exercise our authorities wisely. This is, I think, attributable to the fact that we have this Intelligence Office that Assistant Secretary Gardner leads and that she has been building, but we need to continue to build it, both in terms of personnel and in terms of the infrastructure to support it which is the TFIN network and secure space.

In addition, we need to be able to continue to build up OFAC to follow through on the tactical actions, and so our 2007 budget request includes additional analysts for WMD proliferation and terrorism. On the terrorism issue in particular, what those are for, Mr. Chairman, is to follow up on entities that are already designated, because one thing we know, as you indicated in your opening statement, is that these terrorist entities are very capable and flexible, and we have to be flexible, too. So once we designate someone or an entity, we need to follow up and see how that network is reformulating itself so that we continue to follow up. If we do not do that, then our designation is not nearly as effective. So one of the things we have asked for is support for that.

BANCO DELTA ASIA DESIGNATION

Senator BOND. I think you asked for more time to explain how the impact of the Banco Delta Asia expands. Would you tell us about the follow up on that as well?

Mr. LEVEY. I would love to be able to do that. In fact, we have prepared a diagram. I don't know if you can see that. Do we need to move it closer to you, Senator Murray or Mr. Chairman?

Senator BOND. You don't happen to have it on a little handy cheat sheet, do you?

Mr. LEVEY. Yes, we do.

Senator BOND. That might be a lot easier.

Mr. LEVEY. What this chart shows is how our office works when it works well, and I think this not only a case study, but it is a successful case study.

What we have on the left side with the overlapping circles is TFI, all the different aspects of TFI. You have OFAC, you have the Office of Intelligence Analysis, FinCEN, you have our Policy Office led by Assistant Secretary O'Brien, and you have the IRS which supports us on financial investigations. OIA has the responsibility for pulling all that together through an integrated intelligence analysis. We were looking at North Korean illicit conduct, trying to figure out who were we going to put pressure on North Korean illicit conduct, and through Janice's leadership we were able to pull all of that together and identify what targets we should go after.

We identified a bank in Macau which is a jurisdiction that has money-laundering problems in many ways, but this particular bank was facilitating a wide range of illicit activity on behalf of the government of North Korea, engaged in counterfeiting of U.S. currency, they are engaged in narcotics trafficking, they are engaged in other sorts of criminal conduct, and they were using this bank in order to facilitate that. Not only that, this bank had negotiated a deal with the government of North Korea and these entities that in exchange for fees paid to the bank, they would apply a lower standard of due diligence which is a very tempting thing for someone who is engaged in illicit conduct.

We identified this bank and we designated it under the PATRIOT Act as a primary money-laundering concern. That is the second column. After we all get together and sit down and look at the intelligence analysis. In fact, we have a meeting this afternoon to do this with another target, where we all sit down together and say: "What is the best way to get at this problem?"

In this situation, we identified two things to do to get at the North Korean illicit conduct. The first is the top item, designating the bank under section 311 of the PATRIOT Act. The second one is the Executive order designations below, which is the Executive order that I mentioned in my opening statement that the President issued to give us the power to target and freeze the assets of WMD proliferators. We designated a number. Actually, at this point the President himself designated in the initial Executive order North Korean entities of proliferation concern under that Executive order.

One of those entities that was designated was Tanchon Bank which is a North Korean bank that is the primary financial facilitator for KOMID which is the North Korean military procurement entity, which happened to have a number of accounts and to be a big customer of Banco Delta Asia, so it all came together quite nicely.

Senator BOND. Mr. Levey, we need to get on with the questions. I would say that Banco Delta Asia was what you would call a full-service bank.

Mr. LEVEY. A full-service bank.

Senator BOND. They certainly had it all. I am going to turn now to Senator Murray for questions.

Mr. LEVEY. Thank you, Mr. Chairman.

#### BSA DIRECT

Senator MURRAY. Thank you very much, Mr. Chairman. I want to go back to some previous discussion about the BSA Direct program very quickly before I ask you some other questions. That program in the past was presented to us as a critical program to combat terrorist financing. Now that this program appears to be kind of on life-support, can you tell us what impact that failure will have on your efforts to monitor compliance with the Bank Security Act?

Mr. LEVEY. Senator Murray, just to preface this, you are right to have all the concerns that you have expressed about the BSA Direct Program, and you are right that we have come to this committee and asked for money for, and support, and we appreciate the support, and what has happened is a disappointment to me as I know it is to you. The new Director of FinCEN, Bob Werner who certainly deserves no blame for this, I want to make sure people understand that. Bob Werner is the new Director who came in to a tough situation, identified these problems, and after consulting with me, took the appropriate action which is to put a temporary work stoppage in place so that we could assess exactly where the project is and make sure that we do not continue to spend money if the project is not going to succeed.

Senator MURRAY. Why did it take the appointment of a new Director to find out that we were way off track?

Mr. LEVEY. The answer to that is that that is an excellent question, and I want to know the answer to that, too. I think as the chairman put it in his opening statement, he is going to ask for people to look at this, and I think that that is appropriate. We need to find out, and I also want to find out the answer to that question, and figure out if there is anything I should have been doing better

so that I can make sure that I do not make whatever mistakes I may have made again.

Senator MURRAY. Is this going to move forward now, or are we going to pull the plug?

Mr. LEVEY. What we need to do is, under this temporary stop work order, it gives us 90 days to assess it to determine what is the best next step. The reason we did this now, or the reason that Director Werner recommended that we do this now, and I think it was the right decision, is that by doing this temporary stop work order, we are able to make sure that we do not have a loss of service to our customers in the interim. That is, of course, of the highest priority. We are hopeful that we are going to be able to do this assessment and get through the project without ever losing our customer service. Frankly, we are going to look at the idea I think you mentioned in your opening statement about what benefit we can draw upon and what leverage we can apply to the IRS systems that might be used.

Senator MURRAY. Did I hear you say you are in a 90-day review?

Mr. LEVEY. Yes.

Senator MURRAY. I assume that at the end of that, if you are moving forward, you are going to be able to guarantee to us that you will get all the functionality out of that new system that we were originally promised?

Mr. LEVEY. I will give you a complete briefing on the functionality that will be obtained by the new process and exactly how much it will cost. I think that the chairman's suggestion that we give an action plan on BSA Direct, in whatever time period you think is appropriate, Mr. Chairman, we will do it, is exactly what is called for.

Senator MURRAY. Given all of that, do you still stand behind the request for \$12.5 million for this in 2007?

Mr. LEVEY. I think the request is \$2.4 million. With your permission, Senator, I would want to refer that question to Director Werner. If it is easier, we can respond in writing and do that promptly.

Senator MURRAY. Is he in the room?

Mr. LEVEY. Yes, he is right here.

Senator MURRAY. If you would not mind, Mr. Chairman.

Senator BOND. I was going to ask Director Werner to come forward. The GAO has raised questions about it and you have raised a very good question.

#### BSA DIRECT AND THE CROSS-BORDER WIRE INITIATIVE

Senator MURRAY. And with the cross-border wire request as well, it is a \$12.5 million request.

Mr. LEVEY. With the cross-border wire it is, yes.

Senator BOND. Mr. Werner, if you will state your full name and title for the record, please.

Mr. WERNER. My name is Robert W. Werner, and I am the Director of Financial Crimes Enforcement Network.

Senator MURRAY. Did you say the new Director?

Mr. WERNER. New Director. Good morning, Mr. Chairman, and Madam Ranking Member. You are correct, the cost is \$2.4 million, I think it is \$2.473 million, relates to the BSA Direct components. That includes the secure outreach, the BSA electronic filing, and

the BSA Direct retrieval and storage component, and then there is \$10 million separately requested for the cross-border study.

While the cross-border wire study is related to BSA Direct because ultimately the data would be folded into that program, it is really very distinct at this point. Right now we are in the middle of a feasibility study for the cross-border wire. Given the massive amount of data involved in that, if the Secretary were to approve the feasibility study and decide to go forward with it, that would require tremendous augmentation to existing systems. So the fact of the matter is, we are going to have a retrieval and storage component for BSA Direct, but whether we are able to have the full range of functionality that was originally planned in the current retrieval and storage project, it is too early to say. But we will not have disruption of service to our customers because at this point we are also transitioning to the IRS's Web CBRS system, so we will have a functioning system. Part of what we are reassessing is what exactly the requirement needs are and revalidating those.

Senator MURRAY. This committee will need to know whether you stand by that number or where you are on that fairly soon, so I hope you stay in touch with the committee on that.

Mr. WERNER. We absolutely will, and I can tell you now that the electronic filing component is not involved in the stop work order and is about \$1.3 million of that. In addition, the secure outreach which, again, is an operational functioning system and not part of the stop work, is close to about \$500,000. So the remainder does relate to the retrieval and storage component, and we will keep you very closely apprised of that.

Senator MURRAY. I appreciate that. Thank you, Mr. Chairman.

Senator BOND. Thank you very much, Senator Murray. The GAO has raised a lot of questions that I know Director Werner is going to have to answer, and we are going to have to answer. So I think this is a work in process, and I think 45 days, if you can make it, is a good timeline to let us know what you found, where you are going to go, and how you can make some chicken salad out of what you have been presented.

Mr. WERNER. We will absolutely keep you briefed. I think at this point we are projecting having a written report hopefully sometime in June, but I think within 45 days we will certainly have a much better idea of where we are and what some of the options are.

#### TREASURY FOREIGN INTELLIGENCE NETWORK

Senator BOND. Thank you very much, Mr. Werner. Turning to Ms. Gardner, your work I know is extremely important. The DNI has emphasized to us how critical your information is, and we want to know how we can help you get the work done. I do not want to see all of your time taken up as an IT manager because you have very important work to do. So we will look forward to discussing that with you as the process goes forward.

Now I would like to ask, Ms. Gardner, if you can elaborate on the importance of upgrading the Treasury Foreign Intelligence Network, TFIN, especially in terms of how it can help you improve the way that OIA performs its job, and when do you expect TFIN to be complete?

Ms. GARDNER. Thank you, Mr. Chairman. I appreciate the opportunity to talk about TFIN because it is very near and dear to my heart. We do need this capability in order to deliver all of the things that Under Secretary Levey promised that we would be able to do.

The TFIN system was actually built in the 1990's, and it was built in-house, and so it was great at the time, but clearly we need something more now. What we have done is try to take this in two steps. One is, first, to stabilize the current system. That delivery will be on April 18 so that the system crashes that we have been experiencing hopefully will stop. Then the next phase is actually the upgrade to increase capabilities. When the system was built in the mid-1990's, we were just a liaison shop. We did not have analysts doing analytical work. So now we need to be able to put all the bells and whistles of analytical tools, link analysis tools, data retrieval, all those things on there.

I think that we have segmented it in a way so that all the deliveries will be rolling out over the next year. If we do get the budget request in 2007, we are hoping that we will be able to finish all of the phases by the end of the fiscal year with the slight possibility that the Disaster Recovery Site will probably be at initial operating capability, but not at full operating capability until maybe early first quarter 2008.

INTERNATIONAL TERRORIST FINANCING COOPERATION AND THE BANCO  
DELTA ASIA DESIGNATION

Senator BOND. Thank you. Mr. Levey, I was going to ask you about collaboration with international partners, but I had to cut you off after you just got through the first two columns in your magnificent chart. Let's pick up back on the chart. I would like to know in addition to the particular North Korean Banco Delta Asia, how you are working with the United Nations, the Financial Action Task Force, and other successes, and your challenges, in that area.

Mr. LEVEY. Interestingly, I think right where I stopped is where I was going to get to intelligence cooperation, so I will be able to try to answer two questions at once.

After we took these actions that I described earlier, the next step is to go and talk to our partners around the world and say this is a threat not only to our financial system, it is a threat to the global financial system, and the answer to your question on how that international cooperation is working, Mr. Chairman, is it is working very well. We are getting a huge amount of cooperation internationally when we are able to identify illicit conduct and say this is illicit conduct, it is a threat to our financial system and to yours. And we are getting cooperation not just from governments, but from private financial institutions, and that was the reference I made to UBS in my opening statement.

In the BDA case in particular, I made a trip out to Asia, and then Mr. O'Brien's Deputy also made a trip out to Asia, and we were able to persuade governments in the region that this was a threat to them as well. They took action to put a lot of pressure on this illicit financial network, and they took relevant steps that pushed this North Korean illicit financial activity out of their bank-

ing system and left it with no place to go, or searching for a place to go.

Then the last thing is monitoring follow-up, and it comes back to Janice Gardner's work, which is, now we need to see where they are going to try to put their money into the system. What is their next target? They are going to try to access the financial system in another way, and we have to stay on top of it so that we do not just have a temporary victory.

More broadly, Mr. Chairman, the cooperation internationally particularly on terrorist financing has been excellent. We have a growing number of states using the U.N. system on terrorist financing and designating names which is a real important development, and we are continuing to build on that I think through Mr. O'Brien's leadership. He has been doing a lot of good, hard work and spending a lot of time on the road.

#### TFI REDUNDANCY CONCERNS AND DIFFERENCES BETWEEN TFI COMPONENTS

Senator BOND. One last question. During the early days of TFI there were concerns about the possible redundancy and OIA acting as an operational vice analytical unit. Can you explain how you have addressed these concerns, and explain the differences between FinCEN, OFAC, TFFC, OIA, and any other agencies you have?

Mr. LEVEY. Mr. Chairman, I know that that has been a concern. As you know, when I have come to talk to you in your capacity on the Intelligence Committee, and I have already shown you this in private, this indicates how we work. It is a generalized example of what the North Korean Illicit Finance process is. On the left you see there are particular threats that we feel we need to take action against, and that is where our intelligence function comes in. They are to pull together all the information that we need in order to determine what steps to take. That is not an operational activity, that is classic intelligence analysis, presenting the information to the policy makers so that we can make a choice.

The middle, without going through all the acronyms there, but what that is is a sampling of the tools available to us as an organization, either through OFAC, through FinCEN, through international outreach, through TFFC which is Assistant Secretary O'Brien's organization. We sit down and we go through one of those meetings, we have one this afternoon, as I mentioned, and we will say: "What can we do?" We choose what we think is the right thing to do, and then we go out and do it. We have operational components of what we do in the sense that we are not just developing this information to learn about it, but to act on it, and then we act.

Then the bottom arrow is, after we act, again, just like we are doing with North Korea, the challenge is to see if our action had any effect. To be honest with you, sometimes they are more effective than others. We have to learn not only when we take an action, if it was not as effective as we had hoped, why not, what is the next step so we can learn to do better, and that is, again, where our Intelligence Office comes in.

## ADDITIONAL COMMITTEE QUESTIONS

Senator BOND. As followers of the Senate know, all those bells and whistles means that a vote has started. In closing, I appreciate all the hard work and time you and your good leadership team have put in to combatting terrorist financing and other illicit financing efforts. I support and recognize the importance of the 2007 budget request, but I need your help to make sure you succeed, especially in making sure that TFIN does not experience the same problems that BSA Direct has experienced.

[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 CHRISTOPHER S. BOND

## MANAGEMENT

*Question.* As I noted in my opening statement, I remain concerned about the Department's management especially since the OIG continues to cite management as their No. 1 concern in their annual challenges report and due to the recent information technology failure with BSA Direct.

How are you addressing this concern, especially on the need for effective corporate leadership in resolving serious deficiencies at the bureau level? Please include specific examples in your response.

*Answer.* The Department is committed to exercising strong corporate leadership over all components of the Treasury Department—through the policy offices' supervisory and oversight relationships with our bureaus, as well as through the discipline of the traditional management functions such as human resources, information technology (IT), procurement, budget, strategic planning, and financial management. With nearly a full complement of senior officials now in office at Treasury, our ability to emphasize corporate management has been greatly enhanced.

In describing Treasury's corporate management challenge, the Inspector General emphasized the need to provide IRS and bureau oversight and "ensure consistency, cohesiveness, and economy among all bureaus in achieving Treasury's goals and objectives." Over the past 9 months, the Assistant Secretary for Management and Chief Financial Officer (ASM/CFO) has instituted a better process for coordinating Department-wide management issues. The Bureau Heads' Council has been restructured to serve as one of the primary tools of this coordinated management effort. The Council has become an arena for discussing best practices, cohesive policies and strategic priorities based on the President's Management Agenda (PMA), Treasury goals, and bureau goals. Participation is now limited to bureau principals, the ASM/CFO, and the Deputy Secretary to ensure vigorous discussion and extensive exchanges between participants in order to provide thoughtful recommendations to the appropriate Department officials. This reinvigorated Council has addressed operations, management, Homeland Security Presidential Directive-12 (HSPD-12), OMB Circular A-123, the Working Capital Fund, annual budget submissions, the Department's strategic plan, and Emergency Preparedness. These discussions have led to the creation of sub-groups, comprised of a bureau head "champion" as chairman and other interested bureau heads as members. These sub-groups are addressing issues raised during the Council meetings and providing monthly updates upon which they make recommendations to the appropriate officials.

Other examples of how Treasury provides effective corporate oversight and leadership across management functions include:

- The majority of Treasury IT projects are succeeding, including most of the systems mentioned at the April 6, 2006, Senate Appropriations Committee hearing. For example, Treasury's HR Connect system was recently named a Federal Human Resources Management Line of Business (HR LoB) Shared Service Center (SSC) by the Office of Personnel Management and the Office of Management and Budget (OMB). The HR LoB is one of the Presidential E-Government lines of business, which designates agency centers of excellence to provide government-wide servicing for core functions. Currently, the Department's HR Connect program services Treasury, the Department of Housing and Urban Development (HUD) and components of the Departments of Justice and Homeland Security.
- Treasury migrated HUD to HR Connect last year on time and within budget, adding an estimated 10,000 employees to the system. Both HUD and industry

recognized Treasury for the cost-effective and smooth transition. Treasury clearly has addressed its past problems with the HR Connect program and continues to drive towards enhanced performance and operating efficiency.

- Treasury has made significant improvement across the core IT management areas measured under the Expanding E-Government (E-Gov) Initiative of the President's Management Agenda. For the first time since the establishment of the PMA in 2002, Treasury improved its overall E-Gov status from Red to Yellow in the first quarter of fiscal year 2006. The improved PMA score was based on Treasury's meeting key requirements and performance metrics. These key requirements and performance metrics included developing Treasury-wide IT capital planning policy, maturing the Departmental Enterprise Architecture, and meeting quarterly milestones for Presidential E-Gov Initiative implementation. This was accomplished in large measure by the efforts of all bureaus through the Treasury Chief Information Officers' Council and its sub-councils.
- The Alcohol and Tobacco Tax and Trade Bureau's (TTB) recent successful migration from the Bureau of Alcohol, Tobacco and Firearms and Explosives (ATF) infrastructure is an example of proper oversight and assistance between the Department and a Treasury bureau. When ATF was divided into two organizations in 2003 (ATF became part of the Department of Justice while TTB remained a Treasury bureau), all IT resources remained with ATF. These IT resources included 100 percent of all capital assets, infrastructure, IT support personnel, and resources to continue development of core business applications. Treasury's senior management team worked closely with TTB bureau executives in developing and implementing smart sourcing strategies. TTB accomplished the migration of its entire IT infrastructure off of ATF in 6 months, which is an extremely aggressive schedule for a migration of this scale. In fact, the migration was completed well ahead of schedule and within an extremely tight budget.
- With respect to the Treasury Communications Enterprise (TCE) procurement, Treasury senior management is engaged in the procurement and the issues raised by the Government Accountability Office (GAO) were resolved. The Department is working closely with Treasury's Inspector General and Treasury senior management to improve documentation for the program.
- To address the new requirements in the Office of Management and Budget (OMB) Circular A-123, "Management's Responsibility for Internal Control," the Treasury Chief Financial Officers' Council formed a cross-bureau and office working group that developed a comprehensive methodology to identify, document, test, and assess internal controls. The work group, established in November 2004, includes permanent participation from 22 of Treasury's 24 financial reporting entities involving 8 bureaus and 6 offices, including advisory participation from the Office of the Inspector General. As a result, Treasury has devised collective financial reporting internal controls, established uniform documentation methods, developed comprehensive test approaches and test plans, and completed over 70 percent of the required testing to date.

Part of the corporate leadership response for improving management at the bureau level is to institute a Program Contract Review (Review). This Review will be added to the quarterly Capital Planning and Investment Control (CPIC) process, and will require Contracting Officers to certify that high impact contracts and contracts related to high impact programs are on target with respect to performance (schedule and quality), budget (cost or price), and the required qualifications of the Program Manager, Contracting Officer, and Contracting Officer's Technical Representative. The goal of the Review will be to ensure improved communication and coordination among the bureau-level professionals responsible for different functional aspects of contract management and mission delivery, and to provide a mechanism for early problem visibility and resolution at the bureau and corporate levels, as needed. Initially, the Review will focus on high impact information technology programs and related contracts already in the CPIC database, and will expand to include a review of all high impact acquisitions, including non-IT acquisitions.

This approach will support the introduction of Earned Value Management (EVM) techniques into our contract portfolio, and will help ensure that Treasury managers follow the sound business practices associated with EVM. It builds on the management platform to strengthen cross-disciplinary support and oversight within two already-established governance processes, CPIC and the Office of Procurement Executive's (OPE) Evaluate & Monitor Program, designed to ensure that Treasury's procurement organizations are in compliance with the law, good practice, and are promoting continuous improvement.

The Evaluate and Monitor Program, managed by the Office of the Procurement Executive, will provide improved corporate oversight of and support to Treasury's operational acquisition organizations, including high impact acquisitions. An Acqui-

sition Bulletin, AB 06-04, <http://www.treas.gov/offices/management/dco/procurement/policy/ab06-04.pdf>, was recently issued requiring all bureaus to identify ongoing, planned, or anticipated procurement actions, defined by the following criteria:

- Acquisitions with an estimated value of more than \$10 million;
- Acquisitions with an estimated value more than \$1 million if the proposed acquisitions involve more than one bureau, excluding Administrative Resource Center (ARC) support of other Treasury bureaus;
- Acquisitions that require a review by the Treasury Technical Investment Review Board (TIRB);
- Competitive sourcing actions under OMB Circular A-76;
- Acquisition actions that may be controversial or otherwise sensitive such that they warrant the attention of the Senior Procurement Executive, for example, relevant protests or claims, or acquisitions in which interest or inquiries have been expressed by either the White House or Congress, Inspector General (OIG or TIGTA) or Government Accountability Office (GAO).

The Evaluate & Monitor Program is increasing its staffing to improve oversight. Current staffing is 6 FTE, and oversight and support have been improving commensurately.

- The Program/Contract Review, AB 06-04, and the Evaluate & Monitor Program have been reviewed and approved by the Treasury Acquisition Council (TAC). The Office of the Procurement Executive chartered the TAC in April 2005 to improve governance of the acquisition function. The TAC is comprised of the bureau Chief Procurement Officers, the Treasury CIO, and the Deputy CFO. It is chartered to coordinate cross-cutting policy and management issues, develop and implement innovative acquisition approaches, share best practices and lessons learned, oversee and track progress against improvement goals, and make other decisions on issues that have a potential for Treasury-wide impact on acquisition and financial management programs.

The Department also remains focused on enhancing project management capability by establishing a Treasury-wide training program. In line with OPM and OMB guidance, Treasury's existing IT capital planning policy outlines the skills and competencies required for project managers based on project scope and complexity. Currently, bureau CIOs are required to certify that project managers for major investments are qualified according to these guidelines. This initiative, which supplements bureau training programs, will include a project management course focused on Treasury-specific policy and procedures to ensure consistent implementation across the Department.

#### BSA DIRECT/TFIN

*Question.* The recent problems exposed with the Financial Crimes Enforcement Network's new system called "BSA Direct" raises serious questions about the Treasury's ability to procure, manage, and oversee information technology projects.

How can I be confident that other high-risk projects such as the "Treasury Foreign Intelligence Network" system (TFIN) will not experience the same problems as BSA Direct? Are you personally committed to providing the necessary support and resources for TFIN and other IT projects and that you will ensure that the lessons learned from BSA Direct will be applied to TFIN and other IT projects?

*Answer.* The Treasury Foreign Intelligence Network (TFIN) is the sole source of Top Secret/Sensitive Compartmented Information intelligence at the Department of the Treasury. Stabilizing and modernizing the TFIN system is one of the Department's highest priorities.

From a system development view, BSA Direct involves the design and development of a new and complex database application and data warehouse, while the TFIN concept and design is based on best practices already in use within the Intelligence Community.

An effective governance structure has been in place for TFIN since the inception of the project to ensure mission, business, and technical objectives are achieved. This governance structure consists of the: (1) TFIN Executive Board comprised of senior officials from the Office of Terrorism and Financial Intelligence and the Office of the Chief Information Officer (OCIO), and (2) TFIN Steering Committee comprised of project management and technical leads from stakeholder offices. These governance structures facilitate coordination, track project status, and support executive decision-making. OCIO hired a dedicated project manager to oversee the TFIN project.

Treasury has established additional oversight as well. The Assistant Secretary for Management and Chief Financial Officer (ASM/CFO), the Chief Information Officer (CIO), and the Assistant Secretary for Intelligence and Analysis (OIA) are com-

mitted to ensuring the project's successful completion. The ASM/CFO and CIO are engaged fully with the Assistant Secretary for Intelligence and Analysis, the system's major stakeholder. These officials and their staffs are working closely together to manage the development of TFIN, meeting regularly to resolve quickly problems that might affect the cost and schedule of the system. Treasury also is working closely with and receiving direct support and assistance from the Intelligence Community.

This executive level engagement will continue throughout the project and we expect Treasury to complete the system on time and within budget. For example, the TFIN platform was stabilized successfully according to schedule and budget. Treasury and the Intelligence Community have identified TFIN as a critical investment. As such, the TFIN investment is subject to additional reporting requirements beyond the quarterly "Control" review conducted as part of the IT capital planning and investment control processes.

The Department also is implementing specific initiatives to improve IT investment and contract management. These actions are focused on promoting greater accountability for IT management in the bureaus at the project management level, improving the reliability of information being reported by the bureaus, and establishing additional processes through which to assess and validate project performance. To highlight a number of the key initiatives, the Department is: (1) requiring bureau CIOs to certify the qualifications of their project managers and the accuracy of investment reporting; (2) establishing a more rigorous process for justification and reporting is established when bureaus request baseline change requests for their major investments; (3) implementing a program for reviewing the top 50 investments and contracts within the Department; and (4) expanding the independent verification and validation program at the corporate level to assess the accuracy of bureau project and investment reporting.

#### RESPONSE TO GAO REPORT ON BSA DIRECT

*Question.* Two days ago, the GAO issued a review of FinCEN's fiscal year 2007 budget request. GAO asserted that "FinCEN has experienced cost, schedule, and performance issues while developing the retrieval and sharing component of the BSA Direct project, which raise questions about the project's future. Therefore, the assumptions made by FinCEN when developing the request for new BSA Direct initiatives may no longer be valid, calling into question the need for this funding." I agree with GAO that the BSA Direct problems raise some serious questions about FinCEN's ability to spend effectively the \$12.5 million in additional funding in the budget request. Providing these new funds appears to be "throwing good money after bad."

What is your response? If BSA Direct cannot be salvaged, do you intend to recommend to the Congress that the "Cross-Border Wire Transfer System Initiative" is not feasible and should not be funded for fiscal year 2007?

*Answer.* The \$12.5 million in requested additional funding referenced in the GAO report includes \$2.5 million for BSA Direct and \$10 million for a separate, but related, Cross-Border Wire Transfer System.

BSA Direct is an overall umbrella project composed of three components: electronic filing (e-filing), secure access, and retrieval and sharing. Of the \$2.5 million requested for the BSA Direct umbrella components, \$1.3 million is for enhancements to the e-filing component, \$0.5 million is to meet the customer base of the secure access system, and \$0.7 million is for the retrieval and sharing component.

The electronic filing and the secure access components have been operational for a number of years. Electronic filing reduces the cost to collect BSA data from a range of \$0.76-\$7.15 per paper form to an average of \$0.21 per electronic form submitted. The system is used by more than 300 of the largest financial institutions in the United States. Planned upgrades to the e-file system in fiscal year 2007 will allow: direct input of the BSA filings into the collection system; added features such as reference number assignment, error notification and other correspondence; improved editing of certain types of filing errors; and options for single form filing.

The secure access component serves as a gateway to FinCEN's services, including access to BSA data, analytical products, and online training and support for Federal, State and local law enforcement and regulatory users through secure electronic communication. In fiscal year 2007, FinCEN anticipates a significant increase in the user base for this system, regardless of the status the retrieval and sharing component.

The retrieval and sharing component is being developed by EDS and it alone is the subject of the recent stop work order. This component was designed to provide

a data warehouse with 10 years of enhanced BSA data and additional analytical tools.

The fiscal year 2007 budget request of \$10 million for a Cross-Border Wire Transfer reporting system allows upfront discussions with Congress in the event the Treasury Secretary approves the collection of cross-border wire transfer data. The authorizing language (Section 6302 of the Intelligence Reform Act of 2004 (S. 2845 Public Law 108-458)) charges FinCEN with two tasks: (1) a feasibility study to be completed as soon as practicable; and (2) the implementation of enabling regulations and a technological system for receiving, storing, analyzing, and disseminating the reports, to be completed by December 2007. This request does not represent an assumption that the Treasury Secretary or Congress will authorize the development of the system, but was submitted out of an abundance of caution and the concern that, if approved, resources would be needed for an implementation that would begin during fiscal year 2007.

The technical alternatives analysis that FinCEN will present in the feasibility study rests on the premise that any conceptual system must be flexible enough to incorporate existing, planned, and future data sources—this includes BSA Direct. FinCEN's study will consider whether and how to create a new system to accommodate the cross-border funds transfer data and other BSA data. The criteria applied by FinCEN in its study of the collection and storage of electronic funds transfer reporting are that the system must:

- integrate multiple data sources, including existing BSA data systems;
- require minimum or no alteration to existing BSA data sources;
- enable the concurrent query of the multiple data systems by the users in a transparent fashion; and
- accommodate the addition of future data sources with minimum or no alteration to the existing or planned BSA data sources.

FinCEN currently is working to complete its feasibility study and anticipates submitting a report to the Secretary of the Treasury in the coming weeks. The feasibility study will outline alternative approaches to developing the system and will provide order of magnitude estimates of the costs involved. These alternatives will address the risks and our concerns if we attempt to implement this system by December 2007, as required in the legislation.

While the study still is underway, a preliminary conclusion is that it is not feasible to complete the development and implementation of the system by December 2007. Due to the complexities of implementing a cross-border wire transfer reporting requirement, which would involve developing and issuing new regulations as well as developing the necessary information technology infrastructure to receive, warehouse and analyze the data received, FinCEN will need the time and resources to develop its project management capabilities before it can undertake this effort. The study will outline the organizational resources that FinCEN will need to manage successfully the development of this project.

#### CIO AND CFO OVERSIGHT

*Question.* The Department of the Treasury spends over \$2 billion annually on information technology. What percentage of this investment portfolio does the Treasury CIO directly oversee?

*Answer.* The ASM/CFO and CIO oversee Treasury's entire investment portfolio through formal and informal channels.

Formally, the ASM/CFO meets monthly with the bureau heads to review corporate management issues, including IT management concerns, and agree upon enterprise directions and implementation approaches. As an example, the Department's HSPD-12 initiative, which will meet the requirements of the whole Treasury Department, is being led at this level.

From an IT perspective, the Treasury CIO oversees the entire Treasury Information Technology (IT) investment portfolio. As Chair of Treasury's Technical Investment Review Board (TIRB), which is comprised of bureau CIOs, oversight is provided through a formal Capital Planning and Investment Control (CPIC) process, which we have developed over the last 2 years. The process is multi-layered with both quarterly and annual reporting.

The CPIC process for each fiscal year includes a review of proposed new investments (Pre-Select), decisions regarding the composition of the IT portfolio to be submitted to OMB (Select), quarterly reviews of the portfolio's health (Control), and assessments of steady state investments (Evaluate).

As part of the Control phase of the CPIC process at Treasury, all IT investments are reviewed quarterly to ensure compliance with cost, schedule, security, risk management, and project manager requirements and guidelines. For non-performing in-

vestments, where cost, schedule, or performance fails planned targets by 10 percent, the project managers must submit corrective action plans to the CIO. In addition, Treasury has established a formal baseline change request process to oversee all changes to established IT investment baselines. Finally, we now are asking bureau CIOs to certify cost and schedule performance information provided to the TIRB on quarterly basis.

Informally, both the ASM/CFO and the CIO work directly with their bureau counterparts on a day-to-day basis to ensure that the Department's high priority projects succeed. For example, the ASM/CFO, CIO, and the rest of the Treasury management team work directly with bureau stakeholders to implement the President's Management Agenda. Within the E-Government area, this has included the implementation of government-wide payroll, grants, and recruitment systems across Treasury.

*Question.* How specifically does this oversight occur?

*Answer.* The Treasury CIO reports directly to the Assistant Secretary for Management and Chief Financial Officer (ASM/CFO).

*Question.* How does the CFO ensure adequate performance and accountability by the CIO? What specific criteria does the CFO use to measure the performance of the CIO?

*Answer.* The ASM/CFO ensures performance and accountability by the CIO through a rigorous performance planning process for the CIO's individual performance plan. The CIO's specific performance commitments include: strengthening corporate management for the Department, including addressing control weaknesses and management challenges identified by the OIG and TIGTA, progress in meeting President's Management Agenda requirements for the Expanding E-Gov initiative, and improving enterprise IT operations. The CIO must meet specific performance metrics agreed upon in each of these areas.

#### IT BUSINESS CASE DOCUMENTATION

*Question.* The Government Accountability Office (GAO) recently reported that the business case documentation required for major IT investments is unreliable based on a review of five agencies, including the Department of the Treasury. GAO subsequently recommended that agencies improve the reliability of these business cases.

What specific actions is the Treasury CIO taking to improve the accuracy and reliability of the Department's IT business cases?

*Answer.* Treasury is taking actions to promote greater accountability across the Department's IT management, including steps to improve the reliability of information being reported, and establishing additional processes to assess and validate program performance and reporting.

We are developing, updating, and institutionalizing Treasury-wide policies and guides to improve documentation for major IT investments. For example, over the past year Treasury has issued formal guidance on Treasury Capital Planning and Investment Control Policy, Earned Value Management, Alternatives Analysis, and Baseline Change Request Policy. We are revising overall Treasury IT policy to incorporate minimum life cycle documentation requirements for all major IT projects. This documentation will ensure project managers are developing and maintaining the detailed background records required for effective program management.

In addition, we now are integrating the efforts of the Office of the CIO and the Senior Procurement Executive in overseeing IT projects and establishing an ongoing capability for independent validation and verification of IT investments, as discussed in more detail in response to Senator Bond's first question.

#### CIO'S OVERSIGHT OF BUREAU PROJECT MANAGEMENT TEAMS AND CIOs

*Question.* The Treasury CIO told committee staff that his responsibilities include reviewing and certifying the qualifications of every Treasury bureau CIO and their project management teams and that he has the authority to remove a CIO or project management team if they do not meet his qualifications.

How often does the CIO review and certify the qualifications of each bureau CIO and project management team? What criteria does he use to determine their qualifications? Has the CIO ever removed a bureau CIO or project management team? If so, please provide specific information on when this occurred and the reasons for the removal.

*Answer.* To clarify, the Treasury CIO does not have the independent authority to remove a bureau CIO or project team, nor does he certify the qualifications of each bureau CIO.

In January 2006, the Treasury CIO established a policy pursuant to which each bureau CIO must certify to corporate management the qualifications of its project

managers for major investments. The policy was based on guidance issued by the Office of Personnel Management and Office of Management and Budget (OMB M-04-19) that requires requesting agency CIOs to ensure that major investments are managed by qualified project managers. This certification is required each time there is a new investment added to the IT portfolio or when there is a change in the project manager for a major project. Treasury Capital Planning and Investment Control guidelines require major IT investment project managers to be qualified in accordance with the Federal CIO Council Workforce and Human Capital for IT Committee's Federal IT Project Manager Guidance Matrix. Project managers must document the knowledge, skills, abilities, and experience that qualify them to manage a major IT investment.

The Treasury CIO is continuing to strengthen project management within the Department. A formal Treasury-wide training program is being established to provide project managers with critical skills and competencies in terms of best practices and earned value management concepts. This program will enhance bureau training initiatives. For example, the program will include a course focused on Treasury-specific policy and procedures to ensure consistent implementation across the Department.

The Treasury CIO also is working with FinCEN and the IRS to address specifically a number of critical investments within those bureaus. Treasury CIO management is participating in the selection of new bureau CIOs, including advising the FinCEN Director on the selection of a new FinCEN CIO, as well as participating in the selection of a new CIO for the Bureau of Engraving and Printing (BEP). Where issues or concerns arise with bureau IT performance, the ASM/CFO and the Treasury CIO directly engage bureau heads.

ROLES AND RESPONSIBILITIES OF THE CIO

*Question.* Please describe for the record, the roles and responsibilities of the Treasury CIO and specifically how these roles and responsibilities aligned with each requirement specified in the Clinger Cohen Act, E-Gov Act, and Paperwork Reduction Act.

*Answer.* As outlined by the Government Accountability Office, the Chief Information Officer has 13 major areas of responsibility. The Treasury CIO is responsible for:

- Information Technology/Information Resources Management (IT/IRM) strategic planning [44 U.S.C. 3506(b)(2)]
- IT capital planning and investment management [44 U.S.C. 3506(h) and 40 U.S.C. 11312 & 11313]
- Information security [44 U.S.C. 3506(g) and 3544(a)(3)]
- IT/IRM human capital [44 U.S.C. 3506(b) and 40 U.S.C. 11315(c)]
- Information collection/paperwork reduction [44 U.S.C. 3506(c)]
- Information dissemination [44 U.S.C. 3506(d)]
- Records management [44 U.S.C. 3506(f)]
- Privacy [44 U.S.C. 3506(g)]
- Statistical policy and coordination [44 U.S.C. 3506(e)]
- Information disclosure [44 U.S.C. 3506(g)]
- Enterprise architecture [40 U.S.C. 1401(3)]
- Systems acquisition, development, and integration [44 U.S.C. 3506(h)(5) and 40 U.S.C. 11312]
- E-Government initiatives [44 U.S.C. 3506(h)(3) and the E-Government Act of 2002]

The following table lists a selection of the major requirements within the Clinger-Cohen Act, the E-Gov Act, the Paperwork Reduction Act, and the corresponding role and responsibility of the Treasury CIO.

Requirement	Treasury CIO
Clinger-Cohen Act: Provide IT related advice and other assistance to the agency head and other senior management personnel. Develop, maintain, and facilitate implementation of a sound and integrated IT architecture. Promote effective and efficient design and operation of all major information resources management processes.	Reports to ASM/CFO. Advises and consults with ASM/CFO and other Treasury leadership regarding IT management. Oversees Treasury-wide IT capital planning process. Leads the development and implementation of the Treasury Enterprise Architecture. Chairs the Treasury CIO Council and Treasury Technical Investment Review Board. Promotes policy and process improvements to enhance Departmental IT oversight and management.

Requirement	Treasury CIO
<p>E-Gov Act:</p> <p>Participate in the functions of the Federal CIO Council</p> <p>Monitor the implementation of IT standards . . . including common standards for interconnectivity and interoperability, categorization of Government electronic information, and computer system efficiency and security.</p> <p>. . . Develop citizen and productivity-related performance measures for use of E-Government and IT in meeting agency objectives, strategic goals, and statutory mandates.</p> <p>. . . Comply with OMB E-Guidance, particular emphasis on agency head communicating guidance to key agency executives.</p> <p>. . . Establish and operate IT training programs.</p> <p>Agencies must conduct Privacy Impact Assessments for new IT investments and on-line information collections.</p> <p>Requires each agency to develop, document, and implement an agency-wide information security program to provide information security for the information and information systems that support operations and assets (FISMA).</p>	<p>Participates in the Federal CIO Council and is co-chair of the IT Workforce Committee.</p> <p>Leads E-Government program which incorporates Enterprise Architecture, Enterprise Solutions, and Presidential E-Government functions.</p> <p>Manages and oversees Treasury performance of E-Government requirements as outlined in the President's Management Agenda and the Department's IT strategic planning process.</p> <p>Oversees compliance and dissemination of OMB guidance and policy regarding IT.</p> <p>Assesses and determines the strategy for ensuring adequate IT workforce capabilities; develops and promotes IT training programs for the Department.</p> <p>Serves as the Department's Chief Privacy Official; manages the Department's Privacy Impact Assessments and information collection functions.</p> <p>Leads Treasury computer security program, including overall FISMA compliance. In this role, develops, maintains, and facilitates implementation of Departmental IT guidance, including policies, procedures, manuals, and/or guidelines relative to the Department of the Treasury's unclassified computer security programs of all Departmental elements and classified and sensitive but unclassified telecommunications security.</p>
<p>Paperwork Reduction Act:</p> <p>Overall responsibility for information resources management.</p> <p>Establish an effective information collection and records management program.</p>	<p>Leads comprehensive IT management organization comprised of IT capital planning, IT strategic planning, enterprise architecture, E-Government, Cyber Security, Information Management, Telecommunications, and Enterprise Solutions.</p> <p>Serves as the senior official managing the Department's comprehensive information collection and records management functions. Certifies all Treasury information collection requests and prepares the Department's annual Information Collection budget.</p>

CFIUS

*Question.* The Committee on Foreign Investment in the United States or CFIUS has become a controversial issue over the past year with the Unocal and DPW deals. Even though both deals ended up collapsing due to political pressure, I believe that there are some lessons learned from these two experiences that need to be addressed.

Senator Shelby has taken the lead in reforming the legislation governing CFIUS. However, I believe the Treasury and the administration could take some steps outside of legislation that could improve the process. For example, I think that the Office of Intelligence and Analysis is uniquely positioned to provide intelligence support for the CFIUS process.

What steps is Treasury taking to avoid some of the mistakes from the past year? In particular, how are you improving communication with the Congress so that we learn about these potentially controversial deals prior to the media learning about them?

Answer. The administration supports reform of the CFIUS process and has already begun to take steps to address the concerns expressed by members of Congress. First, the administration is committed to improving communication with Congress concerning CFIUS matters and shares the view that Congress should receive timely information to help meet its oversight responsibilities. Treasury is now promptly notifying Congress of every review upon its completion, and the administration is working hard to be responsive to Congressional inquiries. The administration also has offered to conduct quarterly briefings for Congress on CFIUS matters.

These quarterly briefings were scheduled to begin before the issues with respect to the DP World transaction became the subject of Congressional and media attention. I look forward to your suggestions on how to foster better communication.

Second, the administration supports a high level of political accountability for CFIUS decisions and is committed to ensuring that senior, Senate-confirmed officials play an integral role in examining every transaction notified to the committee. Improvements to the CFIUS process should also ensure that senior U.S. officials are focused on national security issues. CFIUS agencies are briefing at the highest levels in their respective agencies. On-going, high-level engagement occurs regularly on CFIUS issues at Treasury and other CFIUS agencies.

Third, the administration and the Treasury Department also agree that the committee can carry out its role more effectively by strengthening the role of the intelligence community in the CFIUS process, which is essential in a complex and changing national security environment. The Director of National Intelligence (DNI) has begun to do so by assigning an all-threat assessment responsibility to the National Intelligence Council and ensuring that all relevant intelligence community agencies and activities participate in the development of final intelligence assessments provided to the committee, including Treasury's Office of Intelligence Analysis. The committee recently formalized the role of the Office of the DNI, which plays a key role in all CFIUS reviews and investigations by participating in CFIUS meetings, examining every transaction notified to the committee, and providing broad and comprehensive threat assessments. The DNI already contributed greatly to the CFIUS process through reports by the Intelligence Community Acquisition Risk Center concerning transactions notified to the committee, but formalizing its place in the process—and strengthening the threat assessments provided to the committee—represent an enhancement of the intelligence community's role. The DNI does not vote on CFIUS matters and should not, because the role of the DNI is to provide intelligence support and not to make policy judgments based upon that intelligence.

#### IRS BSM

*Question.* The budget request proposes a major increase in funding for BSA Direct of some \$12.5 million but proposes a major cut to the IRS's Business Systems Modernization program of some \$30 million. The GAO just issued a report noting the problems with BSA Direct and the Treasury OIG just issued a report praising the IRS's management of its IT contractors.

Given what we now know about the problems at FinCEN and BSA Direct and the improvement at the IRS, do you agree that the budget request for FinCEN is a case of rewarding bad behavior while the request for IRS is a case of punishing good behavior? How do you reconcile these contradictions? Are you still committed to BSM?

*Answer.* The \$12.5 million in requested additional funding for BSA Direct referenced in the GAO report includes \$2.5 million for BSA Direct and \$10 million for a separate, but related, Cross-Border Wire Transfer System.

Of the \$2.5 million requested for BSA Direct, \$1.8 million is for enhancements to meet the needs of the expanding user base for the e-filing and secure access components, both of which have been operational and successful for a number of years, with the remaining \$0.7 million for continued development of the retrieval and sharing component.

The problems noted in GAO's report have come to light and are being addressed. FinCEN Director Werner proactively has initiated an assessment of the BSA Direct retrieval and sharing component, presently scheduled to be completed in July, to determine the extent of the problems with the project and the next steps that need to be taken with regard to BSA Direct. The Office of the CIO is working closely with FinCEN on this effort.

The \$10 million requested in fiscal year 2007 for the Cross-Border Wire Transfer System is submitted in accordance with Section 6302 of the Intelligence Reform Act of 2004 (S. 2845, Public Law 108-458), which charges FinCEN with two tasks: (1) a feasibility study to be completed as soon as practicable; and (2) the implementation of enabling regulations and a technological system for receiving, storing, analyzing, and disseminating the reports, to be completed by December 2007. FinCEN will submit a report on the results of the feasibility study to the Secretary in the coming weeks, and has included this funding request to allow development of the system to begin in 2007, should the Secretary recommend and Congress authorize doing so.

The administration continues to be committed to the IRS Business Systems Modernization program. We are pleased with the Treasury Inspector General for Tax Administration's recognition of the progress that the IRS BSM program has made

over the past 2 years to improve its performance on delivering projects and releases on time and on budget, while meeting or exceeding scope expectations. In fiscal year 2006 and continuing into fiscal year 2007, BSM is revising its modernization strategy to emphasize the incremental release of projects to deliver business value sooner and at a lower risk. The President's budget request for BSM for fiscal year 2007 aligns with this revised strategy and provides the level of resources the administration believes necessary to deliver the fiscal year 2007 BSM program requirements.

#### DYNAMIC ANALYSIS OFFICE OF TAX POLICY

*Question.* The budget request proposes some \$500,000 to create a new "dynamic analysis office" within the Treasury.

What types of analysis would this office conduct that is not being conducted at Treasury or other Federal agencies? What is the long-term plan for this office in terms of funding and staffing?

*Answer.* The administration has very limited capabilities to conduct dynamic analyses of tax policy changes. The budget request would create a new Dynamic Analysis Division within the Treasury Department's Office of Tax Policy to conduct dynamic analyses of major tax policy changes. The dynamic analyses would focus on the macroeconomic effects of tax policy changes. The new Division would not, at least initially, conduct dynamic scoring of tax policy changes, which would take dynamic analysis one step further and estimate how the macroeconomic changes affect government revenues.

While the fiscal year 2007 budget request for \$513,000 is for the upcoming fiscal year, Assistant Secretary Pack sent a letter on June 8, 2006 to Chairman Bond and Ranking Member Murray proposing that this initiative be accelerated into this fiscal year. The acceleration of this new Division into fiscal year 2006 would be funded within the existing appropriation for this fiscal year. The request for fiscal year 2007 would remain unchanged, funding three full-time positions for 1 full year rather than the estimated six positions for 6 months.

#### TREASURY COMMUNICATIONS ENTERPRISE (TCE)

*Question.* Have the deficient items identified in the TCE bid protest been addressed and corrected? In particular, what measures are being taken to ensure the reasonableness of the price evaluation?

Is the Treasury's office of the Chief Information Officer properly structured and staffed to provide adequate oversight to major systems acquisitions such as TCE?

*Answer.* The issues raised on the TCE bid protest have been addressed fully. In October 2005, Treasury released an amended Request for Proposal, which clarified what is required of vendor price proposals. Furthermore, in evaluating vendor proposals, the evaluation team is working in close concert with both Internal Revenue Service (IRS) legal counsel as well as Treasury's Office of the General Counsel (OGC) to ensure that they are following all appropriate rules and regulations.

The Office of the Chief Information Officer (OCIO) is qualified fully to provide effective oversight to major acquisitions such as TCE. The TCE procurement is being executed through the IRS Office of Procurement, which has extensive experience in conducting acquisitions the size and scope of TCE. The OCIO senior management works in close concert with IRS Procurement, IRS legal counsel, Treasury OGC, and Treasury senior management to provide adequate oversight and management of the acquisition. This collective leadership team meets weekly to monitor the status of the TCE procurement.

The ASM/CFO also established a focused leadership group to provide advice and recommendations on the business case documentation and on the strategy for TCE. This group includes the Treasury CIO, Senior Procurement Executive, Deputy Chief Financial Officer, Assistant General Counsel, and ASM/CFO senior advisors.

#### IRS OVERSIGHT BOARD NOMINATIONS

*Question.* There are currently three vacancies on the IRS Oversight Board. I fully support Chairman Wagner and believe that these vacancies must be filled quickly to ensure that the Board has a quorum to meet and conduct its legislatively-mandated oversight responsibilities.

Has the administration identified individuals to fill these vacancies? When can we expect these nominations to be formally submitted to the Senate?

*Answer.* On May 1, 2006, the President nominated 4 outstanding individuals to fill the vacant or expired seats on the IRS Oversight Board. They are:

—Paul Cherecwich, Jr., of Utah, to be a Member of the Internal Revenue Service Oversight Board for a term expiring September 14, 2009, vice Charles L. Kolbe, term expired;

- Donald V. Hammond, of Virginia, to be a Member of the Internal Revenue Service Oversight Board for a term expiring September 21, 2010, vice Robert M. Tobias, term expired;
- Catherine G. West, of the District of Columbia, to be a Member of the Internal Revenue Service Oversight Board for a term expiring September 14, 2008, vice Karen Hastie Williams, term expired; and
- Deborah L. Wince-Smith, of Virginia, to be a Member of the Internal Revenue Service Oversight Board for a term expiring September 14, 2010, vice Larry L. Levitan, term expired.

## STANDING UP TFI

*Question.* During the early days of TFI, there were concerns about possible redundancy and OIA acting as an operational vice analytical unit.

Please explain how you have addressed these concerns and explain the differences today between FinCEN, OFAC, TFFC, OIA, etc.

*Answer.* The four components of TFI—the Financial Crimes Enforcement Network (FinCEN), the Office of Foreign Assets Control (OFAC), the Office of Intelligence and Analysis (OIA), and the Office of Terrorist Financing and Financial Crime (TFFC)—play distinct but complementary roles in fulfilling the overall mission of safeguarding the financial system from criminal abuse and applying measures to combat key national security threats, including terrorism, the proliferation of weapons of mass destruction, and money laundering. FinCEN is the U.S. Financial Intelligence Unit (FIU). Its mission is to administer and enforce the Bank Secrecy Act (BSA) and to receive, analyze, and disseminate, both domestically and internationally, financial intelligence, including suspicious activity reports, to detect criminal activity so that it can be prevented and prosecuted criminal activity. OFAC administers and enforces economic and trade sanctions, which are 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. In putting together packages for designation under Treasury's various sanctions authorities, OFAC engages in investigations, analysis, and research involving intelligence, law enforcement, and open source information and, as appropriate, extensive field work. As the policy development and outreach office for TFI, TFFC works with the Treasury Department, the U.S. Government interagency community, and its counterparts in Finance Ministries around the world, as well as directly with the private sector to develop and advance policy and specific actions to combat terrorist financing, WMD proliferation, money laundering, and other criminal activities. TFFC leads and coordinates U.S. representation at international bodies dedicated to fighting terrorist financing and financial crime such as the Financial Action Task Force (FATF) and increases our multilateral and bilateral efforts in this field. TFFC also promotes the development of effective targeted financial sanction regimes and the use of other targeted financial authorities through the G7, G20, FATF, United Nations, European Union, and bilaterally with countries of strategic importance.

OIA is Treasury's in-house intelligence analytic unit, focusing on counterterrorism, counterproliferation, and other national security threats. OIA's mission is to support the formulation of policy and execution of Treasury authorities by providing: (1) expert analysis and intelligence production on networks that provide financial and other support to terrorist groups, proliferators, and other key national security threats; and (2) timely, accurate and focused intelligence support on the full range of economic, political, and security issues. We envision that as OIA evolves, it will be widely viewed as a center of analytic expertise on such networks. The TFI components' counterterrorism efforts are closely coordinated, both at daily senior staff meetings, and perhaps even more importantly, at weekly targeting meetings. The targeting meetings, which are led by TFI's Under Secretary, include senior officials from all of the TFI components. At these sessions, based on a review of the relevant intelligence, potential targets are presented and discussed. The participants assess the full range of potential Treasury actions, including designation, and decide on follow up direction and assignments. OIA will continue to host and participate in these sessions in the future, which have proved to be an effective mechanism for translating intelligence information into policy action.

## COORDINATION WITH OTHER AGENCIES

*Question.* With the establishment of TFI, I am curious to know how this new office is coordinating its intelligence activities with other Federal agencies and the Office of the Director of National Intelligence.

How are you working and communicating with the intelligence community, especially with the Office of the Director of National Intelligence and other key intelligence agencies such as the Department of Homeland Security, the Department of Justice and the Federal Bureau of Investigation to make sure that efforts are not being duplicated?

Answer. OIA is the primary Treasury office responsible for ensuring that the Department is fully integrated with the Intelligence Community (IC). Our recently completed report on OIA's fiscal year 2006–2008 strategic direction makes clear that enhancing Treasury's integration into the IC has been—and will remain—one of OIA's top priorities. OIA has been working closely with the Office of the Director of National Intelligence since it was created. The DNI has been very supportive of OIA, and has been of great assistance to OIA at a number of key junctures. OIA has aligned its priorities with those set forth by the Director of National Intelligence in the National Intelligence Strategy. OIA's goals and direction align with key DNI objectives in a number of areas, including: strengthening analysis, WMD proliferation, keeping policymakers informed, and building an integrated intelligence capability. During its short tenure, OIA has already made great strides in integrating TFI specifically, and Treasury more generally, into the IC, and it will continue to build on these efforts. As a result of its improved integration into the IC, OIA analysts are now participating in the drafting and coordination of a variety of IC analytic products. These include: National Intelligence Estimates, CIA studies, Senior Executive Intelligence Briefs and Presidential Daily Briefs. OIA has also initiated both formal and informal analytic exchanges with its intelligence and law enforcement partners. The FBI and OIA, for example, are now working on a joint analytic project, which they intend to complete this year. The additional personnel OIA is now hiring—and those it is requesting in fiscal year 2007—will allow OIA to further increase its contributions to IC products, and to produce additional finished intelligence pieces for dissemination to the IC.

#### OFAC DESIGNATIONS

*Question.* Pursuant to the Treasury's new designation authority to sanction proliferators of weapons of mass destruction, please provide the committee an explanation of the Office of Foreign Assets Control's designation process.

Answer. OFAC follows a three-step process in pursuing designations, which consists of: identifying the target; constructing and de-conflicting an evidentiary package; and publicly announcing the designation. Like its colleagues in law enforcement and the intelligence community, OFAC follows leads. If the initial investigation of a lead shows promise, then OFAC investigators move into the second stage of the designation process—the evidentiary process.

In the WMD proliferation context, as well as in OFAC's other programs, such as the successful counter-narcotics programs, OFAC engages in investigation and research using intelligence, law enforcement and open source information and, as appropriate, field work. Once this evidence is collected, OFAC's investigators draft an evidentiary document analyzing and summarizing the information acquired through their research. This "summary" document describes how the information provides OFAC reason to believe that the target meets the specific criteria for designation. After an evidentiary package has been thoroughly reviewed within OFAC, it is reviewed by Treasury's attorneys to ensure that OFAC has met its evidentiary threshold, and by the Department of Justice's Civil Division, which represents OFAC in court if its designations are challenged.

The next formal stage of OFAC's process involves interagency coordination. In most cases, OFAC engages informally with colleagues in a variety of agencies throughout the investigation process. In fact, initial targets are suggested through an interagency working group, and closely coordinated and vetted within appropriate agencies in the early stages of development. OFAC also works closely with colleagues in OIA and from elsewhere in the Intelligence Community. Nonetheless, OFAC goes through a more formal coordination phase designed to de-conflict its proposed designations with the operational and policy interests of other agencies and to ensure that the targets are consistent with and further the strategic national security and foreign policy goals of the United States. Executive Order 13382 specifically directs that designations by Treasury or State be undertaken in consultation with one another, as well as in consultation with Justice and other relevant agencies.

Once this thorough interagency review process has been completed, the final evidentiary package is presented for signature by the Director of OFAC. At the same time that the package is provided to the Director of OFAC for consideration, two other important processes are in motion. First, OFAC's team of compliance officers

and information technology professionals work closely with OFAC investigators to prepare the information about a target for possible public dissemination through OFAC's List of Specially Designated Nationals and Blocked Persons (SDN list). The SDN list is used by thousands of companies around the country and around the world to screen real-time transactions and accounts for the possible involvement of an OFAC target. The second process occurs if and when OFAC investigators become aware that a designation target has a presence in the United States. At that point, OFAC investigators from both the Designation Investigations Division and the Enforcement Division prepare an operation to block any property that can be identified.

#### BIGGEST CHALLENGES

*Question.* What are the three most immediate challenges for TFI?

*Answer.* The three most immediate challenges for TFI are: (1) the need for additional resources to more aggressively pursue core objectives, including combating the financial underpinnings of weapons of mass destruction (WMD) proliferation; (2) leveraging our authorities most effectively to deal with terrorist-sponsoring regimes Iran and Syria, and working in partnership with governments and the private sector to do so; and (3) building the information technology systems necessary to effectively and efficiently carry out our mission.

First, with respect to resources, Treasury has continued—with the support of your subcommittee—to build the new Office of Terrorism and Financial Intelligence. As TFI has grown in size, the demand for our expertise and capabilities has expanded as well. The President's budget for fiscal year 2007 includes funding for the component offices of TFI to meet this demand. For example, it provides OFAC with additional positions to implement and administer the WMD sanctions program, as well as to monitor and update existing terrorism designations. It provides funding for OIA to continue its efforts to build Treasury's intelligence capabilities by improving its key infrastructure and adding to its analytic breadth and expertise. And it provides FinCEN with additional resources to streamline data processing and enhance its e-filing capabilities to increase the ease of compliance with regulations and improve its abilities to track users' needs.

Second, TFI continues to be challenged to leverage its capabilities to deal with terrorist-sponsoring regimes Iran and Syria. TFI has at its disposal a broad range of tools to pressure obstructionist regimes and freeze the assets of terrorists, proliferators, and other wrongdoers. We have regulatory authorities to help banks and other institutions implement systems to detect and halt corrupt money flows. And, we continue to work with other governments and international institutions to achieve collective action against threats and to take critical steps to stem the flow of illicit finances. The combination of these various measures contributes to the U.S. Government's overall ability to deter and defend against key threats. The dynamic situation in the Middle East requires close and sustained attention and careful coordination across the interagency and the international community to ensure that these capabilities, or, in some cases, the threat to take certain measures, are exercised most efficiently and effectively.

Finally, TFI continues to be challenged to meet its internal information technology requirements, and the fiscal year 2007 budget request, if approved, will move us toward being able to do so. For example, Treasury's Foreign Intelligence Network (TFIN), the sole information technology system in the Department authorized for top secret information has not been modified or upgraded to keep pace with the changes in intelligence, user, or technological requirements. TFIN lacks appropriate analytical tools and a robust disaster recovery capability. The fiscal year 2007 budget provides funding to upgrade this critical system. Additionally, OFAC has a demonstrated need for an Enterprise Content Management (ECM) system to provide electronic document, records and case management functions. The fiscal year 2007 budget request of \$627,000 will assist OFAC and Treasury's Office of the Chief Information Officer (OCIO) in continuing their joint efforts to develop a pilot approach to an ECM system within the context of a government-wide/department-wide enterprise solution.

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#### QUESTIONS SUBMITTED BY SENATOR THAD COCHRAN

*Question.* The New Markets Tax Credit (NMTC) Program relies upon the decennial census to qualify areas as eligible for NMTC financing. Employing 2000 Census Bureau data, only a few census tracts along Mississippi's devastated coast line qualify as "Low-Income Communities". A re-measurement, not contemplated in the current statute would likely qualify them under the program's guidelines. In addition,

I understand that Secretary Snow has the discretion under the Job Creation Act of 2004 to designate "targeted populations" as a group to be treated as a "Low-Income Community".

Will the Community Development Financial Institutions Fund, with the Secretary of the Treasury, designate the census tracts or targeted population of the most heavily damaged areas as "Low-Income Communities" by conducting either a re-measurement of census tracts in the Katrina-affected areas or employing the targeted population discretionary tool which currently exists?

Answer. The CDFI Fund, the Internal Revenue Service (IRS) and NMTC Program participants rely upon Census Bureau data to determine whether projects are located in NMTC-qualifying Low-Income Communities (LICs). To our knowledge, the Census Bureau has not announced plans to re-assess the areas damaged by Hurricane Katrina and provide updated census information. Absent new data from the Census Bureau, the CDFI Fund does not have any means available to provide a re-measurement of these areas.

Although new census data won't be available, the Secretary may designate "Targeted Populations" as LICs. Pursuant to The American Jobs Creation Act of 2004, Targeted Populations may include low-income persons as well as other persons that "otherwise lack adequate access to loans or equity investments" (i.e., persons who have historically been denied access to loans, equity investments or financial services due to factors that are unrelated to their investment or credit worthiness such as gender, race, ethnicity, national origin and creed).

The CDFI Fund, in conjunction with the IRS, is developing guidance to implement this new Targeted Populations provision. As part of this process, we are considering whether and under what circumstances residents of the Hurricane Katrina Gulf Opportunity (GO) Zone could potentially be included as a Targeted Population. We hope to publish guidance on this matter before the end of June 2006.

*Question.* Of the \$8 billion of NMTC Allocations made to date, a very small amount of NMTC allocation (\$15 million of the total \$8 billion) has been made to Community Development Entities ("CDEs") based in Mississippi, and little other NMTC allocation has made its way into the State from allocatees based outside Mississippi. The residents of Mississippi suffered much devastation from the Katrina Hurricane.

Instead of allocating \$1 billion of NMTCs to the entire GO Zone, will the Community Development Financial Institution Fund (CDFI) and Secretary of the Treasury consider designating a pro-rata (based on pro rata storm population in the Katrina affected areas) amount to be spent in each State?

Answer. The NMTC, unlike other credits such as the Low-Income Housing Tax Credit, is a non-apportioned Federal tax credit. That is to say, NMTCs are not apportioned to States on a pro-rata basis. Rather, they are awarded to intermediary entities known as Community Development Entities (CDEs) throughout the country that apply to the CDFI Fund under annual competitive allocation rounds. While the GO Zone Act of 2005 provided an additional allocation of \$1 billion for use in the recovery and redevelopment of the Hurricane Katrina GO Zone, it did not specifically authorize or otherwise instruct the CDFI Fund to convert the allocation authority into an apportioned Federal tax credit to be issued by the affected States.

*Question.* Six hundred million dollars of the supplemental \$1 billion allocation created for the benefit of the GO Zone is being allocated under rules which do not open the opportunity for interested groups in Mississippi to participate in its redevelopment through this incentive. In March 2006, some of my constituents learned that to be considered for the \$600 million, an entity would have had to have submitted an application for NMTCs in September 2005, 3 months before the \$1 billion supplemental was signed into law. To submit an application for NMTCs, an entity would have had to file to become a CDE 1 week before Hurricane Katrina landed onshore. This implementation of the program disadvantaged participants inside the State of Mississippi who would like to be involved in its rebuilding.

For Mississippi CDEs that did apply for NMTCs in this round, will the CDFI Fund and Secretary of the Treasury work with applicants to make revisions necessary to their applications to ensure that they receive minimum threshold scores, qualifying them for allocations?

How will the CDFI Fund and Secretary of the Treasury open this process to those in Mississippi who would like to compete for the \$600 million of NMTCs? Will it hold a special competition (either completely open or with limitations) for the \$600 million? Will the \$600 million be allocated pro rata among the governors of the three States for State-created CDEs, allocations of which could then be allocated to other CDEs in the State?

Answer. The process for allocating the \$600 million of GO Zone allocation authority through the 2006 allocation round was described in a revised Notice of Allocation

Availability (NOAA) published on March 10, 2006. The Treasury Department has no plans to amend these procedures.

The GO Zone Act of 2005 made available \$1 billion of additional allocation authority to be allocated as follows: \$300 million through the 2005 NMTC allocation authority; \$300 million through the 2006 allocation authority; and \$400 million through the 2007 allocation authority. As you are aware, this legislation was enacted in late December 2005—approximately 6 months after the 2005 NMTC award decisions had been finalized. The \$300 million of additional 2005 GO Zone allocation authority was therefore added to the \$300 million of 2006 GO Zone allocation authority, thus enabling the CDFI Fund to allocate up to \$600 million of allocation authority through the 2006 allocation round. This is an addition to the \$3.5 billion of allocation authority that was already available through that round.

When the GO Zone Act was passed in December 2005, the application deadline for the 2006 round of NMTC allocation authority had expired. The Treasury Department decided not to re-open the round to accept additional applications, as this would likely lead to delays of 6 months or more in making available the allocation authority to the GO Zone applicants. The Treasury Department felt that it was critical that these resources be made available as soon as possible in the affected areas.

In determining not to accept additional applications, the Treasury Department took into account the make-up of the 2006 round applicant pool. The CDFI Fund received a total of 254 applications, including 65 that were submitted by organizations that indicated their intent to serve the GO Zone as part of their principal markets. This included 16 applicants (requesting a total of \$2.59 billion in allocation authority) that were headquartered in the GO Zone, 13 of which had received deadline extensions (some as long as 12 weeks) in the wake of Hurricane Katrina. Based on this data, the Treasury Department was confident that there would be a high number of qualified CDEs headquartered both inside and outside of the GO Zone that would be able to make effective use of the credits.

Finally, we believe the GO Zone legislation addresses your concern that local entities be involved in the redevelopment process. The legislation requires that, in making the GO Zone allocation determinations, CDEs must demonstrate that they have a significant mission of recovery and redevelopment in the GO Zone. The CDFI Fund will consider each applicant's track record of redevelopment in the GO Zone, as well as the extent to which it has resources (physical resources as well as personnel) deployed in the GO Zone and/or is partnering with local entities in the GO Zone.

*Question.* There is some evidence that a preponderance of NMTC financing, both loans and investments, have been directed to real estate businesses. There also seems to be less NMTC financing being directed to small business lending and venture capital investing. Both venture capital and small business lending would be helped if regulations governing the reinvestments of capital could be made more flexible—both in terms of the substantially all threshold for reinvestment and in terms of the eligible uses of reinvested funds in terms of geographic area and investments activity.

What regulatory changes are you contemplating to ensure more use of the NMTC for small business and venture capital projects?

*Answer.* The CDFI Fund has collected NMTC transaction level data on transactions completed in 2004 through its Community Investment Impact System. Data on 2005 transactions is due June 30, 2006. The 2004 data indicates that of the 280 transactions reported in 2004, 28 percent were business investments and 72 percent were real estate transactions.

The Treasury Department is aware of the desire to see more use of the NMTC Program to support small business lending and venture fund investing. The NMTC statute does not prioritize allocations among the various types of potential uses such as real estate development, business loans or venture investing. However, the NMTC statute does require that substantially all of a qualified equity investment be used to make qualified low-income community investments throughout a 7-year period. We are told that investors prefer the certainty of real estate transactions both as a matter of mitigating economic risk and as a matter of compliance with the 7-year investment period rule.

The CDFI Fund will award a contract to evaluate the use of the NMTC Program, including evaluating its use in financing small business and venture fund investments. One element of the evaluation will include an assessment of investor behavior and preferences in the NMTC Program. The Fund expects to have information late this fall or early in 2007. The CDFI Fund anticipates that subsequent to the issuance of this assessment and the statutorily-mandated GAO study due in 2007, the CDFI Fund will work collaboratively with the Office of Tax Policy and the Inter-

nal Revenue Service to study appropriate statutory and/or regulatory improvements to the program, if the program is extended.

*Question.* It is my understanding that urban areas claim approximately two-thirds focus of the NMTC program's resources, in terms of percentage of allocations and actual funds. The one-quarter share of funds first devoted to rural geographies has shifted to suburban areas. Only one-sixth of resources were targeted to rural communities in the last round.

What can you do to ensure that more of the credit reaches rural communities?

*Answer.* At the time of application submission, applicants are asked to estimate the percentage of activities that will be undertaken in rural areas. Through three allocation rounds, awardees have estimated that approximately 17 percent of their transactions would be undertaken in rural areas, which is consistent with the percentage of the U.S. population that resides in rural areas (17.4 percent, according to 2000 census data).

In addition, the CDFI Fund has completed an analysis of transactions undertaken by awardees as of fiscal year end 2004, and has determined that approximately 19 percent of the \$1.3 billion of investments closed that year were undertaken in rural communities. The CDFI Fund has also analyzed the application trends in the 2005 application round, and determined that there is no selection bias against applications submitted by organizations serving rural areas. In other words, CDEs focusing activities primarily in rural markets received awards in a rate consistent with their application rate.

That being said, the CDFI Fund will continue its efforts to provide more outreach in markets that do not appear to be benefiting from NMTC investments.

*Question.* I have constituents who are concerned about the use of credit to subsidize transactions that would otherwise move forward without the credit. NMTC should drive capital into new deals not feasible in conventional markets.

What is being done to make sure that the NMTC is being used to subsidize transactions that would not occur without the credit?

*Answer.* Historically we know that low-income communities have not been able to access capital on the terms needed to finance businesses and real estate developments. Based upon preliminary transaction data provided by allocatees through the CDFI Fund's Community Investment Impact System (CIIS), which is required as a matter of compliance with the Fund's allocation agreement, as well as anecdotal accounts of the use of the credits, the CDFI Fund believes that the NMTCs have been very effective at bringing capital into transactions that would not otherwise be financed.

To obtain an allocation through what has been a very competitive application process in each of the four rounds conducted to-date, the CDFI Fund gives each applicant the opportunity to commit that it will go above and beyond minimal program requirements. For instance, while all allocatees are required to invest substantially all (generally 85 percent) of the qualified equity investments they receive in low-income communities, most applicants have committed to invest NMTC proceeds in areas characterized by severe economic distress (i.e., areas that have significantly higher poverty rates and lower median family incomes than those minimally required under the NMTC Program; areas that have unemployment rates at least 1.5 times the national average; and/or areas that have been designated for economic development through other governmental programs such as Brownfields, Empowerment Zones and Renewal Communities). Of the 41 allocatees that received awards under the 2005 round, 37 indicated that at least 75 percent of their activities will be provided in these areas of severe economic distress, and 21 indicated that 100 percent of their activities will be provided in such areas. The CDFI Fund will require these allocatees, through their allocation agreements, to meet the benchmarks identified in their applications.

Similarly, the CDFI Fund requires its allocatees to provide products with non-conventional features, even though this would not otherwise be required under the program regulations. Such features include, among other things: equity and equity-equivalent terms and conditions; subordinated debt; below market interest rates; and reduced origination fees. In the 2005 allocation round, all 41 allocatees indicated that at least 75 percent of their loans and investments will have particularly flexible or non-traditional features, and 36 of the 41 allocatees indicated that 100 percent of their loans and investments will have particularly flexible or non-traditional features. Thus, the CDFI Fund ensures that the commitments made in the applications will be kept through the allocation agreements.

We believe these requirements help ensure that the investments being made through the NMTC Program are not in the locations or not on the terms and conditions that the marketplace would normally finance. Additionally, the CDFI Fund is about to engage an independent contractor in a long-term, longitudinal evaluation

of the NMTC Program. This evaluation will enable the CDFI Fund and Congress to more fully understand and measure the benefits of the tax credit in low-income communities throughout the country.

*Question.* The Internal Revenue Service (IRS) regulations implementing the New Markets Tax Credit Program place an onerous regulatory burden on allocatees seeking to use their credits to make investments in CDEs or intermediary activities. Specifically, the regulations require the “direct tracing” of tax credit investor proceeds to specific activities or projects; thus, making it difficult to use as loan or equity capital. Most CDEs that are CDFIs are small and already have significant reporting burdens required to maintain their CDE/CDFI certification status. The reporting burden has a disproportionate impact on rural or other communities that are typically served only by small- or medium-sized CDE/CDFIs and has effectively locked them out of accessing these important Federal resources.

What can the Treasury Department or IRS do to eliminate the direct tracing requirements for allocatees seeking to use their credits to make investments in Community Development Entities (CDEs) that are also CDFIs?

*Answer.* The NMTC statute requires that for an equity investment to be qualified, substantially all of the cash must be used to make qualified low-income community investments throughout a 7-year period. The tracing requirements are necessary to ensure that the statutory requirements are met. Recognizing the difficulty in such tracing, a safe harbor is provided for determining the use of the cash.

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QUESTIONS SUBMITTED BY SENATOR PATTY MURRAY

TREASURY COMMUNICATIONS ENTERPRISE (TCE)

*Question.* In 2004, the Treasury Department launched the procurement of a new Treasury Communications Enterprise—or “TCE”. TCE was envisioned to allow data, voice, and video technologies in a single network. Your budget told us that it would be worth \$10 billion over a 10-year period.

Every aspect of this procurement appears to have been botched by your Department. You awarded the contract to AT&T but shortly thereafter, several unsuccessful bidders won a bid protest before the GAO because your Department altered the basis upon which the bidders prepared their proposals. Your Department was also found to have understated the cost of the winning bid and failed to fairly evaluate the prices of the competing bids.

In response to GAO’s decision, you decided to terminate the contract with AT&T and acquire the services through the GSA. Then, late last year, you reversed course again and announced that you would proceed with your own independent procurement. For some reason, having failed once with an independent procurement, you are now going forward with one even though the GSA is in the midst of its own similar procurement for much of the rest of the government. The GSA maintains that all the services you will need will be provided by their system.

When the Treasury Inspector General looked into this program, he found that poor planning and execution of TCE resulted in numerous delays and increased costs. They also found little evidence of adequate senior management oversight of the project.

Mr. Secretary, what explains all the problems that have plagued this program? Why did you reverse course and decide not to proceed with the GSA procurement? What critical capabilities will your system have that the GSA’s system will not?

*Answer.* The contract award for TCE in December 2004 was protested by the losing bidders. Due to the considerable interest in Treasury’s ability to use GSA’s Networx program, Treasury and GSA entered into a Memorandum of Understanding (MOU) on December 2, 2004. The MOU stated that Treasury would evaluate the GSA’s Networx services 3 years after the award of TCE. The losing bidders argued that this MOU materially altered the basis under which option years would be awarded. The protest was upheld by GAO in March 2005. Treasury did not intend nor did it believe the MOU impacted the procurement, as the Department already intended to seek the best value for the government by evaluating other service for the option years. Consistent with effective IT management and procurement principles, the goal was to evaluate the TCE contract and determine the most cost-effective long term strategy.

Subsequent to the sustained protest, Treasury conducted a second Acquisition Alternatives Analysis in consultation and cooperation with GSA. Treasury once again considered government-wide contract alternatives and scrutinized carefully these options in light of the protest decision. Treasury and GSA worked to refine the alternatives analysis and reach consensus on the best approach to move forward with

the replacement for the expiring contract, Treasury Communications System (TCS). The Treasury and GSA post-protest analysis confirmed Treasury's conclusions of the initial analysis. Based on the estimated schedule for the award of Networx and a review of other GSA options to serve as a bridge between TCS and Networx, the finding was that a Treasury-led full and open competition was the most reasonable decision based on contract structure, cost, and most importantly, transition risk.

Existing GSA contracting vehicles could not accommodate easily the managed service requirements for TCE. To support the managed services model, the GSA contracts would have required modifications, which would have increased time, cost, and complexity to support a managed services solution. The near-term expiration of GSA contracting vehicles would have required an additional competition and a second transition once the new contracting vehicle—GSA's planned Networx program—was awarded. Two transitions within a 2-year timeframe represented unacceptable risks of potential service interruptions and threat to Treasury's ability to fulfill its mission responsibilities. Using a GSA contract vehicle also was a significantly more expensive option due to GSA overhead and the costs associated with waiting for Networx.

Concurrently, the Office of the Inspector General completed an audit of the TCE procurement, which found that planning documentation was not cohesive or comprehensive. While the project had the full support of Treasury senior officials, who were briefed regularly on TCE, we recognize that the supporting documentation did not reflect consistently and clearly senior management decisions to the extent necessary for management review and audit. Treasury subsequently has undertaken specific actions to address the audit findings.

*Question.* Why hasn't your CIO done a better job of managing this project and all the other troubled IT projects in your agency?

*Answer.* Treasury is taking the necessary steps to address the Inspector General's (IG's) findings and recommendations. Upon receipt of the report, the ASM/CFO directed a team of IT, procurement, and legal executives to develop corrective actions that address all of the IG's findings and recommendations. Specifically, the Department has greatly improved the TCE documentation, and also is strengthening documentation requirements for all major Treasury IT projects.

Department-wide efforts are underway to strengthen IT investment oversight for the Treasury IT portfolio as a whole. Over the past 2 years, the Treasury CIO has been leading efforts to mature the IT capital planning process within the Department. Treasury has made demonstrated progress in: (1) formalizing and standardizing the quarterly review process of the health of the IT portfolio, (2) establishing Department-wide Capital Planning and Investment Control (CPIC) process and Contract Earned Value Management policy guidance, and (3) instituting the use of a common investment portfolio management tool.

Other examples of how Treasury is providing effective corporate oversight and leadership of IT management include:

- The majority of Treasury IT projects are succeeding, including most of the systems mentioned at the April 6, 2006, Senate Appropriations Committee hearing. For example, Treasury's HR Connect system was recently named a Federal Human Resources Management Line of Business (HR LoB) Shared Service Center (SSC) by the Office of Personnel Management and the Office of Management and Budget (OMB). The HR LoB is one of the Presidential E-Government lines of business, which designates agency centers of excellence to provide government-wide servicing for core functions. Currently, the Department's HR Connect program services Treasury, the Department of Housing and Urban Development (HUD) and components of the Departments of Justice and Homeland Security.
- Treasury migrated HUD to HR Connect last year on time and within budget, adding an estimated 10,000 employees to the system. Both HUD and industry recognized Treasury for the cost-effective and smooth transition. Treasury clearly has addressed its past problems with the HR Connect program and continues to drive towards enhanced performance and operating efficiency.
- Treasury has made significant improvement across the core IT management areas measured under the Expanding E-Government (E-Gov) Initiative of the President's Management Agenda (PMA). For the first time since the establishment of the PMA in 2002, Treasury improved its overall E-Gov status from Red to Yellow in the first quarter of fiscal year 2006. The improved PMA score was based on Treasury's meeting key requirements and performance metrics. These key requirements and performance metrics included developing Treasury-wide IT capital planning policy, maturing the Departmental Enterprise Architecture, and meeting quarterly milestones for Presidential E-Gov Initiative implementation. This was accomplished in large measure by the efforts of all bureaus through the Treasury Chief Information Officers' Council and its sub-councils.

—The Alcohol and Tobacco Tax and Trade Bureau's (TTB) recent successful migration from the Bureau of Alcohol, Tobacco and Firearms and Explosives (ATF) infrastructure is an example of proper oversight and assistance between the Department and a Treasury bureau. When ATF was divided into two organizations in 2003 (ATF became part of the Department of Justice while TTB remained a Treasury bureau), all IT resources remained with ATF. These IT resources included 100 percent of all capital assets, infrastructure, IT support personnel, and resources to continue development of core business applications. Treasury's senior management team worked closely with TTB bureau executives in developing and implementing smart sourcing strategies. TTB accomplished the migration of its entire IT infrastructure off of ATF in 6 months, which is an extremely aggressive schedule for a migration of this scale. In fact, the migration was completed well ahead of schedule and within an extremely tight budget.

The Department also remains focused on enhancing project management capability by establishing a Treasury-wide training program. In line with OPM and OMB guidance, Treasury's existing IT capital planning policy outlines the skills and competencies required for project managers based on project scope and complexity. Currently, bureau CIOs are required to certify that project managers for major investments are qualified according to these guidelines. This initiative, which supplements bureau training programs, will include a project management course focused on Treasury-specific policy and procedures to ensure consistent implementation across the Department.

However, it is clear that there still remains work to be done. Treasury is implementing specific actions to promote greater accountability across the Department's IT management, improve the reliability of information being reported, and establish additional processes through which to assess and validate program performance and reporting. These efforts are being undertaken Treasury-wide, with engagement of the leadership across the senior management, IT, and procurement communities.

*Question.* Mr. Secretary, last year in a question for the record, I asked whom you held responsible for this botched procurement. The answer never identified anyone. So, now I want to ask you in person.

Who in your department is to be held responsible for this waste of taxpayer dollars?

*Answer.* Ultimately, as Secretary, I am responsible for the use of all Treasury resources. I rely on the ASM/CFO and the CIO to execute this responsibility related to major IT investments. I am confident that they are taking the necessary steps to provide a solution that is cost effective and meets Treasury's business needs.

The Treasury Department's telecommunications infrastructure is critical to many functions such as: online tax filing and processing, the auction and purchase of Treasury securities, toll-free telephone taxpayer assistance, the disbursement of social security and veterans' benefits, and the collection of payments and delinquent debt owed to the U.S. Government.

A Treasury-led full and open competition represents the most cost-effective use of taxpayer dollars, as well as the most responsible approach in mitigating the risk of service interruption that would impair Treasury's ability to carry out its mission.

Given that no GSA alternative was available at the time it was needed, Treasury had to use a sole-source justification to continue to receive telecommunications services. In addition, GSA delayed the Networx contract awards multiple times, which now are scheduled for March and May of 2007. After those awards, there will be an additional delay before any agency can receive services under Networx in order for the agency, including Treasury, to conduct a competition among vendors in the Networx program.

If TCE were shut down, Treasury would face a potential gap in service from the time the current contract expires, i.e., September 2007, to the time the final Treasury site is transitioned to Networx. To avoid this gap, Treasury would need to use a second sole-source justification to extend the current contract long enough to bridge to services under Networx, possibly until the first or second quarter of fiscal year 2009. This is a best-case estimate assuming: (1) no Networx protests and (2) that Treasury is the first agency in line for competition and transition needed to obtain services from a winning Networx vendor.

Treasury's extension of its current telecommunications contract also would pose the risks: (1) a protest of a second sole-source justification and a significant cost increase by the current provider; (2) termination of service, should the current provider decide to shutdown the existing telecommunications infrastructure for its own business reasons; or (3) considerable time and cost to move sites that already have been transitioned to the TCE vendor back to the current telecommunications provider.

If TCE were shut down, Treasury would be required to end the TCE contract under the contract's "Termination for Convenience" clause. That would make Treasury liable to the contractor for termination costs, such as equipment investment, minimum order costs, work in progress costs, and other costs allowed under a termination for convenience. Treasury also might be liable for the significant sunk investment to build the infrastructure necessary to provide TCE services.

In addition, Treasury currently is spending an estimated \$3.3 million per month for telecommunications services above the estimated TCE monthly costs. The Department will continue to incur this additional cost until it completes the transition to TCE or Network.

#### BSA DIRECT—WHY DID NO ONE SPOT THE PROBLEMS?

*Question.* Mr. Secretary, you heard me discuss the recent problems discovered with the BSA Direct program. That program was supposed to be the key tool for your agency to combat terrorist financing by ensuring compliance with the Bank Secrecy Act.

In our appropriations bill last year, our committee directed you to report to us if there were to be any significant delays with this program. On February 17 of this year, your agency listed the continued development of BSA Direct as a major accomplishment of the agency. Your staff told us that the project was on track and would start functioning at the end of April.

Less than 1 month later, the new director of the Financial Crimes Enforcement Network issued a "stop work" order for BSA Direct and required a top-to-bottom review because the project had failed to meet major performance milestones.

How did this happen and who are you holding responsible for this failure?

*Answer.* In February 2006, as the various commercial software products were integrated and tested, a number of system performance issues surfaced. Due to these performance issues, the system still was not fully tested by mid-March, and so a contingency plan had to be implemented to ensure continued access by our customers to the BSA data.

FinCEN Director Robert Werner issued a 90-day "stop work" order directing FinCEN to perform an assessment of the BSA Direct Retrieval and Sharing component in order to ensure that the best product is developed at the best price, while also taking advantage of already developed technology. An assessment team chaired by the FinCEN BSA Direct project manager and including representatives from the Treasury CIO's office, FinCEN's Acting CIO, subject matter and information technology experts from FinCEN, as well as three support contractors on the BSA Direct project was created in March 2006. This assessment team will assess and refine core requirements for BSA information retrieval, dissemination, sharing, and analysis; determine if this component of BSA Direct can be salvaged and/or leveraged by other alternatives; and define the path to ensure business continuity. The team expects to deliver a report to the FinCEN Director by July 2006, following a recent 30-day extension of the "stop work" order. This time frame will allow the assessment team to offer specific recommendations based on detailed conclusions that are supported by clear, concise and credible evidence.

Throughout this assessment period, FinCEN will be working with the IRS to ensure that there is no disruption of service to its customers in the law enforcement community. BSA Direct users will continue to have access to BSA data via the current FinCEN Secure Outreach web site, and will use the IRS WebCBRS (Currency and Banking Retrieval System) for retrieval and online analysis of information.

#### OVERALL MANAGEMENT OF TREASURY PROJECTS

*Question.* Mr. Secretary, at last year's hearing, when we discussed the mismanagement of major procurements in your Department, I thought that part of the problem might have been the many vacancies that you had in senior positions at the Department. Now, it's a year later and many of those vacancies have been filled.

Looking forward, can we expect to see these costly, wasteful mistakes come to a stop?

*Answer.* The Department has experienced a number of organizational changes and vacancies over the past few years. This turnover, indeed, has precipitated questions regarding the management of major procurements by the Department. With the new team recently put in place, we are working diligently to implement Treasury-wide IT capital planning and contract management policies consistently throughout the Department. These efforts are focused on promoting greater accountability across the Department's IT management, instituting standards for documentation for major projects, and establishing additional processes through which to assess and validate program performance and reporting. The Treasury CIO is

working closely with the Office of the Inspector General to address the Management Challenges identified in the fiscal year 2005 Performance and Accountability Report. Actions include strengthening Treasury-wide IT capital planning policy and guidance, establishing minimum documentation requirements for major projects, and improving the reliability of investment reporting through an expanded independent verification and validation program. We believe these efforts will address key areas for improvement across the full life cycle of IT investments from acquisition, to steady state, to project closure.

*Question.* In particular, your agency is telling us that its new Treasury Foreign Intelligence Network will have a total cost of \$30 million.

Can you guarantee us that the cost will not grow dramatically for this program like it has for so many others?

*Answer.* The President's fiscal year 2007 budget requests \$21.2 million to implement an accelerated deployment schedule to strengthen quickly Treasury's ability to fulfill its expanded intelligence role and to operate as a full partner in Intelligence Community activities. The \$21.2 million will fully fund the needed upgrades to TFIN, which is scheduled to be completed by the end of fiscal year 2007. This brings the total cost of developing the TFIN core network and disaster recovery capabilities to \$37 million.

An effective governance structure has been in place for TFIN since the inception of the project to ensure mission, business, and technical objectives are achieved. This governance structure includes the: (1) TFIN Executive Board comprised of senior officials from the Office of Terrorism and Financial Intelligence and the Office of the Chief Information Officer (OCIO), and (2) TFIN Steering Committee comprised of project management and technical leads from stakeholder offices. These governance structures facilitate coordination, track project status, and support executive decision-making. OCIO hired a dedicated project manager to oversee the TFIN project.

Treasury has established additional oversight as well. The Assistant Secretary for Management and Chief Financial Officer (ASM/CFO), the Chief Information Officer (CIO), and the Assistant Secretary for Intelligence and Analysis (OIA) are committed to ensuring the project's successful completion. The ASM/CFO and CIO are engaged fully with the Assistant Secretary for Intelligence and Analysis, the system's major stakeholder. These officials and their staffs are working closely together in managing the development of TFIN, meeting regularly to resolve quickly problems that might affect the cost and schedule of the system. For example, on April 24, we implemented successfully the new stabilized TFIN platform. This executive level engagement will continue throughout the project. We expect Treasury to complete the system on time and within budget. Treasury also is working closely with and receiving direct support and assistance from the Intelligence Community.

From a Departmental IT investment management perspective, Treasury has identified TFIN as a critical investment internally, as has the Intelligence Community. As such, the TFIN investment is subject to additional reporting requirements beyond the quarterly "Control" review conducted as part of the IT capital planning and investment control.

The Department also is implementing specific initiatives to improve IT investment management, including the expansion of independent verification and validation resources to assess accuracy of project and investment reporting. We do not anticipate requesting additional funds from the Congress for the development of the TFIN system.

#### STOP THE WINE TAX!!

*Question.* Last year, your Department proposed almost \$30 million in new and increased user fees on the wine and alcohol industry. We, in our wisdom, did not adopt your recommendation. Yet, again, this year, you are proposing those same user fees.

These don't appear to be new fees to provide new services to the industry. Rather, they are just new taxes proposed so you can eliminate some appropriated funding in your Department.

Why are you proposing these fees again when you know they are not likely to be approved?

*Answer.* The user fees proposed for TTB are intended to recover the costs in providing regulatory services to the alcohol industry. TTB issues permits to industry members engaged in the business of producing, importing, or wholesaling alcohol. Additionally, TTB must pre-approve all labels for alcohol products bottled, sold, or imported in interstate commerce. TTB must also approve certain formulas and statements of process for alcohol products, and may perform certain laboratory tests.

These services ultimately protect both the general public and industry against misleading labels, adulterated alcohol, and dishonest persons entering the alcohol business, and promote fair competition among industry members. Since these regulatory efforts provide value to the industry, the industry should pay for the benefits it receives.

Charging fees for services to industry can also provide incentives that lead to increased efficiency. For example, in calendar year 2005, 71 percent of applications for approval of alcoholic beverage labels were filed on paper instead of electronically. Fees will encourage industry to file electronically and reduce unnecessary Certificate of Label Approval submissions.

*Question.* Washington State is home to more than 400 wineries and 350 wine grape growers—which is more than California’s Napa Valley. They play an ever-increasing role in the Washington State economy—especially in rural communities throughout the State. I believe these increased fees will severely hinder growth of the wine industry here in the United States.

Can you outline for this committee what new benefits these user fees will provide the industry? Isn’t it true that, once these new fees are assessed, the wineries will not be getting any new services above the ones they are getting today?

*Answer.* Industry members will not receive any new services under this proposal. However, industry is currently receiving benefits from the services TTB provides and should pay for those benefits.

#### ESTABLISHMENT OF A DYNAMIC TAX OFFICE AT TREASURY

*Question.* Your fiscal year 2007 budget request includes an additional \$513,000 and 3 FTE for a Dynamic Analysis Division within the Office of Tax Policy at Treasury.

What resources are you dedicating towards this effort this year—do you plan to reprogram any resources to stand it up sooner?

*Answer.* We would like to accelerate this initiative into fiscal year 2006 and Assistant Secretary Pack sent a letter to this effect to Chairman Bond and Ranking Member Murray on June 8, 2006. Establishing this new Division now will enhance and facilitate our capabilities to perform dynamic analyses of the macroeconomic effects of major tax policy changes, which, as you know, are particularly important to the work currently underway at the Treasury Department on tax reform. The acceleration of the new Division into fiscal year 2006 would be accomplished with no impact on our fiscal year 2006 funding; that is, it will be funded within the Office of Tax Policy’s existing appropriation. The funding that we requested in the fiscal year 2007 budget also would be unaffected.

*Question.* Is it your intention should you receive this funding in fiscal year 2007 that dynamic scoring would be instituted into the government’s budgeting?

*Answer.* This dynamic analysis initiative will allow us to examine the effect that tax policy changes have on the size of the economy and major macroeconomic variables, such as GDP, the size of the capital stock, and total compensation. Dynamic scoring would take this one step further and estimate how the change in the size of the economy translates into higher or lower tax revenues. We envision that the initiative will, at least initially, focus on dynamic analysis, not dynamic scoring. Conventional revenue estimates, which do not take into account changes in the size of the economy, will continue to be produced. The Department needs to develop the capability for and experience with dynamic analysis before it can consider dynamic scoring of tax policy changes.

#### HYPOCRISY OF CHINA VS. CUBA POLICY

*Question.* Mr. Secretary, do you believe that our Nation’s policy of constructive engagement with China, and particularly our trade relationship with them, has helped us press our case for democracy, open markets and human rights?

If you believe that our Nation’s policy of constructive engagement with China has been a positive force change in that country, why is this administration doing exactly the opposite with Cuba?

*Answer.* When formulating U.S. foreign policy, different considerations come into play; and sanctions regimes are designed to respond to country-specific concerns.

While the United States remains concerned about the democracy and human rights record in China, we must also recognize that China is in the midst of an historic transformation from a centrally-planned economy to a market economy. Increasing openness to trade and foreign investment is central to this process, as is the integration of China into the institutions (and the responsibilities) that govern the global trading system. Chinese leaders at the highest level have stressed their commitment to financial sector reform and openness, a major focus in Treasury’s en-

agement with China. On his visit to Washington last month, President Hu stated that his country will not only “continue to advance the reform of the RMB exchange rate regime,” but also “take positive steps in expanding market access, increasing imports, and strengthening the protection of intellectual property rights.” We will continue to leverage our trade relationship to work towards open markets in China, which is in both our interests. There is still a long way to go.

Cuba has a brutal dictatorship that is increasing pressure on opposition groups. In addition to engaging in political repression, the Cuban government is actually reducing the limited economic openings for small-scale entrepreneurs in Cuba. U.S. policy towards Cuba remains to hasten the rapid transition to democracy and a free-market economy. As set forth in the Libertad Act, U.S. policy is to take steps to remove the economic embargo of Cuba when the President determines that a transition to a democratically elected government in Cuba has begun. The State Department is best placed to respond specifically to questions about the administration’s policy toward Cuba.

#### ARE THE RUSSIANS ALLIES WHEN IT COMES TO COMBATING TERRORISM?

*Question.* A senior official in Russia’s Foreign Ministry said last week that, as chair of the G-8, Russia will put forward a number of new initiatives to combat international terrorist financing.

Have you been in contact with the Russian government to help shape this agenda, and if so, what new initiatives should we expect out of the Russians in this area?

*Answer.* Yes, Treasury has been in contact with Russian counterparts regarding the G-8 Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) agenda. For example, AML/CFT issues were discussed in the most recent G-8 Finance Sous Sherpas on May 11. Russia will be hosting an experts meeting from May 31 through June 1, 2006, which will focus on working with the Financial Action Task Force (FATF) style Regional Bodies (FSRBs) to implement AML/CFT standards. Russian proposals in this area are consistent with ongoing bilateral and multilateral AML/CFT initiatives. In particular, Russia has stressed the importance of enhancing the effectiveness of the FSRBs by increasing IMF and World Bank coordination with the regional bodies and by increasing support for their mutual efforts.

The United States and Russia agree that it is crucial for countries to continue to develop strong AML/CFT programs. We agree that the work of the FSRBs to promote implementation of the FATF AML/CFT standards is instrumental to these efforts, as is the support of the International Financial Institutions. We see merit in Russia’s proposals to enhance cooperation between these groups.

*Question.* On a related matter, Russia, as you know, does not officially consider Hamas a terrorist organization. In fact, Russia was one of the first countries to invite Hamas on an official visit following the terrorist group’s victory in the Palestinian legislative elections.

How do disagreements between nations in the definition of who is a “terrorist” affect our efforts to stop the flow of terrorist-related finances?

Do you worry that the Russians’ efforts in this area might undermine our own efforts and those of other allies?

*Answer.* United Nations Security Council Resolution (UNSCR) 1267 requires all countries to freeze the assets of individuals and entities related to Usama Bin Laden, Al Qaeda and the Taliban. UNSCR 1373 requires all countries to freeze the assets of individuals and entities that support global terrorism, but leaves it to member states to determine which groups fall within its scope. Many countries, including the United States and members of the European Union, have designated Hamas as a terrorist organization. Unfortunately, not all countries have followed this lead.

As with any sanctions program, the extent to which a terrorist designation is multilateralized renders it more or less effective. This certainly applies to Hamas. We will continue to work, both bilaterally and multilaterally, to ensure that terrorist organizations find no financial safe haven and that these organizations are to the greatest extent possible deprived of access to the international financial system.

#### DISRUPTING TERRORIST FINANCING NETWORKS

*Question.* Treasury now has at its disposal, increased resources to disrupt terrorists’ financial support networks and you continue to seek more such resources. In fact, the majority of the fiscal year 2007 requested increases go for these purposes.

What kind of progress have you been able to make on cross-border currency transactions, wire transfers, and effective oversight of alternative payment systems such as “hawalas” with other countries?

Answer. In the area of traditional wire transfers, we believe that every major bank in the United States has access to the tools necessary to implement a robust compliance program to interdict transactions potentially violative of OFAC regulations. OFAC has also made considerable progress in the area of cross-border Automated Clearing House (ACH), actively working with industry and with the Federal Reserve's Gateway to develop new standards to increase the transparency of the parties involved in such transactions. OFAC, along with FinCEN, is coordinating with both Federal and State regulators to address money laundering issues within informal value transfer systems. It has, for example, pursued a number of cases, both criminally and civilly, with regard to hawalas acting illegally in sending funds to sanctioned countries, particularly Iran.

FinCEN continues to oversee and better ensure compliance with the Bank Secrecy Act with respect to cross-border currency transactions, wire transfers and transactions conducted in the United States by, for, or on behalf of alternative payment systems such as hawalas. All of these types of transactions are subject to certain reporting, and record-keeping requirements under the Bank Secrecy Act. FinCEN also will continue to evaluate the need for further rule making under the Bank Secrecy Act to better safe guard our financial system from criminal abuse.

Additionally, we have been addressing actively these issues with other countries through our membership in the Financial Action Task Force (FATF) and its network of FATF-Style Regional Bodies (FSRBs). FATF and its FSRBs include approximately 150 countries that have agreed to implement the FATF Forty Recommendations on Money Laundering and Nine Special Recommendations on Terrorist Financing.

Last year, TFI led the effort within the FATF to adopt Special Recommendation (SR) IX. SR IX requires FATF/FSRB members to take steps to detect the physical cross-border transportation of currency and negotiable instruments and to stop or restrain funds that are suspected to be related to terrorist financing or money laundering. FATF/FSRB member countries also are required under Special Recommendation (SR) VI to implement measures to ensure that money remitters are licensed or registered, apply appropriate AML/CFT controls (including customer identification, recordkeeping, and Suspicious Activity Report (SAR) reporting), and to take administrative, civil or criminal action against violators. In the United States, money transmitters (including alternate payment systems such as hawaladars) are required to register with the Financial Crimes Enforcement Network (FinCEN); adopt AML programmatic policies, procedures and controls; identify customers; and report suspicious activity.

With respect to wire transfers, SR VII requires countries to transmit full originator information with cross-border wires, providing law enforcement authorities with ready access to information needed to track illicit funds. These requirements complement those contained in the Travel and Recordkeeping Rules that govern wire transfers in the United States.

As co-chair of the FATF's Working Group on Terrorist Financing, the U.S. Government plays a key role in the implementation of these Special Recommendations. TFI also works within the interagency to provide assistance to other jurisdictions in implementing the FATF 40+9.

#### HOW MUCH CAN REALISTICALLY BE ACCOMPLISHED?

*Question.* Terrorist cells are increasingly self-financing through criminal activity such as drug trafficking, counterfeiting intellectual property, insurance claim fraud to name a few, as opposed to wire transfers. There are strong indications that terrorist operations do not require exorbitant sums of money. The bombings of the U.S.S. *Cole* and those in Bali, Madrid and London, are all estimated to have cost \$50,000 or less, and the 9/11 bombings were estimated to cost \$500,000. Experts in terrorist financing have said that the cost of terrorist attacks is decreasing exponentially.

Are we reaching a point of diminishing returns because terrorists are avoiding the transfer mechanisms that we are good at tracking?

Answer. Treasury's approach to combating terrorist financing is two-fold: first, we seek to identify and close vulnerabilities in the international financial system; second, we seek to identify, disrupt and dismantle the financial networks that support terrorist organizations.

We are meeting this responsibility through a number of initiatives involving various sectors. For example, we are working through organizations such as the FATF and the IMF and World Bank to ensure that all countries are taking effective measures to prevent terrorist abuse of such mechanisms as charities, cash couriers, wire remitters, and informal funds transfer providers.

The imposition of sanctions by the United States and its international partners against terrorists, terrorist organizations and their support structures is a powerful tool with far-reaching effects that goes beyond the blocking of terrorist assets. Designating individuals or organizations as SDGTs (Specially Designated Global Terrorists), SDTs (Specially Designated Terrorists), or FTOs (Foreign Terrorist Organizations) notifies the U.S. public and the world that these parties are either actively engaged in or supporting terrorism or that they are being used by terrorists and their organizations to support the terrorist agenda. Notification also serves to expose and isolate these individuals and organizations and denies them access to the U.S. financial system, and in the case of a United Nations (U.N.) designation, the global financial system. In addition, the imposition of economic sanctions can assist or complement the law enforcement actions of other U.S. agencies and/or other governments.

As long as terrorists, terrorist organizations and their support structures continue to target the United States and its allies, we must make every effort to combat them; targeted sanctions are one of the tools employed by the United States. Terrorists are becoming more sophisticated at attempting to evade sanctions. Such activity necessitates our continuing efforts to identify, expose and target morphed or reformed terrorist organizations, front companies, and agency relationships that may be developed to evade sanctions and allow them access to the United States and international financial systems. Unless the United States and its allies apply constant and unrelenting pressure, terrorists will immediately exploit any opportunities that become available. Denying terrorists, especially their financial supporters, the convenience and benefits of using traditional legitimate economic and financial systems has created another barrier to their activities and has impeded their support networks. Removing those hurdles to the funding of their infrastructures will not produce a benefit because they will be able to revert to using unprotected traditional systems. Keeping those barriers in place requires undiminished commitment by Treasury at the same time that the alternative systems that terrorists and their supporters may choose to use become another target set for action by the U.S. Government. It gains us nothing in the war on terrorism to remove security from the front gate because the terrorists have started trying to tunnel beneath the fence. Consequently, in the War on Terror, there are arguably no diminishing returns, because stopping or impeding even one terrorist act saves lives and adds to the national and economic security of the United States and its allies.

#### PROGRESS WITH CHARITABLE ORGANIZATIONS

*Question.* Charitable organizations can be exploited by terrorists because there is little government oversight, donations are largely anonymous, and these funds are collected by both charitable groups and the government in lieu of taxes for religious, social, and humanitarian purposes. The financial and operating structures of charitable organizations are not easily understood.

How have you been able to deal with this and are you considering measures that will produce transparency in charities?

*Answer.* Treasury has taken an active role in preventing widespread abuse of the charitable sector by terrorists to raise and move funds and provide logistical support. Curtailing such abuse is a critical element in the U.S. Government's national and international strategy to combat terrorist financing generally, as underscored in the 2002 and 2003 National Money Laundering Strategies, numerous U.S. Government counter-terrorist financing strategies, and various international resolutions and standards.

The U.S. Government has developed a comprehensive strategic approach to combat the risk of terrorist financing in the charitable sector. Collectively, these measures include: a coordinated oversight system comprised of Federal, State, and private elements; targeted investigations, prosecutions, and designations; international engagement; and extensive outreach engagements with the private sector.

Under the coordinated oversight prong, Treasury has promulgated effective measures for monitoring charitable organizations' compliance with U.S. law through its terrorist-related designations pursuant to Executive Orders (EO) 13224 and 12947. As of May 2006, the United States has designated 41 charities under EO 13224 and EO 12947 because of their support for terrorist activity. This includes five U.S.-based charities and 36 additional international charities (two of which have branch offices located in the United States). On February 19, 2006, the United States blocked the assets of a sixth U.S.-based charity pending further investigation, which has the effect of freezing all assets located within U.S. jurisdiction and prohibiting U.S. nationals from transacting with the charity. These designations serve a multitude of purposes aside from blocking the flow of funds to terrorist organizations

or purposes, including putting other charities and donors on notice of the designation, deterring donors or charities that may otherwise have funded terrorist organizations, and forcing terrorist organizations to use alternative, riskier financing mechanisms.

To increase awareness of the risk of terrorist financing in the U.S. charitable sector and to provide charities with measures they can take to protect themselves, Treasury's Office of Terrorist Financing and Financial Crime (TFFC) has undertaken an extensive outreach program. In response to numerous dialogues with the sector on how they might better adopt practices to protect themselves from such abuse, and protect the integrity of charitable giving and the confidence of donors, in November 2002, the Treasury Department released the Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities (Guidelines), which were revised and released in draft form to solicit public comment in December 2005. The Guidelines provide measures for charities to take in order to protect themselves against the risks of terrorist financing.

The Guidelines follow a risk-based approach that balances the demands of applying these protective measures with the particular operational risks of each charity and with an understanding that terrorist financing risks vary between charities. They encourage charities to enact and practice sound governance and fiscal policies, which include detailed record-keeping, as well as to collect information on and vet key employees, members of the governing body, and potential grantees. There is also guidance on the adoption of specific practices that help better facilitate compliance with OFAC sanctions programs, including those that address terrorist financing, and provide information on directing inquiries and/or suspicions and referrals to the appropriate State and Federal law enforcement authorities. Moreover, the issuance of the Guidelines initiated a strong, ongoing dialogue with the sector, which reinforced the sector's awareness of the risks of terrorist abuse it faced, and led to a greater understanding of the available resources and measures that could help to protect against such risk.

The Guidelines also led to a strong engagement with the American Muslim charitable community, which often faces heightened risks due to the high-risk regions in which many American Muslim charities operate. TFFC has facilitated meetings with other watchdog and intermediary organizations (such as ECFA and BBB-WGA, etc.) in an effort to facilitate the creation of the National Council for American Muslim Non-profits (NCAMN). Launched in March of 2004, NCAMN is a proactive initiative of the American Muslim charitable community and is working to create standards of transparency and accountability similar to other intermediaries that it can apply to organizations under its purview, including relief organizations, mosques, Islamic schools, etc. TFFC's parallel engagement with the American Muslim charitable sub-sector and the larger charitable sector have resulted in charities adopting more proactive approaches to protect their assets and the integrity of their operations.

TFFC has also acted as an integral component of overall U.S. engagement with the international community. Specifically, TFFC has helped to shape international policy on charities through its work with the FATF. It recently took part in negotiations for the FATF's Interpretive Note to Special Recommendation VIII on non-profits, which is the practical application of the international standard to curb terrorist abuse of non-profit organizations. This Interpretive Note was adopted by the FATF member countries at the February 2006 Plenary. TFFC will continue to engage with the FATF, its regional-style bodies, and individual member countries to encourage implementation of national standards that encourage transparency and accountability in the charitable sectors of those jurisdictions.

Finally, OFAC has a section of its website dedicated to charitable organizations and will shortly be publishing suggestions for analyzing sanctions risk with regard to both donations and grant-making.

#### IS TREASURY TARGETING NON-CONVENTIONAL FUNDING SOURCES?

*Question.* GAO has recommended that the administration pay closer attention to non-financial mechanisms used by terrorist financiers to generate and distribute funds.

To what extent is the Treasury Department, and its Office of Terrorism and Financial Intelligence (TFI) in particular, interested in and able to concentrate on non-conventional money-generating and money-moving networks such as the trade in commodities—gold, diamonds, cigarettes, and gemstones?

*Answer.* TFI examines all forms of financial networks that support terrorist, WMD and other illicit activity, including trade-based money laundering and potentially illicit trade in commodities.

FinCEN recently issued an interim final rule that requires dealers in precious metals, stones or jewels to establish and maintain anti-money laundering programs to prevent and detect money laundering and terrorist financing. In addition, the Bank Secrecy Act requires all trades and businesses in the United States to report the receipt of cash, or cash equivalents, in excess of \$10,000 to FinCEN. This information is captured on the FinCEN/IRS 8300 form which also provides a "suspicious transaction" box to alert law enforcement and regulatory agencies to the possibility of criminal activity. Perhaps most importantly, the Bank Secrecy Act has many reporting and recordkeeping requirements on banks, money service businesses, broker dealers and other financial institutions in the United States including, but not limited to, the reporting of cash and suspicious transactions by customers. Since all types of non-conventional money-generating or money-moving networks use banks or other types of financial institutions to place and move funds, financial activities by these entities are reported, or otherwise available to, law enforcement, intelligence and regulatory authorities. Attempts to evade the Bank Secrecy Act by way of "structuring" or bulk-cash transportation also make criminals vulnerable to detection by law enforcement.

Additionally, TFFC is working with the relevant FATF-style Regional Bodies (FSRBs) to examine trade-based money laundering and to craft innovative solutions. TFFC has worked extensively with the interagency community, particularly Immigration and Customs Enforcement (ICE) at the Department of Homeland Security, to understand and counteract the trade-based money laundering employed by Colombian narcotics groups through the Black Market Peso Exchange. TFFC and ICE have worked through international organizations such as the FATF to develop typologies of trade-based money laundering and continue to collaborate with international partners and exchange trade-based data as a means of identifying trade-based money laundering networks and taking appropriate responsive action.

Finally, OFAC focuses on any entities that meet the criteria for designation under Executive Orders and statutes it implements. Insofar as such entities include non-conventional money generating/moving entities, OFAC investigates the ways in which such entities are moving money in connection with individuals and entities on OFAC's List of Specially Designated Nationals and Blocked Persons (SDN list). Thus, OFAC's focus is not on any one kind of entity, but rather on any entity moving value for the benefit of a narcotics trafficker's or terrorist's or WMD proliferator's organization.

#### WHAT ABOUT ADDRESSING OFFSHORE BANKS, ETC.?

*Question.* It has been suggested that the U.S. Government is neglecting the role played by offshore banks, shell companies, and business fronts in funding terrorism. Do you agree?

*Answer.* No. FinCEN requires financial institutions to establish and maintain adequate anti-money laundering programs with systems and controls, training, testing and designated personnel to detect and report suspicious activity, including terrorist financing. Offshore banks, shell companies and business fronts have long been acknowledged as high risk entities. As such, these entities are subject to elevated due diligence standards by financial institutions to ensure compliance with the suspicious activity reporting requirement of the Bank Secrecy Act. Failure to develop an adequate anti-money laundering program and failure to report suspicious activity involving offshore banks, shell companies and business fronts has resulted in very significant civil money penalties by FinCEN. See [http://www.fincen.gov/reg\\_enforcement.html](http://www.fincen.gov/reg_enforcement.html).

Title III of the USA PATRIOT Act provides the U.S. Government with powerful tools to prevent these entities from being utilized by terrorists to raise and move funds. Section 312 requires financial institutions to apply enhanced due diligence policies and procedures to correspondent accounts maintained for certain foreign banks operating under offshore banking licenses. Section 313(a) prohibits U.S. financial institutions from providing correspondent accounts in the United States to foreign banks that do not have a physical presence in any country. It also requires these financial institutions to take reasonable steps to ensure that correspondent accounts provided to foreign banks are not being used to provide banking services indirectly to foreign shell banks and financial institutions are required to obtain certification to this effect.

The U.S. Government has also taken action against jurisdictions with respect to their offshore sectors. Under the provisions of Section 311, the U.S. Government determined Nauru to be a jurisdiction of primary money laundering concern and proposed instituting special measures against it in 2002 for its failure, among other things, to adequately supervise its offshore banking sector. The U.S. Government

has also been pursuing cases where offshore banks have attempted to manipulate U.S. branches, affiliates, and correspondents by using the U.S. financial system to route transactions in violation of our sanctions. We are working diligently with the banking community and with international regulators to ensure transparency in transfers such as cover payments where there is little information about underlying transactions. We also have extensive outreach and educational programs in place to address manipulation of check-clearing and trade finance mechanisms.

The U.S. Government participates actively in international bodies such as the Financial Action Task Force (FATF) and the Offshore Group of Banking Supervisors (OGBS) that promote effective implementation of international anti-money laundering and counter-terrorist financing standards in offshore financial centers.

OFAC has been pursuing cases where offshore banks have attempted to manipulate U.S. branches, affiliates, and correspondents by using the U.S. financial system to route transactions in violation of our sanctions. We are working diligently with the banking community and with international regulators to assure transparency in transfers such as cover payments where there is little information about underlying transactions. We also have extensive outreach and educational programs in place to address manipulation of check clearing and trade finance mechanisms.

*Question.* Can Treasury play an expanded role in this area?

*Answer.* Treasury continues to monitor jurisdictions and institutions overseas to identify offshore sectors and activities that could pose potential threats to the U.S. financial system. We will utilize the authorities made available to us by Congress under the Bank Secrecy Act (BSA) as amended by the USA PATRIOT Act including section 311, the International Emergency Economic Powers Act (IEEPA) and other statutes to address these specific threats through targeted economic and financial sanctions, rulemaking and the issuance of advisories, alerts and reports to industry.

#### TREASURY'S OFFICE OF INTELLIGENCE ANALYSIS

*Question.* Ms. Gardner, the 9/11 Commission stated that terrorist financing had not been a priority for either domestic or international intelligence collection and, as a result, intelligence reporting on the issue was not up to par.

How has Treasury's relatively new Office of Intelligence Analysis contributed to overall intelligence collection?

*Answer.* While Treasury's Office of Intelligence and Analysis (OIA) is primarily an analytical unit, it has already begun to play a role in improving the Intelligence Community's (IC) collection efforts on terrorist financing. In 2005, OIA hired a full-time Requirements Officer, who submits requirements and evaluations on behalf of all Treasury entities, including OFAC and FinCEN, to the IC. In these requirements submissions, Treasury includes comprehensive background information as well as a detailed statement of Treasury's intelligence gaps to help focus the IC on Treasury's needs. In response to these detailed requirements, Treasury has received a greatly increased level of tailored support from the IC. OIA is in the process of hiring another Requirements Officer to help with its growing responsibilities in this area. OIA has played a particularly significant role in improving IC collection on the Iraqi insurgency. OIA is serving as the co-lead with the Department of Defense on the Baghdad-based Iraq Threat Finance Cell (ITFC). The Treasury presence in Iraq on the ITFC is already paying dividends. More and better detailed information on insurgency finance issues is becoming available, due in part to the increased analytic focus on this issue. In addition, the financial intelligence analysts have provided great support to the military in identifying trends and patterns in insurgency financing in the context of a cash-based economy.

#### WHERE DO WE GO FROM HERE?

*Question.* Mr. Levey and Mrs. Gardner, the 9/11 Commission report suggests that the strategy for terrorist financing should shift from seizing assets to gathering intelligence since it may not be achievable or cost effective to attempt to deny terrorists funding. Terrorists are increasing seeking more informal ways of moving money and terrorist networks themselves are becoming more decentralized and self-supporting.

What, do you believe, is the appropriate combination of goals to address terrorist financing?

*Answer.* The imposition of sanctions by the United States and its international partners against terrorists, terrorist organizations and their support structures is a powerful tool with far-reaching effects that goes beyond the blocking of terrorist assets. Designating individuals or organizations as SDGTs (Specially Designated Global Terrorists), SDTs (Specially Designated Terrorists), or FTOs (Foreign Terrorist Organizations) notifies the U.S. public and the world that these parties are either

actively engaged in or supporting terrorism or that they are being used by terrorists and their organizations to support the terrorist agenda. Notification also serves to expose and isolate these individuals and organizations and denies them access to the U.S. financial system, and in the case of a U.N. designation, the global financial system. In addition, the imposition of economic sanctions can assist or complement the law enforcement actions of other U.S. agencies and/or other governments.

As long as terrorists, terrorist organizations and their support structures continue to target the United States and its allies, we must make every effort to combat them and targeted sanctions is one of the tools employed by the United States. Terrorists are becoming more sophisticated at attempting to evade sanctions. Such activity necessitates our continuing efforts to identify, expose and target morphed or reformed terrorist organizations, front companies, and agency relationships that may be developed to evade sanctions and allow them access to the United States and international financial systems. Unless the United States and its allies apply constant and unrelenting pressure, terrorists will immediately exploit any opportunities that become available.

Denying terrorists, especially their financial supporters, the convenience and benefits of using traditional legitimate economic and financial systems has created another barrier to their activities and has impeded their support networks. Removing those hurdles to the funding of their infrastructures will not produce a benefit because they will be able to revert to using unprotected traditional systems. Keeping those barriers in place requires undiminished commitment by Treasury at the same time that the alternative systems that terrorists and their supporters may choose to use become another target set for action by the U.S. Government. It gains us nothing in the war on terrorism to remove security from the front gate because the terrorists have started trying to tunnel beneath the fence. Subsequently, in the War on Terror, there are arguably no diminishing returns because even stopping or impeding only one terrorist act saves lives and adds to the national and economic security of the United States and its allies.

*Question.* Given these trends and given the fact that we don't have unlimited dollars, how can we get the most for the money spent?

*Answer.* Treasury focuses on two goals regarding terrorist financing: to identify and close vulnerabilities in the international financial system and to identify, disrupt and dismantle the financial networks that support terrorist organizations. The overall impact of these effects is to make it costlier, riskier, and less efficient for terrorists to move their funds through the international financial system. Treasury gets the most for the money spent by focusing on these two strategic priorities. Therefore, the extent to which terrorists are forced to rely on more cumbersome and less reliable methods of funds movement is a measure of success. The response to this development, however, is to redouble our efforts to target all financial channels, both formal and informal.

Treasury will continue to apply its authority, in coordination with the inter-agency national security infrastructure, to disrupt the financing of terrorism and deter terrorist operations.

#### DO BANKING AGENCIES COMPLY WITH FINCEN'S BANK SECRECY REQUIREMENTS?

*Question.* Last year, I asked how regulatory agencies can seriously comply with the required exchange of bank secrecy data when there is no penalty if they don't comply. The Department's answer was to say that an unprecedented level of cooperation has been reached with the banking agencies and that including a penalty provision would have undermined this cooperation.

So, can you say that up through today, since the enforcement action against Riggs National Bank, all the banking agencies have been fully cooperative?

*Answer.* Yes. The Riggs National Bank matter served notice of the problems that can arise with respect to an absence of cooperation, unintentional or otherwise, among Federal agencies with parallel or overlapping jurisdiction. Based partly on the Riggs matter, FinCEN entered into Memoranda of Understanding (MOU) with the Federal banking agencies in October 2004. FinCEN has and will continue to enter into MOU with other Federal and State agencies, as appropriate. The MOU ensure that FinCEN receives timely notice of all significant Bank Secrecy Act (BSA) related findings, and ensure cooperation among the stakeholder agencies with respect to compliance with, and enforcement of, the anti-money laws of the United States.

In accordance with Memoranda of Understanding with FinCEN, all Federal and State law enforcement and regulatory agencies are required to safeguard BSA data acquired from FinCEN from unauthorized disclosures. In order to ensure the effec-

tiveness of the safeguards, FinCEN conducts inspections of agencies that receive BSA data.

In regard to information flowing to FinCEN from the Federal banking agencies, we have instituted systems and controls to ensure the data is not disseminated to unauthorized personnel. In fact, the Memoranda of Understanding with the Federal banking agencies of October 2004 contain an explicit provision prohibiting the unauthorized disclosure of BSA and other “confidential supervisory information” by FinCEN to unauthorized parties.

In addition, 31 U.S.C. 5318(g)(2) prohibits any director, officer, employee or agent of a financial institution to notify any person reported on a suspicious activity report that such a report has been filed with FinCEN. This same section prohibits any officer or employee of any Federal, State or local government from doing the same, other than as necessary to fulfill official duties. Furthermore, government employees are subject to a host of legal and administrative sanctions for unauthorized disclosures of protected information, including BSA information.

*Question.* FinCEN recently stood-up its Office of Compliance, among other things, to analyze Bank Secrecy Act examination data provided by regulators.

What is your assessment of how successful FinCEN has been with its analysis of bank secrecy data and have results been demonstrated?

*Answer.* FinCEN provides a broad range of analyses of Bank Secrecy Act (BSA) data to Federal, State, local and foreign law enforcement and regulatory customers. These analyses play an important role in safeguarding the financial system from the abuse of financial crime, including money laundering, terrorist financing, and other illicit activity. Specifically, FinCEN analysis of BSA data identifies relationships among targets of law enforcement investigations, identifies patterns of funds movement, and identifies the locations of suspects and their assets. FinCEN analysts also enhance BSA data with all-source information in providing findings and options to customers. FinCEN has developed a suite of analytical tools that enable analysts to conduct complex mining of BSA data, and to depict results with graphic displays of data relationships and financial flows.

In fiscal year 2005, FinCEN provided BSA data analysis in response to 1,436 requests from domestic and foreign law enforcement, regulatory and intelligence customers. For the first half of fiscal year 2006, FinCEN provided analysis in response to 742 customer requests. FinCEN’s customers for this work also include foreign financial intelligence units (FIUs) that are members of the Egmont Group of FIUs, comprising 101 participating countries. The Egmont Group is committed to a global effort to combating money laundering and terrorist financing through FIU cooperation and information exchange. During the past 5 years, Egmont FIU case requests to FinCEN have grown 32 percent annually on average. FinCEN also works with financial regulators, including FinCEN’s own regulatory component (FinCEN’s Regulatory Policy and Programs Division), the Federal banking supervisory authorities, the Internal Revenue Service, and 41 State banking supervisory agencies. FinCEN’s BSA data analysis in response to these requests supports pending enforcement actions against particular non-compliant institutions, and also supports possible Bank Secrecy Act policy enhancements. This type of analysis has identified compliance issues previously undetected in certain depository institutions and money services businesses and, since August 2005, has supported at least six significant enforcement actions against three banks, one broker-dealer firm, a casino and a money services business.

FinCEN’s BSA data analysis for regulatory customers also provided filing trends and patterns and identified vulnerabilities in certain financial industry segments. For example, information gleaned from the study of Suspicious Activity Reports (SARs) relating to the insurance industry was used in developing new insurance regulations. FinCEN’s BSA data analysis also supports guidance to the private sector, including “The SAR Activity Review—Trends, Tips & Issues”, as well as the bi-annual publication of “The SAR Activity Review—By the Numbers”, a compilation of numerical data gathered from Suspicious Activity Reports filed by all institutions with mandatory suspicious activity reporting requirements. Financial industries members widely use both analytical publications.

The large volume of customer requests to FinCEN for analysis is one important measure of the effectiveness of FinCEN’s BSA data analysis. Another important measure is customer satisfaction. FinCEN’s most recent survey of customer satisfaction, which was conducted by an independent evaluator from August to October 2005, included a statistically valid sample of the FinCEN customers of four types of analysis products (investigative target reports, investigative case reports, SAR activity review, and strategic analysis products). The survey results indicated 73 percent of FinCEN’s customers found FinCEN’s analytic support valuable.

The effectiveness of FinCEN's analysis of BSA data also is highlighted in the outcomes of specific cases. Recent examples of effective outcomes include the following:

- FinCEN completed a proactive targeting case initiated based on a Suspicious Activity Report that alleged possible terrorist financing based on suspicious wire transfers. The bank referred to numerous instances of the company being identified as a front or shell company for Hezbollah. The report explored potential connections between Islamic terrorism fund-raising and narcotics money laundering through an examination and analysis of Bank Secrecy Act information on a company located in South America, and a company believed to be affiliated in Central America.
- A geographic threat assessment was completed on the Southwest Border based on analysis of all BSA data forms for counties bordering Mexico. The threat assessment was requested by the Texas Department of Public Safety's (DPS) Directed Intelligence Group in an effort to identify money laundering hot spots. The DPS is working toward intelligence-driven operations and investigations, and with this threat assessment of money laundering hotspots will be able to direct and train their intelligence collection efforts much more effectively. Recently, criminal investigators in Texas noted that debriefings of suspects in the southwest border region indicated suspects were under pressure to find crossing points other than Laredo, Texas, and El Paso, Texas, because of the increased observation that those locations have been receiving as a result of the FinCEN assessment.
- FinCEN examined SARs through one of its BSA search and analysis tools to identify activity associated with the suspicious remittance of U.S. dollars to Colombia via Automated Teller Machines (ATMs). Research identified a cluster of 11 interrelated SARs associated with a man and a woman located in the United States who were depositing and transferring funds into or through 36 accounts at 8 U.S. banks. SARs indicated that a large percentage of the funds were subsequently remitted back to Colombia through ATMs at the rate of 57 to 157 withdrawals per day. Currency Transaction Reports (CTR) and Currency and Monetary Instrument Reports (CMIR) verified statements made by the man that the funds were derived from cash imported from Colombia. This activity, initially provided to law enforcement as an investigative referral, provided only a snapshot of what could be a much larger pattern of activity.
- FinCEN supported an Immigration and Customs Enforcement (ICE) field office effort to identify unlicensed/unregistered remittance businesses in a specific geographic area of Virginia. FinCEN found no viable targets through the SAR targeting method of querying key words in the SAR narratives, e.g., "wire transfer," "remittance," "hawala," etc. As a result, FinCEN downloaded CTRs filed by banks in the specified area, and after conducting analysis of the CTRs through an ad hoc database, was able to identify seven targets.
- FinCEN utilized CTR targeting in support of an ICE investigation into alleged willful negligence by a large bank. The investigation was initiated after it was discovered that the bank had not filed SARs on large, suspicious cash deposits by a convicted heroin money launderer. FinCEN focused its efforts on finding other individuals or businesses that had conducted similar activity through the same and other banks in the geographic area. Through the use of CTRs, FinCEN profiled the activity of the heroin money launderer then identified similar activity by downloading all CTRs where the number and amount of CTR activity was similar to that of the money launderer. The effort resulted in an extensive list of targets that resulted in a number of "spin-off" investigations by ICE and IRS-CI.

#### FINCEN'S REGISTRATION OF MONEY SERVICE BUSINESSES (MSBS)

*Question.* The Treasury IG has found that a little over 1 year ago, only a small number of the Money Service Businesses (MSBs) such as Western Union and post offices that do money orders, had registered with FinCEN as required by the Money Laundering Suppression Act of 1994. As of a few months ago, FinCEN's published list of MSBs had only increased a little bit, not much of an improvement.

What is being done to improve this registration effort?

*Answer.* Since the implementation date of the registration requirement for money services businesses on December 31, 2001, it is clear that identifying the universe of businesses subject to our money services businesses-anti-money laundering regulatory regime is one of the greatest challenges we face as an agency. Finding ways to enhance compliance with the registration requirement has been one of our focuses since the inception of the registration concept.

FinCEN developed and is implementing a comprehensive strategy in fiscal year 2006 for addressing the challenges posed by the identification and registration of money services businesses. The success of our efforts to increase registration, and therefore establish transparency in this segment of the financial services industry, will depend in large part upon our approach to communications, education, and industry outreach. We are in the process of upgrading our money services business internet website, translating the current instructional brochures into various foreign languages, fully implementing the Bank Secrecy Act resource center, and developing and implementing a comprehensive education program for the Internal Revenue Service examiners, our State regulatory partners and the industry.

Over the past several years, we have devoted considerable resources to conduct aggressive outreach and education campaigns concerning Bank Secrecy Act (BSA) requirements. Despite those efforts, some in the industry, particularly those that offer these services only as an ancillary component of their primary business, appear to be unfamiliar with or unaware of their obligations under the BSA. At the same time, as indicated by the volume of requests for administrative rulings and numerous questions received at industry conferences, it is apparent that the current regulatory framework would benefit by more clarity that can be provided through the development and issuance of guidance, such as advisories, frequently asked questions, and the like.

Therefore, we have stepped up our efforts to clarify the expectations that accompany these requirements. For example, on April 26, 2005, FinCEN published guidance to the money services business industry which clearly established the expectations for compliance with the registration, anti-money laundering program, record-keeping and reporting requirements of the Bank Secrecy Act. On the same date, FinCEN and the Federal banking agencies published joint guidance to banking organizations that explained these expectations to entities providing banking services to money services businesses. On February 3, 2006, we published guidance to reinforce and clarify the registration requirements for money services businesses.

*Question.* Now that more than 4 years have passed since the registration requirement became effective, how many MSBs have been penalized for non-registration or failure to register?

*Answer.* To date, we have not penalized a money services business for failure to register under the Bank Secrecy Act. However, we have supported efforts by the Internal Revenue Service (IRS) to upgrade its Bank Secrecy Act (BSA) examination capabilities by providing revisions to the IRS examination manual for non-bank financial institutions, and by providing instruction on risk-based examination procedures at IRS examiner training programs. We believe that these efforts are beginning to show positive results. During fiscal year 2005, the IRS conducted examinations of 3,700 entities for compliance with the BSA, including registration. Furthermore, since July 28, 2005, the Office of Compliance at FinCEN referred 27 suspected unregistered money services businesses to the IRS's Small Business/Self-Employed Division for possible examination.

FinCEN has, however, recently penalized a money services business for violating various provisions of the Bank Secrecy Act. On May 9, 2006, FinCEN issued a civil money penalty in the amount of \$10,000 against a money services business located in Tampa, Florida. FinCEN determined that this money services business failed to develop and implement a written anti-money laundering program reasonably designed to ensure compliance with the Bank Secrecy Act which led, in turn, to a failure to file 80 currency transaction reports. In fact, the money services business had a zero currency transaction reporting compliance rate during the period of the BSA deficiencies.

*Question.* How has the registration program for MSBs enhanced FinCEN's ability to identify potential terrorist financing, money laundering, and other financial crimes?

*Answer.* The registration requirement is one of many Bank Secrecy Act (BSA) requirements that enables FinCEN to further its mission of safeguarding the financial system from abuses of financial crime, including terrorist financing, money laundering and other illicit activity. The registration requirement facilitates transparency and critical identifying information about the thousands of money services businesses operating in the United States, including readily available information on agent outlets of the major money service business companies. In cases involving non-compliant money services businesses, we can compel immediate corrective action with registration. In cases involving egregious or willful failure to register under the BSA, we can seek and impose appropriate remedies.

As a natural by-product, the registration requirement also enables banks, which money services businesses must eventually use, to gauge the level of knowledge and compliance with the anti-money laundering and terrorist financing provisions of the

BSA. Upon discovery of suspected criminal activity or non-compliance with the BSA by money services business customers, banks can file suspicious activity reports to enable law enforcement and regulatory agencies to respond appropriately.

CAN THE PRESIDENT'S NEW COMMUNITY DEVELOPMENT PROGRAM FILL THE ROLE OF CDFI FUND?

*Question.* Secretary Snow, you mention in your opening statement that the President is only requesting \$7.8 million for the Community Development Financial Institutions (CDFI) Fund, which was funded at \$55 million last year. The funding that the President is requesting will only support the New Markets Tax Credit program. The other CDFI Fund activities he proposes to consolidate with other community development programs as part of the Strengthening America's Communities Initiative (SACI). As you know, the President made a similar proposal last year, which the Congress rejected.

The other programs within the CDFI Fund are critical in bringing financial services and private investment into underserved communities. For every dollar that the Federal Government spends, these CDFIs are able to attract \$20 in private sector investment. These funds are used to support programs that help support the creation of small businesses, assist with homeownership, even bring ATMs to communities. In my home State of Washington, one CDFI, the Cascadia Revolving Loan Fund has used grant money to increase its capacity and support innovative programs like their Child Care Fund which offers financing and technical assistance to child care providers so that they can open their own child care centers and bring quality child care to these communities.

Since the CDFI Fund helps to bring capital and financial services to communities and individuals that traditional banks view as too risky, how will the President's proposed community development program specifically address this need for access to financial institutions in underserved communities?

*Answer.* The proposed Strengthening America's Communities Initiative (SACI) for fiscal year 2007 differs substantially from the fiscal year 2006 SACI envisioned model. Last year, 18 community and economic development programs, which included three of the CDFI Fund's monetary award programs and the Department of Housing and Urban Development's Community Development Block Grant (CDBG) Program, among others, were to be consolidated under the aegis of the Department of Commerce. This proposal was rejected by Congress.

The fiscal year 2007 SACI proposal has the CDBG Program remaining at HUD with revised eligibility criteria; with the exception of the Economic Development Administration, all of the other community and economic development programs have been zeroed out with no new program funding (or substantially reduced funding) and no planned program transfers to HUD or the Department of Commerce.

Thus, the President's proposed fiscal year 2007 budget eliminates the Fund's three monetary award programs and provides \$7.8 million to administer only the NMTC Program and the portfolio of existing awards.

*Question.* Instead of developing a new program to serve this purpose, wouldn't it make more sense to continue one that is successful in meeting these needs?

*Answer.* While there are numerous community development programs, we believe a more focused SACI program would provide better results to individuals and communities.

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QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

THE NATIONAL DEBT

*Question.* In my opening statement, I talked briefly about the ramifications of the massive amount of our national debt that is currently held by foreign governments. I alluded to the fact that I wanted to talk a bit more about China in particular. Here's why: according to the Associated Press, earlier this week a vice chairman of China's parliament suggested that China should stop buying U.S. Treasuries and should take steps to reduce its holdings in those bonds.

Mr. Secretary, if foreign governments start dumping our debt, won't that destabilize our economy? Won't that destabilize the whole international financial system, which for years now has relied upon American demand to fuel economic growth? What do you think will happen if China starts selling?

*Answer.* The market for Treasury securities is large, liquid, and deep. China could reduce its rate of accumulating Treasury securities, even substantially, without significantly affecting U.S. financial markets. Despite recent large purchases, China's holdings of Treasury securities are still modest relative to the size of the market.

China's holdings of Treasury securities are estimated to be 7.8 percent of the \$4.1 trillion in Treasury securities not held by U.S. Government and Federal Reserve accounts at the end of March.

Chinese investors bought around \$98 billion in Treasury securities to their portfolios in the 12 months through March 2006. This is around \$400 million per trading day. The daily turnover in the Treasury market is over \$500 billion. The Chinese authorities have subsequently stated that they do not plan to change the proportion of U.S. Treasury securities purchased for or held in their foreign reserves.

In this regard, it is notable that net purchases of U.S. securities by all foreign official institutions have declined substantially from the peak year 2004 without exerting a significant influence on U.S. financial markets. Foreign official purchases of long-term reached \$236 billion in 2004, before falling to \$111 billion in 2005.

#### THE TAX GAP

*Question.* Mr. Secretary, it's tax time. As my constituents in Illinois are racing to get their taxes filed before the deadline in a couple of weeks, good people assume that they should pay their taxes because it is the right thing to do, because everyone needs to do their part. But in 2001, an estimated \$353 billion in Federal revenues has been lost because some people decided not to pay or to underpay their taxes. That works out to \$16 out of every \$100 owed. This so-called "tax gap" has likely gotten even worse since 2001.

I don't think that Treasury should make it their mission to track down every last dollar owed to the government, because that is too expensive for the government to do that and would lead to unnecessary hassling of good, honest families that are trying their best to pay their taxes correctly. But \$353 billion is a big, big number. We simply have too much debt outstanding to ignore this problem.

What is Treasury going to do to close this gap?

*Answer.* Our tax gap estimates are derived from a National Research Program (NRP) study of Tax Year 2001 individual income tax returns. The final estimates from that study showed that the gross tax gap was \$345 billion while the net tax gap, what's left after enforcement and late payment collection, is \$290 billion. This is a voluntary compliance rate of 83.7 percent.

The IRS is committed to increasing the voluntary compliance rate to 85 percent by 2009 and is taking several steps to achieve this goal. First, and perhaps most importantly, the IRS must continue the balanced approach of emphasizing both service and enforcement as the best means to achieve compliance. From a service perspective, the IRS is increasing its focus on electronic tax administration. Large businesses and large tax exempt organizations are already required to e-file. In the most recent filing season, over 70 million individual taxpayers filed their returns electronically. This number rises every year. E-filing is a win-win for both the taxpayer and the IRS. For the taxpayer, there is less chance of error on a return prepared and filed electronically. Plus, the taxpayer receives a quicker refund and a notice that the return has been received. For the IRS, the marginal cost for an e-file return is \$0.28 as compared to \$2.65 for paper returns. This cost savings allows the IRS to re-direct resources to other areas.

IRS is also putting in place a Taxpayer Assistance Blueprint, an ambitious program designed to improve the overall level of service provided to taxpayers.

From an enforcement perspective, IRS is making good use of the additional \$442 million included in the fiscal year 2006 IRS budget for enforcement. It is focusing those resources to maximize the use of each dollar dedicated to enforcement. Specifically, the IRS is:

- Increasing the coverage of high-risk compliance issues to address the largest portion of the tax gap—the underreporting of tax—across all major compliance programs;
- Looking at complex high-risk issues in abusive tax avoidance transactions, promoter activities, corporate fraud and aggressive transactions, all resulting in increased corporate and high income audit coverage;
- Improving our ability to identify compliance risks within the tax exempt communities; and
- Leveraging our resources with those of the States to address common tax gap issues such as more timely data matching, increased use of State data for IRS enforcement actions and the development of complementary Federal/State enforcement strategies based on the NRP data.

Second, the IRS is trying to find ways to increase third party information reporting. This will allow the IRS to match what a third party reports with what the taxpayer reports on his or her income tax return. The NRP study showed that there is a high correlation between items subject to information reporting systems and

taxpayers' reporting of such items on their tax return. Where there is no third party reporting, the compliance rate drops dramatically. As a result, it is incumbent on us to find ways to increase information reporting that will not overly burden either the taxpayer or the entity that is required to report. A good example of this is the proposal in the President's fiscal year 2007 budget to require reporting of aggregate payment card reimbursements made to retail merchants each year. This will allow the IRS to match payments made to retail merchants by a payment card issuer to what the merchant reports as income on his or her income taxes.

Third, we must become more efficient in resource utilization. One of the benefits of the NRP study is that it will allow us to refine our audit selection formulas for several examination classes. In addition, these formulas will help us better calibrate the resources in our various business units so they can operate more efficiently and impose less of a burden on compliant taxpayers. We do not have the resources to return to the high audit rates of the past, but we are using the NRP results to manage our compliance programs more effectively and to design pre-filing activities that help taxpayers comply with the law.

Fourth, we need to change the law in several critical areas. I have already mentioned the legislative proposal in the President's fiscal year 2007 proposed budget to require payment card issuers to report aggregate payments made to retail merchants. There are four other specific legislative proposals included in the President's fiscal year 2007 proposed budget designed to reduce the tax gap also included. They are:

- Clarify the circumstances in which employee leasing companies and their clients can be held jointly liable for Federal employment taxes;
- Expand information reporting to certain payments made by Federal, State and local governments to procure property and services;
- Amend Collection Due Process procedures for employment tax liabilities; and
- Expand to non-income tax returns the requirement that paid return preparers identify themselves on such returns and expand the related penalty provision.

In conclusion, it is safe to say that substantial reductions in the tax gap will only be achieved through fundamental reform and simplification of the tax laws. Achieving significant reductions, absent such reform, would necessitate draconian measures that would involve the IRS in the lives of taxpayers in ways that they would never accept. But we can and will make improvements in the mean time as embodied in our goal of 85 percent compliance by 2009.

#### WORKER MISCLASSIFICATION

*Question.* Mr. Secretary, I am concerned with how many contractors currently misclassify their workers as independent contractors rather than employees. Contractors do this so they have no responsibility for the withholding of State, Federal, and social security taxes from employee's paychecks, as that responsibility rests on the worker. These contractors gain an additional competitive advantage in that they avoid all the insurance costs of having employees.

Workers are then paid in cash by the contractor, and all too often, the worker does not declare any income, and does not pay any of the required taxes. The loss of tax revenues has been estimated at over \$400 billion per year.

Not only is this misclassification issue shortchanging various State and Federal agencies, and therefore the general public who relies on programs such as social security and Medicare, but it is putting honest contractors and honest workers out of business. The cheating contractors can do business at 24 percent less cost than honest contractors, and honest contractors and workers have a hard time competing for jobs.

In my home State of Illinois, this is a growing problem that has to be addressed immediately. From the years 2001–2004, State of Illinois Audits found that 17.3 percent of Illinois employers audited had misclassified workers as independent contractors. In 2004 alone, the rate of misclassification was 21 percent—67,745 employers statewide and 7,478 in construction. This results in \$158 million in lost income tax in Illinois alone in 2004, \$18 million of which is lost from the construction sector.

Are you aware of this misclassification issue? If so, are you planning on stepping up enforcement efforts to catch the cheats who game the system at the cost of the general public and honest contractors?

Answer. Misclassification of workers has been a long-standing issue for the Internal Revenue Service (IRS).

There is currently no estimate for the portion of the tax gap attributable to misclassification of workers, however, we believe it is significant. The portion of the tax gap attributable to employment taxes is estimated to be \$54 billion. Of the Fed-

eral tax gap, \$109 billion is attributable to underreporting of business income. Schedule C income, which is subject to little or no third-party reporting or withholding, has a net misreporting percentage of 57.1 percent. This includes the misclassification of workers. As you can surmise, noncompliance with Federal employment tax laws also affects State budgets, State unemployment compensations funds, and Workman's Compensation pools.

It is important to note that the misclassification of workers can run the gamut from employers who are just not aware of their employment tax requirements to intentional noncompliance.

We are planning on stepping up enforcement in this area. The IRS has increased its efforts over the past few years to address the employment tax gap. In fiscal year 2005, 33,748 employment tax returns were examined, an increase of 85 percent compared to fiscal year 2004. Worker classification issues were raised in approximately 2,400 of these examinations. Our work plans for fiscal year 2006 called for increasing employment tax examinations of which approximately 5,800 will address worker classification issues. We are currently increasing our Employment Tax staff which will allow us to perform additional work in the future.

The most egregious worker classification issues are identified through the Employment Tax Worker Classification Examination Program which identifies employers who may be misclassifying workers based on filing of Forms 1099.

Additionally, several other initiatives are in process to address the misclassification issue including:

- The Social Security Administration (SSA) processes corrections to individual earnings records (including situations where earnings are missing from the record). Each week, SSA refers a listing of workers whose earnings have been corrected to the IRS. Some of the employers identified did not file income tax or employment tax returns, and further investigation often reveals the employers paid the workers in cash and also did not file Forms 1099-MISC.

- As the Administrator of the Bank Secrecy Act (BSA), the Financial Crimes Enforcement Network (FinCEN) requires depository institutions and other industries vulnerable to money laundering to file Currency Transaction Reports (CTRs) which report cash transactions of \$10,000 or more. Acting as FinCEN's agent under the BSA, these reports are transferred to the IRS Detroit Computer Center and entered into a database called the Currency and Banking Retrieval System (CBRS) which is accessed by FinCEN's law enforcement customers. The IRS also uses FinCEN's BSA data to identify employers who cash large checks in a pattern consistent with using the money to fund employee cash payrolls or pay incorrectly classified workers in cash with little or no accounting thereof. We are increasing the number of audits we conduct based on this information in fiscal year 2007.

We have also used IRS databases to compare wage and labor deductions on business returns with corresponding employment tax return filings. Where the appropriate employment tax returns are not filed, an employment tax examination is considered with a potential worker classification issue. We are planning an increase in these audits in fiscal year 2007 as well.

Workers who feel they should be classified as employees can file Form SS-8, Determination of Worker Status, with the IRS. After an exchange of information with the employer, the IRS makes a determination of worker status and refers the more egregious employers to the field for possible examination. In the past 3 years, workers filed more than 17,000 Forms SS-8. This is a source of worker misclassification cases that we use to identify employers for examination.

We also have misclassification cases under investigation as part of our emphasis on abusive transactions and abusive schemes. As an example, we have identified a corporation that targets other client companies and assists them, for a fee, in converting all their employees to independent contractors.

#### ENFORCEMENT PRIORITIES

*Question.* Mr. Secretary, let's discuss the law enforcement that Treasury conducts for a moment. I'm told that a professor and a graduate student from Southern Illinois University were recently targeted for scrutiny by your Office of Foreign Assets Control because they were going to travel to Cuba. I presume that these two individuals were singled out for scrutiny because they also happen to be public officeholders in Illinois, but they were traveling under the Cuba license that SIU has held since 2000.

I don't expect you to have intimate knowledge of every case that Treasury investigates, but I do want to ask you about your enforcement priorities.

Shouldn't Treasury and all of its offices be focusing more on chasing terrorists, and focusing less on harassing pre-approved university travelers to Cuba? Do you believe that Treasury's enforcement resources are being allocated properly right now?

Answer. Please be assured that Treasury allocates its investigatory and enforcement resources according to national security priorities established by the administration. Terrorism is, by everyone's measure, the No. 1 priority. Although OFAC does not comment on open investigations, it is important to keep in mind that each license carries with it specific requirements including who may and may not be included on delegations traveling to Cuba. When OFAC becomes aware of potential violations, it investigates and, if warranted, takes appropriate action to address the situation.

FinCEN's administration of the Bank Secrecy Act also ensures the proactive filing of suspicious activity reports involving potential terrorist financing. As evidenced by FinCEN's \$24 million civil money penalty against Arab Bank in August 2005, financial institutions that fail to report suspicious transactions involving potential terrorist financing, which can be so critical to assisting authorities in their efforts to identify and prevent terrorist acts and disrupt terrorist networks, are subject to severe sanctions.

#### PERFORMANCE MEASURES

*Question.* I've been interested for quite some time in making sure that we are doing everything we can to stop the flow of financial support that terrorists rely upon in order to wreak their havoc. As you know, last year the GAO completed a report which Senate Finance Committee Chairman Grassley and I requested, along with Senate Homeland Security and Governmental Affairs Chairman Susan Collins, to analyze the effectiveness of U.S. Government efforts to combat these terrorism financial networks. The GAO report made several strong recommendations for where the government should try to improve. I'd like to discuss two of those recommendations today.

First, I think that if we can measure success appropriately then we will target our efforts more efficiently. The GAO report recommended that strong performance measures be put in place so that we can better assess how well we are doing in disrupting terror financing. I recognize that this is not an easy thing to measure, but nonetheless we need some benchmarks by which we can judge our progress in rooting out these money networks.

After I wrote to the Treasury to ask about this last fall, I received a response from an Assistant Secretary a couple of weeks ago that stated that the Office of Foreign Assets Control had finished developing performance measures . . . but then he gave no indication of what those measures were.

How do you plan to measure your success in disrupting the financing of terrorism?

Answer. OFAC will measure the impact of Terrorism, Proliferators of Weapons of Mass Destruction, and Narco-Trafficking sanctions programs as high, medium or low impact. For this outcome performance measure, developed in conjunction with Treasury's Office of Strategic Planning and submitted in connection with the Performance and Accountability Report, impact is measured by their effectiveness in identifying, exposing, isolating, impeding, and/or incapacitating the targets (micro and macro) of the sanctions program as demonstrated by, but not limited to, the presence or absence of the following, types of actions:

- Facilitation of law enforcement activity (domestic or foreign);
- Facilitation of intelligence collection by intelligence community;
- Response by the international financial community—voluntary compliance;
- Response by the international business community—voluntary compliance;
- Response by the targets (e.g. attempts to evade sanctions, attempts to restructure organization, etc.);
- Response by foreign governments;
- Response by other government agencies;
- Effectiveness of public exposure;
- Deterrent effect of threat of further action; and
- Impact on targeted network.

#### AGENCY COOPERATION

*Question.* The GAO report also criticized Treasury, State, Justice, and other governmental departments for not working in a more coordinated fashion to fight terrorism funding. The report suggested that Treasury does not accept the idea that the State Department should lead this fight, nor does Treasury accept the proce-

dures recommended by the State-led Terrorist Finance Working Group in delivering training and technical assistance abroad.

In the departmental responses to the GAO, Treasury, State, and the other agencies seemed to reject the idea that there was a problem in coordinating our efforts to monitor, track, and eliminate sources of terrorist financing. Please explain to me how Treasury and the other agencies have improved their coordination in these areas and in implementing the procedures recommended by the State-led Terrorist Finance Working Group in delivering training and technical assistance abroad.

Answer. The fight against terrorist financing is among Treasury's highest priorities. Treasury works closely with our partners in the interagency community and our counterparts abroad to ensure that vulnerabilities in the international financial system are closed to terrorists and terrorist financing networks are disrupted and dismantled. Though there is always more that can and must be accomplished, we believe that the U.S. Government's achievements in the fight against terrorist financing have been considerable, as reflected by the "A-" issued to the U.S. Government in the area of terrorist financing in the 9/11 Commission's "Final Report Card on 9/11 Commission Recommendations." The positive assessment is the result of all agencies within the U.S. Government working together and cooperating closely.

The referenced GAO report does not focus on the fight against terrorism funding broadly, but rather is limited to an examination of interagency coordination on the provision of technical assistance related to terrorist financing to certain priority countries. This is a small, though vitally important, component of the U.S. Government's broad counter-terrorist financing efforts. The GAO correctly notes that there can be improvement in the way that the State Department—which has the lead in the provision of technical assistance—and agencies such as the Treasury Department—which has technical expertise in this area—interact and coordinate with each other. Since the publication of the GAO report, considerable effort is underway, both within Treasury and throughout the interagency community, to improve this process. For example, under State Department leadership, the Training and Assistance Sub Group (TASG)—a senior-level interagency group dedicated to overseeing the provision of counterterrorism technical assistance—has been reinvigorated in order to provide enhanced oversight and guidance to the State-led Terrorist Finance Working Group (TFWG). Moreover, more senior representatives have been assigned to the TFWG itself to ensure that it is functioning efficiently. We will continue to work both within Treasury and through the interagency community to improve the coordination and delivery of technical assistance in this vital area.

#### SUBCOMMITTEE RECESS

Senator BOND. I thank you for coming here today, and you can be sure that we will be continuing to work with you, following your activities, helping where we can, and commenting where needed.

With that, my sincere thanks to the witnesses. The hearing is recessed.

Mr. LEVEY. Thank you, Mr. Chairman.

[Whereupon, at 11:03 a.m., Thursday, April 6, the subcommittee was recessed, to reconvene subject to the call of the Chair.]



**DEPARTMENTS OF TRANSPORTATION, TREASURY, THE JUDICIARY, HOUSING AND URBAN DEVELOPMENT, AND RELATED AGENCIES APPROPRIATIONS FOR FISCAL YEAR 2007**

THURSDAY, APRIL 27, 2006

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

The subcommittee met at 9:35 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Christopher S. Bond (chairman) presiding.

Present: Senators Bond, Murray, Durbin, and Dorgan.

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

STATEMENTS OF:

MARK W. EVERSON, COMMISSIONER  
RAYMOND T. WAGNER JR., CHAIRMAN, IRS OVERSIGHT BOARD  
J. RUSSELL GEORGE, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

ACCOMPANIED BY:

DAVID A. POWNER, INFORMATION DIRECTOR, GOVERNMENT ACCOUNTABILITY OFFICE  
JAMES WHITE, DIRECTOR, STRATEGIC ISSUES, GOVERNMENT ACCOUNTABILITY OFFICE

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Good morning. The Subcommittee of the Senate Transportation, Treasury, the Judiciary, HUD, and Related Agencies, Appropriations will come to order.

This is the budget hearing on the fiscal year 2007 budget for the Internal Revenue Service. We have a very distinguished panel of witnesses today. I welcome back IRS Commissioner Mark Everson. I also welcome Ray Wagner, Chairman of the IRS Oversight Board; Nina Olson, the National Taxpayer Advocate, and I believe that Russell George, Treasury Inspector General for Tax Administration will be joining us shortly.

I also note that the Government Accountability Office has submitted a statement for the record at my request and has sent two senior officials to answer any questions during the hearing, and we appreciate that. GAO has served us extremely well, especially with

their detailed reviews and oversight of the IRS Business Systems Modernization program.

Before I begin my formal comments, personally I thank all of the witnesses today for their service and commitment to the IRS. The IRS is probably one of the least appreciated Federal Agencies, but it is definitely one of the most important to the functioning of our Government and the payment of our salaries. I would add as a personal note, as for those who would wish to take my questions and comments out of context and suggest that I am opposed to the IRS or question its leadership, let me be clear. We had our hearing 3 weeks ago on the Treasury, and I commended Secretary Snow for doing an excellent job, but in the course of our questions, as we do in all agencies, we asked them about problem areas, and we are here, my distinguished ranking member and I, not only to commend what is going on, but to find out how we can help in areas where additional resources are needed.

So we will be asking tough questions because there are many challenges in this area, and we want to be as supportive of Commissioner Everson and the people who assist him in their roles today, and I want that known for the record.

The tax filing deadline ended 10 days ago. So we will be able to review some of the preliminary results of the IRS performance for this tax filing system. We will also focus on the agency's efforts and plans in addressing the so-called tax gap. I look forward to all the witnesses' views on these issues and their suggestions on how we can improve taxpayer compliance.

To the IRS credit, the Service continues to improve its tax administration performance. Based on preliminary results from the current filing season, returns processing has been smooth and taxpayers are receiving refunds without too many problems. Electronic filing is growing. More taxpayers are turning to the IRS website for information. Telephone service has improved. The accuracy of IRS responses to tax law and accounting questions has improved. Compared to the 1990's, the IRS has come a long way in its service delivered to taxpayers and to the people of the United States.

On the enforcement front, IRS has made major strides. Enforcement revenue over the past 5 years has increased by \$13.5 billion from \$33.8 billion to \$47.3 billion, or almost 40 percent. The IRS has accomplished these results by stepping up audits, combating illegal and abusive tax shelters, and increasing criminal convictions. These actions are very positive not only deterring taxpayers from cheating, but in increasing honest taxpayers' confidence in the Government.

There are, however, some troubling signs. Electronic filing is growing at a slower pace compared to previous years, and the IRS will not meet the congressionally mandated goal of 80 percent of taxpayers E-filing by 2007. The IRS continues to be overly dependent upon an antiquated system which will limit both service and enforcement capabilities, and most troubling is the tax gap does not appear to be shrinking. Some believe that the tax gap may be actually higher than projected.

The gap, which is the difference between what taxpayers timely and accurately pay in taxes and what they should pay under the law, not only creates an unfair burden on taxpayers who volun-

tarily and honestly pay their taxes, but also hurts our Nation's fiscal stability for our future generations. I would urge everyone to read the Comptroller General's February 15 testimony before the Senate Budget Committee. I think the CG did a commendable job of putting the tax gap in context of our Nation's fiscal health. While most of the attention on our fiscal health is on discretionary spending or tax cuts in the economy, the CG adds that we cannot ignore the tax gap. He concludes that while our long-term fiscal imbalance cannot be eliminated with a single strategy, reducing the tax gap is one approach that could help address the looming fiscal challenge facing the Nation, closed quote, and I agree with that assessment.

The views of the CG should be more than sobering. They should energize us to attack the tax gap because it is about good Government. The Government has a moral obligation in punishing those who unfairly burden honest citizens who voluntarily pay their taxes as their civic duty. It is also about our future. The consequence of a persistent tax gap hurts our long-term fiscal and economic health. It harms our children's future and the future of the children's children, and ultimately their future will be directly impacted by the actions we take today in addressing the tax gap.

Closing the entire tax gap is not realistic, but there is not any reason, there is no excuse, not to dedicate ourselves to attacking this problem and lessening the tax gap. Even small or moderate reductions will yield significant results. Even a 1 percent reduction in the tax gap could yield some \$3 billion annually. The administration has set a very laudable goal in addressing the tax gap to increase voluntary compliance to 85 percent by 2009. I support this goal, but 85 percent should be a floor. We need a detailed plan. So today, I will direct the IRS to work with the IRS Oversight Board, the National Taxpayer Advocate, and other important stakeholders to develop a plan to achieve this goal by 2009 and to quantify the amount by which this will reduce the gap.

To achieve any reduction in the tax gap, multiple strategies will be required, such as simplifying the tax code, which I happen to believe is a compelling overwhelming need, conducting more sustained research, obtaining better data on noncompliance, improving taxpayer service, enhancing enforcement, and leveraging technology. I support all of these strategies, but I recognize that some of these strategies require additional resources. Therefore, it is through the lens of the tax gap that we scrutinize the budget request before us today. To say that I am disappointed in what came out of OMB would be an understatement.

In terms of the 2007 budget request, the administration proposes some \$10.6 billion for the IRS. This budget request is an increase of \$18.1 million or 0.2 percent above the 2006 enacted level. The request, however, contains a number of budget assumptions that pose significant risks to the IRS. Some might even call them a slight of hand. Specifically, it assumes \$135 million in new user fees, some \$121 million in savings through program efficiencies, and \$137 million in budget cap adjustment. There is some merit to these ideas, but if these assumptions are not attained, the IRS would face a cut of some \$240 million from the fiscal year 2006 en-

acted level, and to be blunt, I question whether these assumptions are realistic and that the bases can be achieved.

Moreover, even if the IRS attains savings in new fees, the GAO calculates that the budget request is still a small decrease compared to the 2006 enacted level after adjusting for expected inflation. In fact, the GAO notes that the budget request would result in staffing cuts to both service and enforcement.

The budget request cuts the IRS Business Systems Modernization program by \$30 million or 15 percent. I will be the first to admit that the BSM has had challenges and risks; however, cutting this program by 15 percent when the IRS continues to be highly dependent upon systems from the dark ages makes no sense to me. From my young sports car enthusiasts, I have heard that it is equivalent to running a Formula One race with a Ford Pinto. I strongly believe that the BSM should be the IRS's top priority due to its impact on service and enforcement and ultimately in reducing the tax gap. GAO noted the reduction to the BSM "could delay delivery of improved services for taxpayers." Further, the IRS team, led by a very competent Associate CIO, has begun to make real progress on BSM. For example, the new Customer Account Data Engine System processed over 6 million returns and dispersed 5.3 refunds this year without disruptions and faster than under the old system. Cutting BSM greatly damages the momentum built up over 2 years. To me, cutting the BSM is equivalent to punishing good behavior.

Frankly, I question cutting any part of the IRS budget. The IRS needs more resources. It needs more resources for taxpayer services. It needs more resources for enforcement. It needs more resources for system modernization.

In terms of taxpayer services, this budget request cuts these activities by some \$85 million from the 2006 enacted level without assuming new user fees. While I do not object to the IRS retaining user fees for their activities, using them to offset direct appropriations is not appropriate in my view. The IRS has made significant improvements in taxpayer services over the past several years, but some services may be in peril. Since 2004, IRS taxpayer services have been cut by \$180 million, or 4.8 percent. While these cuts have not appeared to impact performance, IRS officials have cautioned that, "the agency cannot continue to absorb reductions in taxpayer service without beginning to compromise some services".

Now, all the witnesses here today have acknowledged that improving taxpayer service is a key component of reducing the tax gap. GAO believes that, "providing quality services to taxpayers is an important part of any overall strategy to improve compliance and thereby reduce the tax gap".

Over the past year, IRS has forwarded a number of cost-cutting proposals to its taxpayer service programs; however, stakeholders and auditors have raised questions about these proposals. For example, TIGTA reviewed the IRS analysis behind its proposal to close 68 walk-in taxpayer assistance centers and found that the IRS lacked accurate and complete information on its centers, which hindered the IRS's ability to make appropriate decisions when determining locations and services it provides to taxpayers seeking assistance.

In addition, the IRS has justified some of its proposed cuts where programs' reduced usage of service was caused by the IRS's own policies. For example, the IRS established guidelines to reduce tax return preparation in the taxpayer assistance centers by 20 percent.

Another example is the Electronic Tax Law Assistance, or ETLA, feature on the service's website. GAO reported that usage of this program has declined apparently by design. Specifically, the GAO found that the IRS purposely moved the ETLA feature to a less prominent position on the website and found that, "in its current location, IRS does not expect taxpayers to be aware of the ETLA feature unless they stumble on it accidentally". Because of these actions, the reduction in demand and usage of these particular programs becomes a self-fulfilling prophecy.

The IRS must provide an accurate analysis of any reductions to ensure that taxpayer compliance and its effort to reduce the tax gap are maximized, especially as the tax code gets more and more complicated. IRS believes the tax gap includes, "a significant amount of noncompliance due to the complexity of the tax law that results in errors of ignorance, confusion, and carelessness". For those of you old enough to remember the cartoon strip Pogo, I believe it was his famous words that "we have met the enemy, and he is us", and that is Congress.

The IRS repeatedly and justifiably touts the success of its E-filing service on its website with such tools as "Where is my refund?". However, I fear that taxpayers will begin to ask "Where is my service?"

In addition to my concerns about the budget request, I raise concerns about the IRS privacy rule on section 7216 of the tax code and the recent problems identified with the "Free File" program.

In terms of the IRS proposed regulations on disclosure and use of taxpayer information, there are concerns, legitimate concerns, about taxpayer privacy being compromised by the proposed regulations. Some of these concerns seem to be based on misunderstandings whereas others are legitimate issues regarding the disclosure of confidential taxpayer information. This is a complex issue with a number of land mines. As a result, many in Congress, including the Senate Finance Committee, thankfully, are examining the proposed rule and the underlying statute to address taxpayer privacy concerns. I look forward to the wise guidance of the Finance Committee and hope that the Treasury and IRS can balance the needs and problems to ensure that maximum confidentiality of all taxpayer information to the extent possible is under the current statute, but given the limitations under the current statute, additional legislative action may be needed to resolve these concerns.

#### PREPARED STATEMENT

In terms of Free File, I am concerned that fewer taxpayers are using the program, which is impacting the overall number of E-filings. One possible solution that Senator Grassley and others have suggested is the creation of a direct electronic filing portal through the IRS website. I think that idea has merit and I ask the wit-

nesses to look into that matter and we will be happy to discuss it with them.

It is now my pleasure to turn to my colleague and ranking member, Senator Murray, for her statements and comments.

[The statement follows:]

PREPARED STATEMENT OF SENATOR CHRISTOPHER S. BOND

The subcommittee will come to order. This morning, the Senate Transportation, Treasury, the Judiciary, HUD, and Related Agencies Appropriations Subcommittee will conduct its budget hearing on the fiscal year 2007 budget for the Internal Revenue Service. We have a distinguished panel of witnesses here today. I welcome back the IRS Commissioner Mark Everson to the hearing. I also welcome Ray Wagner, the Chairman of the IRS Oversight Board; J. Russell George, the Treasury Inspector General for Tax Administration; and Nina Olson, the National Taxpayer Advocate. I also note that the Government Accountability Office has submitted a statement for the record at my request and has sent two senior officials to answer any questions during the hearing. GAO has served us extremely well, especially with their detailed reviews and oversight of the IRS's Business Systems Modernization program.

Before I begin my formal comments, I personally thank all of the witnesses today for their service and commitment to the IRS. The IRS is probably one of the least appreciated Federal agencies but is definitely one of the most important to the functioning of our government.

The tax filing deadline ended 10 days ago, so today we will be able to review some of the preliminary results of the IRS's performance for this tax filing season. We also will focus on the agency's efforts and plans in addressing the so-called "tax gap." I look forward to all the witnesses' views on these issues and their suggestions on how we can improve taxpayer compliance.

To the IRS's credit, the IRS continues to improve its tax administration performance. Based on preliminary results from the current filing season, returns processing has been smooth and taxpayers are receiving refunds without too many problems. Electronic filing is growing. More taxpayers are turning to the IRS website for information. Telephone service has improved. The accuracy of IRS's responses to tax law and account questions has improved. Compared to the 1990's, the IRS has come a long way in service.

On the enforcement front, the IRS has made major strides. Enforcement revenue over the past 5 years has increased by \$13.5 billion—from \$33.8 billion to \$47.3 billion—or by almost 40 percent. The IRS has accomplished these results by stepping up audits, combating illegal and abusive tax shelters, and increasing criminal convictions. These actions are very positive in not only deterring taxpayers from cheating, but in increasing honest taxpayers' confidence in government.

There are, however, some troubling signs. Electronic filing is growing at a slower pace compared to previous years and the IRS will not meet the congressionally-mandated goal of 80 percent of taxpayers e-filing by 2007. IRS continues to be overly-dependent upon antiquated systems, which limits both service and enforcement capabilities. And most troubling is that the tax gap does not appear to be shrinking. Some believe that the tax gap may actually be higher than projected.

The tax gap—the difference between what taxpayers timely and accurately pay in taxes and what they should pay under the law—not only creates an unfair burden on taxpayers who voluntarily and honestly pay their taxes but also hurts our Nation's fiscal stability for our future generations. I urge everyone to read the Comptroller General's February 15, 2006, testimony before the Senate Budget Committee. I believe the CG did a commendable job in putting the tax gap in context of our Nation's fiscal health. While most of the attention on our fiscal health is on discretionary spending or tax cuts or the economy, the CG adds that we cannot ignore the tax gap. He concludes that while "our long-term fiscal imbalance cannot be eliminated with a single strategy, reducing the tax gap is one approach that could help address the looming fiscal challenges facing the nation." I agree.

The views of the CG should be more than sobering. They should energize us to attack the tax gap because it is about good government. The government has a moral obligation in punishing those who unfairly burden honest citizens who voluntarily pay their taxes as their civic duty. It is also about our future. The consequences of a persistent tax gap hurt our long-term fiscal and economic health. It harms our children's future and the future of our children's children. And ultimately, their future will be directly impacted by the actions we take today in addressing the tax gap.

Closing the entire tax gap is not realistic but this is no excuse to not dedicate ourselves to attacking this problem. Even small or moderate reductions in the tax gap will yield significant results. For example, even a 1 percent reduction in the tax gap would yield some \$3 billion annually. The administration has set a very laudable goal of addressing the tax gap by setting a goal to increase voluntary compliance to 85 percent by 2009. I support this goal but 85 percent should be a floor. However, we need a detailed plan. So today, I direct the IRS to work with the IRS Oversight Board, the National Taxpayer Advocate, and other important stakeholders to develop a plan to achieve this goal by 2009 and to quantify the amount by which this will reduce the tax gap.

To achieve any reduction in the tax gap, multiple strategies will be required such as simplifying the tax code, conducting more sustained research, obtaining better data on noncompliance, improving taxpayer service, enhancing enforcement, and leveraging technology. I support all of these strategies. But, I recognize that some of these strategies require additional resources. Therefore, it is through the lens of the tax gap that we scrutinize the budget request before us today.

In terms of the fiscal year 2007 budget request, the administration proposes some \$10.6 billion for the IRS. This budget request is an increase of \$18.1 million or 0.2 percent above the fiscal year 2006 enacted level. The request, however, contains a number of budget assumptions that pose significant risks to the IRS. Specifically, it assumes \$135 million in new user fee revenues, some \$121 million in savings through "program efficiencies", and \$137 million in a budget "cap adjustment." There is some merit to these ideas. But, if these assumptions are not attained, the IRS will face a cut of some \$240 million from the fiscal year 2006 enacted level. And to be blunt, I question whether these assumptions will be achieved.

Moreover, even if the IRS attains these savings and new fees, the GAO calculates that the budget request is still a small decrease compared to the fiscal year 2006 enacted level after adjusting for expected inflation. In fact, the GAO notes that the budget request would result in staffing cuts to both service and enforcement.

The budget request cuts the IRS's Business Systems Modernization program by \$30 million or 15 percent. I will be the first to say that BSM has many challenges and risks. However, cutting this program by 15 percent when the IRS continues to be highly dependent upon systems from the dark ages makes no sense to me. It is equivalent to running a formula one race today with a Ford Pinto. I strongly believe that BSM should be the IRS's top priority due to its impact on service and enforcement and, ultimately, in reducing the tax gap. GAO noted that the reduction to BSM "could delay delivery of improved services for taxpayers." Further, the IRS team, led by a very competent Associate CIO, has begun to make real progress on BSM. For example, the new Customer Account Data Engine system processed over 6 million returns and dispersed 5.3 million refunds this year without disruptions and faster than under the old system. Cutting BSM greatly damages the momentum built up over the past 2 years. In other words, cutting BSM is equivalent to punishing good behavior.

Frankly, I question cutting any part of the IRS's budget. The IRS needs more resources. It needs more resources for taxpayer services. It needs more resources for enforcement. It needs more resources for systems modernization.

In terms of taxpayer services, this budget request cuts these activities by some \$85 million from the fiscal year 2006 enacted level without assuming the new user fees. While I do not object to the IRS retaining user fee revenues for their activities, using them to off-set direct appropriations is inappropriate. The IRS has made significant improvements in taxpayer services over the past several years. However, some of the services may be in peril. Since fiscal year 2004, IRS taxpayer service programs have been cut by some \$180 million or 4.8 percent. While these cuts have not appeared to have impacted performance, IRS officials have cautioned that "the agency cannot continue to absorb reductions in taxpayer service without beginning to compromise some services."

All of the witnesses here today have acknowledged that improving taxpayer service is a key component of reducing the tax gap. GAO believes that "providing quality services to taxpayers is an important part of any overall strategy to improve compliance and thereby reduce the tax gap."

Over the past year, the IRS has forwarded a number of cost-cutting proposals to its taxpayer service programs. However, stakeholders and auditors have raised questions about these proposals. For example, TIGTA reviewed the IRS's analysis behind its proposal to close 68 walk-in taxpayer assistance centers and found that the IRS lacked accurate and complete information on its centers, which hindered IRS's ability to make appropriate decisions when determining the locations and services it provides to taxpayers seeking assistance.

In addition, the IRS has justified some of its proposed cuts where a program's reduced usage of services was caused by the IRS's own policies. For example, the IRS established guidelines to reduce tax return preparation in the taxpayer assistance centers by 20 percent.

Another example is the Electronic Tax Law Assistance feature on IRS's website. The GAO reported that usage of this program has declined apparently by design. Specifically, the GAO found that the IRS purposely moved the ETLA feature to a less prominent position on the website. GAO found that "in its current location, IRS does not expect taxpayers to be aware of the ETLA feature unless they stumble upon it accidentally . . .".

Because of these actions, the reduction in demand and usage of these particular programs became a self-fulfilling prophecy.

The IRS must provide an accurate analysis of any reductions to ensure that taxpayer compliance and its efforts to reduce the tax gap are maximized, especially as the tax code gets more and more complicated. IRS believes that the tax gap includes "a significant amount of noncompliance due to the complexity of the tax laws that results in errors of ignorance, confusion, and carelessness." The IRS repeatedly and justifiably touts the success of its e-filing services and its web site with such useful tools as "Where's my refund?" However, I fear that taxpayers will begin to ask "Where's my service?"

In addition to my concerns about the budget request, I raise concerns about the IRS's privacy rule on section 7216 of the tax code and the recent problems identified with the "Free File" program.

In terms of the IRS's proposed regulations on disclosure and use of taxpayer information, there are concerns about taxpayer privacy being compromised by the proposed regulations. Some of these concerns seem to be based on misunderstandings whereas others are legitimate issues regarding the disclosure of confidential taxpayer information. This is a complex issue with a number of landmines. As a result, many in Congress, including the Senate Finance Committee, are examining the proposed rule and the underlying statute to address taxpayer privacy concerns. I am hopeful that the Treasury and the IRS can balance out the needs and problems to ensure the maximum confidentiality of all taxpayer information to the maximum extent possible under the current statute. But given the limitations under the current statute, some additional legislative action may be needed to resolve these concerns.

In terms of Free File, I am concerned that fewer taxpayers are using the program, which is impacting the overall number of e-filing. One possible solution that Senator Grassley and others have suggested is the creation of a direct electronic filing portal through the IRS web site. I think this idea has merit and request that all the witnesses look into at this matter.

I now turn to my colleague and ranking member, Senator Murray for her statement and any comments.

#### STATEMENT OF SENATOR PATTY MURRAY

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

Exactly 10 days ago, millions of taxpayers hurried to the Post Office to file their 2005 tax return right at the deadline. American taxpayers have come to expect certain things when it comes to the way their taxes are prepared, processed, and collected in this country. First, they expect honesty. They expect that, like themselves, the vast majority of their neighbors are paying what they owe and that the IRS is there to ensure that everyone pays his or her fair share.

Second, they expect integrity. They expect that their taxes will be processed correctly, especially if they have paid a tax preparation firm to do it for them.

Third, they expect privacy. They expect that the personal financial information that they share with the IRS will be kept private and will stay private whether it is in the hands of tax preparers or the IRS.

And, finally, they expect some help. They expect that if they need some help understanding the very complex tax code, the IRS will be there to assist them.

Those are all reasonable expectations. Unfortunately, today the IRS is falling short of meeting those expectations. Rather than everyone paying his or her fair share, it has become clear that we have a huge tax gap in this country—estimated at \$345 billion. That is the difference between the amount that the Americans owe and the amount that the IRS actually collects. Now, I want to note that the IRS Commissioner deserves some credit for being outspoken on this problem.

When it comes to taxes being prepared accurately, the IRS has at times had a spotty record in providing accurate tax advice to inquiring citizens. Now we see more recent reports indicating that even the tax preparation professionals are doing an inadequate job of preparing people's taxes, exposing our citizens to potentially significant fines and tax debts.

When it comes to keeping taxpayer information private, we have seen several instances where IRS contractors have been granted inappropriate access to taxpayers' information—access they do not need to do their job. And now we have a new regulatory proposal from the IRS to modernize the rules that pertain to privacy. In some cases, that proposal actually makes it easier for taxpayer information to be sold to private vendors.

Let me be clear. Taxpayers deserve more privacy, not less. If taxpayers really want salesmen to have access to their tax returns, they can mail it to them themselves. The IRS should not be an accomplice in selling taxpayer information.

Now, I recognize the IRS's new privacy proposal is complicated and some aspects of it can be seen to improve privacy while some aspects certainly can be seen to degrade it. But for me the question is not whether we should make it slightly harder or easier for an individual's taxpayer information to be sold. For me the question is whether any of this taxpayer information should be sold to anybody, ever. What consumer wants to have this information available to marketing firms? What consumer really wants to have their dinner interrupted by a telemarketer who is looking at a copy of their private tax return? If those taxpayers are out there, I don't know any of them.

So I hope the IRS will take a fresh look at those regulations and provide an outright prohibition on this information being shared with anybody. When it comes to the taxpayers getting help from the IRS, the IRS is moving in the wrong direction by trying to cut back on taxpayer services.

Worse still, when the IRS tried to minimize the impact of these service cuts, they couldn't get it right. Last year, Commissioner Everson testified to us his desire to close almost 70 Taxpayer Assistance Centers across the Nation. He told us these reductions would only be made after his careful analysis of the location, costs, demographics, and workloads of those centers. Now, many of us in Congress, including the chairman and myself, had deep-seated doubts about the wisdom of that proposal. As a result, we added language to the fiscal year 2006 Appropriations act that prohibited the Commissioner from closing those centers until the Inspector General completed a study on the impacts of reducing taxpayer services on compliance and assistance. That act further directed the IRS to consult with and get approval from the Appropriations

committees prior to any such eliminations, consolidations, or reorganizations of the workforce.

Well, the Inspector General has now reported that the data the IRS used to close those centers was faulty and outdated. The report makes it clear that the IRS was hastily putting together inaccurate data simply for the purpose of defending its plan to close those centers without any real regard for the needs of local citizens. The record with this proposal raises the question as to whether this subcommittee should believe any representation from the IRS when it comes to the availability of adequate taxpayer services.

Officially, the President's budget for fiscal year 2007 does not include formal cuts to taxpayer services though it is notable that the increase is less than the rate of inflation; however, included in this budget is more than \$84 million in so-called efficiencies—areas where the IRS intends to make budget cuts next year with consequences that are either unknown or unexplained.

Mr. Chairman, I hope we will pursue today exactly what efficiencies the Commissioner intends to launch next year so we don't find out after the fact that taxpayers have once again lost access to important forms of assistance when they are preparing their taxes. Taxpayers should not have their reasonable expectations dashed again.

Thank you, Mr. Chairman.

Senator BOND. Thank you, Senator Murray.

Now we turn to Senator Dorgan for his comments and any questions he may wish to leave for the record.

#### STATEMENT OF SENATOR BYRON L. DORGAN

Senator DORGAN. Mr. Chairman, thank you very much. I won't be able to stay for the entire hearing, but I wanted to be here. The hearing with respect to the appropriations request for the Internal Revenue Service is very important.

I used to be a tax commissioner, I think probably about the time that the chairman of the committee was the Secretary of State in Missouri and I was State Tax Commissioner in North Dakota.

Senator BOND. When was that?

Senator DORGAN. Back in the 1970's.

Senator BOND. I was Governor.

Senator DORGAN. You were Governor then.

Being a tax commissioner, I understood we had an income tax. I understood that there are fines and jail time for unauthorized disclosure of tax information. And I understood the need for safeguarding taxpayers' information is very important. I want to talk about that for just a moment.

First, I notice the discussion about the tax gap. The tax gap has been around a long time. I want to put up a picture that I have used before. This is called the Uglan House. It is on Church Street in the Cayman Islands. I think perhaps I used this with the IRS previously, but David Evans from Bloomberg News has done some pretty good work of pointing out that this five-story building is home to 12,748 corporations. Let me say that again. This five-story building on a quiet street called Church Street in the Cayman Islands is home to 12,748 corporations. Are they there? No,

they are not there. They just use the address. An attorney fixed them up with an address here.

What does that mean? They are avoiding a lot of taxes. I have used this picture on the floor of the Senate many times. I am wondering whether anybody has been sent down there to take a look at who all these companies are. I assume Treasury or IRS has done that, but if not, I am going to ask if you can give us some information about it.

My point is this: Hundreds of billions of dollars are being shifted away from the tax authorities in this country, some legally, some illegally. Part of that responsibility has to be Congress'. We have to plug the holes here. And part of it has to be aggressive enforcement by the Internal Revenue Service. Frankly, I don't think either has done its job with respect to this, but I point this out as an example of what is going on. It is unbelievable, and we are losing a substantial amount of tax revenue as a result of it.

The new construct, as you know, is to export good American jobs, import cheap labor, and sell your products in America and run the income through the Cayman Islands so you don't pay U.S. taxes. That is a strategy I think that weakens this country dramatically.

But let me get to the point on the IRS's proposed regulation involving section 7216 of the Internal Revenue Code, that one of my colleagues just described. Mr. Commissioner, you have sent me a letter dated yesterday in response to my letter to you about section 7216. This issue about disclosure and the use of taxpayers' information is not about regular business. In your letter to me, Mr. Commissioner, you suggest somehow that there is an unfairness to certain tax preparers because some tax preparers are in businesses with affiliated groups and so they have a broader range of opportunities to use taxpayer information that they have acquired through their tax preparation business for other business enterprises, or business solicitations and because some of the smaller and other tax preparers aren't involved in affiliated groups, you need to give them an opportunity to have as much business opportunity as others do.

This is not about business. With all due respect, this is about safeguarding the information that is filed by the American taxpayers and by preparers. Frankly, I don't believe when someone holds themselves out to do business as a tax preparer and gets paid for it that they ought to be using that tax return information that is given them by American taxpayers for unrelated purposes. You seem to suggest in your written testimony that this might be a radical proposal.

You say if Congress would prohibit the use of tax return information by tax preparers to solicit additional business, that somehow that would be a disadvantage. I don't think so. You say the law has existed 30 years. It may have existed 30 years, but eliminating the affiliated group requirement for solicitations and providing greater opportunity for others is not going to solve the problem. I would say as well, in 30 years, there has been much greater concentration in business through mega-mergers and that has dramatically changed what this affiliated group definition really means.

So I think you are headed in the wrong direction. You say that the rule is not complete and you also say that you are surprised

by the furor over this. Don't be surprised. The furor is going to get worse if you go ahead and do this.

This is not about business, about allowing someone to generate additional business by using confidential return information from their tax preparer business. If that is what we want to do, we are dead wrong, and I hope you will close the door rather than open the door.

Having said all of that, I am going to submit a list of questions on the issues that I have raised, the tax gap, the Uglund House, and the section 7216 proposed regulations. I don't want to brow-beat here, but I hope at the end of the day that you will not be surprised by the outcry from the American people and from Congress about this. They expect the information they file on their tax returns to be kept confidential. Those who would disclose tax return information in an unauthorized basis are subject to fines and jail terms because it is sensitive information. We should not expect this to be widely distributed for commercial or business purposes, and that is where I think this proposed regulation is heading. I think it is dead wrong and I think it disserves American taxpayers. I hope you will re-think that and make a change.

At any rate, thank you for being here. You have a tough job, and you have a chairman and a ranking member who I have the privilege of working with that want you to do your job successfully. This is a tough, tough job, trying to figure out how you collect these taxes, diminish the tax gap, and get rid of tax avoidance and tax evasion. Because it is not easy, we want to work with you to do that.

Mr. Chairman, thank you.

PREPARED STATEMENT OF SENATOR TED STEVENS

Senator BOND. Thank you very much, Senator Dorgan. We will be happy to include your questions for the record. We will also include Senator Stevens' statement for the record at this time.

[The statement follows:]

PREPARED STATEMENT OF SENATOR TED STEVENS

I support the IRS' technology modernization and agree that many benefits are derived from the modernization. However, I am concerned with the difficulties experienced by rural Alaskan taxpayers when they have attempted to use the national toll-free information line. In light of these difficulties, many Alaskans have sought the assistance of the Taxpayer Advocate Service Center when they need help to complete their tax submissions. The Center provides a necessary service to Alaskans. I support the Taxpayer Advocate Service Center in Alaska and believe the Center should be fully staffed in order to answer tax questions.

STATEMENT OF MARK W. EVERSON

Senator BOND. Now, with that, we will turn to the Commissioner.

Welcome, Mark. We will have your full statement, all of your full statements, included for the record, and if you would highlight what you think is most important for us to focus on.

Mr. EVERSON. Certainly. Thank you, Mr. Chairman, Senator Murray, Senator Dorgan.

Before I start, I would like to introduce two people. This is Take Your Kid to Work Day, I am informed, and Emma Everson, if she

could stand up, is here. She knows the chairman pretty well. She has not met the ranking member, but I want to point out that she has never been to Missouri. After school ends this year, she is going to take a trip out to see her cousins in Seattle. So if that gets us some help in the questioning and you choose not to embarrass me a little because my daughter is here, I will take whatever I can get.

Senator BOND. A cheap trick, but a very good defense.

Mr. EVERSON. I try to be effective.

The other person I would like to introduce is Evelyn Petchek. Evelyn, if you could stand. She is my chief of staff who has served for 2 years, and as the chairman knows, she has played an important role from time to time in terms of sorting some things out with the committee. She is retiring about a month from now and she is going back to her beloved New Mexico, but she has done a great job in a long career with the IRS. So I thank her as well.

Senator BOND. We thank her for her service and wish you well and know that it is going to be tough to find somebody to support the Commissioner.

Mr. EVERSON. And, Senator Dorgan, if you have to leave, I would certainly want to come see you directly and visit you soon to talk about some of these important issues, which we will cover.

Senator DORGAN. I would be happy to do that, and we would invite your daughter if she is driving from here to Seattle to stop in North Dakota for an extended stay.

Mr. EVERSON. Very good.

Okay. It is good to be back before the subcommittee to discuss the 2007 budget as proposed by the President. We believe, if fully funded, we can maintain the important balance between strong taxpayer service and the enforcement that is necessary to reduce the tax gap.

Before I discuss the proposed budget, let me first thank the members of the subcommittee for fully funding the IRS as part of the 2006 budget process. This has allowed us to move forward on several important initiatives, particularly in the area of enforcement.

The 2007 budget would sustain this progress. Our request is for \$10.6 billion in direct appropriation supplemented by \$135 million in an incremental user fee to represent a total operational level of about \$10.7 billion or 1.4 percent above the previous budget.

Before taking your questions, let me turn briefly to IRS efforts in our three areas of strategic focus, services, enforcement, and modernization, and then make brief comments on certain legislative proposals accompanying the 2007 budget which would help to close the tax gap.

First, services. We are drawing to a close of a successful filing season. Electronic filing is up by over 6 percent from last year, reflecting in particular a strong increase in the use of tax software on home computers. Our phone level of service is consistent with last year. The accuracy of our answers to tax law questions has improved. I would note that the results on the phones have exceeded our expectations, explained by the fact that call volumes are down from last year.

We have also seen strong growth in our community-based volunteer tax preparation program. The VITA sites are an increasingly important part of our efforts, and, in fact, last year the IRS was recognized by the Points of Light Foundation for its successful efforts. This is the first time a government agency has received this recognition. Usually it has been Mothers Against Drunk Drivers, March of Dimes, organizations like that. This program has grown by 8 percent compared to last year.

As to enforcement, the fiscal year 2005 results demonstrate that we have restored the credibility of our enforcement programs. Individual audits were up 20 percent from 2004 to 1.2 million. They are up 97 percent since 2000. High income audits were also up and have increased 120 percent since 2000. Corporate audits bottomed out in 2003, but by 2005 had recovered by over 50 percent. Collections are more robust. Last year, we had 2.7 million levies versus 200,000 in 2000. All told, enforcement revenues increased from 43.1 billion in 2004 to 47.3 billion last year.

Concerning 2006, we expect continued progress, although not as dramatic as some of these double-digit increases that I have just indicated. We are bringing on new personnel with the monies you provided, but it will take some time before they fully get up to speed.

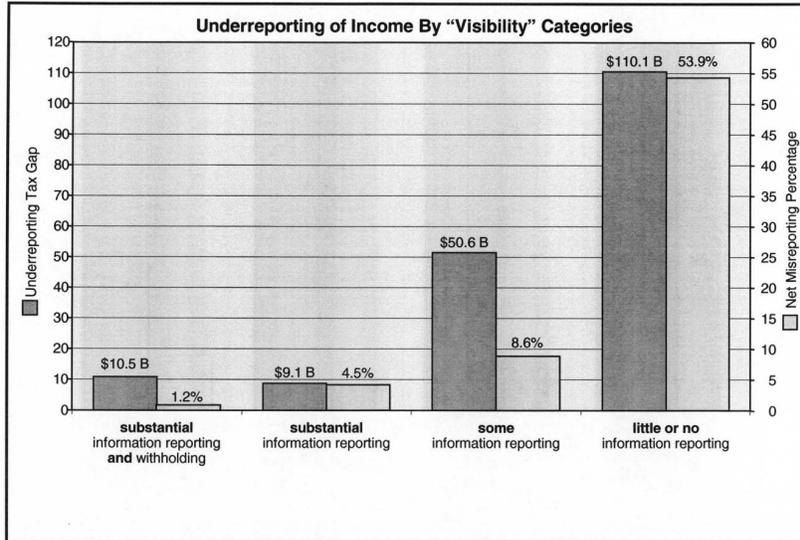
In terms of modernization, we have realized a number of achievements. In particular, I would note the progress of our taxpayer master file update, the CADE system. Last year CADE posted 1.4 million returns. This year, we have processed 6.6 million returns through CADE and refunded more than \$3 billion.

The 2007 budget request has two important components. The funding request keeps the IRS basically at level funding up just slightly to largely absorb inflation. Part of this funding is from increased user fees. If the appropriation request is fully funded, these monies will allow us to maintain the progress we are making both in the service and enforcement missions of the agency as well as to continue our modernization efforts.

Before taking your questions, let me make one additional point. We recently refined our estimates of the tax gap. We will be using this information to update our audit models and selection procedures and to calibrate our resource allocation within business units. The research also clearly indicated that where there is a third-party reporting, there is better compliance.

What this chart says, over to the left, you have a noncompliance rate of about 1 percent on wages. One-hundred-fifty million Americans get W-2s. They don't get it wrong when they report the information to us. All the way out at the right, you have categories where we don't get any information or very little information. Principally, this is about individuals who organize themselves as small businesses, but aren't incorporated and there is no reporting that comes to us. There, the noncompliance rate is over 50 percent.

### Tax Year 2001 Individual Income Tax Underreporting Gap



Based on updated estimates derived from the National Research Program underreporting compliance study.

#### PREPARED STATEMENT

In the President's budget request, we have made several administrative and reporting proposals. The most important of these is the proposal to mandate reporting to the IRS of gross receipts by credit card issuers for their business customers. I believe the five legislative proposals that accompany the funding request can make a significant contribution to reducing the tax gap. So I hope they will enjoy your support.

Finally, let me indicate that I remain a strong advocate of simplification of the code. Thank you.

[The statement follows:]

#### PREPARED STATEMENT OF MARK EVERSON

##### INTRODUCTION

Senator Bond, Ranking Member Murray and members of the subcommittee, it is good to be back before the subcommittee to discuss the fiscal year 2007 IRS budget as proposed by the President. We believe if funded fully, we can maintain the important balance between strong taxpayer service and the enforcement that is necessary to reduce the tax gap.

Before I discuss the proposed budget, let me first thank the members of the subcommittee for fully funding the IRS as part of the fiscal year 2006 budget. This allowed us to move forward on several important initiatives, particularly in the area of enforcement.

My goal this morning is to offer you insight on what we are accomplishing with that full funding in fiscal year 2006 and to offer some insight in what we hope to accomplish in fiscal year 2007. I also hope to touch on some current issues that I know are of concern to subcommittee members as well as other Senators.

First, however, I want to provide you the latest information on 2006 Filing Season.

We expect to process almost 135 million individual tax returns in 2006, and we anticipate a continued growth in the number of those that are e-filed. In the 2005 filing season, over 50 percent of all income tax returns were e-filed.

We fully expect to exceed that number this year. As of April 15, we have received over 63 million tax returns filed through e-file, an increase of 2.25 percent compared to the same period last year. This represents 63 percent of the more than 100.3 million returns that had been filed as of that date.

This increase in e-filing is being driven by people preparing their tax returns using their home computers. The total number of self-prepared returns that are e-filed is up by over 13 percent compared to this time a year ago. Over 17.3 million returns have been e-filed by people from the comfort of their own home, up from 15.3 million for the same period a year ago. Fully, 27 percent of all electronically filed returns have been done on home computers. This is 2.6 percentage points above last year.

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 2 weeks or less. That is about half the time it takes us to process a paper return. Moreover, the error rate for e-filed returns is less than for paper returns, saving IRS resources and avoiding taxpayer inconvenience.

Despite this overall growth in e-file, we are disappointed that we are experiencing a significant decline in the number of taxpayers that are using our Free File program. Currently, we have almost 24 percent fewer taxpayers choosing to use Free File as compared to 2005. I will discuss this in more detail later in my testimony.

More people are choosing to have their tax refunds directly deposited into their bank than ever before. So far this year, we have directly deposited more than 49 million refunds, or 64 percent of all refunds issued this tax filing season. This is up from 60 percent for the same period in 2005.

People are also visiting our web site, IRS.gov, in record numbers. The IRS has recorded over 114 million visits to our web site, up from 110 million for the same period a year ago. This is a 3.4 percent increase.

The millions of taxpayers that have visited IRS.gov have benefited from many of the updates that we have made for this filing season. We have made it easier for taxpayers to get answers to many of their tax questions. The web site:

- Allows a taxpayer to determine whether he or she might qualify for the Earned Income Tax Credit (EITC);
- Assists the taxpayer in determining whether he or she is subject to the Alternative Minimum Tax (AMT);
- Allows more than 70 percent of taxpayers the option to actually file their tax returns at no cost through the Free File program;
- Assists hurricane victims with information on many of the changes in the tax laws that are designed to help them and provides a toll free number for victims to get their questions answered; and
- Allows taxpayers who are expecting a refund to track its progress via the “Where’s My Refund?” feature on the site.

The 100.3 million individual tax returns received as of April 15 represents a decline of 3.7 percent over the same period as last year. We have issued 78.1 million refunds this year for a total of \$177 billion. The average refund this year is \$2,265, \$98 more than last year. In addition, more than 20 million taxpayers have tracked their refund on IRS.gov, up 14 percent over last year.

Our planning assumptions called for reducing toll-free operating hours from 15 hours to 12 hours while still maintaining the same level of taxpayer service. When this change was not implemented, the expected savings were restored and used to increase overtime. In addition, resources from answering paper correspondence were diverted to telephones. To date, these strategies have produced positive results.

In addition to these personnel actions, we have not yet experienced some of the workload increases that were anticipated as a result of the hurricane disasters. Overall, this filing season through April 15, we have actually received about 1.4 million fewer telephone calls than last year (32.4 million in 2006 vs. 31 million in 2005). As a result, our Customer Service Representative (CSR) Level of Service (percent of calls answered) is above last year (83.25 percent in 2006 vs. 81.65 percent in 2005). However, because we deployed Adjustments staff to the telephones, paper inventories are 117.2 percent of last year (1,108,774 in 2006 vs. 946,223 in 2005). The number of cases that are over-age has also increased significantly (123,425 in 2006 vs. 63,580 in 2005).

As of April 8, our Taxpayer Assistance Centers (TACs) are reporting a 12.5 percent decline in face to face contacts this filing season as compared to last year. We

believe that the decline in visits to our TACs as well as the reduction in the number of calls is largely attributable to taxpayers increasing their use of IRS.gov and other electronic means to get their questions answered and obtain tax forms.

The use of other service alternatives, such as volunteer return assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly sites (TCEs), has steadily increased while the numbers of TAC contacts have decreased. In fiscal year 2005 over 2.1 million returns were prepared by volunteers. As of April 15, volunteer return preparation is up 7.3 percent above last year's level. Volunteer e-filing is also up, by 4.7 percent over the same period in the last tax filing season. This is reflective of continuing growth in existing community coalitions and partnerships.

PRESIDENT'S FISCAL YEAR 2007 BUDGET MAINTAINS THE BALANCE BETWEEN TAXPAYER SERVICE AND ENFORCEMENT

Our total budget request for fiscal year 2007 is \$10.6 billion in direct appropriations, supplemented by \$135 million in new user fee revenue, for a total operating level of \$10.7 billion. This request represents a total increase of 1.4 percent from the fiscal year 2006 enacted level. The fiscal year 2007 budget sustains the enforcement funding increase provided in fiscal year 2006 to improve tax compliance. More importantly, the budget maintains the balance between service and enforcement.

The IRS's taxpayer service and enforcement activities are funded from three appropriations: Processing, Assistance and Management (PAM); Tax Law Enforcement (TLE); and Information Systems (IS). The total fiscal year 2007 budget request for these three operating accounts is \$10.4 billion supplemented by the \$135 million in new user fee revenue, for a total operating level of \$10.5 billion, or 1.8 percent increase over the fiscal year 2006 enacted level.

The \$135 million in new user fees revenue will be generated from several increased and new user fees earned from special or non-routine services provided to taxpayers by the IRS. These would include such services as providing private letter rulings for interpretations of tax law and applications for exempt status. The largest portion of the anticipated increase in fees will come from new and restructured installment agreements (\$66.7 million). Another \$47.1 million is expected from letter rulings and determinations. The remainder will come from technical training and enrolled agent fee increases. These increased fees were designed to more fully reflect the actual cost of providing these services, as required by OMB Circular A-25.

The budget includes an additional \$137 million for enforcement to fund the pay raise and other cost adjustments needed to maintain the fiscal year 2006 enforcement initiative increase, a 2 percent increase. Similar to last year, the President's budget proposes to fund this enforcement increase through an adjustment to the discretionary cap, which in effect would increase the amount of funding dedicated to tax enforcement from \$6.82 billion in fiscal year 2006 to \$6.96 billion in fiscal year 2007. The IRS will continue to focus its enforcement resources on efforts designed to increase compliance and reduce the tax gap. We will continue our examination of tax-exempt entities used to facilitate abusive transactions and our examination of tax strategies involving international elements for both corporations and high income individuals.

I would remind the subcommittee that in fiscal year 2005 we brought in a record of \$47.3 billion in enforcement revenue, an increase of \$4.2 billion from the previous year. In fiscal year 2006, we expect that total to increase to \$48.1 billion, a 42 percent increase from fiscal year 2001.

We believe taxpayers have a right to expect a return on the additional investment in enforcement. We estimate that when we receive the full productive benefits of the fiscal year 2006 funding increase, the return on investment (ROI) for additional enforcement resources will be 4:1. Stated another way, we estimate that each \$1 invested in enforcement will return \$4 in additional enforcement revenue, although this should not be interpreted as a fixed ratio.

This estimated "return" is based on the amount of additional tax collected and attributes the revenue to the enforcement occupations that originated each case. For each type of IRS enforcement employee, the associated amount of additional tax collections is estimated based on an extensive data base, covering the most recent 11 years of collection experience.

This analysis does not include the indirect effect of increased enforcement activities in deterring taxpayers considering engaging in non-compliant behavior. Econometric estimates of the indirect effects indicate a significant impact from increased enforcement activities.

The \$3.58 billion for taxpayer service in the fiscal year 2007 budget request, including the \$135 million from new user fee revenue, will maintain our commitment

to provide high-quality taxpayer services through improvements to information technology and other targeted efficiencies such as those resulting from increased electronic filing.

The Business Systems Modernization appropriations account funds the IRS's costs to develop and deploy our critical, major information systems. The requested level for BSM is \$167.3 million, a 15.1 percent reduction from the fiscal year 2006 level. This is discussed later in the testimony.

Lastly, the Health Insurance Tax Credit appropriation (HITCA) remains a separate account that funds the administration of a refundable tax credit. The fiscal year 2007 request for HITCA is \$14.9 million, a 25.8 percent reduction from the fiscal year 2006 enacted level.

#### FISCAL YEAR 2007 DETAILED BUDGET SUMMARY

Our fiscal year 2007 budget request of \$10.7 billion, which includes the \$135 million in new user fee revenue, primarily funds costs to maintain the IRS's current levels of service and enforcement (\$272.2 million) and an initiative to consolidate the Philadelphia Campus (\$20.9 million). This request also includes several program savings and efficiencies that reflect the IRS's aggressive efforts to identify and deploy technology improvements that will benefit both taxpayer service and enforcement programs. Collectively, these cost savings total \$116.1 million:

—*E-File Savings: -\$6,760,000 / -174 FTE.*—This savings results from increased electronic filing (e-file) and a reduction in Individual Master File paper returns. Estimated e-file savings are based on the projected reduction in the number of paper returns processed each year, offset by the cost of processing e-filed returns.

—*Improvement Project Savings: -\$8,215,000 / -135 FTE.*—This savings results from operational improvements generated by the Contact Recording, Queuing Management (Q-Matic), Correspondence Imaging Systems, and End-to-End Publishing improvement projects already in progress.

—*Competitive Sourcing Savings: -\$17,000,000 / -242 FTE (The -242 FTE is a revised figure which corrects an error included in the fiscal year 2007 President's budget request for the IRS).*—These savings reflect efficiencies and savings that will be achieved through the IRS's competitive sourcing efforts resulting from six different projects in various phases of implementation.

—*Program Efficiencies: -\$84,100,000 / -873 FTE (-873 FTE is a revised figure, which corrects an error included in the fiscal year 2007 President's budget request for the IRS).*—These savings reflect Service-wide efficiencies resulting from the elimination of duplicative overhead in internal support functions, increased productivity through improved workload selection, and distribution techniques, automation of certain taxpayer assistance functions, and deployment of the fiscal year 2006 enforcement hires to full time examiner positions. These efficiency savings can be realized with no adverse impact on taxpayer service and enforcement operations.

The \$84.1 million in efficiency savings is broken down into three major categories. *Shared Services in Support of Taxpayer Service and Enforcement Operations (\$31.4 million).*—This includes approximately \$24 million in expected savings from renegotiated information systems and telecommunication contracts that the Treasury Department plans to award. Another \$7.2 million will come from implementing improved processes for issuing notices.

*Enhanced Productivity and Efficiencies in Enforcement Programs (\$35.0 million / 433 FTE).*—The Service will realize \$14.5 million (256 FTE) in savings due to the implementation of several productivity efficiencies. These savings will be achieved through an improved employee to management span of control, the elimination of non-critical vacancies, and the reduction of resources allocated to overhead and internal support functions. In addition, the Service will benefit from higher productivity levels resulting from the transition of the new hires to examiner work and the return of trainers to full time exam work. Other savings in this area include:

—\$500,000 (5 FTE) due to improved productivity stemming from more effective workload selection techniques such as creating and implementing new discriminate index function (DIF) formulas, which also will decrease taxpayer burden by allowing us to focus enforcement resources on the most egregious examples of abuse.

—\$12.1 million (120 FTE) by implementing improvements in the corporate examination process through improved techniques in data collection and risk identification. These improvements will result in earlier issue resolution, reduced audit cycle time, and increased inventory turnover. In addition, scanned returns will allow examiners to follow and evaluate data electronically.

- \$800,000 (13 FTE) due to the deployment of various technology improvements. The Generalized Integrated Data Retrieval System (IDRS) Interface and the Intelligent Call Management system will increase productivity and improve the quality and level of service to taxpayers.
- \$7.1 million (39 FTE) from enhanced investigations of tax fraud through the implementation of technology improvements to systems that process electronic data and evidence. The streamlined work processes and technological advancements will reduce administrative burden of investigations involving domestic and offshore abusive scheme promoters, corporate fraud, and other complicated investigations involving multi-national financial transactions.

*Taxpayer Service Programs and Processes (\$17.7 million/440 FTE).*—IRS operations will improve through a variety of efforts, including enhanced workload distribution and the automation of certain taxpayer assistance functions. The IRS will achieve \$14.6 million (355 FTE) in efficiencies from improved employee to management span of control throughout the organization, judicious distribution of management work, identification and elimination of non-critical vacancies, and the replacement of journeymen losses with lower-graded/entry-level positions. The deployment of the Individual Taxpayer Identification Number Real Time System saves time and money for both the Service and taxpayers. The system automates the process of providing a Taxpayer Identification Number (TIN) to those taxpayers ineligible for a Social Security Number but required to provide identifying information on a tax return. The Service anticipates \$3.1 million (85 FTE) in efficiencies due to this new automated system.

In addition to the program savings and increases for taxpayer service and enforcement, the fiscal year 2007 budget includes a \$5.5 million reduction to the Health Insurance Tax Credit Administration (HICTA) Program. This funding adjustment for HITCA reflects the program's effort to align fiscal year costs with contract year expenditures.

#### IRS MODERNIZATION

The requested level for BSM of \$167.3 million, a decrease of \$29.7 million, will continue the support for Customer Account Data Engine (CADE), Filing and Payment Compliance (F&PC) and the Modernized e-File (MeF) project along with some of the needed investments to upgrade our infrastructure.

After several years of cost, schedule, and performance problems, the BSM program has improved its performance in the past 2 years by delivering projects and releases on time, on budget, and meeting or exceeding expectations. Taxpayers are now realizing the benefits of our enhanced BSM program management capabilities. In fiscal year 2006 and continuing in fiscal year 2007, we are revising our modernization strategy to emphasize the release of projects to deliver business value sooner at a lower risk. We will concentrate on delivering releases of major tax administration projects, along with infrastructure initiatives that support all modernization projects, and continuing our improvements to program management operations. These projects and initiatives address core IRS strategic priorities: taxpayer service, enforcement, and modernization.

As part of our continuing effort to improve taxpayer service, we plan to expand services provided and the number of taxpayers served by Modernized E-File (MeF). MeF uses the latest secure Internet technology and speeds turnaround time for tax return submissions, equating to significant reductions in burden and time for corporate and tax-exempt taxpayers.

As of April 16, MeF had processed nearly 684,000 returns. This compares to approximately 176,000 in 2005, a 289 percent increase. In recent regulations, the IRS has mandated the Nation's largest corporations and tax exempt organizations file electronically in 2006 through the use of MeF.

Finally, we will continue to expand the use of the Customer Account Data Engine (CADE). CADE will ultimately replace our antiquated Master File system, which is the repository of taxpayer information. CADE allows faster refunds, improved taxpayer service, faster issue detection, more timely account settlement, and a robust foundation for integrated and flexible modernized systems. CADE posted more than 1.4 million returns and generated more than \$427 million in refunds in 2005. In 2006, CADE has posted over 6.4 million returns and generated over \$3 billion in refunds. In the 2007 filing season, we expect CADE to process 33 million returns. CADE serves as the single authoritative repository for account and return data for those returns.

## PRIVATE COLLECTION AGENCIES (PCA)

The American Jobs Creation Act of 2004 created section 6306 of the Internal Revenue Code, which allows the IRS to use private contractors to collect delinquent taxes in instances where the amount owed is not in dispute. It is important to understand that these PCAs will only be assigned cases where the tax balance is not in dispute and will not be performing audits or assessing penalties, or taking enforced collection actions of any kind. They will only be used in instances where what is owed has been determined but the taxpayer has not paid.

On March 9, we announced the award of contracts to 3 PCAs. It is our expectation that these firms will begin work as soon as issues are resolved regarding protests to these awards. If cases are placed in fiscal year 2006, as allowed by statute, the IRS will retain 25 percent of any posted revenue receipts from this program which we will use to supplement our existing budget (for collection related activities). We anticipate an even greater return for fiscal year 2007 since case placements are expected to increase.

## THE TAX GAP

To understand the need for full funding of IRS's proposed fiscal year 2007 budget, one also must understand the nature of the tax gap. 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.

It is the need to reduce that gap that drives much of what we do. This is true not only from a revenue standpoint, but also from a taxpayer fairness perspective. Our tax system is largely based on voluntary compliance and that compliance is enhanced if taxpayers believe that everyone is paying their fair share.

A year ago, we released preliminary estimates of the tax gap based on data derived from a National Research Program (NRP) study conducted on individual income tax returns from Tax Year 2001. This was the first comprehensive update of our tax gap estimate since 1988. We have now revised those estimates and I would like to summarize them for you.

Our latest numbers show that the overall gross tax gap for Tax Year 2001 was approximately \$345 billion, resulting in a noncompliance rate of 16.3 percent. Both of these numbers are in the upper end of the range of estimates provided last spring. Our estimate of the corresponding net tax gap, or what remains unpaid after enforcement and other late payments, is \$290 billion, also in the upper end of the earlier range.

Noncompliance takes three forms: not filing required returns on time; not reporting one's full tax liability even when the return is filed on time; and not paying by the due date the full amount of tax reported on a timely return. We have separate tax gap estimates for each of these three types of noncompliance.

Underreporting constitutes 82.6 percent of the gross tax gap, up slightly from our earlier estimates. Nonfiling constitutes 7.8 percent and underpayment 9.6 percent of the gross tax gap.

Individual income tax accounts for 46 percent of all tax receipts. However, individual income tax underreporting amounts to approximately \$197 billion, or 57 percent of the overall tax gap.

As in previous compliance studies, the NRP data suggest that well over half (\$109 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). Approximately 28 percent (\$56 billion) came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining \$32 billion came from overstated reductions of income (i.e. statutory adjustments, deductions, and exemptions), and from overstated tax credits. The corresponding estimate of the self-employment tax underreporting gap is \$39 billion, which accounts for about 11 percent of the overall tax gap. Self employment tax is underreported primarily because self-employment income, which is not subject to third party reporting, is underreported for income tax purposes. Taking individual income tax and self employment tax together, then, we see that individual underreporting constitutes over two-thirds of the overall tax gap.

## INCREASING COMPLIANCE THROUGH SERVICE AND ENFORCEMENT

It is important to understand that the complexity of our current tax system is a significant reason for the tax gap. It is easy for even sophisticated taxpayers to make honest mistakes. Accordingly, helping taxpayers understand their obligations under the tax law is a critical part of addressing the tax gap.

IRS is committed to assisting taxpayers in both understanding the tax law and remitting the proper amount of tax. We are continuing to do this by maintaining the balance between service and enforcement that is so critical to tax administration.

#### *Service*

I have already talked about IRS.gov and how it can answer many taxpayer questions on issues ranging from the Earned Income Tax Credit (EITC) to the Alternative Minimum Tax (AMT) to refund tracking. On a recent day, our site ranked third in overall hits according to Yahoo's Buzz Index. The American Customer Satisfaction Index has ranked our site well ahead of the government benchmark in the areas of content, functionality, navigation, privacy, satisfaction and in many other areas. Thus far this year, visits to our site are up 3.4 percent over the same period a year ago.

This success has been recognized by others. In 2004, IRS.gov won the Keynote Performance Award as the most reliable Federal web site for performance and availability. It won the 2005 Government Computer News agency award for innovation and is a finalist for the 2005 Excellence.gov Award in recognition of being an outstanding Federal interactive web site.

We believe the internet has become our primary vehicle for delivering service information to taxpayers. Please note that I said primary and not exclusive. We recognize that we will always have a percentage of taxpayers that we need to serve through either direct personal service or over the telephone, but we hope to continually drive that number down, while at the same time improving the levels of service and taxpayer satisfaction. This will not only save us time and resources, but also will provide a valuable service to taxpayers. They can get answers to their questions at their home, at their convenience, rather than visiting a walk-in site.

We continue to get good marks on various customer service surveys. Our toll free telephone service customer satisfaction rating is 94 percent. In fiscal year 2005, the IRS's customer assistance call centers answered 59.1 million calls. We achieved an 82.6 percent toll-free-telephone CSR level of service, exceeding our fiscal year 2005 target of 82 percent. We also improved our toll free tax law accuracy rate to 89 percent, an increase from 80 percent in fiscal year 2004. While this is the highest yearly rate ever, we continue to strive to improve. This filing season through March, the tax law accuracy rate is 90 percent.

We provided and staffed toll-free FEMA phone assistance lines for hurricane victims and answered approximately 950,000 calls. The IRS also implemented numerous tax law changes to help the victims of Hurricanes Katrina, Rita and Wilma, businesses located in the disaster areas, and individuals donating to charities to support the victims.

We continue to leverage community partnerships to provide free tax return preparation assistance through successful programs such as Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE). In 2005, 62,000 trained volunteers at 14,000 locations across the country prepared more than 2.1 million tax returns, an 80 percent increase since 2001. We expect the number of customers served this year to exceed 2.2 million.

I personally have had the opportunity to visit several VITA sites and I remain impressed by the diligence, the competence, and the commitment of the thousands of volunteers that make this program work.

For small businesses, we simplified the employment tax filing process for more than 950,000 small companies by allowing them to file their employment tax returns and pay their employment tax liabilities annually, rather than quarterly. Our office of Taxpayer Burden Reduction led a collaborative effort to redesign the Form 1041 Schedule K-1, which among other things, is used to report income, deductions, and credits from trusts and estates to beneficiaries.

We are also making progress on our Taxpayer Assistance Blueprint (TAB). This is an ambitious, agency-wide, 5-year taxpayer services plan aimed at improving IRS services.

Over the past 5 years we have taken significant steps to understand the needs and preferences of individual taxpayers, our primary customers, and their representatives. Many studies, such as the Multilingual Initiative, the EITC outreach, and partnerships with organizations such as AARP and the National Community Tax Coalition have focused on understanding key demographic and behavioral differences in our customers. Before now, those initiatives have not been integrated to form a complete picture of customer needs.

The TAB project will pull the pieces of the puzzle together and develop a complete picture of our customer base. Through a systematic data collection and analysis process, a dynamic plan (or Blueprint) will be developed to meet our short and long

term business needs as it relates to taxpayer assistance and address concerns expressed by Congress and other oversight bodies.

In short, TAB will help us better understand our customers—their characteristics, how they access our services, what services they use and prefer, and if our services truly meet their needs.

We have completed the first phase of the TAB project. In Phase 1, we conducted research and surveyed taxpayers, stakeholders, and IRS employees to form a preliminary assessment of taxpayer needs, preferences, and demands. We have just recently delivered our Phase 1 report to the subcommittee. In Phase 2, we will perform extensive primary research with taxpayers to refine our assessment and conclude by creating an IRS blueprint for taxpayer service delivery. We will complete this phase in October 2006.

#### *Enforcement*

The IRS made significant progress towards achieving its enforcement related goals in fiscal year 2005. We achieved increases in every major area of enforcement. We have:

- Audited nearly 220,000 high income taxpayers in 2005, more than double the number audited in 2000.
- Increased audits for individuals to 1.2 million, 20 percent more than 2004 and almost double the level 5 years earlier.
- Audited nearly 5,000 businesses with assets over \$250 million, an increase of 11 percent. In addition, we audited one out of every five companies with assets of \$10 million. Finally, audits of businesses with less than \$10 million in assets rose 145 percent from 2004.
- Generated more than \$4.7 billion in revenue through two prominent settlement initiatives aimed at reducing examination and litigation expenses while deterring the use of abusive tax shelters.
- Increased collection closure cases by 12 percent and dollars collected by 14 percent over 2004.
- Increased criminal convictions to 2,151 (from 1,926 in 2002).
- Increased overall collections by 10 percent through heightened enforcement efforts, from \$43.1 billion in 2004 to \$47.3 billion in 2005.

Combating abusive tax shelters remains a high priority in fiscal year 2006. Last October we announced a global settlement initiative that covered 21 listed and non-listed transactions. They include a wide range of transactions involving funds used for employee benefits, charitable remainder trusts, offsetting foreign currency contracts, debt straddles, lease strips, and certain abusive conservation easements.

Taxpayers had until January 23, 2006 to file an election to take part in the global settlement program. Under the terms of the settlement, taxpayers will generally be required to pay 100 percent of taxes owed, interest and, depending on the transaction, either a quarter or half the accuracy-related penalty the IRS will otherwise seek.

We have been pleased by the response to this initiative, and we believe the response was buoyed by provisions in the Gulf Opportunity Zone Act of 2005 that modified the rules for calculating interest on tax deficiencies of individual taxpayers who participated in certain abusive tax shelters, increasing the incentives for individuals to come forward as part of this program.

In addition, our Large- and Mid-Sized Business Division (LMSB) has issued more than 500 administrative summonses as part of our attack on shelter promoters, and we have approximately 200 active promoter examinations under way. Entities being looked at include banks, accounting firms, law firms and brokerage houses. We want to make it clear that taxpayers who take aggressive return positions relying on the “audit lottery” and the chance they will not be examined have made a really bad decision.

In addition, we are continuing to focus on improper uses of certain tax exempt bonds and trusts, questionable transfer-pricing practices, offshore accounts, and charitable donations of intangible assets.

Another enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. Our system of tax administration depends upon the integrity of practitioners. The vast majority of practitioners are conscientious and honest, but even the honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures.

We have done quite a bit to restore faith in the work of tax professionals. We have strengthened regulations governing the standards of tax practice to discourage the manufacturing of bogus legal opinions on the validity of tax shelters. New Treasury Department regulations took effect last June that revise Circular 230 governing tax

practitioner behavior. The new regulations establish standards for written tax advice prepared by practitioners.

Further, additional revisions to Circular 230 were recently proposed to make disciplinary proceedings more transparent so that practitioners may learn the types of behavior IRS is likely to challenge under the Circular.

The IRS has made noncompliance by tax exempt and governmental entities and misuse of the tax exempt status of such entities by third parties for tax avoidance purposes another major enforcement priority. For example, earlier this year, we concluded that more than 30 credit counseling firms, accounting for more than 40 percent of the industry's revenues, are not entitled to tax exempt status. The proposed revocations of the tax exempt status of these entities are the culmination of more than 2 years of work covering more than 60 credit counseling organizations.

These organizations were originally granted tax exempt status because they were supposed to be educating and assisting people who have credit or cash flow problems. Unfortunately, too many of these organizations instead operate for the benefit of insiders or are improperly in league with profit making companies. We want to make sure that money donated to charities goes for the purpose intended and not into the pockets of individuals associated with the charitable organization.

In 2006, our Tax Exempt/Government Entities (TE/GE) division will continue to focus on key areas where organizations are abusing their exempt status or where others are using them for unintended purposes. Three of the areas in which we anticipate renewed enforcement include political intervention, executive compensation and abusive transactions.

Regarding political intervention by entities claiming tax exempt status, in 2006 we will be finishing up contacts with 130 organizations suspected of political intervention in the 2004 election. Almost half of these are churches. Thus far we have completed 82 examinations and have concluded that nearly three-quarters of the non-profits examined, including churches, engaged in some level of prohibited activity. Most of these exams concerned one-time, isolated occurrences of prohibited campaign activity, which the IRS addressed through written advisories to the organizations. In three cases involving non-churches, the prohibited activity was egregious enough to warrant the IRS proposing the revocation of the organization's tax-exempt status.

We have also issued a fact sheet designed to offer guidance to non-profits on what is and is not permissible activity for tax-exempt organizations. In addition, we have taken steps to ensure that all referrals regarding campaign activity that the IRS receives from the public, as well as activity the IRS itself uncovers, are reviewed expeditiously, and treated consistently and fairly.

Excessive compensation of executives also will be a main focus of our enforcement efforts. There are indications that tax-exempt organizations have allowed key executives too great a voice in determining their own compensation or otherwise have not used due diligence in setting compensation levels. We have contacted almost 2,000 Section 501(c)(3) organizations, including about 400 private foundations regarding this issue. In addition, we are exploring compensation to tax-exempt hospital executives.

In the fiscal year 2006 budget, our enforcement resources increased by \$442 million (post-rescission). I know it is important to you, and it is equally important to us, to show a return on that investment.

Of the total \$442 million in increased funding, \$180 million funds the pay and non-pay inflationary costs to maintain the \$6.4 billion devoted to enforcement. The remaining \$262 million funds direct costs for enhanced enforcement hiring, including staff for the Counsel and Appeals organizations, and associated indirect costs for these hires. We will focus these resources on:

- Increased coverage of high-risk compliance problems to address the largest portion of the tax gap—the underreporting of tax—across all major compliance programs;
- Complex high-risk issues in abusive tax avoidance transactions, promoter activities, corporate fraud and aggressive transactions, resulting in increased corporate and high income audit coverage;
- Efforts aimed at reversing the erosion of individual tax compliance and support of the strategy to implement a balanced compliance program;
- Improved ability to identify compliance risks and significantly expanded coverage of tax-exempt communities;
- Safeguarding compliant customers from unscrupulous promoters through earlier detection of abusive schemes and heightened efforts to prevent their proliferation; and
- Increased vigilance to ensure the assets of tax-exempt organizations are put to their intended tax-preferred purpose and not misdirected to fund terrorism or

for private gain, including enhanced processing of questionable exemption applications and increased technical support to the examination process.

#### LEGISLATIVE PROPOSALS

While fundamental tax reform is the only comprehensive solution to reducing the tax gap, until that is achieved, we must work within the current system to reduce the tax gap as much as possible. Allow me to discuss five specific legislative proposals that are offered as part of the fiscal year 2007 budget and designed to reduce the tax gap. Collectively, these five changes should generate \$3.6 billion over the next 10 years.

The first and perhaps most important proposal would increase reporting on payment card transactions. Our tax gap study shows clearly that increased information reporting and backup withholding are highly effective means of improving compliance with tax laws. More than 150 million wage earners already have their information reported directly by their employer to the IRS and the non-compliance rate for this group is less than 1 percent. All of these wage earners are also subject to mandatory withholding of taxes.

Payment cards (including credit cards and debit cards) are a growing form of payment in retail business transactions. The failure of some merchants to accurately report their gross income, including income derived from payment card transactions, accounts for a significant portion of the tax gap and creates a significant competitive advantage for those businesses that underreport.

The administration proposes that the Treasury Secretary be given the authority to promulgate regulations requiring annual reporting of the aggregate reimbursement payments made to merchants in a calendar year, and to require backup withholding in the event that a merchant payee fails to provide a valid taxpayer identification number.

Because reimbursement information is already provided to merchants, requiring this information to be reported to the IRS on an aggregate annual basis will impose minimal burden on payment card companies and no burden on the affected merchants. In addition, implementing a backup withholding system for payment card reimbursements to businesses would lead to material improvements in the compliance rates of these taxpayers without imposing a significant burden on the card companies. Finally, the IRS will be able to use payment card reporting information to better focus its resources and relieve the burden that existing audits place on businesses that accurately report their gross income.

The second legislative proposal would clarify when employee leasing companies can be held liable for their clients' Federal employment taxes. Employee leasing is the practice of contracting with an outside business to handle certain administrative, personnel, and payroll matters for a taxpayer's employees. Typically, these firms prepare and file employment tax returns for their clients using the leasing company's name and employer identification number, often taking the position that the leasing company is the statutory or common law employer of the clients' workers.

Non-compliance with the Federal employment tax reporting and withholding requirements is a significant part of the tax gap. Under present law, there is uncertainty as to whether the employee leasing company or its client is liable for unpaid Federal employment taxes arising with respect to wages paid to the client's workers. Thus, when an employee leasing company files employment tax returns using its own name and employer identification number, but fails to pay some or all of the taxes due, or when no returns are filed with respect to the wages paid by a company that uses an employee leasing company, there can be uncertainty as to how the Federal employment taxes are assessed and collected.

The administration's proposal would set forth standards for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes. The proposal would also allow employee leasing companies to qualify to be solely liable if they met certain specified standards.

Our third proposal would amend collection due process procedures for employment tax liabilities. Currently, we are authorized to take various collection actions including issuing Federal tax levies to collect past-due taxes. Before a tax levy can be issued, however, the IRS generally must provide the taxpayer with notice and an opportunity for an administrative collection due process (CDP) hearing, and for judicial review.

Frequently, an employer who fails to satisfy its Federal tax liabilities for one period will also fail to satisfy them for later periods, resulting in a "pyramiding" of unpaid taxes. Some employers who request a CDP hearing or judicial review for one tax period will continue to accrue, or pyramid, their employment tax liabilities dur-

ing the CDP proceedings. Liabilities for the subsequent periods cannot be collected by levy until the employer has been given notice and opportunity for a hearing and judicial review for each period. The existing CDP framework compounds the pyramiding problem by depriving the government of enforced collection as a tool to encourage employers to satisfy their current Federal employment tax obligations.

Our proposal would allow the levy to be imposed prior to a CDP hearing in a fashion similar to current law provisions for levies issued to collect a Federal tax liability from a State tax refund. Taxpayers would have the right to a CDP hearing with respect to employment tax liabilities within a reasonable time after the levy. Taxpayers would also continue to have access to existing pre-collection administrative appeal rights other than CDP.

The fourth proposal would require increased information reporting and backup withholding for certain government payments for property and services. It should be noted that present law generally requires information reporting for the provision of services and direct sales, but does not for provisions of goods and other property. This proposal will extend information reporting, with some exceptions, to the purchase of property by Federal, State, and local governments.

Our proposal would authorize the Treasury Secretary to promulgate regulations requiring information reporting and backup withholding on non-wage payments by Federal, State and local governments to procure property and services. Certain payments would, of course, be exempt. These include payments of interest, payments for real property, payments to tax exempt entities or foreign governments, intergovernmental payments, and payments made pursuant to a classified or confidential contract.

The final legislative proposal would expand the signature requirement and penalty provisions applicable to paid tax return preparers. Under current law a paid tax return preparer is required to sign and include his/her taxpayer identification number (TIN) on an income tax return and related documents that he/she prepares for compensation. Paid return preparers, however, are not required to sign and include their TINs on non-income tax returns, such as employment tax returns, excise tax returns, and estate and gift tax returns, and tax return related documents filed with the IRS. The administration's proposal would expand preparer identification and penalty provisions to non-income tax returns and tax return-related documents prepared for compensation. Further, it would impose penalties for preparing tax return related documents that contain false, incomplete, or misleading information or certain frivolous positions that delay collection.

These five legislative changes strategically target areas where: (1) research reveals the existence of significant compliance problems; (2) improvements will burden taxpayers as little as possible; and (3) the changes support the administration's broader focus on identifying legislative and administrative changes to reduce the tax gap.

In addition to these specific legislative proposals, we will study the distinction between independent contractors and employees under current law. The improper classification of employees as independent contractors is a significant problem and substantial contributor to the tax gap.

#### FREE FILE

The IRS wants to make free filing of tax returns available to as many taxpayers as possible. We have looked to the private sector for assistance to make this happen as quickly as possible. I referenced earlier the fact that we are experiencing a significant decline in the use of the Free File program in the 2006 Filing season. I also recognize there have been some questions raised as to the renewal of our Free File agreement. Allow me to update you on both the background of Free File and the new agreement.

Free File's roots can be found in the President's fiscal year 2002 Management Agenda. It contained five Government-wide initiatives, one of which was to expand electronic government. The overarching goal was to "champion citizen-centered electronic government that will result in major improvements in the federal government's value to the citizen."

Subsequently, in November 2001, OMB's Quicksilver Task Force established 24 e-government initiatives as part of the President's Management Agenda. These initiatives were designed to improve government-to-government, government-to-business, and government-to-citizen electronic capabilities.

One initiative instructed the IRS to provide free online tax return preparation and filing services to taxpayers. In accordance with this OMB directive, the IRS began working in partnership with the tax software industry to develop a solution.

The IRS believes that private industry, given its established expertise and experience in the field of electronic tax preparation, has a proven track record in providing the best technology and services available. IRS's partnership with private industry: (1) provides taxpayers with high quality services by using the existing private sector expertise; (2) maximizes consumer choice; (3) promotes competition within the marketplace; and (4) meets these objectives at the least cost to taxpayers.

On October 30, 2002, the IRS and the Free File Alliance, LLC, signed an agreement that created a public-private partnership to provide free services to the majority of taxpayers. The Free File Alliance, LLC, is a private-sector consortium of tax preparation software companies. The original agreement was for 3 years with a series of 2-year renewal options. The primary candidates for Free File services were those taxpayers who prepare their own taxes and still file paper returns.

While membership in the Alliance may change from time to time, all members must meet certain IRS standards. Specifically, we must approve each member's proprietary tax preparation software. In addition, each member must obtain third party privacy and security certification. Finally, all Alliance members must adhere to all Federal laws regarding taxpayer privacy.

Each Free File Alliance member was allowed to set taxpayer eligibility requirements for its program. Generally, eligibility was based on such factors as age, adjusted gross income, State residency, eligibility to file a Form 1040EZ or for the Earned Income Tax Credit. But, as a whole, under the original agreement, the Alliance was required to provide free filing services to at least 60 percent or 78 million of the Nation's individual taxpayers. In addition, all active armed forces, Federal reservist and National Guard personnel were eligible to free file through a separate program operated by the military.

While the IRS did not support or endorse any Free File Alliance company or product offering, it did provide a listing of the Alliance members via the Free File web page, which is hosted on IRS.gov. Companies were allowed to offer ancillary services to taxpayers for a fee, but the taxpayer was under no obligation to purchase any of those services as a condition of getting their Federal tax return prepared free of charge.

The intent of the Free File program was to reduce the burden on individual taxpayers, make tax preparation easier and expand the benefits of electronic filing to a majority of Americans. In the 2003 filing season, 2.8 million taxpayers took advantage of Free File. This number rose to 3.4 million in 2004. In 2005, the number increased to over 5 million. Nearly 3.9 million taxpayers have utilized Free File in this filing season.

The 2005 number may be a bit of an aberration in that many of the companies in the Alliance opted to lift qualification restrictions on taxpayers thus allowing any taxpayer, regardless of income, to utilize Free File. This started as some companies sought a competitive advantage by expanding their base and ended with many of the companies in the Alliance offering free return preparation services to anyone.

While this was good for taxpayers in general, it posed a serious threat to the survival of the Alliance and was a prime topic of discussion when the contract was up for renewal at the end of last year. Many of the companies could not continue in the Free File Alliance unless it returned to offering the free service to low and moderate income individuals. The loss of these companies would have jeopardized the continued existence of the Alliance.

As we prepared for negotiations to extend the Free File agreement in 2005, the IRS took the position that Free File should be available to as many taxpayers as possible. The Alliance's position was that Free File should only be available to low and moderate income taxpayers.

As is the case in most negotiations, we compromised and agreed that Free File would be offered to 70 percent of taxpayers, or anyone with an AGI of \$50,000 or less in 2005. This covers approximately 93 million of the 133 million individual taxpayers expected to file returns this year. This is an improvement over our prior agreement which only guaranteed coverage of 60 percent or availability to 78 million taxpayers. The active armed forces, Federal reservist and National Guard personnel continue to be eligible to free file under their own program.

In 2006, three Free File Alliance members are offering State filing for free. Seven members are offering to file Form 4868, Extension of Time to File Individual return. Approximately 46,000 extension forms had been filed as of April 15. In addition, there are two companies offering free packages in Spanish.

While the number of taxpayers taking advantage of Free File in 2006 will likely be less than in 2005, we are unable at this time to fully explain the decline. Certainly the fact that it is not available to everyone is one factor, but there likely are other factors as well.

A year ago, the Free File program benefited greatly from a major article on the front page of USA Today. Immediately following that article, there was a tremendous surge of positive publicity as well as a surge in Free File usage by taxpayers. We have not been the beneficiary of similar publicity this year and to the extent we have received coverage much of it has focused on the taxpayers that Free File does not cover.

One of the major concerns that many critics of the Free File program have had has been the ability of the Alliance members to use Free File to market other services to taxpayers. These include the filing of State tax returns and the offering of refund anticipation loans (RALs). We make it clear to taxpayers that the IRS does not endorse any of these products or services nor is the completion of their tax return at no cost conditioned on the purchase of any product or service.

Because the IRS does not directly monitor Free File return preparation, we generally do not know what, if any, fee services taxpayers actually use from the Free File vendors. The one service that we do have data on is refund anticipation loans (RALs). RALs are designed to provide the taxpayer an immediate refund in the form of a consumer loan. Often the costs incurred with the RAL are disproportionate to the amount of the refund, especially considering that a taxpayer that files electronically will get the refund from the IRS in about 2 weeks. Unfortunately, it is often low income taxpayers, the ones who can least afford it, who choose RALs.

What we are seeing from our Free File data thus far in this regard is encouraging. Only 0.6 percent of the taxpayers utilizing Free File have utilized a RAL. In fact, half of the Free File vendors do not even offer refund anticipation loans. In part this may be due to the strong consumer protection language included in the new agreement. The agreement specifies that any alliance member offering a RAL must include clear language indicating that RALs are a loan and not a faster way of receiving an IRS refund. It also requires them to specify that because the RAL is a short term loan, interest rates may be higher than some other forms of credit available to consumers. The agreement also limits an Alliance member to asking a taxpayer about a RAL only once. If the taxpayer says no, then there can be no other pressure applied to convince him or her to change his or her mind.

This 0.6 percent RAL participation for Free File is the lowest of any of our electronic filing groups. Other online filers have a 0.8 percent participation rate. The rate for online returns done by paid tax return preparers is the highest. Approximately 20 percent of the paid preparer returns submitted electronically include a RAL.

#### 7216 PROPOSED REGULATIONS

Another issue about which there has been considerable controversy is the proposed modification of regulations under section 7216 of the Internal Revenue Code, which addresses use and disclosure of tax return information by tax preparers. I must admit that I was somewhat surprised by the reaction to the proposed regulations particularly since the current regulations have allowed for taxpayer consent to disclosure for more than 30 years. Protecting the confidentiality of tax return information is of paramount importance to the IRS and our intent in proposing the regulations was to tighten existing rules and articulate how the tightened rules should be applied in an electronic return preparation environment.

The furor that has arisen in recent weeks over the proposed changes tells me that few taxpayers were previously aware of this provision and of the consequences of consenting to disclosure or use of their tax return information. To that extent, the debate has been good in that taxpayers are hopefully now better educated about disclosure and sharing of information and will be more careful about what they consent to.

Beyond that, it is important to remember several things. First, this is only a proposed regulation. We have had numerous comments both in writing and at the public hearing we held on April 4. We will evaluate all those comments before going forward with any final regulation.

Second, the proposal contains some important taxpayer protections relative to what a tax return preparer would have to do in order to get consent to share or use any of the taxpayer information the taxpayer gave the return preparer to prepare his or her tax return. In addition, there are important new restrictions on the ability of tax return preparers to shift tax return information overseas for tax return preparation or data processing purposes.

Third, the proposed regulations would treat all tax return preparers the same way. Under the current regulations, tax return preparers that are part of an "affiliated group" of corporations can obtain taxpayer consent to use information to solicit business for their corporate affiliates. This rule was written over 30 years ago and

has no application to the vast majority of return preparers that are not organized as affiliated groups of corporations. This leads to illogical results, particularly when contrasted with the provision in the current rules that allows taxpayers to consent to “disclose” their tax return information to third parties that have no connection whatsoever with the tax return preparer. The IRS has received a number of comments on this issue and will carefully consider them in finalizing the proposed regulation to ensure that the goal of protecting taxpayer privacy is achieved.

Finally, an outright ban on sharing of tax return information raises some interesting questions and may lead to illogical results if taxpayers were prohibited by law from ever consenting to a tax return preparer disclosing or using their tax return information for any purpose.

#### CONCLUSIONS

Mr. Chairman, members of the subcommittee, I would like to emphasize the following points:

- E-Filing continues to grow. Over 63 million people have already e-filed their return, 63 percent of all returns filed.
- Taxpayers who are e-filing from their home computers show the greatest increase in e-filing, up almost 13 percent from a year ago.
- Hits to IRS’s web site, IRS.gov are almost 114 million, up 3.39 percent over last year.
- Returns filed by VITA and TCE sites are up 7.3 percent over a year ago.

In addition, the best way to maintain our success in our compliance and enforcement efforts, reduce the tax gap, and continue the achievements made in 2006 is the adoption of the President’s proposed budget for fiscal year 2007, particularly the \$137 million for enforcement that is part of a program integrity cap adjustment, and enactment of the five legislative proposals.

Thank you, Mr. Chairman and I will be happy to respond to any questions.

#### STATEMENT OF RAYMOND T. WAGNER, JR.

Senator BOND. Thank you very much, Commissioner, and now let me turn to Chairman Wagner.

Mr. WAGNER. Thank you, Mr. Chairman.

Before I begin, I almost feel compelled to dial up my 11-year-old daughter, Mary Ruth, and put her on my speakerphone right here or at least take her photo and put it on the front side of my name tag.

Mr. Chairman, members of the committee, Senator Murray, thank you for the opportunity to present the IRS Oversight Board’s recommendations for the fiscal year 2007 budget. Before I begin my testimony on the budget, I would like to take a moment to commend the Commissioner and the Internal Revenue Service on what appears from all accounts to be a very successful filing season.

I have submitted a detailed written statement and ask that it be made a part of the hearing record.

The Oversight Board recommends a fiscal year 2007 IRS budget of \$11.3 billion, an increase of \$732 million or 6.9 percent over the enacted fiscal year 2006 budget as compared to the administration’s request of \$10.6 billion. The two budgets share some essential elements. Both reflect the same adjustments for inflation of \$272 million. Both show a savings and reinvestment of \$122 million, and both are supplemented by \$135 million in increased user fees.

The board recognizes the theme of fiscal austerity in the President’s budget and respects the administration’s request; however, our statutory charge is to recommend a budget that will ensure that the IRS can carry out its mission and annual and long plans.

Mr. Chairman, you are very aware of the large tax gap. You spoke of it in your opening statement. We believe that reducing the

tax gap requires a comprehensive long-term plan with organizational commitment and actions described in my written statement. The board believes that a flat IRS budget does not do enough to shrink the tax gap and recommends an increase of \$705 million in four program areas: \$44 million for more taxpayer services, \$368 million for more enforcement, \$105 million for management and infrastructure, \$189 million for the Business Systems Modernization program.

In the area of customer service, the board seeks to restore the telephone level of service on IRS's main toll-free line to the fiscal year 2004 level of performance or 87 percent. The board also recommends an additional \$368 million for enforcement. Of that, \$308 million would provide for the modest increase in IRS enforcement resources across all taxpayer segments. The IRS has demonstrated there is a positive return on these types of investments.

The remaining \$60 million for our enforcement increase is for additional research. The IRS needs to know much more about the noncompliance to mount a successful campaign against the tax gap. It is time that the IRS make up-to-date research the normal way of doing business. To this end, the board recommends that the IRS make the National Research Program permanent and perform compliance research annually. This effort should be guided by a long-term plan for research. We also need solid research on customer service needs and how customer service affects compliance.

I want to emphasize that taxpayers want more service and more enforcement from the IRS. The board surveys of taxpayer attitudes in 2004 and 2005 indicates that approximately two-thirds of taxpayer support additional IRS funding for both service and enforcement.

Time does not permit me to describe our recommendation for infrastructure and management fully, but I would like to highlight one specific recommendation, the need to restore leadership development training to fiscal year 2003 levels, which is especially critical during a period in which approximately 50 percent of IRS managers are eligible for retirement.

It is also critical to discuss Business Systems Modernization. Despite productivity improvements, the IRS is still forced to rely on a 40-year-old information system for its central recordkeeping, which limits the IRS to weekly updates of its primary taxpayer records. No modern financial institution in the private sector could survive under these conditions. Eliminating these limitations are key to making the IRS as efficient and effective as a modern financial institution.

#### PREPARED STATEMENT

Improved management focus has helped BSM deliver important technology projects that are generating greater efficiencies and real world benefits for taxpayers, such as CADE and modernized E-file. Cutting back on modernization will force the program to take longer and cost more than necessary in the long run. The board recommends that BSM move forward at an accelerated pace.

Mr. Chairman, this concludes my oral statement and I will be pleased to accept your questions.

[The statement follows:]

## PREPARED STATEMENT OF RAYMOND T. WAGNER, JR.

## INTRODUCTION AND OVERVIEW

Mr. Chairman, thank you for this opportunity to present the Oversight Board's views on the administration's fiscal year 2007 IRS budget request. I will explain in my testimony why the Board believes its proposed budget is needed to meet the needs of the country and of taxpayers. In developing these recommendations, the Board has applied its own judgment but has also drawn on the collective wisdom of others in the tax administration community, including the IRS, Government Accountability Office (GAO), the Treasury Inspector General for Tax Administration (TIGTA), National Taxpayer Advocate, and Congress.

In fulfilling its responsibilities, the Board must ensure that the IRS's budget and the related performance expectations contained in the performance budget support the annual and long-range plans of the IRS, support the IRS mission, are consistent with the IRS goals, objectives and strategies and ensure the proper alignment of IRS strategies and plans. In addition to my statement today, the Board is developing a formal report in which it will explain why it has recommended this budget for the IRS.

Now is a fiscally challenging time for our Nation. Defense and homeland security needs coupled with rebuilding efforts along the hurricane-ravaged Gulf Coast have placed an enormous strain on the Federal budget.

In addition to our fiscal challenges, taxpayers are expected to comply with an increasingly complex tax code which places heavy burdens on honest taxpayers who wish to comply and offers untold opportunities for mischief by those who do not.

Against this backdrop, it is imperative that government work better and smarter and get the most out of every taxpayer dollar. But there is also a drain on the Treasury that undermines our country's tax revenues and threatens the integrity of our tax administration system—the tax gap.

The IRS recently disclosed that the Nation's annual tax gap—the difference between what is owed and what is collected annually—stands at \$345 billion, and some experts believe it could be even more. The Board considers the existence of such a large tax gap to be an affront to honest taxpayers, and is pleased with the attention that Congress has focused on the tax gap in the last year, especially with the release of the IRS's latest tax gap estimates. The Board, along with many other members of the tax administration community, believe that reducing the tax gap requires a comprehensive, multi-faceted plan with action on many fronts—from a simpler tax code and more complete income reporting to better enforcement and quality customer service.

Such an approach needs to be more thoughtful and comprehensive than merely increasing IRS resources and expecting that the gap will shrink. However, increased IRS resources are certainly a part of the solution. A successful strategy will encompass several separate but interrelated approaches that will reinforce each other to produce the desired result. In the Board's opinion, a number of actions that can be taken will require additional IRS resources.

The Oversight Board recommends an integrated set of strategies to close the tax gap: (1) tax code simplification; (2) improved information reporting and enforcement tools related to the cash economy; (3) improved customer service to make taxpayers aware of their obligations and modern technology to ease their burdens; (4) greater focus on research; (5) more productive partnerships between the IRS and tax professionals; and (6) and more emphasis on personal integrity.

There can be no doubt that in the last 5 years the agency has achieved significant progress in all dimensions of its mission. Customer service has rebounded from the lows of the 1990's and through targeted investments and greater management focus, IRS enforcement has also turned the corner.

This across-the-board improved performance has not gone unnoticed—especially among taxpayers. According to the 2005 American Customer Service Index, overall satisfaction among individual tax filers with the Internal Revenue Service remains stable at 64 percent; it is even higher among e-filers. The IRS Oversight Board 2005 Annual Survey also found that American taxpayer support for overall compliance reached an all-time high. However, the IRS's job is far from complete and it must close the tax gap while achieving balance in other parts of its critical mission.

The Board recommends budget increases in four IRS program areas in fiscal year 2007: customer service, enforcement, Business Systems Modernization, and infrastructure and management tools.

To achieve balance and ultimately compliance, the Board recommends two modest investments in customer service to ensure that there is no slippage in hard won gains. For example, the toll-free telephone level of service is slightly down and wait

times have increased compared to fiscal year 2004. The Board proposes restoring customer service to fiscal year 2003–2004 levels and investing in telephone infrastructure. It is far less expensive to prevent or solve a problem early on than let it grow.

The Board proposes a modest increase in resources for virtually all IRS enforcement activities. This is money well-spent and there is a growing recognition of the positive return on money invested in the IRS. The Board strongly believes that the enforcement increase includes a significant investment in research to better understand enforcement and customer service needs and the impact of customer service on voluntary compliance. The Board's recommended budget puts the IRS on track to make the National Research Program (NRP) permanent and produce annual tax gap estimates. The Board further recommends that the IRS consider developing a long-term strategic plan for research.

Business Systems Modernization is also a priority and the Board advocates a larger investment in information technology to improve IRS productivity and reduce taxpayer burden. Despite productivity improvements in recent years, the IRS is still hampered in its efforts to modernize because of its reliance on a 40-year-old information system for its central recording-keeping functions, which limit the IRS to weekly updates of its central taxpayer records. No modern financial institution in the private sector could survive under these conditions and eliminating these limitations is key to making the IRS an efficient and effective modern financial institution.

Lastly, the Board recommends a number of management increases that will help the IRS cope with unfunded mandates, implement BSM projects, and restore leadership training to fiscal year 2003 levels, which has become especially critical during a period in which over 50 percent of IRS managers are eligible to retire.

Overall, the Oversight Board proposes a budget that is good for the country, good for taxpayers, and allows the IRS to achieve its strategic goals and objectives in an efficient and effective manner. It calls for \$11.3 billion funding for fiscal year 2007, a 6.9 percent increase over last year's appropriation.

The Board has also voiced concern that two items in the administration's proposed fiscal year 2007 budget for the IRS pose significant risks. First, the budget proposes \$84 million in savings from program efficiencies. The Oversight Board believes there is a risk that these reductions will decrease performance. Second, last December the IRS announced that it would dramatically raise fees for certain services and the President's budget assumes that the IRS will receive an additional \$135 million in fee revenue. Although the IRS has expressed confidence it would receive this amount in additional fees based on its estimates, there is still some risk whether the estimated fee revenue can be achieved. In addition, external stakeholders have expressed concern that the additional fees could have an unintended negative impact on taxpayer compliance.

In conclusion, the Board believes that it has constructed a fiscally responsible and realistic budget for the IRS that meets national needs and priorities. It would help shrink the tax gap while providing taxpayers with a level of service they rightly deserve and need. It would speed the modernization of the IRS's antiquated technology and give it the research tools to better understand current and developing trends. Most importantly, it would maintain that delicate but critical balance between enforcement and customer service that America's taxpayers have said time and again they want, and which has been validated through the Board's Taxpayer Attitude Survey. The IRS is now solidly on the right track and is making progress, but we must give it the resources to do its job. It is the right investment for this and future generations of taxpayers.

#### *Recommended IRS Oversight Budget in Brief*

The IRS Oversight Board recommends a fiscal year 2007 IRS budget of \$11.31 billion, an increase of \$732 million over the enacted fiscal year 2006 budget.<sup>1</sup> This recommendation compares to the President's budget request for the IRS of \$10.59 billion in direct appropriations. The two budgets share the following characteristics:

- Both reflect the same adjustments for inflation, \$272 million.
- Both show a savings and reinvestment of \$121.6 million.
- Both are supplemented by \$135 million in increased user fees to achieve a higher operating level.

<sup>1</sup> The President's budget includes on pages IRS–127 to IRS–129 of the Congressional Justification, as required by law, a copy of the fiscal year 2007 IRS budget the Oversight Board approved and submitted to the Department of the Treasury. The Board's recommended budget, as shown on these pages, is higher than the request shown above; Appendix 6 provides an explanation of the differences.

The Board's budget, however, proposes program increases of \$705 million compared to a proposed program decrease of nearly \$9 million in the President's budget, as shown in the table below.

COMPARISON OF BOARD AND PRESIDENT'S PROGRAM INCREASES

[In thousands of dollars]

Function	Oversight Board Recommendation	President's Request
Taxpayer Service .....	43,637	.....
Enforcement .....	367,768	.....
Infrastructure and Mgt Modernization .....	104,715	20,900
Business Systems Modernization .....	188,600	(29,700)
Total Program Increases (Decreases) .....	704,720	(8,800)

Recommended initiatives for enforcement, customer service, infrastructure and management and Business Systems Modernization can be found in the individual sections of this statement and Appendices 2 through 5.

*IRS Performance From Fiscal Year 2001 to Fiscal Year 2005*

The agency, which had become synonymous with poor customer service in the late 1990's, has demonstrated a remarkable performance improvement in the last 5 years. Toll-free telephone level of service has steadily increased from 56 percent in fiscal year 2001 to a high of 87 percent in fiscal year 2004. (In fiscal year 2005, there was a slight 3 percent drop which the IRS attributes to reduced funding for taxpayer services.) Toll-free tax law accuracy also rose from 82 percent in fiscal year 2003 to an impressive 88 percent in fiscal year 2005.

Perhaps the most important and notable gain recorded over the past 5 years is the percent of individuals filing electronically—31 percent in fiscal year 2001 to 51 percent in fiscal year 2005.<sup>2</sup> And although it will miss the 2007 deadline, the IRS is making steady progress in closing in on the 80 percent e-file goal established by the IRS Restructuring and Reform Act of 1998.

Through targeted investments and greater management focus, IRS enforcement has also turned the corner. Enforcement revenue rebounded from \$33.8 billion in fiscal year 2001 to \$44.1 billion in fiscal year 2005. Audit rates also steadily increased. For high-income individuals they rose from 0.79 percent in fiscal year 2001 to 1.61 percent in fiscal year 2005. Over the same time period, corporate and small business audits increased respectively from 13.5 percent to 16.9 percent and 0.88 percent to 1.32 percent.

*Taxpayers Respond to Better Performance but Problems Remain*

This across-the-board improved performance has not gone unnoticed—especially among taxpayers. According to the 2005 American Customer Service Index, overall satisfaction among individual tax filers with the IRS remains stable at 64 percent. However, the number is much higher among e-filers who had an ACSI score of 77 percent.<sup>3</sup> By way of comparison, the IRS received a 51 percent score in 1998. Taxpayer attitudes have also improved. Since 2002, the IRS Oversight Board has conducted an annual survey to gain a deeper understanding of taxpayers' attitudes. Of great concern was the growing number of individuals who thought it acceptable to cheat on their taxes.

In 2003, 12 percent of respondents thought it acceptable to cheat a "little here and there" on their taxes, and 5 percent would cheat as much as possible. However, 2 years later those numbers have dropped to 7 and 3 percent respectively and public support for tax compliance is at an all-time high. Moreover, the 2005 survey found that 82 percent of respondents say that their own personal integrity has the greatest influence on whether or not they report and pay their taxes honestly—double the number who cite any other factor. Significantly, the survey also found two out of three surveyed expressed continued support for additional funding for both IRS assistance and enforcement.<sup>4</sup> America's taxpayers want a balanced tax administration system.

However, as welcome as the news may be, it cannot disguise the hard fact that the tax gap has remained unacceptably high. In testimony before the Senate Budget

<sup>2</sup>Statistics provided to the Oversight Board by the IRS.

<sup>3</sup>Professor Claes Fornell, "ACSI Commentary: Federal Government Scores", December 15, 2005.

<sup>4</sup>IRS Oversight Board, 2005 Taxpayer Attitude Survey.

Committee, Comptroller General David Walker stated that the \$345 billion tax gap estimated by the IRS could indeed be greater: “IRS has concerns with the certainty of the overall tax gap estimate in part because some areas of the estimate rely on old data and IRS has no estimates for other areas of the tax gap. For example, IRS used data from the 1970’s and 1980’s to estimate underreporting of corporate income taxes and employer-withheld employment taxes.”<sup>5</sup>

The tax gap is more than an abstract number. According to National Taxpayer Advocate Nina Olson, it hurts taxpayers in a very concrete way:

“The collective failure by certain taxpayers to pay their taxes imposes greater burdens on other taxpayers. The IRS receives approximately 130 million individual income tax returns each year. Given the size of the net tax gap, the average tax return includes a ‘surtax’ of about \$2,000 to make up for tax revenues lost to non-compliance. The tax gap may also impose significant costs on businesses in the form of unfair competition by noncompliant competitors who can pass along a portion of their tax ‘savings’ to customers by charging lower prices.

“Most importantly, the tax gap can erode the level of confidence that taxpayers have in the government, thereby reducing Federal revenue and increasing the need for more examination and collection actions. The tax gap, then, can produce a vicious cycle of increased noncompliance and increased enforcement.”<sup>6</sup>

The IRS Oversight Board believes that its fiscal year 2007 IRS budget recommendations are part of the solution to reversing this corrosive trend.

#### *Budget Environment Should Not Discourage Investment*

The IRS does not operate in a vacuum and the Oversight Board recognizes that the current budget environment stresses fiscal restraint and austerity. However, at the same time, we should not throw up our hands in defeat and say we can do no more to improve tax administration. We should look at the larger picture.

Unlike other government agencies, there is a positive return on money invested in the IRS. Senate Budget Committee Chairman Judd Gregg agrees. He observed at a recent hearing on the tax gap, “We’ve got to talk to the CBO about scoring on that [investing in IRS enforcement], clearly there’s a return on that money.”<sup>7</sup>

The Board would welcome such a change but also recognizes that this is a problem that has plagued the IRS for decades. Former IRS Commissioner Charles O. Rossotti wrote:

“When I talked to business friends about my job at the IRS, they were always surprised when I said that the most intractable part of job, by far, was dealing with the IRS budget. The reaction was usually, ‘Why should that be a problem? If you need a little money to bring in a lot of money, why wouldn’t you be able to get it?’”<sup>8</sup>

Indeed, this lack of recognition of a direct return on investment has left many puzzled. In his April 14, 2004 column, Washington Post financial writer Al Crenshaw wondered why the administration and Congress “aren’t falling over themselves to give the IRS more money. Tax Enforcement pays for itself many times over, and it would be a good way to cut the deficit.”<sup>9</sup>

In its fiscal year 2007 budget recommendation, the Board calls for increases in enforcement that would result in a real return on investment, ranging from \$3 to \$6 on every \$1 spent, resulting in \$730 million revenue by fiscal year 2009 on a \$242 million investment.

The Oversight Board urges Congress to adopt the Board’s budget recommendations and invest in more effective tax administration.

#### SIX STRATEGIES TO REDUCE THE TAX GAP

The Board considers the existence of such a large tax gap to be an affront to honest taxpayers, and is pleased with the attention that Congress has focused on the tax gap in the last year, especially with the release of IRS latest tax gap estimates. The Board, along with many other members of the tax administration community,

<sup>5</sup> Comptroller General David Walker, Testimony Before the Senate Budget Committee, “Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions,” February 15, 2006, GAO-06-453T.

<sup>6</sup> Nina E. Olson, National Taxpayer Advocate, Testimony Before the Senate Subcommittee on Federal Financial Management, Government Information, and International Security Committee on Homeland Security and Governmental Affairs, October 26, 2005.

<sup>7</sup> Tax Notes, February 16, 2006.

<sup>8</sup> Charles O. Rossotti, “Many Unhappy Returns: One Man’s Quest to Turn Around the Most Unpopular Organization in America,” Harvard University Press, 2005, p. 278.

<sup>9</sup> Al Crenshaw, “Letting Cheaters Prosper,” Washington Post, April 14, 2004.

believe that reducing the tax gap requires a comprehensive, multi-faceted plan with action on many fronts—from a simpler tax code and more complete income reporting to better enforcement and quality customer service.

Such an approach needs to be more thoughtful and comprehensive than merely increasing IRS resources and expecting that the gap will shrink. That being said, however, increased IRS resources are a part of the solution. A successful strategy will encompass several separate but interrelated approaches that will reinforce each other to produce the desired result. In the Board's opinion, a number of actions that can be taken will require additional IRS resources.

The Board supports six strategies that it believes would constitute an over-arching plan to reduce the tax gap. This information is presented here only to provide some additional background to understand the Board's fiscal year 2007 budget recommendations, so that these recommendations can be understood in the context of an overall approach where the individual elements reinforce each other.

The first is a simplified tax code. Our complex and ever changing tax code not only confounds honest taxpayers who want to comply with their obligations under the law, but provides ample opportunity for those who exploit its complexity to cheat. The President's Advisory Panel on Federal Tax Reform observed:

"Since the last major reform effort in 1986, there have been more than 14,000 changes to the tax code, many adding special provisions and targeted tax benefits, some of which expire after only a few years. These myriad changes decrease the stability, consistency, and transparency of our current tax system while making it drastically more complicated, unfair, and economically wasteful. Today, our tax system falls well short of the expectations of Americans that revenues needed for government should be raised in a manner that is simple, efficient, and fair."<sup>10</sup>

Second, the Oversight Board recommends improved information reporting and enforcement tools to address large areas of the tax gap related to what has been called the cash economy. Although the Board is prohibited by statute from endorsing any specific proposal, we note that in its fiscal year 2007 budget submission for the IRS, the administration makes five legislative recommendations to close the tax gap that include: (1) increasing information reporting on payment card transactions; and (2) expanding information reporting to certain payments made by Federal, State and local governments to procure property and services. They certainly merit congressional discussion and consideration.

The National Taxpayer Advocate also recommended in her 2005 Annual Report to Congress that the IRS create a cash economy program office, similar to the Earned Income Tax Credit program office. The Board is pleased that the IRS Small Business/Self-Employed Operating Division Commissioner has agreed to establish a task force on the cash economy that will seek to determine the feasibility of this and other recommendations.

In testimony before the Senate Budget Committee, the National Taxpayer Advocate further recommended that to address the tax gap "we should begin by identifying various categories of transactions that currently are not subject to information reporting and determine, on a case-by-case basis, whether the benefits of requiring reporting outweigh the burdens such a requirement would impose."<sup>11</sup> The Board supports such analysis.

Third, the Board believes that the IRS must improve customer service to make taxpayers aware of their legal obligations and ease taxpayer burden through modernization. Indeed, not all non-compliance is willful; a significant amount of it is due to the complexity of the tax laws that results in errors. IRS Commissioner Mark Everson recently testified:

"[T]he tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to the complexity of the tax laws that results in errors of ignorance, confusion, and carelessness. This distinction is important, though, at this point, we do not have sufficiently good data to help us know how much arises from willfulness as opposed to innocent mistakes. This is an area where we expect future research to improve our understanding."<sup>12</sup>

Fourth, there should be a much greater emphasis and focus on research so the IRS can more effectively target areas of major non-compliance. It bears mentioning

<sup>10</sup>Statement by the Members of the President's Advisory Panel on Federal Tax Reform, "America Needs a Better Tax System," April 13, 2005.

<sup>11</sup>National Taxpayer Advocate, "Testimony Before the Senate Budget Committee, Causes and Solutions to the Federal Tax Gap," February 15, 2006.

<sup>12</sup>IRS Commissioner Mark Everson, Testimony Before the Senate Budget Committee, February 15, 2006.

that a lack of research in the 1990's contributed in part to the IRS's failure to detect the emergence and subsequent epidemic of illegal tax avoidance schemes. The Board recommends an additional \$60 million in funding for research. The IRS needs to know much more about non-compliance than it currently does to mount a successful campaign against the tax gap.

Fifth, the Board urges a more productive partnership between IRS and the tax administration community. At the Board's 2006 open meeting, the AICPA supported the IRS's efforts to partner with professional organizations in the area of pro bono tax assistance, noting that such a synergy provides the IRS with the opportunity to leverage precious resources and increase customer service at the same time. The Board would add that such a partnership also contributes directly to compliance.

Sixth, there must be more emphasis on personal integrity in making tax decisions. The Board has found that the vast majority of taxpayers state that their personal integrity is a very important factor in influencing their tax compliance. In the Board's most recent Taxpayer Attitude Survey, 82 percent of taxpayers cite personal integrity as the principal factor for reporting and paying their taxes honestly. Commissioner Everson also testified at the Senate Budget Committee tax gap hearing:

"[A]nother enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. Our system of tax administration depends upon the integrity of practitioners. The vast majority of practitioners are conscientious and honest, but even the honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures."<sup>13</sup>

Our tax administration system should challenge taxpayers to be conscious of the need for integrity when making tax decisions.

The Oversight Board recognizes that no single initiative or program will solve the tax gap—a multi-faceted effort must be taken to shrink it. The plan must be more comprehensive than just applying additional resources to do more of what is being done today. Indeed as Commissioner Everson told the Senate Budget Committee, a combination of appropriate funding, legislative changes, new enforcement tools, tax simplification and auditing and taxpayer service improvements, will allow the IRS to collect an additional \$50 billion to \$100 billion.<sup>14</sup> The \$705 million in additional funding recommended by Board to help in this effort is dwarfed in comparison to this estimate of new revenues collected.

#### COMPARING THE PRESIDENT'S AND BOARD'S FISCAL YEAR 2007 BUDGET RECOMMENDATIONS

The size of the tax gap should be a clarion call for our Nation to examine the tax administration system and invest time, energy, and resources to making it better.

This is not the time to stand still but to move forward in a comprehensive and unified way to build on what has already been accomplished and give America's taxpayers a better, more efficient and fair system in return—what the President's tax reform panel suggested. The Oversight Board's fiscal year 2007 budget recommendations focus on the IRS resources needed to move forward in fiscal year 2007, but much more needs to be done.

To this end, the Board recommends additional investments in better service, enforcement, infrastructure and management, and BSM in the following amounts:

- Taxpayer Service—\$43,637.
- Enforcement—\$367,768.
- Infrastructure and Management—\$104,715.
- BSM—\$188,600.

Additionally, the Oversight Board has identified two areas of significant risk in the IRS's fiscal year 2007 budget request. First, the IRS budget justification includes \$84.1 million in savings coming from program efficiencies. The Board is concerned that the IRS may not be able to achieve these efficiencies without decreasing performance.

Second, the proposed IRS budget for fiscal year 2007 in direct appropriations is supplemented by \$135 million in increased user fees. The IRS announced last December that it would charge taxpayers for receiving advance assurance from the IRS

<sup>13</sup> Everson, *op. cit.*

<sup>14</sup> Tax Notes, "Everson Says IRS Could Collect Up To \$100 Billion More Per Year", February 16, 2006.

about the tax consequences of certain transactions. For example, the fee for IRS Chief Counsel private letter rulings will increase from \$7,000 to \$10,000.<sup>15</sup>

The Oversight Board believes that there is risk in assuming that this revenue stream will be available without a proven record of collecting fees at this level, especially since the IRS could not present the Board with fiscal year 2006 data to confirm the realism of the proposed fiscal year 2007 revenue stream. The Board recommends that Congress evaluate actual fiscal year 2006 fee collection data to evaluate the validity of the proposed fiscal year 2007 revenue expected from increased fees.

The Board is also concerned about the negative impact these fees might have on taxpayer compliance. Testifying at the Board's annual public meeting, the AICPA was also apprehensive that these increases will result in a substantial reduction in general taxpayer use of critical IRS programs:

"These programs for the most part encourage taxpayers to seek advance assurance from the IRS that the tax consequences of their proposed actions will be treated consistently by both the taxpayer and the IRS. Actions by the IRS that discourage use of programs, such as private letter ruling requests, could result in greater compliance costs for taxpayers and enforcement costs for the IRS."<sup>16</sup>

*Customer Service: What Is "Good Enough?"*

Good customer service leads to fully informed and satisfied taxpayers who understand their tax obligations and experience few problems in interacting with the IRS. Clearly, there is a linkage between customer service and compliance. Speaking at the Board's 2006 open meeting, Diana Leyden, Associate Clinical Professor of Law, University of Connecticut School of Law Tax Clinic said:

"Customer service at the Internal Revenue Service has a direct impact on voluntary compliance and ultimately on the tax gap. For example: (1) making it easier for taxpayers to get their returns prepared free of charge and quickly encourages taxpayers to become compliant; (2) providing face-to-face interaction with IRS employees helps taxpayers get advice in 'real time' and usually reduces the time for resolution of problems."<sup>17</sup>

At the April 14, 2005 Senate Finance Committee hearing on closing the tax gap, Ranking Member Max Baucus similarly observed:

"The IRS cannot close the tax gap simply by increasing enforcement. Issuing more liens. Conducting more seizures. Levying more bank accounts. We do need targeted, appropriate enforcement. If, however, the IRS lets taxpayer service slide—if the IRS diminishes the access and accuracy of taxpayer service—including the essential need for face-to-face taxpayer service—then we fail to help taxpayers comply with the law on the front end. Ensuring up front quality is more efficient than back end enforcement."<sup>18</sup>

However, efforts to provide quality customer service are hindered by the fact that there is no consensus among the tax administration community on desired customer service standards of performance, which makes informed decision-making about desired levels of service very difficult. Achieving such a consensus among the executive and legislative branches and external stakeholder organizations would allow customer service requirements to influence budget decisions rather than having budget decisions set service levels.

The drive for improved customer service is further aggravated by the lack of data on the impact that service levels have on taxpayer compliance. Such data could be used to make a stronger case to policy makers about the importance of customer services. We should not retreat from the high customer service levels previously achieved during fiscal year 2003/2004. Two initiatives contained in the Board's budget are designed to prevent such a reduction.

First, although significant progress has been made during the past 5 years, toll-free telephone level of service is slightly down from fiscal year 2004 and call wait-time on hold has increased. To restore the level of service, the Oversight Board proposes an initiative to restore the toll-free telephone service to fiscal year 2003/2004

<sup>15</sup> IRS Press Release, "IRS to Raise Some User Fees in 2006," IR-2005-144, December 19, 2005.

<sup>16</sup> AICPA, Statement Presented to the IRS Oversight Board, "Meeting the Customer Service Needs of Taxpayers and the Importance of Measures", February 8, 2006.

<sup>17</sup> Statement of Diana Leyden, Associate Clinical Professor of Law, University of Connecticut School of Law Tax Clinic Before the IRS Oversight Board, February 8, 2006.

<sup>18</sup> Senator Max Baucus, Opening Statement, Senate Finance Committee, Hearing, April 14, 2005.

levels. Although the cost is \$35 million, the Board believes that this level of service should be provided to taxpayers. The potential impact of lower service is that taxpayers will not get the assistance they need, hurting compliance, and creating a need for additional enforcement. As Senator Baucus rightly observed, preventing problems is more cost-effective than the price of future corrections, such as collection.

Second, the Board also recommends an \$8.7 million investment in telephone infrastructure to expand services to callers and provide telephone representatives with a more state-of-the-art call center environment. The IRS predicts this investment would result in lower queue times across the enterprise for all applications and would counter a negative trend in telephone service. (Wait time on hold for taxpayers has been increasing in the last 3 years. It has gone from 158 seconds in fiscal year 2004 to 258 seconds in fiscal year 2005, and the fiscal year 2006 target is 300 seconds.)

*Enforcement Must Continue to Improve; More Research Needed*

As noted earlier in this report, the IRS has boosted its enforcement activity, and enforcement revenue has increased during the last 2 years. The IRS is working smarter and it needs to continue to improve and build on this important trend.

However, it should be noted that despite these positive results, it is difficult to evaluate the impact that increased enforcement activity has had on overall taxpayer compliance.

Absent this information, the Oversight Board still believes that one important element of the campaign to reduce the tax gap should be increasing IRS enforcement resources, especially since the application of additional resources has a positive return on investment. The Board recommends a modest increase in enforcement resources in virtually all IRS enforcement activities, including:

- 1. *Combat Egregious Non-Compliance and Prevent Tax Gap Growth (+\$136 million).*—Add 748 FTEs to enhance coverage of high-risk compliance areas and address the tax gap associated with small business and self-employed taxpayers.
- 2. *Intensify Tax Enforcement (+\$28 million).*—Add 86 FTEs to curtail non-compliance in abusive schemes, corporate fraud, non-filers, employment tax and Bank Secrecy Act.
- 3. *Attack Fraudulent Payments (+\$27 million).*—Add 62 FTEs to address fraudulent payments made through the EITC program.

The IRS must also do a better job of identifying where non-compliance is occurring. For example, IRS data indicates impressive results on abusive, high-profile tax shelters, such as Son-of-BOSS. However, the most recent research indicates that a majority of the tax gap is the result of underreporting of income in areas where there is little third-party reporting.

According to the IRS's National Research Program, half (\$109 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). Approximately 28 percent (\$56 billion) came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining \$32 billion came from overstated subtractions from income (i.e. statutory adjustments, deductions, and exemptions), and from overstated tax credits.

Given this situation, the Oversight Board believes that special attention should be placed on the National Research Program and additional research be conducted on customer service and its relation to compliance. Indeed, the National Taxpayer Advocate "recommends that the IRS undertake a research-driven needs-assessment, from the taxpayers' perspective, to help identify what services taxpayers need and want and how best to deliver them."<sup>19</sup> These efforts are necessary to improve tax administration to the point where the effects of IRS activities on taxpayer compliance can be better understood. To this end, the Board proposes two research initiatives: (1) Improve Tax Gap Estimates (+\$46 million); and (2) Additional Customer Service Research (+\$15 million).

The first of these two initiatives, Improve Tax Gap Estimates, will establish permanent staffing for the NRP program and put the IRS on a path to conducting research annually. The Oversight Board recommends that the NRP be made a permanent program. The NRP is now reporting estimates of the tax gap based on 2001 tax returns. Prior estimates were based on extrapolations of 1988 data. It is time to progress from "catching up" to making current research the normal and preferred way of doing business.

<sup>19</sup>The National Taxpayer Advocate, 2005 Annual Report to Congress, Executive Summary, p. I-1.

The Board also proposes that the IRS consider developing a long-range strategic plan for research that goes beyond the current 2009 end date for the IRS Strategic Plan, and covers approximately a decade. In such a plan, the IRS should describe how it will bring its research on all taxpayer segments up to date, and perform a limited sample every year so that its research on all segments will be as current as possible.

The Board believes the availability of up-to-date research data will allow the IRS to more effectively focus its service and enforcement programs on areas that have the greatest impact on taxpayer compliance, and use the changes in taxpayer compliance rates as feedback to evaluate the effectiveness of IRS's service and enforcement program on actual taxpayer compliance. Achieving such a capability will be a vast improvement over the current situation in which the lack of data makes it virtually impossible to evaluate the effectiveness of IRS activity on taxpayer compliance and make informed decisions.

The second research initiative recommended by the Board is to add \$15 million to begin research on the impact of customer service on voluntary compliance and the service needs of taxpayers. The need for such research is also consistent with recommendations made by Treasury Inspector General for Tax Administration and the National Taxpayer Advocate in testimony last year to the Senate Appropriations Committee on the closing of a number of Taxpayer Assistance Centers. (The committee has also requested TIGTA to evaluate the connection between service and compliance in its study of TAC closings, but TIGTA was unable to find much existing research.)

However, the IRS has told the Oversight Board that it could extend and update research efforts in two major areas: evaluating the service needs of taxpayers and estimating the effect of customer service on taxpayer compliance. Additional resources in fiscal year 2007 would be used to further evaluate the service needs of taxpayers and to scope and design the data gathering and analysis capability to estimate the effect of customer service on taxpayer compliance.

A modest initial effort should include identifying promising areas of research and determining data needs. If the initial efforts are promising, this could be expanded in future years. Due to the long-term nature of these studies, resources should be provided on a multi-year basis.

#### *Modernizing Infrastructure and Management*

The Oversight Board is pleased that the IRS is developing an IRS Infrastructure Roadmap. It is a detailed plan for replacing the agency's aging IT equipment in an orderly and cost-effective manner. Rather than replacing outdated equipment on a one-for-one basis, the roadmap will identify and prioritize opportunities to consolidate equipment, retire redundant and low-demand infrastructure components, and replace old equipment with new technology that is cheaper to maintain and use. Because the IRS fully anticipates that the Infrastructure Roadmap will identify new strategies for IT infrastructure delivery that will mitigate the cost of replacing old IT equipment while assuring a sound IRS IT infrastructure, the Board is deferring any recommendations on modernizing IT infrastructure until fiscal year 2008.

The Oversight Board does recommend funding infrastructure and management initiatives that will assist the IRS to cope with unfunded mandates, implement BSM projects, and restore its capacity for leadership development training to fiscal year 2003 levels:

- 1. Fund Business Unit IT Solutions (Non-Major Investments);
- 2. Implement e-Travel;
- 3. Fund HR Connect;
- 4. Consolidate Philadelphia Campus (included in the President's budget); and,
- 5. Restoration of Leadership Development Training to fiscal year 2003 levels (Board-initiated).

The Board notes that a lack of leadership training capacity at the IRS is especially critical during a period in which approximately 50 percent of IRS managers are eligible for retirement. The Board recommends a consistent budget base to allow planning for these anticipated leadership development training needs.

The requested funds would enable the IRS to: (1) eliminate the backlog of untrained leaders at all levels by the end of fiscal year 2007; (2) ensure enough capacity to train new managers upon selection in all Business Units; (3) improve and expand readiness programs to provide a cadre of manager candidates to step up to management positions; (4) revise the management curriculum to incorporate more e-learning and promote continuous learning; and (5) evaluate the effectiveness and impact of the leadership development training program.

Funding Leadership Development Training at fiscal year 2003 levels will also assist in meeting the objectives of the President's Management Agenda, which in turn

will improve performance and the IRS's objectives of enhanced employee engagement, employee satisfaction and customer satisfaction.

*Business Systems Modernization*

The Board is pleased that the IRS's once-troubled BSM program experienced better performance in fiscal year 2005. In a recent report submitted to Congress on the BSM fiscal year 2006 expenditure plan, the Government Accountability Office offered these positive comments:

"IRS has made further progress in implementing BSM . . . Future BSM project deliveries face significant risks and issues which IRS is addressing . . . IRS has made additional progress in addressing high-priority BSM program improvement initiatives. [They] appear to be an effective means of assessing, prioritizing, and addressing BSM issues and challenges . . . In response to our prior recommendations, IRS reports having efforts under way to develop a new Modernization Vision and Strategy to address a new modernization roadmap."<sup>20</sup>

GAO also had some criticism of the IRS and BSM, but improved management focus over the past few years has helped the BSM program deliver within cost and budget targets important technology projects that will generate greater efficiencies throughout the agency and real world benefits for taxpayers.

The first taxpayers have already been moved to a modernized data base known as the Customer Account Data Engine (CADE) and corporate taxpayers are now able to file their income tax returns with the IRS electronically using the Modernized e-File system. Indeed, CADE will process more than 30 million returns in 2007 and will process 70 million by 2009. Daily updates by CADE will allow taxpayers to receive their refund in just a few days.

Future BSM deliverables are also critical to improved customer service and enforcement. The IRS does not yet offer products and services familiar to customers of many financial institutions, such as daily updating of accounts, electronic access by customers to account records, and a full range of electronic transactions. However, with the help of modern technology, the IRS can close this gap.

If the IRS can continue to demonstrate improvement, it would seem desirable and logical to increase BSM's pace and program funding in fiscal year 2007, especially as BSM funding levels were severely reduced in the last several years: from \$388 million in fiscal year 2004 to \$203 million in fiscal year 2005, and a requested \$199 million in fiscal year 2006. In addition to the base, the Board would fund:

- 1. Web-based Self-service (+ \$24 million);
- 2. Filing and Payment Compliance (+ \$30 million);
- 3. Modernized e-Filing (+ \$70 million);
- 4. Customer Account Date Engine (+ \$25 million);
- 5. Core Infrastructure (+ \$18 million);
- 6. Architecture, Integration, and Management (+ \$13 million); and,
- 7. Management Reserve (+ \$9 million).

Therefore, the Board recommends that the BSM program move forward at an accelerated pace. Not only will this allow the IRS to operate more efficiently and effectively, it will strengthen the agency's efforts to enforce the tax law and improve customer service. Despite productivity improvements in recent years, the IRS is still hampered in its efforts to modernize because of its reliance on a 40-year-old information system for its central recording-keeping functions, which limit the IRS to weekly updates of its central taxpayer records. No modern financial institution in the private sector could survive under these conditions, and eliminating these limitations is key to making the IRS an efficient and effective modern financial institution.

We would like to make one last point on modernization. Both GAO and TIGTA have reported on the cost overruns and delays the BSM program has experienced. However, one cost you will not hear about is the significant cost to the taxpayers of delaying the benefits of a modernized IRS.

Professor Joel Slemrod of the University of Michigan testified to the President's Advisory Panel on Federal Tax Reform that individual taxpayers spend approximately \$85 billion a year complying with the tax code.<sup>21</sup> If a modernized IRS makes

<sup>20</sup> General Accountability Office, Report to Congress, "Business Systems Modernization: Internal Revenue Service's fiscal year 2006 Expenditure Plan," February 2006, GAO-06-360, pp. 2-3.

<sup>21</sup> Statement of Professor Joel Slemrod, University of Michigan Ross School of Business, before the President's Advisory Panel on Federal Tax Reform, March 3, 2005.

taxpayers only 5 percent more efficient, that would still save taxpayers over \$4 billion a year.

CONCLUSION

The IRS Oversight Board believes that it has constructed a fiscally responsible and realistic budget for the IRS that meets national needs and priorities. It would help shrink the tax gap while providing taxpayers with a level of service they rightly deserve and need. It would speed the modernization of the IRS's antiquated technology and give it the research tools to better understand current and developing trends. Most importantly, it would maintain that delicate but critical balance between enforcement and customer service that America's taxpayers have said time and again they want. The IRS is now solidly on the right track and is making progress but we must give it the resources to do its job. It is an investment we must make for this and future generations of taxpayers.

*Appendices.*—(1) Comparison of the Administration's IRS Fiscal Year 2007 Budget Request and IRS Oversight Board Recommendation; (2) Recommended Fiscal Year 2007 Program Increases: Enforcement; (3) Recommended Fiscal Year 2007 Program Increases: Taxpayer Service; (4) Recommended Fiscal Year 2007 Program Increases: Infrastructure and Management Modernization; (5) Recommended Fiscal Year 2007 Program Increases: Business Systems Modernization; (6) Explanation for Difference in IRS Oversight Board Budget in the Administration's Fiscal Year 2007 Budget Request and This Recommendation.

APPENDIX 1

COMPARISON OF THE ADMINISTRATION'S IRS FISCAL YEAR 2007 BUDGET REQUEST AND IRS OVERSIGHT BOARD RECOMMENDATION

[Dollars in thousands]

Final Board Budget	Board's Budget	President's Budget	Difference
Fiscal Year 2006 Enacted Budget (with 1 percent rescission) .....	\$10,573,706	\$10,573,706	.....
Fiscal Year 2007 Maintaining Current Levels (MCLs) Adjustments (includes HITCA):			
Labor Annualization .....	\$61,994	\$61,994	.....
Labor MCL (2.7 percent) .....	\$149,819	\$149,819	.....
Non-Labor MCL (1.5 percent) .....	\$60,418	\$60,418	.....
Total MCL Adjustments .....	\$272,231	\$272,231	.....
Base Reinvestment:			
Increase Returns processing efficiencies .....	\$12,237	\$12,237	.....
Program Cost Savings:			
E-file savings .....	(\$6,760)	(\$6,760)	.....
Improvement project savings .....	(\$8,215)	(\$8,215)	.....
Competitive sourcing savings .....	(\$17,000)	(\$17,000)	.....
Program efficiencies .....	(\$84,121)	(\$84,121)	.....
HITCA program efficiency .....	(\$5,500)	(\$5,500)	.....
Total Savings and Reinvestments .....	(\$121,596)	(\$121,596)	.....
Transfer Out to TIGTA .....	(\$941)	(\$941)	.....
Total, Fiscal Year 2007 Current Service Level .....	\$10,735,637	\$10,735,637	.....
Program Increases:			
Tax Administration Operations:			
Taxpayer Service .....	\$43,637	.....	\$43,637
Enforcement .....	\$367,768	.....	\$367,768
Infrastructure and Mgt Modernization .....	\$104,715	\$20,900	\$83,815
Business Systems Modernization .....	\$188,600	(\$29,700)	\$218,300
Total, Program Increases Above Fiscal Year 2006 Current Service Level .....	\$704,720	(\$8,800)	\$713,520
Total, Fiscal Year 2007 Operating Level .....	\$11,440,357	\$10,726,837	\$713,520

COMPARISON OF THE ADMINISTRATION'S IRS FISCAL YEAR 2007 BUDGET REQUEST AND IRS  
OVERSIGHT BOARD RECOMMENDATION—Continued

[Dollars in thousands]

Final Board Budget	Board's Budget	President's Budget	Difference
Fee Adjustment .....	(\$135,000)	(\$135,000)	.....
Fiscal Year 2007 Budget Appropriation Request .....	\$11,305,357	\$10,591,837	\$713,520
Growth Over Fiscal Year 2006 Enacted Budget .....	\$731,651	\$18,131	\$713,520
Percent Growth .....	6.9	0.2	.....

APPENDIX 2

RECOMMENDED FISCAL YEAR 2007 PROGRAM INCREASES: ENFORCEMENT

[In thousands of dollars]

Enforcement Program Increases	Total	Enforcement- Related	Service-Related
<i>Combat Egregious Non-Compliance and Prevent Tax Gap Growth.</i> —This initiative provides an increase of 748 FTE and \$135.5 million to enhance coverage of high-risk compliance areas as well as address the tax gap associated with small business and self-employed taxpayers .....	135,518	132,696	2,822
<i>Increase Individual Taxpayer Filing and Payment Compliance.</i> —The initiative provides 84 FTE (87 positions) and \$8 million to support the IRS's enforcement presence through contracts with Private Collection Agencies (PCAs) for Qualified Tax Collection Contracts .....	7,773	6,968	805
<i>Detect and Deter Non-Compliant Enterprise Structures.</i> —This initiative provides an increase of 200 FTE (400 positions) and \$37 million to increase the coverage of the flow-through population, including examination of controlling enterprise entities, that are posing significant compliance risks .....	37,008	37,008	.....
<i>Increase Individual Taxpayer Reporting Compliance.</i> —This initiative provides an increase of 100 FTE (125 positions) and \$10.8 million to enable the Automated Underreporter (AUR) program to address reporting compliance in a program that is effective, efficient, less labor intensive and less costly .....	10,821	8,808	2,013
<i>Enhance Enforcement in the Tax-Exempt and Governmental Sectors.</i> —This initiative requests an additional 69 FTE (138 positions) and \$12,940,668 to improve detection of compliance risks, accelerate enforcement actions, and balance the pursuit of critical enforcement initiatives while maintaining adequate coverage of the exempt community .....	12,941	12,941	.....
<i>Intensify Tax Enforcement.</i> —This initiative requests an increase of 86 FTE (172 positions) and \$27.6 million to curtail non-compliance in the following areas: abusive schemes, corporate fraud, non-filers, employment tax and Bank Secrecy Act (BSA) .....	27,570	27,570	.....
<i>Attack Fraudulent Payments.</i> —This initiative, which provides an increase of 62 FTE (123 positions) and \$27 million, relates directly to the President's Management Agenda Program Initiative "Eliminating Improper Payments," and also supports the IRS's strategies for addressing erroneous payments and non-compliance involving Earned Income Tax Credits (EITC) .....	26,998	26,837	161
<i>Improve Compliance With the Bank Secrecy and PATRIOT Acts.</i> —This initiative provides an increase of 124 FTE (248 positions) and \$25.9 million to improve the Bank Secrecy Act (BSA) compliance program .....	25,858	25,858	.....

## RECOMMENDED FISCAL YEAR 2007 PROGRAM INCREASES: ENFORCEMENT—Continued

[In thousands of dollars]

Enforcement Program Increases	Total	Enforcement-Related	Service-Related
<i>Strengthen Regulatory Compliance.</i> —This initiative provides an increase of 38 FTE (76 positions) and \$6.6 million to strengthen regulatory compliance activities to deter fraud, abuse, and terrorist financing in the tax exempt and governmental entities community .....	6,616	6,376	241
<i>Improve Enforcement of Circular 230.</i> —This initiative provides an increase of 8 FTE (16 positions) and \$4.1 million to detect and address tax practitioner misconduct. The IRS, Treasury, and Congress are placing increased emphasis on practitioner misconduct by providing new statutory and regulatory tools to address abusive behavior .....	4,104	4,104	.....
<i>Improve Tax Gap Estimates, Measurement and Detection of Non-Compliance.</i> —Supports 268 FTE (536 positions) and \$45.9 million to fund and support ongoing Reporting Compliance Studies through the National Research Program .....	45,942	45,942	.....
<i>Study EITC Compliance.</i> —This initiative provides an increase of 49 FTE (65 positions) and \$6.8 million to develop estimates of Earned Income Tax Credit compliance .....	6,822	6,822	.....
<i>Improve Compliance Through Data-Driven Workload Identification.</i> —This initiative provides an increase of 67.5 FTE (90 positions) and \$4.8 million to develop and test decision analytical tools and models for improved identification of high-risk filers .....	4,796	.....	4,796
<i>Customer Service Research.</i> —Begin research on the impact of customer service on voluntary compliance and the service needs of taxpayers .....	15,000	15,000	.....
Subtotal Enforcement .....	367,768	356,931	10,837

## APPENDIX 3

## RECOMMENDED FISCAL YEAR 2007 PROGRAM INCREASES: TAXPAYER SERVICE

[In thousands of dollars]

Taxpayer Service Program Increases	Total	Enforcement-Related	Service-Related
<i>Increase Accounts Management Efficiencies.</i> —Provides funding to improve the telephone infrastructure, e.g., Compliance Services and Accounts Management call centers, by expanding services to customers and providing telephone representatives with a more state-of-the-art center environment and providing taxpayers with improved service through multiple access channels. Enterprise queuing will eliminate the queuing of calls at the local level and be queued at the enterprise level, reducing taxpayer wait times .....	8,657	.....	8,657
<i>Restore Customer Service to Fiscal Year 2004 Levels.</i> —Supports 450 FTE from W&I to restore telephone level of service back to 87.3 percent achieved in fiscal year 2004 rather than the current 82 percent target. Improves TE/GE service measures for EP and EO determination timeliness, CAS toll-free level of service, correspondence timeliness measures to fiscal year 2004 levels .....	34,980	.....	34,980
Subtotal: Taxpayer Service .....	43,647	.....	43,647

## APPENDIX 4

## RECOMMENDED FISCAL YEAR 2007 PROGRAM INCREASES: INFRASTRUCTURE AND MANAGEMENT MODERNIZATION

[In thousands of dollars]

Infrastructure and Mgt Modernization Program Increases	Total	Enforcement-Related	Service-Related
<i>Expand IT Security—Personal Identity Verification.</i> —This initiative requests an increase of \$20 million to ensure IRS's compliance with Homeland Security Policy Directive-12 (HSPD-12) and Federal Information Processing Standards-201 (FIPS-201) .....	20,000	12,576	7,424
<i>Close Financial Management Material Weaknesses—Custodial Detail Data Base.</i> —This initiative provides \$4.7 million to develop the CFO Custodial Detail Data Base (CDDDB) which will establish the foundation for building an IRS-modernized custodial financial management system .....	4,743	2,982	1,761
<i>Fund Modernization Information Systems (Major Investments) O&amp;M.</i> —This initiative will result in modernized information systems to improve enforcement activities .....	15,000	9,432	5,568
<i>Fund Business Unit IT Solutions (Non-Major Investments) O&amp;M.</i> —This initiative provides an increase of \$15 million for the successful transition of Business Systems Modernization (BSM) projects to the Current Production Environment (CPE), funding their operations and maintenance as they move to full production .....	9,972	7,121	2,851
<i>Implement e-Travel.</i> —Treasury has mandated that IRS must implement e-Travel by October 1, 2006 .....	10,000	6,288	3,712
<i>Fund HR Connect.</i> —The initiative requests \$11.9 million in fiscal year 2007 to fully fund the additional Operations and Maintenance cost associated with the HR Connect system that the IRS has implemented and is billed through the Treasury's Working Capital Fund .....	11,900	7,482	4,418
Consolidate Philadelphia Campus .....	20,900	14,215	6,685
<i>Restoration of Leadership Training to Fiscal Year 2003 Levels.</i> —The requested funds would enable the IRS to: (1) eliminate the backlog of untrained leaders at all levels by the end of fiscal year 2007; (2) ensure enough capacity to train new managers upon selection in all Business Units; (3) improve and expand readiness programs to provide a cadre of manager candidates to step in to management positions; (4) revise the management curriculum to incorporate more e-learning and promote continuous learning; and (5) evaluate the effectiveness and impact of the leadership training program .....	12,200	7,564	4,636
Subtotal Modernization .....	104,715	67,660	37,055

## APPENDIX 5

## RECOMMENDED FISCAL YEAR 2007 PROGRAM INCREASES: BUSINESS SYSTEMS MODERNIZATION

[In thousands of dollars]

Business Systems Modernization Program Increases	Total
<i>Web-based Self Service.</i> —Identify and design initial set of internet self-service applications .....	24,200
<i>Filing &amp; Payment Compliance (F&amp;PC).</i> —Completes delivery of full capability needed to support Private Collection Agencies .....	30,000
<i>Modernized e-file (MeF).</i> —Funds development, testing and deployment of modernized electronic filing for Form 1040 .....	70,200
<i>Customer Account Data Engine (CADE).</i> —Process 33 million returns for the fiscal year 2007 filing season .....	25,000

RECOMMENDED FISCAL YEAR 2007 PROGRAM INCREASES: BUSINESS SYSTEMS  
MODERNIZATION—Continued

[In thousands of dollars]

Business Systems Modernization Program Increases	Total
<i>Core Infrastructure Projects.</i> —Improve the facilities which allow pre-deployment testing and integration of modernized systems, which help ensure modernized systems will operate as needed when they are deployed .....	17,900
<i>Architecture, Integration &amp; Management.</i> —Ongoing support and improvements to BSM's program with planning, engineering, and management activities .....	12,800
Management Reserve .....	8,500
Subtotal BSM .....	188,600

APPENDIX 6

EXPLANATION FOR DIFFERENCE IN IRS OVERSIGHT BOARD BUDGET IN THE  
ADMINISTRATION'S FISCAL YEAR 2007 BUDGET REQUEST AND THIS RECOMMENDATION

After the Board-approved budget is submitted to the Department of Treasury, it is reviewed and modified by both the Treasury Department and the Office of Management and Budget (OMB) before being incorporated into the President's budget. During the first several years of IRS Oversight Board operation, the Treasury Department would inform the Oversight Board of changes as the IRS budget progressed through the formulation process. However, for the past 2 years, the Treasury Department has taken the position that although RRA98 provides the Oversight Board with the responsibility of reviewing and approving the budget request prepared by the Commissioner and submitted to the Department of the Treasury, this authority does not include participating in subsequent budget decision adjustments and formulation of the President's Budget.

Consequently, changes in IRS requirements that occur after the Board approves the IRS budget are not provided to the Board, and can only be considered by the Board when the President's budget is made available to the public. The Board adjusted its previously approved budget to account for the following circumstances:

- The Board's initial fiscal year 2007 budget was based on the fiscal year 2006 President's request, not the enacted appropriation, and is adjusted to use the fiscal year 2005 enacted level as the base.
- The inflation factors for labor and non-pay inflation were not known to the Board when it first approved the IRS budget, and are adjusted to reflect the lower base as well as changes in rates.
- The IRS budget submitted to the Board identified approximately \$15 million in savings, which the Board approved. During subsequent reviews with the Treasury Department and OMB, the IRS identified an additional \$106 million in savings, for a total savings of \$121 million. The Board's budget is adjusted to reflect these additional savings, despite the Board's assessment that they may represent some risk.
- The IRS budget submitted to the Board did not identify any fee offsets, which were not yet authorized by Congress. The Board's budget is adjusted to reflect these offsets.
- The budget is adjusted to reflect the development of an IRS Infrastructure Blueprint to define a cost-effective approach to meeting IRS infrastructure needs and the elimination of the need to fund Kansas City growth in fiscal year 2007.

STATEMENT OF J. RUSSELL GEORGE

Senator BOND. Thank you very much, Chairman Wagner.

Now we turn to Treasury Inspector General for Tax Administration, or TIGTA, Mr. Russell George.

Mr. GEORGE. Thank you, Mr. Chairman.

Mr. Chairman, Ranking Member Murray, thank you for the opportunity to testify today regarding the 2007 appropriations for the Internal Revenue Service. Just over a year ago, I testified before you on the IRS's 2006 appropriations. Unfortunately, many of the challenges I discussed last year remain today.

At the outset, I am pleased to report that our reviews thus far have shown that the IRS has done a very good job responding to taxpayers affected by Hurricanes Katrina and Rita. Still, I remain concerned about the potential for fraudulent claims resulting from the response to those disasters. TIGTA will continue to monitor this effort.

I agree with the Commissioner's motto for customer service plus enforcement resulting in greater taxpayer compliance. Given its limited resources, the IRS is attempting to find the proper balance between these two important goals. The IRS proposed curtailing some levels of service, including closing 68 of its 400 taxpayer assistance service centers and reducing the hours of its toll-free telephone service from 15 hours a day to 12.

TIGTA is required to review these plans before they are implemented. We have examined the proposed TAC closures and concluded that the IRS did not have sufficient or reliable data to determine the effects of the proposed closures on taxpayers. One of our concerns about closures is that more taxpayers need to rely on the IRS's volunteer income tax assistance programs, which has significant problems in providing taxpayers with accurate answers. During the 2006 filing season, TIGTA made anonymous visits to both TACs and VITA sites to determine if taxpayers are receiving accurate assistance preparing their tax returns. We found that VITA volunteers accurately prepared tax returns at only 39 percent of the scenarios TIGTA presented to them, which was a slight improvement over last year's accuracy rate of 34 percent.

TIGTA also visited 50 Taxpayer Assistance Centers and posed 200 questions to determine if taxpayers received correct answers to their questions. TAC assisters correctly answered 73 percent of the questions we presented compared to 66 percent during the 2005 filing season. We visited another 20 TACs and posed 80 tax law questions specifically related to the Katrina Emergency Tax Relief Act. Assisters answered 75 percent of those questions correctly.

We are currently assessing the IRS's plans to reduce the operating hours of its toll-free telephone service. Thus far, we have found that the average speed of answering calls to this line is about 60 percent of the time that had been planned by the IRS.

Commendably, the IRS has seen a steady growth in the electronic filing of income tax returns over the last 3 years. While the IRS may not meet its mandated goal of having 80 percent of all tax returns E-filed by 2007, it has done a laudable job of providing helpful information on the internet and is anticipating that 54 percent of filed returns will be filed electronically this year; however, I am concerned that more taxpayers are not using the E-file services offered by the IRS. This year, the number of taxpayers E-filing from their home computers rose by just over 16 percent at the same time the number of taxpayers taking advantage of free online filing has fallen by 22 percent.

This drop may be the result of a change in the "Free File" agreement between the IRS and the Free File Alliance, a consortium of private sector companies that provide preparation software and transmit tax returns pursuant to the agreement. Although the intent of the program was to provide a free method of E-filing to taxpayers, the IRS and the Alliance amended the agreement. This

year, the agreement allowed only taxpayers with adjusted gross incomes of \$55,000 or less to use the service.

In addition, the IRS eliminated its telefile program for individual taxpayers in August 2005. This program allowed taxpayers the simplest tax returns, such as Form 1040EZ, to file by telephone. The alternative filing methods for these taxpayers included using Taxpayer Assistance Centers and VITA sites. They could also use a free-file program if they qualified, among other options. It appears, however, that many taxpayers who previously used the telefile system reverted to using paper tax returns.

We have also found that the IRS is attempting to address its major challenges; however, much more is required on its part. For example, while the IRS is making progress with the Business Systems Modernization program, BSM remains behind schedule, over-budget, and is not delivering all of the functionalities that were promised. In TIGTA's initial review of the IRS's plan to use private debt collectors, we found that the IRS has taken positive steps to implement certain aspects of the program. TIGTA is working closely with the IRS to address security concerns, the protection of taxpayers' rights and privacy, and the development of integrity and fraud awareness training for contract employees.

The last issue I will address is the tax gap, which the IRS has estimated at approximately \$345 million. TIGTA has evaluated the reliability of the IRS-developed tax gap figure, and in a report released just on Tuesday, we think concluded that the IRS still does not have sufficient information to accurately assess the overall tax gap and voluntary compliance rate. The IRS has significant challenges in attaining complete and timely data and in developing the methods for interpreting that data. We urge the Commissioner to continue this effort and have provided recommendations toward obtaining a more accurate assessment of this important measurement.

#### PREPARED STATEMENT

Mr. Chairman, Ranking Member Murray, Senator Durbin, I hope my discussion of the 2006 filing season and some of the significant challenges facing the IRS will assist you with your consideration of the budget, appropriations rather. Mr. Chairman and the subcommittee, thank you for allowing me to share my views. I will accept your questions at the appropriate time.

[The statement follows:]

#### PREPARED STATEMENT OF J. RUSSELL GEORGE

##### INTRODUCTION

Chairman Bond, Ranking Member Murray, and members of the subcommittee, I thank you for the opportunity to testify as you consider the fiscal year 2007 appropriations for the Internal Revenue Service (IRS). It was just over 1 year ago that I appeared before you to testify on the IRS's fiscal year 2006 appropriations. Since my prior testimony, significant events have affected tax administration including Hurricanes Katrina and Rita, which impacted thousands of taxpayers and required rapid responses from many departments and agencies, including the IRS.

When I testified before the subcommittee last year, I had only served as the Treasury Inspector General for Tax Administration (TIGTA) for a few short months. As I testify before the subcommittee today, I have been the TIGTA for 17 months. My four priorities as the TIGTA are to maintain our focus on IRS efforts to modernize its technology, enhance our ability to protect tax administration from corrup-

tion, assist the IRS with improving tax compliance initiatives, and monitor the IRS's use of private debt collection agencies. As the TIGTA, my observations are primarily based on the body of work my organization has developed through audits and investigations of the IRS. To assist you in your consideration of the IRS's fiscal year 2007 budget, I will focus on the 2006 Filing Season, electronic filing, the tax gap, customer service, the IRS's Private Debt Collection initiative and other major challenges facing the IRS.

#### THE 2006 FILING SEASON

##### *Preparing for the Filing Season*

Planning for the 2006 Filing Season was difficult for the IRS because of many tax law changes enacted late last year in response to unprecedented natural disasters. Disaster relief provisions were enacted into law for taxpayers affected by Hurricanes Katrina, Rita, and Wilma, and were intended to provide relief to over 11 million taxpayers who lived in the affected areas of the Gulf Coast, as well as to others who may have been adversely impacted by these storms.

This year, TIGTA reviewed 28 new tax law provisions and is also closely monitoring the implemented changes that are intended to assist taxpayers adversely affected by the 2005 hurricanes. New tax law provisions were included in the Katrina Emergency Tax Relief Act of 2005,<sup>1</sup> the Gulf Opportunity Zone Act of 2005,<sup>2</sup> and also in the Working Families Tax Relief Act of 2004<sup>3</sup> and the American Jobs Creation Act of 2004,<sup>4</sup> all of which became effective in 2005. The latest legislation, the Gulf Opportunity Zone Act of 2005, was signed into law on December 21, 2005.

TIGTA reviewed the IRS's preparation for the 2006 Filing Season and determined that the IRS accurately updated its tax products and computer programming to incorporate the tax law changes that became effective in 2005. TIGTA reviewed 42 tax forms, publications, and instructions that required updating, and determined that they were accurately updated. The IRS also accurately updated its computer programming and returns processing programs for the new tax law provisions and other adjustments or changes.<sup>5</sup> TIGTA is continuing to monitor the IRS's processing of income tax returns during the 2006 Filing Season and will report its results later this year.

While planning for the 2006 Filing Season, the IRS considered the impact of Hurricanes Katrina and Rita. Specifically, the IRS accounted for all employees affected by the hurricanes and located alternate office space in affected areas. All Taxpayer Assistance Centers (TAC) in impacted areas were open and operational for the 2006 Filing Season. The IRS also added services to help lessen taxpayer burden, including tax return preparation for taxpayers affected by the hurricanes regardless of the income guidelines. Additionally, the scope of tax law topics in which assistors are trained was expanded to provide assistance to taxpayers with questions about casualty losses. Furthermore, the IRS will treat taxpayers affected by Hurricanes Katrina and Rita as meeting extreme hardship criteria. That designation allows affected taxpayers to request and immediately receive transcripts of prior year tax returns instead of having to order them and wait for delivery.

##### *Processing Tax Returns*

During the 2006 Filing Season, the IRS expected to process an estimated 135 million individual returns. So far, TIGTA has not identified any significant problems with the IRS's processing of individual tax returns. As of April 8, 2006, the IRS has received over 87.7 million returns. Of those, 57.7 million were filed electronically (an increase of 3.5 percent from this time last year), and 29.9 million were filed on paper (a decrease of 7.1 percent from 2005). Additionally, \$164.5 billion in refunds have been timely issued. Of this amount, \$124.3 billion were directly deposited to taxpayer bank accounts, an increase of 9.3 percent compared to last year.

##### *Providing Quality Customer Service*

While the IRS continues to face longstanding challenges, it deserves recognition for making progress in an area that will always be a challenge: providing quality customer service to the American taxpayer. Providing quality customer service is the first component of Commissioner Everson's principle for the IRS, Serv-

<sup>1</sup>Public Law No. 109-73, 119 Stat. 2016 (to be codified in scattered sections of 26 U.S.C.).

<sup>2</sup>Public Law No. 109-135, 119 Stat. 2577 (2005).

<sup>3</sup>Public Law No. 108-311, 118 Stat. 1166 (2004).

<sup>4</sup>Public Law No. 108-357, 118 Stat. 1418 (2004).

<sup>5</sup>Draft Report "Tax Products and Computer Programs for Individual Income Tax Returns Were Accurately Updated for the 2006 Filing Season" (Audit No. 200640015, date April 24, 2006).

ice + Enforcement = Compliance. 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](http://www.irs.gov)).

Furthermore, it is encouraging to note that the IRS took numerous actions to provide broad relief to taxpayers affected by Hurricanes Katrina and Rita. These broad relief efforts included postponing deadlines for filing and payment, providing relief from interest and penalties, and waiving some low-income housing tax credit rules. The IRS also waived the usual fees and expedited requests for copies of previously filed tax returns for affected taxpayers that need them to apply for benefits or file amended tax returns to claim casualty losses.<sup>6</sup>

IRS employees also provided tax assistance at Federal Emergency Management Agency (FEMA) Disaster Assistance Sites in a number of locations. Additionally, the IRS assigned 5,000 employees to augment Federal Government telephone call sites and provided additional employees to assist in approximately 34 FEMA disaster recovery centers in 13 States.

#### *IRS.gov*

IRS.gov continues to be one of the most visited Internet sites in the world, especially during filing seasons. As of the week ending April 8, 2006, the IRS reported a 6.46 percent increase in the number of visits to IRS.gov over the same period during the last filing season. The IRS now provides practitioners with online tools to provide better service to their customers, such as electronic account resolution, transcript delivery, and disclosure authorization. As of the week ending April 8, 2006, the IRS also reported a 17.02 percent increase in taxpayers obtaining their refund information online via the "Where's My Refund" option found on the Internet site.

#### *Toll-Free Telephone Operations*

The 2006 Filing Season presented unique challenges for the IRS toll-free operations. The IRS had also planned to reduce the hours of its toll-free telephone operation in fiscal year 2006. The IRS had about 400 fewer Full-Time Equivalents<sup>7</sup> for toll-free telephone operations than it had in fiscal year 2005 because of plans to reduce operating hours from 15 to 12 per day. Congress, the Taxpayer Advocate and the National Treasury Employees Union expressed concerns about the IRS reducing operating hours for the toll-free telephone lines. A new law enacted in November 2005 requires the IRS to consult with stakeholder organizations, including TIGTA, regarding any proposed or planned efforts to terminate or significantly reduce any taxpayer service activity.<sup>8</sup> Congress recently further defined a reduction of taxpayer service to include limiting available hours of telephone taxpayer assistance on a daily, weekly, and monthly basis below the levels in existence during the month of October 2005. TIGTA is currently assessing the IRS's plans to reduce operating hours and will report its results later this year.

As of April 8, 2006, assistor level of service had not been negatively impacted, with an IRS-reported level of service rate of 83.8 percent.<sup>9</sup> In addition, about 6.49 percent fewer assistor calls were answered, but the number of taxpayers who hung up prior to reaching an IRS assistor was up 10.9 percent. The average speed of answer was about 66 percent of the time planned, so those taxpayers who called and spoke with an assistor did not experience longer wait times.

In planning for fiscal year 2006, IRS management expected fewer calls program-wide, even after taking into consideration taxpayers affected by Hurricanes Katrina and Rita. IRS management believed that most taxpayers needing disaster relief assistance obtained it during the latter part of 2005. Prior to the start of the filing season, TIGTA brought to IRS management's attention our concern that more taxpayers than expected could call the help line with questions due to the effects of Hurricanes Katrina and Rita.

After we shared this concern, IRS management raised the estimated volume of services to these telephone lines by about 78,000 services, from approximately 27,000 to about 105,000. The estimate is for services from January through June

<sup>6</sup>"Planning for the 2006 Filing Season Is on Course, but Challenges Exist for the Toll-Free Telephone Operations" (Reference No. 2006-40-053, dated February 2006).

<sup>7</sup>A measure of labor hours in which 1 Full-Time Equivalent is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For fiscal year 2005, 1 Full-Time Equivalent was equal to 2,088 hours.

<sup>8</sup>The Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act, Public Law No. 109-115, 119 Stat. 2396 (2006).

<sup>9</sup>Level of Service is the primary measure of providing service to taxpayers. It is the relative success rate of taxpayers that call for services on the IRS's toll-free telephone lines.

2006, a 365.1 percent increase over the total fiscal year 2005 services provided on those telephone lines.<sup>10</sup> For the 2006 Filing Season it appears that the calls to these telephone lines were higher than anticipated. For example, the IRS had planned 77,235 services for one of its applications devoted to assisting disaster victims; however, through April 8, 2006, the IRS has already provided 136,552 services.

#### *Taxpayer Assistance Centers*

##### *2006 Filing Season Services*

The TACs are walk-in sites where taxpayers can receive answers to both account and tax law questions, as well as receive assistance preparing their returns. The IRS acknowledged that staffing would be a challenge during the 2006 Filing Season since not all TACs would be fully staffed and not all TACs would provide standard services or standard hours of operation (from 8:30 a.m. to 4:30 p.m., Monday through Friday). As of December 1, 2005, the IRS identified 47 TACs with critical staffing shortages (a critical vacancy is one that must be filled to ensure that a TAC remains open).

The IRS took actions to minimize the impact of the staffing shortages. As of January 31, 2006, the IRS had hired additional frontline technical employees, recalled intermittent employees back to work, detailed former TAC employees from their current positions in other IRS functions back to the TACs, and made plans to have some employees travel between TACs to ensure that all TACs remained open daily. The IRS's decision to focus more resources on compliance activities, however, further limited resources available for the TAC Program. As a result, the IRS limited some assistance services and not all TACs were open during standard operating hours. As of the week ending April 8, 2006, the IRS reported a 12.5 percent reduction in TAC contacts with taxpayers.

Although the IRS publicized when TAC operating hours were limited, it did not publicize when TACs would only provide limited services. When notified by TIGTA, the IRS implemented changes and standardized the list of services offered at each TAC. Furthermore, the IRS modified its Internet site, IRS.gov, to indicate when TACs would provide limited services.

TIGTA made anonymous visits to 50 TACs and asked 200 questions to determine if taxpayers received quality service, including correct answers to their questions. Assistors correctly answered 73 percent of the questions compared to 66 percent during the 2005 Filing Season. TIGTA visited an additional 20 TACs and asked 80 tax law questions specifically related to the Katrina Emergency Tax Relief Act of 2005. Assistors answered 75 percent of those questions correctly. IRS assistors should have been trained to answer these questions. TIGTA's observations were that assistors sometimes inappropriately referred taxpayers to publications to conduct their own research, or responded to tax law questions without following required procedures, such as using the publication method guide that requires them to ask probing questions.

##### *Closure*

Over the past few years, customer service at TACs has shown improvement. In May 2005, the IRS announced plans to close 68 of its TACs nationwide. Closing the 68 TACs was expected to yield staffing and facilities cost savings of \$45 million to \$55 million. After the IRS's closure announcement, Congress enacted legislation to delay the closure of any TACs.<sup>11</sup> The IRS is prohibited from using funds provided in the fiscal year 2006 budget appropriation to reduce any taxpayer service function or program until TIGTA completes a study detailing the effect of the IRS's plans to reduce services relating to taxpayer compliance and taxpayer assistance. TIGTA completed its study in March.

TIGTA reviewed<sup>12</sup> the IRS's TAC Closure Model and data used to select the 68 centers scheduled for closure and identified that although the structure of the Model was sound, not all data used were accurate or the most current available, and some of the data were based on estimates and projections instead of actual available data. Data discrepancies affected the scores the Model calculated for each TAC and, ultimately, the ranking and overall selection of centers for closure. In addition, data

<sup>10</sup>A service is defined when a call is answered by an assistor. When the assistor answers the caller's question, a service is provided. If the same caller has an additional question or issue and is transferred to another area or assistor, an additional service is provided.

<sup>11</sup>Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act, 2006, Public Law No. 109-115, 119 Stat. 2396 (2005).

<sup>12</sup>"The Taxpayer Assistance Center Closure Plan Was Based on Inaccurate Data" (Reference Number 2006-40-061, dated March 2006).

discrepancies affected the IRS's ability to accurately determine cost savings. The IRS should ensure that data used in any decision-making tool are accurate and reliable before using them. For the TAC Program, the IRS should include data to identify customer characteristics and capture customer input to effectively measure the impact any changes might have on taxpayer service or compliance.

I am concerned that the IRS does not sufficiently ensure that it uses adequate and reliable data for making decisions that impact customer service operations. The decision to close TACs was based primarily on input from IRS functional areas and considered other factors that included internal priorities, resource demands, and shifts in the IRS's customer service perspective. However, data were not obtained from taxpayers who use these services to determine the impact of removing or reducing them.

#### *Volunteer Income Tax Assistance (VITA) Program*

The VITA Program plays an increasingly important role in IRS's efforts to improve taxpayer service and facilitate participation in the tax system. The VITA Program provides no-cost Federal tax return preparation and electronic filing to underserved taxpayer segments, including low income, elderly, disabled, and limited-English-proficient taxpayers. These taxpayers are frequently involved in complex family situations that make it difficult to correctly understand and apply tax law.

TIGTA visited VITA sites to determine if taxpayers received quality service, including the accurate preparation of their individual income tax returns. TIGTA developed scenarios designed to present volunteers with a wide range of tax law topics that taxpayers may have needed assistance with when preparing their tax returns. These scenarios included the characteristics (e.g., income level, credits claimed, etc.) of tax returns typically prepared by the VITA Program volunteers based on an analysis of the Tax Year 2004 VITA-prepared tax returns. TIGTA had 36 tax returns prepared with a 39 percent accuracy rate, comparable to the 34 percent accuracy rate reported for the 2005 Filing Season. TIGTA's observations were that volunteers did not always use the tools and information available when preparing returns. TIGTA will report its final results later this year.

#### *The Tax Gap*

In an April 2004 U.S. Senate Committee on Finance news release, Senator Max Baucus called for 90 percent voluntary tax compliance by 2010. Senator Baucus stated, in part, that "Today, I'm calling on the IRS to achieve a 90 percent voluntary compliance rate by the end of the decade, which would raise at least an additional \$100 billion each year without raising taxes." Perhaps the greatest challenge facing the IRS is finding ways to improve the voluntary compliance rate.

Using different terms, Senator Baucus challenged the IRS to reduce what is commonly known as the tax gap. The IRS defines the gross tax gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year. In February 2006, the IRS estimated the gross tax gap at \$345 billion for Tax Year 2001.

TIGTA evaluated the reliability of the IRS-developed tax gap figures and concluded that the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and voluntary compliance.<sup>13</sup> The IRS has significant challenges in both obtaining complete and timely data and developing the methods for interpreting the data.

A reliable estimate of the overall tax gap and its components is important to tax administration and tax policy decision-makers. Without a reliable estimate, inappropriate decisions may be made on how to address the tax gap. If we assume that the total tax liability in Tax Year 2010 is the same as it was in Tax Year 2001, noncompliant taxpayers would have to pay timely and voluntarily an additional \$134 billion to achieve Senator Baucus' challenge to reach a 90 percent voluntary compliance rate by 2010.

Despite the significant efforts undertaken in conducting the individual taxpayer National Research Program (NRP)<sup>14</sup> for underreporting, the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and the voluntary compliance rate. TIGTA's primary concerns are described in the following areas of nonfiling, reporting compliance, and payments collected.

<sup>13</sup>"Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections" (Reference Number 2006-50-077, dated April 2006).

<sup>14</sup>The NRP was a study designed to accurately measure reporting compliance of individual taxpayers while minimizing the burden on taxpayers during the process.

### *Nonfiling*

Prior to the NRP, the IRS's estimate of the nonfiling gap was \$30.1 billion, consisting of \$28.1 billion for individual income taxes and \$2 billion for estate taxes. In February 2006, the IRS updated this estimate to \$25 billion for individuals. Supplementary data, however, suggest that substantial amounts are not included in the estimates provided in the tax gap projections. The IRS describes the nonfiling estimate as reasonable despite the missing segments of corporate income, employment, and excise taxes. These facts suggest the nonfiler estimate is incomplete and likely inaccurate.<sup>15</sup>

### *Reporting Compliance*

At an estimated \$285 billion, underreporting is by far the largest identified portion of the tax gap. Yet, this estimate may not be complete since there are at least four areas that suggest substantial amounts are not included in the tax gap estimates.

- The effect that the current NRP on Subchapter S corporations will have on individual taxpayer compliance estimates could be substantial, as well as the effect on employment tax estimates.<sup>16</sup>
- The \$5 billion underreporting estimate for small corporations and the \$25 billion estimate for large corporations date back to the 1980's and, according to the IRS, are considered weak.
- The estimate for estate taxes was not updated during the current NRP, and no estimate has been made for excise taxes.
- The dated estimate for the Federal Insurance Contributions Act taxes and unemployment taxes are considered weak by the IRS.

### *Payments Collected*

The IRS estimates that it recovers about \$55 billion of the annual tax gap through enforced collections and other late payments.<sup>17</sup> This figure does not represent an actual amount but is an estimate based on formulas devised from historical analyses. The actual basis of these formulas seems to be very limited, as well as dated. Furthermore, these collections have two basic parts—voluntary payments received by the IRS and payments that result from some type of IRS intervention.<sup>18</sup> The IRS does not currently correlate either type of payment to the applicable tax year and thus does not determine actual collections.

### *Measuring Noncompliance*

TIGTA attempted to determine whether the IRS's tax gap estimates coincide with estimates developed by independent sources. Although some independent studies exist, none provided sufficient information to allow close comparisons. One possible source of comparison was the annual Bureau of Economic Analysis estimate of the difference between its personal income figures and the IRS's measure of Adjusted Gross Income to derive what is called an Adjusted Gross Income Gap. IRS Office of Research officials suggested that this is a narrow definition of tax noncompliance based, in part, on IRS estimates. For Tax Year 2001, the Bureau of Economic Analysis reported an Adjusted Gross Income Gap of \$834.4 billion.<sup>19</sup>

The private sector has also developed some estimates of the tax gap. For example, in January 2005, financial analysts calculated the number of illegal immigrants in the United States at more than double the United States Census Bureau's estimated 9 million. These undocumented workers may hold as many as 15 million jobs, with perhaps 5 million collecting untaxed cash wages, costing the Federal Government an estimated \$35 billion yearly.<sup>20</sup>

Performing a compliance measurement program is expensive and time consuming. The estimated cost for performing the Tax Year 2001 individual taxpayer NRP was approximately \$150 million. The IRS Office of Research staff explained that re-

<sup>15</sup>There are no plans to update the estate tax segment or to estimate the corporate, employment, and excise tax nonfiler segment.

<sup>16</sup>This study is expected to take 2 years to 3 years to complete from its inception in October 2005.

<sup>17</sup>According to one IRS representative, these collections can take up to 10 years because of appeals and court decisions.

<sup>18</sup>Voluntary late payments are generally those remittances received after their due dates but before collection notices were sent or other collection actions were taken.

<sup>19</sup>This number is an income gap rather than a tax gap. Thus, it would have to be multiplied by a tax rate to determine the associated tax gap. Similarly, the \$35 billion stated in the following paragraph could be significantly smaller, depending on whether some of these workers have actual filing obligations. Neither the BEA nor the IRS assumes a tax rate to calculate a tax gap estimate based on this income gap.

<sup>20</sup>Bear Stearns, "The Underground Labor Force Is Rising To The Surface".

source constraints are a major driver in NRP studies and will affect how often the NRP is updated. From fiscal years 1995 through 2004, the revenue agent workforce declined by nearly 30 percent while the number of returns filed grew by over 9 percent. Additionally, operational priorities must be balanced against research needs. This shortfall in examiner resources makes conducting large-scale research studies problematic.

The IRS's budget submission to the Department of the Treasury (Treasury) for fiscal year 2007 requests funding to support ongoing NRP reporting compliance studies. It requests funding for 268 Full-Time Equivalents and \$45.9 million that will include 26 analytical and technical positions to estimate reporting compliance for new segments of taxpayers (such as S corporations, partnerships, and other business entities) and to update estimates of reporting compliance for other segments. It also requests 510 additional revenue agents to conduct reporting compliance research examinations. The initiative seeks to provide a foundation for conducting compliance studies and to limit the diversion of resources to research audits from operational priorities. The IRS Oversight Board supports ongoing dedicated funding for compliance research. Unfortunately, funding for those resources in previous fiscal years did not materialize. Without a resource commitment to continually update the studies, the information will continue to be stale and less useful in improving voluntary compliance.

TIGTA's review of the tax gap concluded that a determination cannot be made about the IRS's ability to meet Senator Baucus' challenge of 90 percent voluntary compliance by 2010 with the information currently available. Regardless of whether a 90 percent voluntary compliance rate can be achieved, the IRS faces formidable challenges in completely and accurately estimating the tax gap and finding effective ways to increase voluntary compliance.

#### ELECTRONIC FILING

The IRS has seen a steady growth in electronic filing (e-file) of income tax returns over the past several years. In Calendar Year 2002, 35.9 percent of the 130.3 million individual income tax returns received by the IRS were e-filed. Last year, the percentage of e-filed returns increased to 51.7 percent of the total individual income tax returns received. The number of e-filed returns increased 46.2 percent over the 3-year span. While the IRS will not meet its goal of having 80 percent of all tax returns e-filed by 2007, it does expect to see continued growth in electronic filing, although at a somewhat diminished growth rate from year to year. For example, the IRS expects the e-file percentage to reach 54.1 percent this year, 57.7 percent in 2007, and 60.6 percent in 2008.

Although e-filing continues to increase overall, TIGTA found some indications that taxpayers are shifting between the various types of e-filed returns, and some segments of e-filed returns are starting to show a decrease in the numbers filed. E-filed returns are generated from three basic sources—paid preparers who transmit their clients' tax returns, taxpayers who purchase tax-preparation software and file their own returns via the Internet from their personal computers, and taxpayers who take advantage of free e-filing options, such as the Free File Program, or in previous years via the TeleFile Program.

Overall, as of April 8, 2006, e-filing has increased 3.5 percent compared to the same period in 2005, which is significantly less than the 6 percent increase the IRS expected. While the number of taxpayers e-filing from their home computers is up 16.6 percent this Filing Season, the number of taxpayers taking advantage of free online filing is down 22 percent below last year. I am concerned that more taxpayers are not using the free e-filing services offered by the IRS.

#### *Free File Program*

##### *Background*

The IRS Restructuring and Reform Act of 1998 (RRA 98)<sup>21</sup> established a goal for the IRS to have 80 percent of Federal tax and information returns filed electronically by 2007. It also required the IRS to work with private industry to increase electronic filing.

In February 2002, President Bush established the President's Management Agenda to improve the overall management of the Federal Government. One of the five initiatives in the President's Agenda is E-Government. The goal of this initiative is to make it easier for citizens and businesses to interact with the government, save

<sup>21</sup>Public Law 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.).

taxpayer dollars and streamline citizen-to-government transactions. In response to the President's E-Government initiative, the Office of Management and Budget (OMB) developed the EZ Tax Filing Initiative. EZ Tax Filing was intended to make it easier for citizens to file taxes in an Internet-enabled environment. Citizens would no longer have to pay for basic, automated tax preparation. The goal of this initiative was to increase the number of citizens who filed their tax returns electronically.

In response to this requirement and the statutory requirement of RRA 98, in 2003 the Treasury, the OMB and the IRS launched the Free File Program featuring private-sector partners that allow qualifying taxpayers to prepare and file their taxes online for free. The Treasury, OMB and IRS made this possible through a public-private partnership with a consortium of tax software companies, the Free File Alliance, LLC (Alliance).

The Free File Program provides taxpayers with access to free online tax preparation and e-filing services made possible through a partnership agreement between the IRS and the tax software industry. Eligible taxpayers may prepare and e-file their Federal income tax returns using commercial online software provided by Alliance members. After the IRS and Alliance entered into a Free File Agreement, the Free File Program debuted in January 2003. According to statistics provided by the Alliance, more than 2.79 million taxpayers used the program in its first year. In subsequent years, use of the Free File Program increased significantly to about 3.51 million taxpayers in 2004 and 5.12 million taxpayers in 2005.

*The Amended Free File Alliance Agreement and Its Potential Impact on Electronic Filing*

After the 2005 Filing Season, the IRS and the Alliance amended their agreement to continue the Free File Program through October 2009. With the amended agreement, the overall focus of the Free File Program changed significantly. While the amended agreement still contributes to the original goal of increasing the number of citizens who electronically file their tax returns, new limits effectively changed the intent of the Free File Program. The original intent of the program was to provide free tax preparation and electronic filing services to all taxpayers. The revised intent is to assist lower income and underserved taxpayers.

The original 2002 agreement between the IRS and the Alliance established a minimum number of taxpayers who should be served by the Free File Program and was more in line with the intent of the EZ Tax Filing Initiative. There is, however, some support in Congress for the shift in the program's focus to lower income and underserved taxpayers. For example, according to the House Appropriations Committee Report accompanying the IRS's fiscal year 2005 Budget Appropriations, the committee reaffirmed its position that the Alliance is first and foremost intended to provide electronic Federal tax return preparation and e-filing services at no cost to the working poor and other disadvantaged and underserved taxpayers.

As part of the amended agreement, new limits were set for participation in the Free File Program. The new limits stem, in part, from the differing objectives of the IRS and the Alliance members. One of the IRS's principal purposes for establishing the program was to add another avenue for electronic filing with the intent of increasing electronic filing overall. However, Alliance members are businesses that incur a cost to provide free services. According to representatives of Alliance member companies who TIGTA interviewed, their primary goal is to keep the Federal Government from entering the tax preparation business.<sup>22</sup> A secondary benefit of their participation in the program is the opportunity to market their other products for free. Taxpayers opting to use these services provide additional revenues to Alliance members.

Per the initial agreement, a minimum of 60 percent of all taxpayers (approximately 78 million) were eligible for the Free File Program. Last year, the Alliance opened the program up to almost 130 million taxpayers. However, only 5.12 million taxpayers took advantage of it. The amended agreement now limits the program's availability to 70 percent of taxpayers (approximately 93 million). For Tax Year 2005, this limitation equates to an Adjusted Gross Income (AGI) of \$50,000 or less. The maximum AGI to achieve the 70 percent limit, however, may vary from year to year. The net impact of this new limit is that during the 2006 Filing Season approximately 40 million taxpayers were no longer offered free filing services through the program.

As mentioned earlier, online filing on home computers is up 16.6 percent this Filing Season. This increase, however, appears to be the result of an increase in the number of taxpayers who paid for online filing services. As of April 8, 2006, paid online filing is up 33.7 percent while free online filing is down 22 percent. Two pos-

<sup>22</sup>TIGTA interviewed a sample of 6 of the 20 Alliance member companies.

sible explanations for the growth in online filing from home computers and the decline in free online filing are: (1) taxpayers who filed electronically through a practitioner last year may have decided to purchase software and file online this year; and (2) taxpayers who filed through the program last year do not qualify this year and therefore purchased software to file online.

Another factor that appears to have contributed to the decline in free online filing is elimination of the IRS's TeleFile Program. The IRS and the Alliance had hoped that many of the 3.3 million taxpayers who used TeleFile in 2005 would migrate to the Free File Program. However, current Filing Season statistics indicate that many former TeleFile users are no longer filing electronically and instead are filing their returns on paper.

#### *Positive Provisions of the New Free File Alliance Agreement*

Although the changes in the amended Free File Agreement limit the number of taxpayers offered free tax return preparation and filing services, several other changes enhance the quality of the program. Under the amended agreement, Alliance members must adhere to more stringent disclosure of the nature, costs, and alternative methods of receiving refunds faster. In addition, not all taxpayers will be offered a Refund Anticipation Loan (RAL). There is some controversy over RALs because of the high fees and rates sometimes associated with those loans. Starting in 2006, the agreement guarantees that some taxpayers using the Free File Program will have the option to prepare and file their tax return without being offered a RAL. The decision of whether or not to accept an RAL lies with the taxpayer; however, these new provisions make the choice more clear. If taxpayers choose to apply for an RAL, all terms of the loans must be fully disclosed.

The amended agreement also increased security requirements and added performance measures for the individual Alliance members. Alliance members must have third-party security assessments to ensure that taxpayer information is adequately protected. Also, performance standards require a 60 percent acceptance rate<sup>23</sup> for providers who e-file returns through the program. This acceptance rate will be gradually increased in future years.

Under the amended agreement, Alliance members also agreed for the first time to provide the IRS with an indicator that identifies those taxpayers who use the Free File Program. Prior to the amendment, the IRS had no way to independently determine how many taxpayers participated in the program, or which taxpayers were using it. Previously, individual Alliance members reported data on participation in the program, and the IRS lacked a method to monitor participation. This significantly hampered the IRS's ability to evaluate the program's success or the effects of changes to the program.

#### *Difficulties Using the Free File Program*

Although the Free File Program offers some taxpayers the option to prepare and file their tax return for free, the program may not be accessible to all who are eligible for it, and it is not necessarily easy to use. The Free File Internet site readily allows taxpayers to determine whether they qualify for the program, but finding the best software provider for their needs is time consuming and may be difficult for less savvy computer users.

Taxpayers must access the Free File Program through the IRS's Internet site at IRS.gov. The Internet site clearly identifies the basic requirements for participation in the program and provides a tool that guides taxpayers to free filing providers. This tool presents taxpayers with a number of providers from which to choose based on some basic information that taxpayers provide. Although this tool guides taxpayers to the providers they qualify to use, the tool does not assist taxpayers in determining which of those providers best meets their needs.

Taxpayers must access each provider's Internet site to determine the services offered and must then compare the services offered and select the provider that is the best for them. Additionally, each Alliance member company sets taxpayer eligibility requirements for its own program. These requirements may differ from company to company. Generally, eligibility is based on such factors such as age, adjusted gross income, State residency, military status or eligibility for the Earned Income Tax Credit.

Although the Free File Program is currently focused on low-income taxpayers, many of these taxpayers do not have access to the tools to use it. For example, taxpayers who speak limited English have not been provided access to all of the filing options offered. Only two providers offer services in Spanish and neither of them offer free electronic filing of Form 4868, Automatic Extension of Time to File.

<sup>23</sup>The percentage of returns an individual provider must transmit to the IRS error free.

The Free File Program also requires taxpayers to have access to a computer and the Internet. Taxpayers who have access to the necessary technology must also be savvy enough to navigate the IRS's and the Alliance members' Internet sites. The focus of the program on lower-income taxpayers may be at odds with their ability to participate in it. In her 2004 Report to the Congress, the National Taxpayer Advocate wrote that in 2001 approximately 50 percent of low-income families<sup>24</sup> used a computer and only 38 percent had access to the Internet. Furthermore, access to a computer or the Internet does not necessarily indicate that a person has the ability to navigate the Internet or use tax preparation software.<sup>25</sup>

The IRS offers free assistance to taxpayers with tax preparation and filing through its Taxpayer Assistance Centers, Voluntary Income Tax Assistance, and Tax-Aide Programs as well as through the Free File Program. Similar to the Free File Program, taxpayers must meet certain requirements in order to receive assistance from those other programs. The Free File Program, however, is the only free filing option that taxpayers may use from their homes. Taxpayers must bring their tax documentation to an assistance site to take advantage of the other free tax return preparation and filing services.

The addition of the RAL provisions, increased security, and added performance measures to the agreement are important provisions to further promote public confidence in the Free File Program. Adding the electronic indicator to returns filed through the program will provide the IRS with information to measure the program's success. However, limiting the scope of the program to 70 percent of taxpayers has impacted the use of the program. Based on the statistics Alliance members provided in previous years, the new limits in the amended agreement appear to be substantially reducing participation in the program. Furthermore, the AGI limit also keeps the program from achieving the full intent of the EZ Tax Filing Initiative, which never specified any such limits for access to free, basic, automated tax return preparation and electronic filing. Not yet known, however, is whether the IRS's ability to better understand who is using and who is not using the program could help the IRS better market the program and expand its usage despite the new limits. The answer to that question may ultimately have a significant effect on the overall growth rate of electronic filing.

#### *Elimination of the TeleFile Program*

As mentioned earlier in my statement, one factor that appears to have negatively impacted the Free File Program is the elimination of the TeleFile Program. The IRS discontinued this program for individual taxpayers in August 2005. The TeleFile Program allowed taxpayers with the simplest tax returns<sup>26</sup> to file their returns by telephone. The pilot TeleFile Program was launched on a limited basis in 1992, and the program became available nationally in 1997. The RRA 98 included the expectation that the IRS would continue to offer and improve TeleFile and make a similar program available on the Internet.

Despite its initial success, use of the TeleFile Program began to decrease in 1999. According to IRS electronic filing statistics as of April 17, 2005, approximately 3.3 million filers used TeleFile in 2005, a 12.7 percent decline from the previous year. Until the IRS eliminated the TeleFile Program last year, participation in the program had declined every year since 1999 when 5.2 million filers used it.

Declining use was one factor the IRS considered when deciding whether or not to end the TeleFile Program. Other contributing factors included the increasing cost of maintaining an aging TeleFile system, declining and discontinued State TeleFile programs, and the growing use of other electronic filing alternatives, such as the Free File Program.

According to the IRS, taxpayers who previously used TeleFile may continue to file electronically using one of the following five methods:

- 1. Tax preparers;
- 2. Personal computers with Internet access and tax preparation software;
- 3. IRS's Free File Program;
- 4. Free tax assistance sites, such as the Voluntary Income Tax Assistance and Tax-Aide Programs; and
- 5. IRS Taxpayer Assistance Centers.

However, two of the five alternatives require the taxpayer to pay for tax preparation and filing services that were previously free, and two other options require taxpayers to have access to computers and the Internet. Consequently, in many cases,

<sup>24</sup>Income of less than \$25,000.

<sup>25</sup>National Taxpayer Advocate 2004 Annual Report to the Congress, Volume 1", December 2004.

<sup>26</sup>Forms 1040EZ.

the most cost-effective avenue for the taxpayer is to file a paper tax return. According to initial IRS statistics, a significant number of former TeleFile users are reverting to filing paper returns this year. As of April 8, 2006, the number of paper Form 1040EZ returns filed has increased 19.2 percent compared to this time last year (5.9 million in 2006 compared to 4.9 million in 2005), and there has been a corresponding decrease in electronically filed Forms 1040EZ (6.7 million in 2006 vs. 8.4 million in 2005).

TIGTA will further evaluate the impact of the elimination of the TeleFile Program on taxpayers and the IRS's efforts to increase electronic filing, and will report the results later this year.

#### PRIVATE DEBT COLLECTION

As of September 2005, the gross accounts receivable to the IRS was \$258 billion. On October 22, 2004, the President signed the American Jobs Creation Act of 2004<sup>27</sup> that included a provision allowing the IRS to use Private Collection Agencies (PCA) to help collect Federal Government tax debts. The law allows PCAs to locate, contact, and request full payment from taxpayers specified by the IRS. The law also allows the IRS to retain and use an amount not in excess of 25 percent of the amount collected by the PCAs to pay for the cost of PCA services, and an amount not in excess of 25 percent collected for collection enforcement activities of the IRS. According to the IRS, the initiative to use PCAs will help reduce the significant and growing amount of tax liability deemed uncollectible because of IRS resource priorities, will help maintain confidence in the tax system, and will enable the IRS to focus its existing collection and enforcement resources on more difficult cases.

The provisions of the Fair Debt Collection Practices Act<sup>28</sup> apply to PCAs. PCAs are prohibited from committing any act or omission that employees of the IRS are prohibited from committing in the performance of similar services. The IRS requires that PCAs adhere to all taxpayer protections. PCAs are also prohibited from threatening or intimidating taxpayers or otherwise suggesting that enforcement action will or may be taken if a taxpayer does not pay the liability. The PCAs must also adhere to all security and privacy regulations for systems, data, personnel, physical security, and taxpayer rights protections. To ensure compliance with these requirements, the IRS is responsible for providing oversight of PCA actions.

The IRS issued a detailed Request For Quotation<sup>29</sup> (RFQ) for solicitation of debt collection services in support of the Private Debt Collection program on April 25, 2005. However, this RFQ was canceled after the United States Court of Federal Claims filed an order on July 25, 2005, informing the IRS it intended to enjoin the solicitation. The order ruled that the IRS's restriction of the solicitation only to vendors with current Federal Government debt collection task orders was arbitrary and capricious. The IRS subsequently revised the RFQ and reissued it on October 14, 2005.

TIGTA reviewed the revised RFQ and determined that it adequately addressed the deficiencies cited by the United States Court of Federal Claims. The IRS deleted the requirement that PCAs must have a current Federal Government debt collection task order to be eligible for the solicitation. TIGTA did not identify any other restrictions in the RFQ which would have unnecessarily limited the procurement process. Further, the revised RFQ was reviewed by the IRS's Office of Procurement Policy Quality Assurance Branch and General Legal Services as required by IRS procurement procedures.

On March 9, 2006, the IRS announced that it awarded contracts to three firms to participate in the first phase of its private debt-collection initiative. The IRS has developed its own guidelines for the private firms, including background checks on all private-firm personnel associated with the projects as well as a mandatory, IRS-directed training program for company personnel. The IRS planned to begin delivering delinquent tax account cases to the selected PCAs by July 2006. However, on March 23, 2006, the IRS announced that it had issued stop-work orders to the three PCAs after two unsuccessful bidders filed bid protests with the Government Accountability Office (GAO).

In the second phase of the private debt-collection initiative, scheduled for 2008, the IRS intends to contract with up to 10 firms. Over the course of 10 years, the

<sup>27</sup> Public Law No. 108-357, 118 Stat. 1418 (2004).

<sup>28</sup> 15 U.S.C. § 1601 note, 1692-1920 (2000).

<sup>29</sup> An RFQ is issued by the IRS's Office of Procurement and describes the requirements that prospective contractors should provide in support of needed products or services. TIGTA reviewed the RFQ dated April 25, 2005. The Private Debt Collection Request for Quotation Outlines Adequate Procedures and Controls (Reference Number 2005-10-156, dated September 2005). TIGTA will soon report on its review of the revised RFQ dated October 14, 2005.

IRS expects that the private firms will help it collect an additional \$1.4 billion in outstanding taxes.

While the use of private collection agencies could result in significant recoveries of unpaid taxes, the potential for abuse exists. Experience at the State level demonstrates that the use of PCAs should be closely monitored. In December 2005, the State of New Jersey Commission of Investigation reported that what began as an effort to privatize the collection of tax debt 12 years ago evolved into a corrupt association between high- and mid-level managers in the Divisions of Taxation and Revenue and the PCAs.<sup>30</sup> The State of New Jersey may have been over-billed by more than \$1 million for a 5-year period.

The Commission reported that a lack of oversight and a lack of audits and quality controls directly contributed to the undetected over-billing. Additionally, the PCAs repeatedly ignored contract requirements and Taxation and Revenue officials failed to enforce them. While the Commission's report did not address this particular issue, TIGTA is also concerned about the quality of taxpayer service from PCAs during their attempts to collect outstanding taxes. Poor taxpayer service by PCAs could potentially have a negative impact on voluntary compliance.

Since the IRS is just now embarking on this initiative, TIGTA has not yet seen indications of problems with the IRS's private debt-collection initiative similar to those in New Jersey. However, a recent news story reported that a former official of one of the IRS's three selected PCAs for the first phase of this initiative was indicted for bribery of public officials to win a contract to collect unpaid fines and fees. According to the story, the official pleaded guilty to one count of conspiracy to commit bribery and one count of bank fraud in 2005, and was sentenced to 30 months in prison and a \$1 million fine. This particular case and the State of New Jersey experience clearly illustrate the need for proper oversight of this important initiative. According to the IRS, it has established an oversight unit responsible for ensuring that PCAs adhere to established procedures and that a tremendous amount of rigorous oversight will be applied to the PCAs.

Overseeing the IRS's private debt-collection initiative is a top priority for TIGTA. TIGTA has coordinated with the IRS during the initial phases of implementation of this initiative by addressing security concerns with the contracts and protection of taxpayer rights and privacy, and by developing integrity and fraud awareness training for the contract employees. TIGTA plans to provide a presentation to IRS trainers for PCAs about TIGTA's role in the private debt-collection initiative.

TIGTA has also developed a three-phase audit strategy to monitor this initiative and provide independent oversight. In the first phase, TIGTA is reviewing the IRS's planning and initial implementation of the program. As mentioned previously, our limited scope reviews of the original and revised RFQs did not identify any material omissions that would adversely affect the IRS's ability to manage this initiative effectively. Additionally, TIGTA recently reported that overall, the IRS has taken positive steps to effectively plan and implement certain aspects of the Private Debt Collection program. For example, the IRS has developed a draft letter and a related publication with pertinent information to notify taxpayers when their accounts are transferred to PCAs.

While the IRS has taken positive steps to implement the Private Debt Collection program, TIGTA noted that approximately 72 percent of the IRS's original inventory of cases available for placement in the program had balances due<sup>31</sup> that were over 2 years old. The IRS is now considering a revision to its case selection criteria that will increase the balance-due age even further. IRS management indicated that there is a long-term strategy in place to include more current cases in the program. However, the new Filing and Payment Compliance project<sup>32</sup> currently limits their ability to accomplish this strategy.

For the initial phase of the program, the IRS plans to place simpler cases with PCAs, such as those in which the taxpayer has filed all tax returns due. TIGTA determined, however, that contrary to IRS intentions, the case selection criteria the IRS had established would have allowed certain nonfiler cases to be assigned to the PCAs. The IRS subsequently agreed to review nonfiler conditions and determine whether the nonfiler cases should be excluded from inventory.

In the second phase, TIGTA will review the initiative after full implementation, which may not occur until fiscal year 2007. In the third phase, TIGTA will review the effectiveness of the program. The goal of this audit strategy is to ensure that

<sup>30</sup> State of New Jersey Commission of Investigation, "The Gifting of New Jersey Tax Officials" (December 2005).

<sup>31</sup> A balance due represents an unpaid assessment for which a taxpayer owes the IRS.

<sup>32</sup> The Filing and Payment Compliance project was initiated to address the inventory of delinquent tax debt that is not actively being collected by the IRS due to limited resources.

the IRS effectively exercises its new authority to use private debt collectors, while also ensuring that taxpayers' due process and privacy rights are protected.

#### OTHER MAJOR CHALLENGES FACING THE IRS

Despite the overall progress in customer service and the broad relief provided to Hurricane victims, improvements need to be made in customer service and other areas in which the IRS faces significant challenges in accomplishing its mission. TIGTA has identified the following additional management and performance challenges that confront the IRS:

- Modernization of the IRS;
- Security of the IRS;
- Complexity of the Tax Law;
- Using Performance and Financial Information for Program and Budget Decisions;
- Erroneous and Improper Payments;
- Taxpayer Protection and Rights;
- Managing Human Capital.

Each of the above presents its own unique challenges, which I will address individually in the remaining portion of my testimony.

#### *Modernization of the IRS*

Modernizing the IRS's computer systems has been a challenge for many years and will likely remain a challenge for the foreseeable future. The latest effort to modernize the IRS's systems, the Business Systems Modernization (BSM) program, began in fiscal year 1999, and is a complex effort to modernize the IRS's technology and related business processes. According to the IRS, this effort involves integrating thousands of hardware and software components. Through February 2006, the IRS has received appropriations of approximately \$2 billion to support the BSM program, and the President has requested an additional \$167 million for fiscal year 2007.

Succeeding in the modernization effort is critical—not only because of the amount of time and money at stake but also to improve the level of service provided to taxpayers. To accomplish the modernization effort, the IRS hired the Computer Sciences Corporation (CSC) as the PRIME<sup>33</sup> to design, develop, and integrate the modernized computer systems. However, in January 2005, the IRS began taking over the role of systems integrator from the PRIME due to reductions in funding for the BSM program and concerns about the PRIME's performance.

The BSM program has shown progress. The IRS and its contractors have been focusing on defining and delivering smaller, incremental releases of projects.<sup>34</sup> For example, the IRS recently issued the fourth incremental release of the Modernized e-File project. The Modernized e-File project has provided the capability for corporations, exempt organizations, governmental entities, private foundations, and trusts to file 106 tax forms electronically. In January 2006, the IRS released the fourth incremental release of the Customer Account Data Engine (CADE) project which will eventually replace the IRS's existing Master File.<sup>35</sup>

Although progress is being made, the modernization program is behind schedule, over budget, and is delivering less functionality than originally planned. TIGTA has identified four primary challenges that the IRS must overcome for modernization to be successful:

- (1) The IRS must implement planned improvements in key management processes and commit necessary resources to succeed;
- (2) The IRS must manage the increasing complexity and risks of the modernization program;
- (3) The IRS must maintain continuity of strategic direction with experienced leadership; and

<sup>33</sup>The PRIME is an acronym for Prime Systems Integration Services Contractor.

<sup>34</sup>A release is a specific edition of software.

<sup>35</sup>The Master File is the IRS database for storing taxpayer account information on individuals, businesses, employee retirement plans, and exempt organizations. The CADE will include applications for daily posting, settlement, maintenance, refund processing, and issue detection for taxpayer account and return data. In conjunction with other applications, the CADE will allow employees to post transactions and update taxpayer account and return data online from their desks. Updates will be immediately available to any IRS employee who accesses the data and will provide a complete, timely, and accurate account of the taxpayer's information. In contrast, the current Master File processing system can take up to 2 weeks to update taxpayer accounts, and IRS employees may need to access several computer systems to gather all relevant information related to a taxpayer's account.

—(4) The IRS must ensure contractors' performance and accountability are effectively managed.

In response to modernization challenges and reduced funding, the IRS began making dramatic changes to significant areas within the BSM program over the last year. For example, the GAO recommended and the House and Senate Appropriations Committees directed the IRS to develop a new version of the Modernization Vision and Strategy. In addition, the IRS's prior modernization approach involved a huge development effort aimed at replacing all current systems. The IRS is now focusing on using current systems to accomplish modernization. I believe these extensive changes signal the beginning of a different design and structure for the entire modernization effort.

As risks and issues are identified within the BSM program, frequent changes are often required. However, the IRS's recent and planned changes do not eliminate the four challenges we have identified. Due to the criticality of the BSM program, the IRS must confront identified challenges and proactively address them in order to come closer to realizing expectations in this new phase of the BSM program.

#### *Security of the IRS*

Millions of taxpayers entrust the IRS with sensitive financial and personal data, which are stored and processed by IRS computer systems. The risk of sensitive data being compromised has increased over the last few years because of the increased threat of identity theft. According to the Social Security Administration, identity theft is one of the fastest growing crimes in the United States. The Department of Commerce estimates that more than 50 million identities were compromised in 2005. The sensitivity of taxpayers' information stored by the IRS and the IRS's use of the Social Security Number as a taxpayer identifier on its computer systems add to the risks the IRS must address.

As the Nation's primary revenue collector, the IRS may also be a prime target for attacks on its computer systems by anti-government protestors, international terrorists, and disgruntled employees. In addition to identity theft concerns, computer attacks can cause the loss of revenue and productivity by disrupting computer operations. Although many steps have been taken to limit risks, IRS systems and taxpayer information remain susceptible to threats that could impact the confidentiality, integrity, and availability of data and information systems.

The IRS has focused on technical solutions to protect its computer systems and data, and has established reasonable technical controls to prevent intruders from entering the IRS network. However, managerial and operational controls have not been adequately emphasized, leading TIGTA to conclude that systems and data remain vulnerable. In the past, the IRS relied mainly upon the Chief Information Officer and Chief, Mission Assurance and Security Services, to provide security controls. The IRS has recently increased business unit involvement to ensure adequate security and has added security responsibilities to executives' position descriptions. These changes are critical but will take time to improve the security posture of the IRS.

The IRS has improved its processes and devoted additional resources for certifying and accrediting its systems; however, only 35 percent of its systems had been certified and accredited as of September 2005. Annual testing had not been conducted on a majority of its systems. In addition, only 300 of its 2,737 employees with key security responsibilities had received any specialized training in the last fiscal year. We have attributed several security weaknesses in the past to the lack of training for these employees and expect these weaknesses will persist until specialized training is given more emphasis. In addition, contractors and States who use taxpayer information to administer their States' tax laws have not been given sufficient oversight.

Hurricanes Katrina and Rita affected 25 IRS offices. By adequately planning and taking aggressive actions after the hurricanes hit, the IRS was able to locate its employees and restore its computer operations to continue tax administration activities in the Gulf Coast area. However, disaster recovery plans for the IRS's large computing centers and campuses require additional development, testing, or personnel training to ensure that the IRS can quickly recover in the event of a disaster.

For the IRS to make the largest strides in improving computer security at a relatively low cost, managers and employees must be aware of the security risks inherent in their positions and consider security implications in their day-to-day activities. IRS business unit managers should be held accountable for the security of their systems and key security employees should be adequately trained to carry out their responsibilities. It is also vital that the IRS continues to refine its plans and capabilities to manage emergency situations in a manner that protects employees and allows restoration of business operations in a timely manner.

*Complexity of the Tax Law*

The scope and complexity of the United States tax code make it virtually certain that taxpayers will face procedural, technical, and bureaucratic obstacles before meeting their tax obligations. The IRS has consistently sought to ease the process for all taxpayers. But each tax season brings new challenges, and old problems sometimes resist solution.

According to the November 2005 Report of the President's Advisory Panel on Tax Reform, last year Americans spent more than 3.5 billion hours doing their taxes, the equivalent of hiring almost 2 million new IRS employees—more than 20 times the IRS's current workforce. About \$140 billion is spent annually on tax preparation and compliance—about \$1,000 per family.

The Joint Committee on Taxation conducted a study in 2001 that demonstrates the vastness of the tax code. The study found that, in 2001, the tax code consisted of nearly 1.4 million words. There were 693 sections of the code applicable to individuals, 1,501 sections applicable to businesses, and 445 sections applicable to tax exempt organizations, employee plans, and governments.<sup>36</sup>

The complexity of the code hampers the ability of the IRS to administer the Nation's tax system and confuses most taxpayers. The IRS has attempted to provide assistance to taxpayers with questions about the tax code through toll-free telephone lines, TACs, kiosks, and the IRS Internet site. TIGTA has performed numerous audits of the accuracy of IRS responses to taxpayer questions submitted via these methods and found that even some IRS employees cannot apply the tax code correctly.

Tax law complexity contributes to the IRS's challenges in reaching accuracy goals to tax law questions, as well as to taxpayer frustration with attempting to decipher the tax code. For example, assistants are trained and expected to be knowledgeable in 318 tax law topics with 395 subtopics. Additionally, they are expected to be able to respond to taxpayer issues for the current and prior tax years.

In part because of the tax law complexity, taxpayers are continuing to receive inaccurate answers to their tax law questions. TIGTA's results for the 2006 Filing Season show that assistants provided accurate answers to 73 percent of the tax law questions asked at the TACs. Although this is an improvement from the accuracy rate of 66 percent TIGTA reported for the 2005 Filing Season,<sup>37</sup> taxpayers are still receiving incorrect answers to 27 percent of their questions asked at the TACs. Using its own methodology to calculate the accuracy rate, however, the IRS did meet its accuracy rate goal of 80 percent for the 2006 Filing Season.

As well as adding to the burden on the taxpayer and the IRS, tax law complexity also may inadvertently contribute to the tax gap. Complexity has given rise to the latest generation of abusive tax avoidance transactions, with taxpayers attempting to take advantage of the tax code's length and complexity by devising intricate schemes to illegally shelter income from taxation. The Son of Boss (Bond and Option Sales Strategies) is one such abusive tax shelter.<sup>38</sup> Other than generating tax benefits, the IRS determined it lacked a business purpose.

Overall, the IRS estimated the Son of Boss abusive tax shelter understated tax liabilities in excess of \$6 billion. The IRS describes the Son of Boss abusive tax shelter as a highly sophisticated, technically complex, no-risk scheme designed to generate tax losses without corresponding economic risks, which was promoted by some prominent firms in the financial services industry to investors seeking to shelter large gains from the sale of a business or capital asset.

The scheme used flow-through entities, such as partnerships, and various financial products<sup>39</sup> to add steps and complexity to transactions that had little or no relationship to the investor's business or the asset sale creating the sheltered gain. Additionally, the losses generated from the transactions were often reported among other "legitimate" items in several parts of the income tax return. Some losses from the Son of Boss abusive tax shelter, for example, were reported as a reduction to gross sales, cost of goods sold, or capital gains.

Taken together, these characteristics, especially the use of flow-through entities, made it very difficult for the IRS to detect the Son of Boss abusive tax shelter

<sup>36</sup>"Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986", Staff of the Joint Committee on Taxation, JCS-3-01 (Apr. 2001).

<sup>37</sup>"Customer Accuracy at Taxpayer Assistance Centers Showed Little Improvement During the 2005 Filing Season" (Reference Number 2005-40-146, date September 2005).

<sup>38</sup>IRS Notice 99-59 issued in December 1999 described Boss transactions as certain losses involving partnerships and foreign corporations that would not be allowed for tax purposes.

<sup>39</sup>The IRS defines financial products as instruments used in the global marketplace and include, among others, stocks, bonds, foreign currencies, mortgages, commodities, and derivatives.

through its traditional process of screening returns individually for questionable items.<sup>40</sup> Administering such a complex tax code makes the job of pursuing abusive tax avoidance schemes, such as the Son of Boss, challenging and costly to the IRS.

As part of its goal to improve service to taxpayers, the IRS includes simplifying the tax process as an objective in its Strategic Plan. Simplification could incorporate a range of actions from developing legislative recommendations to clarifying tax instructions or forms. Changing tax laws, however, can be a lengthy process since the IRS only administers the tax code that is passed by Congress. Thus, the IRS must work extensively with its stakeholders, as well as the Department of the Treasury, to identify and develop legislative recommendations that would reduce tax law complexity and taxpayer burden.

*Using Performance and Financial Information for Program and Budget Decisions*

The President's Management Agenda aims to place a greater focus on performance by formally integrating it with budget decisions. In addition, without accurate and timely financial information, it is not possible to accomplish the President's agenda to secure the best performance and highest measure of accountability for the American people. The IRS has made some progress. However, integrating performance and financial management remains a major challenge.

The IRS has achieved mixed success in establishing long-term goals to integrate performance and financial management. During the fiscal year 2005 budget formulation process, the IRS took the important step of aligning performance and resources requested. The IRS also modified its budget and performance plans to include more customer-focused and "end result" measures. However, TIGTA believes that the IRS must continue to integrate performance into its decision-making and resource allocation processes to completely achieve an integrated performance budget.

The IRS also continues to analyze the critical data needed to develop long-term enforcement outcome measures. For example, the IRS released the first results from its NRP, which provided fresh data on taxpayer voluntary compliance levels—the first in more than a decade. Such data are essential to establishing enforcement measures and effectively allocating resources to related activities. The IRS, however, needs to develop a more strategic approach to the entire tax administration system. Such an effort would better identify the characteristics of an effective and efficient tax administration system, would help pinpoint desired outcomes, and would create a road map for the next decade that would complement the IRS's strategic, budget, and annual performance plans.

This past year TIGTA reported on two circumstances that highlight the need for more integration of performance and budget data. The Federal Workforce Flexibility Act of 2004<sup>41</sup> requires agencies to regularly assess their training efforts to determine whether their training is contributing to the successful completion of the agencies' missions. However, the IRS was not able to assess how effectively the approximately \$100 million spent on training enhanced its ability to fulfill its mission.<sup>42</sup> Additionally, the IRS could better manage its facilities and office space. TIGTA determined that the lack of appropriate performance data prevents the IRS from cataloging office space freed up by employees who regularly participate in the IRS's telecommuting program. This lack of performance data prevented the IRS from freeing up underutilized space with an estimated annual cost of \$18 million.<sup>43</sup>

The IRS has reported a yield of more than \$4 in direct revenue from IRS enforcement efforts for every \$1 invested in the IRS's total budget. However, we do not believe there is an adequate basis to use the total IRS budget to determine a return on investment for enforcement activities. Enforcement is only one component of the IRS that collects revenue. Enforcement revenue (\$43.1 billion in fiscal year 2004) compared to the enforcement costs (\$6.1 billion in fiscal year 2004) actually equates to an overall return on investment for enforcement activities of 7 to 1. The IRS also provided estimates that it would eventually achieve approximately \$1.17 billion in additional revenues for its proposed fiscal year 2006 enforcement initiatives. This would equate to a 4.4 to 1 return on investment. However, our analysis indicates the revenue estimate may be too high. Furthermore, the IRS currently does not

<sup>40</sup>"The Settlement Initiative for Investors in a Variety of Bond and Option Sales Strategies Was Successful and Surfaced Possible Next Steps for Curtailing Abusive Tax Shelters" (Reference Number 2006-30-065, dated March 2006).

<sup>41</sup>Public Law 108-411 [S. 129] (2004).

<sup>42</sup>"The Internal Revenue Service Does Not Adequately Assess the Effectiveness of Its Training" (Reference Number 2005-10-149, dated September 2005).

<sup>43</sup>"The Internal Revenue Service Faces Significant Challenges to Reduce Underused Office Space Costing \$84 Million Annually" (Reference Number 2004-10-182, dated September 2004).

have a methodology to measure the revenue resulting from any initiatives that it implements.<sup>44</sup>

The IRS's financial statements and related activities also continue to be of concern to IRS stakeholders. The GAO audits the IRS's financial statements annually. The audit determines whether the IRS: (1) prepared reliable financial statements, (2) maintained effective internal controls, and (3) complied with selected provisions of significant laws and regulations, including compliance of its financial systems with the Federal Financial Management Improvement Act of 1996.<sup>45</sup>

In audits of the IRS's financial statements, the GAO has concluded that the statements were fairly presented in all material respects.<sup>46</sup> The GAO, however, identified some continuing serious deficiencies in the IRS's financial systems, including control weaknesses and system deficiencies affecting financial reporting, unpaid tax assessments, tax revenue and refunds, and computer security. Also, the IRS again had to rely extensively on resource-intensive compensating processes to prepare its financial statements. Without a financial management system that can produce timely, accurate, and useful information needed for day-to-day decisions, the IRS's financial stewardship responsibilities continue to be one of the largest challenges facing IRS management.

During fiscal year 2004, the IRS collected over \$2 trillion in Federal tax revenue, which constituted approximately 95 percent of all Federal revenue. However, as reported by the GAO for the last several years, the systems used to account for these revenues do not meet current Federal financial management guidelines. For example, the IRS's Federal tax revenue financial management systems lack adequate audit trails, cannot readily produce reliable information regarding unpaid assessments at interim periods, and cannot readily generate custodial financial information needed for year-end reporting.

To address these weaknesses, the IRS is developing the Custodial Detail Database (the Database). The purpose of the Database is to provide sub-ledgers for the custodial financial activities of the IRS. The IRS also plans to use the Database to track unpaid assessments throughout the year and to help support the lengthy extraction, reconciliation, and summarization process needed to produce the IRS's annual financial custodial statements. TIGTA's preliminary assessment indicates that the IRS faces a number of significant challenges in meeting these objectives, especially the development of a system that would support the production of current and reliable information regarding tax receivables throughout the year.

To provide useful information on tax receivables at interim periods, the Database will also need to address collectibility issues, and accurately account for and eliminate duplicate assessments. Furthermore, the IRS continues to be unable to determine the specific amount of revenue it actually collects for three of the Federal Government's four largest revenue sources, primarily because the accounting information needed to validate and record payments to the proper trust fund is provided on the tax return, which is received months after the payment is submitted. The IRS has to use statistical methods to estimate the amounts of these taxes.<sup>47</sup>

#### *Preventing Erroneous and Improper Payments*

One of the goals of The President's Management Agenda is to reduce erroneous payments.<sup>48</sup> Further, the Improper Payments Information Act of 2002<sup>49</sup> greatly expanded the administration's efforts to identify and reduce erroneous and improper payments in government programs and activities. While the administration has pushed to prevent erroneous and improper payments, stewardship over public funds remains a major challenge for IRS management.

Improper and erroneous payments include inadvertent errors, payments for unsupported or inadequately supported claims, payments for services not rendered, payments to ineligible beneficiaries, and payments resulting from outright fraud

<sup>44</sup>"A Better Model is Needed to Project the Return on Additional Investments in Tax Enforcement" (Reference Number 2005-10-159, dated September 2005).

<sup>45</sup>Public Law No. 104-208, 110 Stat. 3009.

<sup>46</sup>"Financial Audit: IRS's fiscal years 2005 and 2004 Financial Statement" (GAO-06-137, dated November 2005).

<sup>47</sup>The three revenue sources cited are Social Security, hospital insurance, and individual income taxes. "The Custodial Detail Database Should Help Improve Accountability; However, Significant Financial Management Issues Still Need to Be Addressed" (Reference Number 2006-10-029, dated December 2005).

<sup>48</sup>"The President's Management Agenda", announced in the summer of 2001, is the President's aggressive strategy for improving the management of the Federal Government. It focuses on five areas of management weakness across the Government where improvements should be made.

<sup>49</sup>Public Law No. 107-300, 116 Stat. 2350.

and abuse by program participants or Federal employees. For the IRS, improper and erroneous payments generally involve improperly paid refunds, tax return filing fraud, or overpayments to vendors or contractors.

Some tax credits, such as the Earned Income Tax Credit (EITC), provide opportunities for taxpayer abuse. The EITC is a refundable credit available to taxpayers who do not exceed a certain amount of income per year. The EITC was intended to provide significant benefits to the working poor, but some taxpayers have abused the credit, which has resulted in a significant loss of revenue. The IRS has estimated that approximately 30 percent of all EITC claims should not have been paid, which was approximately \$9 billion of the \$31 billion in EITC claimed for Tax Year 1999.<sup>50</sup> The IRS has been developing an EITC initiative to combat the problems of fraudulent EITC claims. The initiative is focused on three concepts: certification of qualifying child residency requirements, verification of filing status, and verification of reported income. In October 2005, the IRS reported that as a result of these efforts, it had identified and prevented the payment of over \$275 million in erroneous EITC claims. TIGTA has conducted an ongoing assessment of this initiative as the three concepts have been tested.<sup>51</sup>

The Criminal Investigation function of the IRS is responsible for detecting and combating tax refund fraud, through its Questionable Refund Program (QRP). TIGTA has repeatedly reported over the last 6 years that additional controls and procedures were necessary to not only identify additional instances of potential fraud, but also to properly and timely release refunds that are later determined not to be fraudulent. This latter issue recently has been the subject of much debate, coming on the heels of the National Taxpayer Advocate's 2005 Annual Report to the Congress in which the Taxpayer Advocate criticized the IRS for unnecessarily stopping refunds owed to legitimate taxpayers.

TIGTA previously reported in March 2003 that there were unnecessary delays issuing legitimate, non-fraudulent refunds.<sup>52</sup> That same audit, however, identified expired statutory periods for making civil assessments of tax, thereby preventing recovery of erroneously refunded monies through an examination of income or expense items on the tax returns.

TIGTA is extremely concerned about this issue, believing that a necessary balance must be struck between protecting the revenue by not allowing refund fraud to go unchecked, and ensuring that legitimate taxpayers receive their refunds timely or, if challenged by the IRS, are afforded due process and notification. TIGTA is continuing its review of the IRS QRP and will report on its audit work later in the year.<sup>53</sup>

Additionally, at the request of the House Committee on Ways and Means, TIGTA initiated an audit of the Electronic Fraud Detection System (EFDS). EFDS was designed to identify potentially fraudulent tax returns. We plan to report our results later in the year.

In addition to erroneous payments of credits, contract expenditures represent a significant outlay of IRS funds and are also susceptible to mistakes or abuse. As of October 2005, the IRS was responsible for administering 553 contracts with a total systems life value of \$28.2 billion. TIGTA continues to perform audits of select contracts to ensure payments on selected vouchers are appropriate and in accordance with contract terms and conditions. TIGTA also provided the IRS with a summary report highlighting several system deficiencies identified by the Defense Con-

<sup>50</sup> IRS report, "Compliance Estimates for Earned Income Tax Credit on 1999 Returns" (dated February 2002).

<sup>51</sup> Audit reports previously issued: "The Earned Income Tax Credit Income Verification Test Was Properly Conducted" (Reference Number 2005-40-093, dated May 2005); "The Earned Income Credit Recertification Program Continues to Experience Problems" (Reference Number 2005-40-039, dated March 2005); "Initial Results of the Fiscal Year 2004 Earned Income Tax Credit Concept Tests Provide Insight on Ways Taxpayer Burden Can Be Reduced in Future Tests" (Reference Number 2005-40-006, dated October 2004); and "Management Controls Over the Proof of Concept Test of Earned Income Tax Credit Certification Need to Be Improved" (Reference Number: 2004-40-032, dated December 2003).

<sup>52</sup> "Improvements Are Needed in the Monitoring of Criminal Investigation Controls Placed on Taxpayers' Accounts When Refund Fraud Is Suspected" (Reference Number 2003-10-094, dated March 2003).

<sup>53</sup> Audit reports previously issued: "The Internal Revenue Service Can Improve the Effectiveness of Questionable Refund Detection Team Activities" (Reference Number 2000-40-018, dated December 1999); "Revised Questionable Refund Program Procedures Were Not Consistently Implemented" (Reference Number 2001-40-025, dated January 2001); "Improvements Are Needed in the Monitoring of Criminal Investigation Controls Placed on Taxpayers' Accounts When Refund Fraud Is Suspected" (Reference Number 2003-10-094, dated March 2003); and "The Internal Revenue Service Needs to Do More to Stop the Millions of Dollars in Fraudulent Refunds Paid to Prisoners" (Reference Number 2005-10-164, dated September 2005).

tract Audit Agency (DCAA) in the past 5 years for a major IRS contractor. These deficiencies could lead to overstated and unsupported labor and other costs. Although the contractor is making progress in addressing previously reported system inadequacies, TIGTA believes significant risk still remains for the IRS on this contract.

*Taxpayer Protection and Rights*

Congress realized the importance of protecting taxpayers and taxpayer rights when it passed the RRA 98. This legislation required the IRS to devote significant attention and resources to protecting taxpayer rights. The RRA 98 and other legislation require TIGTA to review IRS compliance with taxpayer rights provisions. Our most recent audit results on some of these taxpayer rights provisions are:

- Notice of Levy.*—TIGTA reports have recognized that the IRS has implemented tighter controls over the issuance of systemically generated levies, and TIGTA testing of these controls indicated that they continue to function effectively. In addition, revenue officers who manually issued levies properly notified taxpayers of their appeal rights.<sup>54</sup>
- Restrictions on the Use of Enforcement Statistics to Evaluate Employees.*—The IRS is complying with the law. A sample review of employee performance and related supervisory documentation revealed no instances of tax enforcement results, production quotas, or goals being used to evaluate employee performance.<sup>55</sup>
- Notice of Lien.*—The IRS did not completely comply with the law. For example, the IRS did not always timely mail lien notices. In other cases, the IRS could not provide proof of mailing. In addition, the IRS did not always follow its guidelines for notifying taxpayer representatives and resending notices when they are returned as undeliverable.<sup>56</sup>
- Seizures.*—The IRS did not comply with all legal and internal guidelines when conducting seizures. TIGTA's review did not identify any instances in which taxpayers were adversely affected, but not following legal and internal guidelines could result in abuses of taxpayer rights.<sup>57</sup>
- Illegal Tax Protestor Designations.*—The IRS is prohibited by law from designating taxpayers as “illegal tax protestors” but may refer to taxpayers as “nonfilers.” TIGTA has reviewed the Master File<sup>58</sup> for illegal tax protestor designations. We found that the IRS has not reintroduced such designations on the Master File and formally coded illegal tax protestor accounts have not been assigned similar Master File designations. In addition, the IRS does not have any current publications with illegal tax protestor references and has initiated actions to remove references from various forms of the Internal Revenue Manual. However, a few illegal tax protestor references still exist in isolated case files.<sup>59</sup>
- Denials of Requests for Information.*—The IRS improperly withheld information from requesters in 7.1 percent of the Freedom of Information Act and Privacy Act of 1974 requests, and 3.1 percent of the 26 U.S.C. § 6103 requests reviewed.<sup>60</sup>
- Collection Due Process.*—A significant portion of the Appeals Collection Due Process and Equivalent Hearings closed case files requested could not be located or did not contain sufficient documentation. As a result, TIGTA could not determine if the IRS complied with legal guidelines and required procedures to protect taxpayer rights. Moreover, some Appeals determination letters did not contain clear and detailed explanations of the basis for the hearing officers' decisions and did not adequately communicate the results of the hearings to tax-

<sup>54</sup>“Taxpayer Rights Are Being Protected When Levies Are Issued” (Reference Number 2004-30-072, dated June 2005).

<sup>55</sup>“Fiscal year 2005 Statutory Audit of Compliance With Legal Guidelines Restricting the Use of Records of Tax Enforcement Results” (Reference Number 2005-40-157, dated September 2005).

<sup>56</sup>“Fiscal Year 2004 Statutory Review of Compliance With Lien Due Process Procedures” (Reference Number 2005-30-095, dated June 2005).

<sup>57</sup>“Fiscal Year 2005 Review of Compliance With Legal Guidelines When Conducting Seizures of Taxpayers' Property” (Reference Number 2005-30-091, dated June 2005).

<sup>58</sup>The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

<sup>59</sup>“Fiscal year 2005 Statutory Audit of Compliance With Legal Guidelines Prohibiting the Use of Illegal Tax Protester and Similar Designations” (Reference Number 2005-40-104, dated July 2005).

<sup>60</sup>“Some Improvements Have Been Made to Better Comply With the Freedom of Information Act Requirements” (Reference Number 2005-10-089, dated May 2005).

payers. Some determination letters did not address the specific issues raised or tax periods discussed by the taxpayers in their hearing requests.<sup>61</sup>

Neither TIGTA nor the IRS could evaluate the IRS's compliance with three RRA 98 provisions since IRS information systems do not track specific cases. These three provisions relate to: restrictions on directly contacting taxpayers instead of authorized representatives, taxpayer complaints, and separated or divorced joint filer requests.

#### *Human Capital*

Like much of the Federal Government, managing the extensive human capital resources at the IRS remains a serious concern. Workforce issues, ranging from recruiting to training and retaining employees, have challenged Federal agencies for years. The GAO, the OMB, and the Office of Personnel Management have all made the strategic management of human capital a top priority. Specifically for the IRS, recent reorganization and modernization efforts, such as the focus on e-filing, have made many jobs dealing with processing paper tax returns redundant.

The IRS also faces personnel shortages in certain functions. The Wage and Investment Division is experiencing critical staffing shortages in its TAC program. The IRS's decision to focus more resources on compliance activities has limited available resources and the IRS's Field Assistance Office does not have the resources to offer unlimited services. Additionally, the uncertainty around the TAC closures created critical vacancies as TAC employees left for other jobs in the IRS. As of December 1, 2005, the Field Assistance Office Headquarters had identified 47 TACs with critical staffing shortages. Five vacancies are in TACs located in areas impacted by Hurricanes Katrina and Rita—three in Louisiana and two in Texas. These shortages come at a time when taxpayer visits in these areas may increase and the Field Assistance Office is adding services to help reduce the burden on taxpayers affected by the hurricanes. As noted earlier, the IRS has reported fewer taxpayers are seeking assistance at the TACs.<sup>62</sup>

The Large and Mid-Size Business Division reported in its fiscal year 2006 strategic assessment that it will continue to lose substantial experience in the revenue agent position through attrition. Similarly, in the Small Business/Self-Employed Division, the human capital crisis continues to intensify as employees in key occupations increasingly become eligible for retirement, are lost through attrition, or migrate to other areas. Stagnant funding allocations have impacted the IRS's ability to attract new hires and retain existing employees. Thus, potential losses in critical occupational groups, coupled with concerns regarding grade and competency gaps, further emphasize the need to strategically manage human capital. The IRS must devote significant attention to managing human capital to overcome the 10 challenges discussed in this testimony.

#### CONCLUSIONS

While the 2006 Filing Season appears to have been successful based on TIGTA's preliminary results, I am concerned about some of the challenges the IRS faces. In particular, it appears that changes in the Free File Agreement as well as the elimination of the TeleFile Program may have contributed to a significant slowing of the growth in electronic filing this year. This slowed growth comes at a time when the IRS is still far from reaching Congress's goal of 80 percent electronic filing by 2007. This slower growth will defer the efficiency gains for the IRS that result from electronic filing.

Also, without reliable estimates of the tax gap, IRS's compliance and customer service efforts may not be as effective as necessary to improve the voluntary compliance rate and reduce the tax gap. Additionally, reductions in customer services, such as TAC closures, the elimination of the TeleFile Program, and a reduction in toll-free telephone hours of operation, to gain resource efficiencies must be carefully considered before any further decisions are made. TIGTA continues to be concerned that the IRS does not ensure that it has adequate and reliable data prior to making decisions that impact customer service operations. Before proceeding with these efforts, the IRS needs to better understand the impact of such changes on taxpayers as well as taxpayers' abilities to obtain these services through alternative means.

I hope my discussion of the 2006 Filing Season and some of the significant challenges facing the IRS will assist you with your consideration of the IRS's fiscal year

<sup>61</sup> "The Office of Appeals Should Strengthen and Reinforce Procedures for Collection Due Process Cases" (Reference Number 2005-10-138, dated September 2005).

<sup>62</sup> "The Field Assistance Office Has Taken Appropriate Actions to Plan for the 2006 Filing Season, but Challenges Remain for the Taxpayer Assistance Center Program" (Reference Number 2005-40-037, dated March 31, 2006).

2007 appropriations. Mr. Chairman and members of the subcommittee, thank you for allowing me to share my views. I would be pleased to answer any questions you may have.

Senator BOND. Thank you very much, Mr. George, and we trust you will continue to monitor the Katrina emergency filing to make sure that people who deserve refunds are getting them and only those who deserve them. I think this is a concern that all of us share.

**STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE,  
TAXPAYER ADVOCATE SERVICE**

Senator BOND. Now we turn to Ms. Nina Olson, the National Taxpayer Advocate. Ms. Olson, welcome.

Ms. OLSON. Thank you, Mr. Chairman, Senator Murray, and Senator Durbin.

The overriding objective of the IRS should be to maximize voluntary compliance with the tax laws. The IRS recently estimated that the voluntary compliance rate was 83.7 percent in 2001, and it has established a goal of raising the voluntary compliance rate to 85 percent by 2009. That is an appropriate goal. Compared with 10 years ago, there is little doubt that the IRS has become 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 5 years, particularly with regard to corporate tax shelters and high income individuals, but we can't just rest on our recent improvements and say that we are doing good enough. The IRS's central responsibility is to ensure that taxpayers comply with the tax laws. In fulfilling that responsibility, I believe job No. 1 is to provide high-quality outreach, education, and taxpayer assistance to enable taxpayers to meet their tax obligations voluntarily.

In most cases, that will be sufficient, but where taxpayers are unwilling to comply with the laws, job No. 2 for the IRS must be to detect noncompliance where it exists and address it through appropriate enforcement action for the IRS getting the biggest bang for the buck places a premium on superior research and strategic planning. Direct revenue gains resulting from an IRS action are easy to measure, but it is the combination of direct and indirect revenue gains resulting from IRS actions that determine how much progress we are making in reducing the tax gap. Not all service and enforcement actions generate the same return on investment.

Will the IRS ultimately bring in more revenue if it spends its next dollar on services or enforcement and more specifically on which services and on which enforcement activities? The truth is we don't know, and we, therefore, have limited information on which to base strategic decisions. Research is not cheap, but the IRS needs to devote more resources to understanding the causes of noncompliance and the relative returns of alternative compliance strategies in order to do its job more efficiently.

On the service side, the recently released report on phase one of the Taxpayer Assistance Blueprint, or the TAB, is the first step toward establishing a long-term strategy for delivering needed taxpayer services within existing resource limitations. In the next

phase of the TAB, we must focus on a number of areas that could have significant impact on congressional or IRS decisions about service delivery to taxpayers. In phase two, we must develop a baseline of services. We cannot assume that the current level of services reflects taxpayer preferences. The status quo is not necessarily what taxpayers want. It is merely what the IRS is currently willing or able to deliver.

We must identify what we are doing now, what we still don't know about taxpayer needs, and what services we need to provide to meet those needs. We also must identify the best method to deliver those needed services, and we must keep in mind that there are taxpayers who cannot or will not use self-service options.

To identify which services it should provide, the IRS must measure the impact of taxpayer service on compliance. The TAB notes that it is difficult to measure this impact. I believe the IRS does have the capability to develop useful estimates, and in my written testimony, I suggest a general framework for conducting this research. For example, we could identify a group of taxpayers who receive a particular service and an otherwise comparable group who do not receive that service. We could then measure the subsequent compliance of both groups by applying the three measures the IRS now uses to estimate the tax gap: payment compliance, filing compliance, and reporting compliance.

The IRS can also do a better job of estimating the full costs of its programs, including what I call the downstream consequences of its actions. For example, what are the downstream consequences of a lien or a levy, including the resources that TAS, the Taxpayer Advocate Service, Appeals Council and the courts may ultimately devote to resolving a taxpayer challenge? Failure to incorporate these downstream costs can provide an extremely inaccurate portrait of a program's return on investment. Downstream consequences analysis not only tells us the true cost of IRS actions, but it also gives us clues as to how to improve our processes from an IRS and a taxpayer perspective.

#### PREPARED STATEMENT

In conclusion, I believe that the IRS has taken major strides forward, but it can still do more to deliver its core mission more efficiently and effectively. To increase voluntary compliance, the IRS 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 service and enforcement strategies, including those pertaining to the cash economy; and, finally, it must have sufficient resources to move forward with its technological improvements on both a short-term and a long-term basis.

Thank you.

[The statement follows:]

## PREPARED STATEMENT OF NINA E. OLSON

Mr. Chairman, Ranking Member Murray, and distinguished members of the subcommittee, thank you for inviting me to testify today regarding the proposed budget of the Internal Revenue Service for fiscal year 2007.<sup>1</sup>

The overriding objective of the Internal Revenue Service 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.

While a variety of measures can be applied to measure the IRS's performance, one of the best measures is the percentage of taxes that taxpayers pay voluntarily. The IRS's most recent estimate of the gross tax gap (i.e., the amount of tax unpaid before accounting for late payments and collection activity) was \$345 billion in tax year 2001, which implies a compliance rate of 83.7 percent.<sup>2</sup> The IRS recently established a long-term performance goal of increasing the compliance rate to 85 percent by 2009.<sup>3</sup> In my view, this is a laudable goal.

What steps is the IRS currently taking to maximize voluntary compliance? What additional steps should it take? Can the IRS do more to reduce the tax gap without intruding unduly on fundamental taxpayer rights? These are the key questions I would ask in determining whether the IRS is making optimal use of its resources.

In many respects, the IRS is doing a better job of performing its core mission than it did in years past. By the IRS's current objective measures, it is providing customer service at a much higher level than it did a decade ago. On the enforcement side, it is performing more audits and aggressively pursuing corporate tax shelters and noncompliance by high-income individuals. However, the IRS's existing measures do not adequately capture costs associated with the "downstream consequences" of its programs and planning.<sup>4</sup>

To improve, the IRS must conduct an analysis of downstream consequences, including their impact on taxpayer service, and incorporate the results of that analysis into its strategic plans. Without adequate analysis of the downstream consequences of its options, the IRS cannot make informed strategic decisions about how to allocate resources between taxpayer service and enforcement activities and cannot tell its appropriators that it is using its limited resources wisely. Moreover, problems with IRS technology create additional downstream consequences. The IRS must be funded sufficiently to correct problems now with its existing technology—while it simultaneously strives to modernize its computer systems.

In the balance of my testimony, I will identify key issues I believe the IRS should address to get the biggest compliance bang for its buck.

THE IRS COULD DO A BETTER JOB OF ALLOCATING ITS RESOURCES PROPERLY IN ORDER  
TO INCREASE OVERALL COMPLIANCE

Over the last 3 years, in hearings before the Senate Finance, Budget, and Homeland Security and Governmental Affairs committees, I have testified about ways to close the tax gap, both by reducing opportunities for noncompliance and by enhancing traditional enforcement actions.<sup>5</sup> In the National Taxpayer Advocate's 2005 An-

<sup>1</sup>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.

<sup>2</sup>See IRS News Release IR-2006-28, "IRS Updates Tax Gap Estimates" (Feb. 14, 2006).

<sup>3</sup>Office of Management and Budget, Proposed Budget of the United States Government for Fiscal Year 2007, at 232.

<sup>4</sup>By "downstream consequences," I mean the cost of additional work that IRS or taxpayers must perform to correct problems or mistakes that result from an IRS action or failure to take an action. For example, inadequate taxpayer service may lead to inadvertent taxpayer noncompliance, limitations of IRS computer systems may lead to IRS rework and direct harm to taxpayers, and inadequate communication with taxpayers during the audit process may result in rework via audit reconsideration or work performed in Appeals or the Taxpayer Advocate Service.

<sup>5</sup>See Written Statement of Nina E. Olson, National Taxpayer Advocate, Before United States Senate Committee on the Budget on The Causes of and Solutions to the Federal Tax Gap (Feb.

nual Report to Congress, I discussed in detail what the IRS can do administratively and what Congress can do legislatively to address the “cash economy,” which is the largest component of the tax gap.<sup>6</sup>

The question remains, however, whether the IRS is focusing its resources in the right direction to close the tax gap. The answer to that question depends, in part, on how we measure success. Is the IRS’s goal merely to increase enforcement revenues? Or is the goal to increase compliance? Or is it to increase voluntary compliance?

As I noted above, approximately 83.7 percent of the tax dollars known to be due and owing are voluntarily paid to the IRS. That figure is an IRS success, in and of itself. Now, what more can we do to achieve compliance with respect to the remaining 16.3 percent of the tax dollars for which taxpayers need some “nudging” to pay up? What types of “nudging” should the IRS apply? What resources does the IRS need to help these taxpayers comply or, in some instances, make them comply? The answers to these questions should inform the IRS’s resource allocation decisions.

The IRS is properly focused on increasing its traditional enforcement resources, since some taxpayers won’t comply unless they are “helped” in that way. The IRS also needs an enforcement presence so that taxpayers are a bit nervous about fudging—or worse—on their taxes. Yet, although we may want slightly “nervous” taxpayers, we don’t want them intimidated. That is, when taxpayers have a problem or a question, we want taxpayers to call the IRS so they will not make mistakes and join the ranks of noncompliant taxpayers. Every time a taxpayer calls the IRS or visits a taxpayer assistance center (TAC), the resulting interaction gives the IRS an opportunity to help that taxpayer comply with the tax laws. Why would we try to minimize these opportunities and not make positive use of them when they occur?

In my view, then, the real challenge facing the IRS is determining how to allocate its resources to increase overall compliance, including voluntary compliance, and determining what actions it must take—whether service or enforcement—to increase the number of taxpayers who voluntarily comply. In order to answer these questions, we must start with an understanding of taxpayer service needs—not what the IRS is willing or able to provide taxpayers, but what the taxpayer needs to have provided or available. The IRS mantra should be “know your taxpayer.”

THE IRS SHOULD UNDERSTAND MORE ABOUT THE IMPACT OF TAXPAYER SERVICE ON COMPLIANCE AND THE WAYS IN WHICH TAXPAYERS NEED SERVICES TO BE DELIVERED

It is true that the IRS has improved its delivery of many aspects of taxpayer service over the last decade. However, we cannot just rest on this improvement and say that we are doing “good enough.” The IRS’s central responsibility is to ensure that taxpayers comply with the tax laws. In fulfilling that responsibility, the IRS must provide taxpayers with the service, assistance, and education they need to comply. What we must consider now is just what level of service, assistance, and education is necessary for compliance.

I define taxpayer service very broadly—it includes notice clarity, tax law assistance, account resolution, free tax preparation, free e-filing, short response time, clear forms, and excellent education initiatives. This broad definition of taxpayer service makes clear its impact on compliance. Where noncompliance is attributable to complexity or confusion, for example, better forms, notices, and education initiatives can reduce the need for enforcement action.

Acknowledging the impact taxpayer service has on compliance, Congress directed the IRS, its Oversight Board, and the National Taxpayer Advocate to develop a 5-year plan for taxpayer service that includes long-term goals that are strategic and quantitative and that balance enforcement and service.<sup>7</sup> I have previously voiced my concerns about the IRS’s need to study the trends in taxpayer service in order to

15, 2006); Written Statement of Nina E. Olson, National Taxpayer Advocate, Before the United States Senate Committee on Homeland Security and Governmental Affairs Subcommittee on Federal Financial Management, Government Information, and International Security (Oct. 26, 2005); Statement of Nina E. Olson, National Taxpayer Advocate, Before the United States Senate Committee on Finance on the Tax Gap (April 14, 2005); Testimony of Nina E. Olson, National Taxpayer Advocate, Before the Senate Committee on Finance on The Tax Gap and Tax Shelters (July 21, 2004).

<sup>6</sup>National Taxpayer Advocate 2005 Annual Report to Congress 55–75, 381–396. See also National Taxpayer Advocate 2004 Annual Report to Congress 478–489; National Taxpayer Advocate 2003 Annual Report to Congress 20–25, 256–269.

<sup>7</sup>S. Rep. No. 109–109, at 133–134 (2005).

understand the impact of taxpayer service on compliance and how taxpayers need services to be delivered.<sup>8</sup>

The IRS is facing a challenge. It has a responsibility to serve all taxpayers with limited resources. Thus, it must decide by taxpayer segment how to deliver needed services in the most effective and efficient manner possible, and in a way that does not negatively impact taxpayers' ability to comply with the tax laws. Toward this end, the IRS must gather data and develop criteria to make those decisions. The recently released report on Phase I of the Taxpayer Assistance Blueprint (TAB) is the first step toward developing a comprehensive 5-year plan for taxpayer service that will establish a long-term strategy for delivering needed taxpayer services within existing resource limitations.

In Phase I, we gathered both primary and secondary data about taxpayer needs and preferences. We also collected some information about our current level of services offered to taxpayers. From this and other information, we developed five hypotheses or "themes" that we think will improve service to taxpayers. However, Phase I is only the beginning. Phase II of the TAB will be even more critical because the goal of Phase II should be to test those hypotheses. To determine whether any of the hypotheses is correct, we must collect more primary source data about taxpayer service needs. We must then identify the gaps between taxpayer service needs and our present service offerings by analyzing how well our current level and type of service is actually serving different taxpayer segments. We will then see whether our hypotheses would improve service to different taxpayer segments.

I applaud the dedicated work of the IRS team that has labored over this strategic plan and gathered important information over the last 5 months. While we embark on the next phase of the TAB, we must focus on a number of areas that could have significant impact on Congressional or IRS decisions about service delivery to taxpayers.

*We must develop a baseline of services.*—This baseline should consist of specific numbers addressing how well the IRS is currently meeting customer service preferences and needs by service, taxpayer segment, and delivery method. Although the TAB Phase I report states that the current baseline of taxpayer services is one item on which the strategic improvement themes of the report are predicated, I do not believe this statement is completely accurate. Throughout the TAB Phase I report, we examine the current usage and volume of current IRS services. However, these current usage statistics do not serve as a proxy for taxpayer preference. We cannot assume that the current level of service reflects taxpayer preferences. The status quo is not necessarily what taxpayers want—it is merely what the IRS has been willing (or able) to deliver. Instead, during Phase II, we must conduct research to develop this baseline of services. Only after this research is completed will we be able to measure how effective we are in improving our ability to meet taxpayer needs.

*We must identify what we don't know.*—Before we can move forward with our research in Phase II, we need to understand what we still need to know and what questions we need to ask in order to find the right answers. It is important that the TAB not rely on pre-conceived decisions, but instead identify what we are doing now, what we still do not know about taxpayer needs, and what we need to do to address those needs or educate taxpayers and move them to other channels.

*We must identify the best channels through which to deliver services to taxpayers.*—While electronic and self-assistance channels may be growing in popularity, mere use or access to these services does not necessarily mean that taxpayers are able to frame questions, conduct complex searches, and process or use the information correctly. Additionally, we must always remain cognizant that there is a segment of the population that cannot and will not avail itself of self-service options. However, by providing more self-service opportunities for taxpayers, the IRS should be able to reserve its in-person (face-to-face or telephone) interaction for those issues and taxpayers that need such engagement.

Thus, as part of the TAB, the IRS must commit to conduct—or at least to attempt to conduct—the additional research necessary to enable it to establish a broad baseline identifying how well taxpayer needs and preferences are currently being met for each of the major types of services by customer segment and channel—and to

<sup>8</sup>Statement of Nina E. Olson, National Taxpayer Advocate, Before the United States House Appropriations Subcommittee on Transportation, Treasury, and Housing and Urban Development, the Judiciary, District of Columbia, and Related Agencies (March 29, 2006); National Taxpayer Advocate 2005 Annual Report to Congress 2–24; Statement of Nina E. Olson, National Taxpayer Advocate, Before the United States Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies (Apr. 7, 2005).

quantify the impacts associated with not meeting those needs (i.e., the downstream costs and taxpayer-compliance impact). Moreover, we need to understand why certain taxpayer segments have difficulties with our various types of services and why they are reluctant to use lower cost channels (if indeed they are). Only then can we develop effective “migration” strategies to encourage and educate taxpayers about appropriate lower cost channels—ones that will not ultimately increase non-compliance and lead to greater downstream costs.

For example, it is true that computer ownership and Internet access have increased over the last decade.<sup>9</sup> But those numbers do not necessarily mean that the computer owner is computer literate and can conduct site searches for complex tax information, much less understand how to apply that information once he finds it. In fact, in the financial services sector, banks have reversed the trend of closing branches in the hope of moving taxpayers to Internet banking.<sup>10</sup> Instead, they are developing migration strategies for customers to complete certain types of transactions on-line or by phone, and are retaining their in-person services for more complicated transactions or for those customers who really cannot navigate the phones or Internet. Banks are certainly not turning those customers away, and now recognize that those customer segments are a relatively untapped market in need of services. There are lessons here for the IRS.

#### THE IRS SHOULD WORK WITH “PARTNERS” BUT NOT RELY ON THEM EXCESSIVELY

The IRS is increasingly relying on partners to deliver core IRS services. Clearly, partners are very important to effective tax administration, and I applaud the efforts of dedicated professionals and volunteers in assisting taxpayers. However, this reliance raises several concerns. First, when the IRS relies on partners to deliver a message, we need to study what happens to the message in the course of delivery. Does the message change over distance and time? Is it less accurate? The worst result is a broad dispersion, through partners, of an incorrect or distorted message. Second, we need to measure the downstream consequences of this trend. What are the true costs of effective oversight over these partners? Who conducts such oversight and bears the cost? If taxpayers bear the cost, will they continue to comply if the cost is too great or the quality too poor? Will the IRS actually realize any savings or will it incur more expense through additional enforcement activity that could be avoided if the IRS itself delivered the assistance?

On the other hand, if we begin to rely more heavily on our partners for the delivery of services, we must also ensure that we are providing our partners with adequate support and assistance. Without a sufficient support system in place, we cannot expect our partners to act as a delivery channel for services we are unable or unwilling to provide.

Finally, we don’t know what the impact on compliance or what the downstream cost will be if most of the IRS’s direct contact with taxpayers is in the form of enforcement actions and most taxpayer assistance and service is delivered by third parties. As the IRS becomes more remote, except with respect to enforcement actions, will noncompliance increase because taxpayers feel less connection with their government?<sup>11</sup>

#### THE IRS SHOULD NOT IMPOSE UNREASONABLE BURDENS ON VOLUNTEER INCOME TAX ASSISTANCE (VITA) PROGRAMS

As the IRS struggles with the challenge of serving all taxpayers with limited resources, we have already begun to reduce free tax preparation assistance previously provided to taxpayers. Over the past 3 years, the IRS has reduced the number of tax returns prepared in Taxpayer Assistance Centers (TACs) from 665,868 tax re-

<sup>9</sup> Internal Revenue Service, Wage and Investment Office of Research, “Taxpayer of the Future” (June 2003), 11.

<sup>10</sup> Bruce C. Smith, “In Age of Online Banking, Lenders Branch Out”, Indianapolis Star (Oct. 2, 2005), available at <http://www.indystar.com/apps/pbcs.dll/article?AID=/20051002/BUSINESS/510020335>.

<sup>11</sup> See Leslie Book, “The Poor and Tax Compliance: Once Size Does Not Fit All”, 51 Kan L. Rev. 1145, 1151, 1175–1176 (2003). Professor Book discusses various studies that note that enforcement may be more effective in addressing intentional noncompliance where the taxpayer segment is disaffected from government and society at large. On the other hand, “taxpayers who felt a shared identity with authorities seem to be more concerned with the overall justice of the tax system and the fairness of their treatment, regardless of individual outcome.” *Id.* at 1151 n. 21.

turns in fiscal year 2003 to a proposed 305,000 tax returns in fiscal year 2006.<sup>12</sup> Instead, the IRS has increased its reliance on the Volunteer Income Tax Assistance (VITA) Program to fill the gap and provide free tax preparation assistance to taxpayers.<sup>13</sup> As IRS service has decreased, the VITA Program continues to expand. However, this expansion may have come too fast.

The VITA Program provides a vital service to an underserved segment of taxpayers, but there are limits to what volunteers and volunteer-staffed organizations can do. Although there are a number of successful volunteer organizations around the world, hallmarks of these success stories are that they are year-round organizations supported by a large, paid infrastructure dedicated to the support of the volunteers. The VITA Program primarily operates for 4 months during the tax season and receives limited resources and support from the IRS. This makes it hard to ensure quality and consistency in the returns prepared at VITA sites.

While the service VITA provides is critical, the IRS cannot rely entirely on these volunteers to provide a service the IRS has deemed too costly or time consuming to provide itself. Instead of concentrating on expanding the VITA Program, the IRS should concentrate on developing a fundamental support structure for the program, including site management, training, and quality review.<sup>14</sup> Once the IRS has developed a strong infrastructure for the VITA Program and has established consistent quality in the returns prepared by volunteers, then the IRS can work to expand the program. However, the IRS must remain cognizant that VITA, or any volunteer program, cannot and should not be expected to serve as a substitute for IRS-provided service.

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.<sup>15</sup> 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 to easily capture return data electronically, and enables the IRS to process and review returns more quickly.<sup>16</sup>

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.<sup>17</sup>

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 uni-

<sup>12</sup>Wage and Investment, "Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2006"; Wage and Investment, "Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2005"; Wage and Investment, "Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2004"; Wage and Investment, "Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2003".

<sup>13</sup>The VITA Program was designed to provide free tax preparation to individuals who are unable to afford professional assistance. Stakeholder Partnerships, Education and Communication, "VITA Celebrates Its Thirtieth Year of Service". VITA is a diverse program comprising several segments, including community-based VITA, academic VITA, military VITA, Tax Counseling for the Elderly (TCE), and co-located VITA, each serving a different taxpayer population.

<sup>14</sup>The IRS has taken a step in the right direction with the development of the Link & Learn training site which allows volunteers to receive training and become certified online. According to IRS data, the new training program has proven successful and the number of certifications issued for 2006 was 11,885, compared with 10,402 certifications issued as of the same time last year.

<sup>15</sup>See S. Rep. No. 105-174, at 39-40 (1998).

<sup>16</sup>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). The 80 percent e-filing goal is probably not achievable by 2007. However, we believe Congress should reiterate its commitment to seeing the IRS increase the e-filing rate as quickly as possible.

<sup>17</sup>See National Taxpayer Advocate 2004 Annual Report to Congress 471-477 (Key Legislative Recommendation: Free Electronic Filing for All Taxpayers).

versally 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 spent \$19.99 to purchase tax preparation software. When I completed preparing my return, the software program informed me that, to file electronically, I would have to pay a fee of \$14.95. If I wanted this fee deducted from my refund rather than charged to a credit card, an even higher fee would apply. 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.<sup>18</sup> 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 direct filing portal would go a long way toward addressing this problem and would result in a greater number of taxpayers filing their returns electronically. Both taxpayers and the government would stand to benefit.<sup>19</sup>

#### THE IRS CAN AND SHOULD DO A BETTER JOB OF MEASURING THE IMPACT OF TAXPAYER SERVICE ON COMPLIANCE

The Taxpayer Assistance Blueprint 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 has been done in this area, I believe the IRS does have the capability to develop useful estimates, and 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 meas-

<sup>18</sup> IRS Tax Year 2004 Taxpayer Usage Study (Aug. 26, 2005).

<sup>19</sup> In addition to benefiting taxpayers and the IRS, I believe this proposal would be good for the software industry. Under the existing Free File arrangement, the industry is making its Federal tax products available for free to tens of millions of taxpayers. By itself, that is hardly a recipe for business success. If industry is able to make a profit under this arrangement, it is only because it is aggressively marketing ancillary products to taxpayers and making money on the sale of those ancillary products. The provision of a basic preparation and filing option would enable taxpayers who don't want to pay a fee and know how to prepare their tax returns to do so, but all taxpayers who want the benefits of a question-and-answer format and checks to ensure they do not overlook any tax benefits to which they are entitled would have to pay to purchase the tax product. Moreover, the IRS would be unlikely to develop a template itself. The IRS almost certainly would contract with the private sector to develop it. In that respect, the IRS would be utilizing the innovation of the private sector—not competing with it.

ures 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 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).

#### RETURN PREPARATION

The IRS has data that enable us to estimate compliance for the entire population of returns by type of preparation: IRS prepared, VITA/TCE, commercial, taxpayer prepared. I think it would be interesting to compare estimated reporting compliance for IRS prepared returns against comparable returns (i.e., low income, especially EITC) prepared by the other methods. We might find that IRS-prepared returns are substantially more compliant—especially when EITC is claimed. If so, this would provide strong support for continuing and perhaps expanding return preparation in the TACs.

#### 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 5 succeeding years.<sup>20</sup> Five years is a long enough period to enable the taxpayer to “learn” a new norm of behavior, namely,

<sup>20</sup>If a taxpayer fails to comply with all his tax obligations over the 5-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.

compliance. And when you compare the 16 cents on the dollar that IRS receives from offers<sup>21</sup> to the virtually no cents it collects after year 3 of the 10-year collection period,<sup>22</sup> 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. 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 Criminal Investigation Division's Questionable Refund Program (QRP) is a recent example of the failure to capture an accurate return on investment. The QRP serves an important tax administration purpose by helping the IRS detect and prevent the payment of fraudulent refund claims.<sup>23</sup> Criminal Investigation (CI) dedicates approximately 600 Full Time Equivalents (FTEs) to this program. As we described in the National Taxpayer Advocate's 2005 Annual Report to Congress, the QRP was freezing hundreds of thousands of refunds each year without notifying the affected taxpayers. This failure to notify taxpayers that their refunds were being held generated more taxpayer calls to the IRS toll-free lines and to the Taxpayer Advocate Service (TAS) than CI could respond to in a timely fashion.

In fiscal year 2005, the Taxpayer Advocate Service (TAS) received over 28,000 QRP cases. In TAS's office in the Atlanta campus, approximately 65 percent of case inventory per case advocate involves QRP. Moreover, during fiscal year 2005, the IRS Examination function reviewed 25,621 QRP cases, and some of those cases went on to the IRS Appeals function. This level of activity protected approximately \$2.2 billion in fiscal year 2004, of which \$1.8 billion was attributable to just two returns that should have been discovered anyway, particularly since the Joint Committee on Taxation must review any refund over \$2 million. So, the maximum direct revenue protection generated by all that IRS activity was \$400 million. In addition, my office found in a study of the 28,000 QRP cases that came to TAS that fully 80 percent of taxpayers whose refunds were frozen as potentially fraudulent ultimately were found to be entitled to a full or partial refund. Had the IRS actually tracked the downstream consequences of the QRP and included these costs in the program's ROI, the IRS probably would have figured out a way to protect the same level of revenue with fewer FTE or developed a better method of identifying cases with the same CI FTE that did not generate the need for phone, exam, Appeals, and TAS FTE—not to mention interest the IRS is having to pay to tens of thousands of taxpayers whose refunds were frozen unnecessarily.

The QRP is a prime example of an IRS program that grew up over time without the benefits of true strategic planning or proper oversight. Despite the volume of taxpayer calls coming in on our toll-free lines about these refunds, the Fraud Detection Centers have limited capacity to make or receive phone calls. Thus, their processes are designed to avoid any direct or interactive contact with taxpayers or others. As TIGTA noted in several reports,<sup>24</sup> the QRP has inadequate management oversight processes, including inadequate reports of inventory levels and case status. Further, the little taxpayer correspondence generated by QRP was uninformative and intimidating. Today, the IRS is scrambling to meet the terms of its agreement with my office as to how it will correct these program deficiencies. Each day we face challenges, primarily arising from system limitations in re-programming.<sup>25</sup>

<sup>21</sup>IRS Small Business/Self Employed Division, Offer In Compromise Program, "Executive Summary Report" (Jan. 2006).

<sup>22</sup>IRS Automated Collection System Operating Model Team, "Collectibility Curve" (August 5, 2002).

<sup>23</sup>For a detailed discussion of the Questionable Refund Program, see National Taxpayer Advocate 2005 Annual Report to Congress 25–54.

<sup>24</sup>Treasury Inspector General for Tax Administration, "The Internal Revenue Service Needs to Do More to Stop the Millions of Dollars in Fraudulent Refunds Paid to Prisoners" (Ref. No. 2005–10–164) (September 2005); Treasury Inspector General for Tax Administration, "Improvements Are Needed in the Monitoring of Criminal Investigation Controls Placed on Taxpayers' Accounts When Refund Fraud Is Suspected" (Ref. No. 2003–10–094) (March 31, 2003); Treasury Inspector General for Tax Administration, "Revised Questionable Refund Program Procedures Were Not Consistently Implemented" (Ref. No. 2001–40–025) (Jan. 2, 2001); Treasury Inspector General for Tax Administration, "The Internal Revenue Service Can Improve the Effectiveness of Questionable Refund Detection Team Activities" (Ref. No. 2000–40–018) (Dec. 22, 1999).

<sup>25</sup>The National Taxpayer Advocate believes that the QRP will only function properly, productively, within the norms of taxpayer rights, and without creating excessive downstream consequences if it is moved out of the sole jurisdiction of CI and into a collaborative arrangement

IRS STRATEGIC PLANNING AND RESOURCE ALLOCATION DECISIONS SHOULD BE BASED  
ON MORE AND BETTER RESEARCH

The need for better research underlies all of these challenges. The IRS must 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.<sup>26</sup> 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 5-year strategic plan for taxpayer service.<sup>27</sup>

I have written at length elsewhere on the need to understand the causes of non-compliance so that the IRS doesn't adopt a one-size-fits-all enforcement approach.<sup>28</sup> 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, just as other world-class tax administration systems do.

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

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between CI and either the Wage & Investment or Small Business/Self-Employed Operating Division. This approach reflects the current model for the Frivolous Filer program.

<sup>26</sup>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).

<sup>27</sup>Public Law 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 develop 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).

<sup>28</sup>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).

identifies systemic problems for which the complete solution requires some sort of BSM fix.

When 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 2 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. Indeed, improvements to TAS's own Systemic Advocacy Management System, our database for receiving, tracking, and managing taxpayer and IRS employee submissions of systemic problems in tax administration, were requested in November 2004. Although worked on intermittently, these changes are not yet completed or delivered. Until recently, this project was ranked number 33 on a list of 33 projects in terms of priority.

I will provide one illustration of the impact of the IRS's outdated computer systems. In the National Taxpayer Advocate's 2004 Annual Report to Congress, I reported that the IRS is miscalculating collection statute expiration dates on certain taxpayer accounts. The collection statute expiration date (CSED) represents the date beyond which the taxpayer is no longer obligated on a tax debt and the IRS must cease its collection efforts.<sup>29</sup> Miscalculations of CSEDs can negatively affect a taxpayer when the CSED on a particular tax erroneously appears on the IRS computer systems as being within the statute of limitations period, resulting in continued IRS collection activity, when in fact the statutory period for collections has expired. An incorrectly calculated CSED can also negatively impact the IRS when the CSED is miscalculated to reflect that the statute of limitations period has expired when in fact the debt is still collectible.<sup>30</sup> This problem continues today and harms tens of thousands of unsuspecting taxpayers. Where the IRS or the taxpayer identifies a case of unlawful collection, the taxpayer experiences delays in receiving a return of the unlawfully levied proceeds. In some instances, the IRS takes the position that the taxpayer will never receive the unlawfully levied funds because the refund is barred by the applicable statutory period of limitations.

In response to TAS's concerns, the IRS and TAS established a joint team that identified impacted taxpayers, developed additional guidance and training alerts, and submitted requests for systems improvements to eliminate the problem of incorrectly calculated CSEDs. Given the current demand on IRS programming personnel, the final system modifications are not now scheduled to occur until some time in 2007.

Internal Revenue Code Section 7433 permits a taxpayer to file a civil action for damages against the United States in Federal district court where an IRS officer or employee disregards any provision of the Code or its regulations with respect to collection of tax. In general, damages under this provision are limited to \$1 million where the breach is attributable to reckless or intentional disregard and \$100,000 where it is attributable to negligence. Thus, the IRS's knowing failure to correct the CSED problem in a timely fashion exposes the government to potentially large damages.

THE IRS'S FILING AND PAYMENT COMPLIANCE (F&PC) INITIATIVE SHOULD BE MADE A PRIORITY

Filing and Payment Compliance (F&PC) is one of the IRS's most important business modernization initiatives.<sup>31</sup> The F&PC initiative was designed to offer the IRS a modernized collection system with a focus on applying the right collection "touch" to suit the characteristics of the case. Instead of the automatic three-stage IRS col-

<sup>29</sup> IRC § 6502(a)(1).

<sup>30</sup> National Taxpayer Advocate 2004 Annual Report to Congress 180–192.

<sup>31</sup> Testimony of Internal Revenue Service Commissioner Mark W. Everson, Before the Senate Committee on Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development and Related Agencies (April 7, 2005).

lection process that does not differentiate among the causes of non-compliance,<sup>32</sup> the implementation of F&PC was going to establish four treatment streams for collection cases:

—*Self-Assist / Self-Correct*.—Using enhanced systems, the IRS would allow for electronic payment, Internet-based payment, and payment via telephone application. Thus, taxpayers would have more payment options to resolve delinquency issues.

—*Assisted Correction*.—Using commercially available decision analytic software, the IRS would select the appropriate treatment for taxpayers depending on factors such as payment history and other actions taken by the taxpayer. Modernized systems would provide up-to-date taxpayer information so that decisions would be made on the most recent data.

—*Private Collection Agencies*.—The IRS proposed using private collectors to locate and contact taxpayers, request that full payment be sent to the IRS, and in appropriate cases, request taxpayer financial information. While we are extremely concerned about the use of private collectors and about the structure being put in place to support the initiative,<sup>33</sup> its use in conjunction with other appropriate treatment streams provided some assurance that the IRS would narrowly tailor the use of private collectors.<sup>34</sup>

—*Enforcement*.—For those cases that cannot be resolved through communication efforts with the taxpayer, traditional enforcement efforts would be used.<sup>35</sup>

Release 1 of the F&PC initiative involves the use of private collectors.<sup>36</sup> Release 2 will employ commercial off-the-shelf software to assist in case selection for the private collection effort as well as the development of the Self-Assist treatment. In Release 3, the case selection software will be augmented with additional decision analytics software for the development of Assisted Correction treatments.<sup>37</sup>

The F&PC initiative has not been adequately funded to ensure that the most useful, taxpayer-friendly, and forward-thinking treatments, i.e. Self-Assist and Assisted Correction, will be funded. While it appears that the IRS is fully committed to privatizing collection, having already reached Release 1,<sup>38</sup> cuts to F&PC funding will endanger the prospects of achieving F&PC's other objectives—objectives that do not raise the significant taxpayer rights concerns of the Private Debt Collection initiative.<sup>39</sup> Thus, the failure to fund F&PC Releases 2 and 3 ensures that the only legacy of F&PC will be private debt collection.

We are also concerned that the lack of funding for F&PC systems not only deprives taxpayers of a sophisticated collection approach but also encourages the IRS to take actions to reduce collection cycle time without adequate consideration for taxpayer rights or taxpayer compliance.<sup>40</sup>

<sup>32</sup>In the 2004 Annual Report to Congress, we set forth a critique of the IRS's traditional approach to collection and identified the elements of a modern collection strategy, including the ability to identify the appropriate collection touch for the particular cause of noncompliance. National Taxpayer Advocate 2004 Annual Report to Congress 226.

<sup>33</sup>We have addressed numerous concerns about the initiative, including the limited training of frontline private collection employees on issues such as taxpayer rights. See National Taxpayer Advocate 2005 Annual Report to Congress 76. We are also skeptical that the PDC initiative will produce a positive return on investment. See discussion, *infra*.

<sup>34</sup>In testimony last month before a House Appropriations subcommittee, IRS Commissioner Mark Everson acknowledged that tax debts to be assigned to private collection agencies could be collected more efficiently by additional IRS collection personnel. See Dustin Stamper, "Everson Admits Private Debt Collection Costs More, Defends Return Disclosure Regs," 2006 Tax Notes Today 61-1 (March 30, 2006); Rob Wells, "US Rep. Rothman Calls IRS Pvt Tax Collection Fact Wasteful," Dow Jones Newswires (March 29, 2006).

<sup>35</sup>Filing and Payment Compliance Concept of Operations, Filing and Payment Compliance Project Office, April 18, 2005, 75-80.

<sup>36</sup>Treasury Inspector General For Tax Administration, Ref. No. 2006-20-026, "The Alternatives for Designing and Developing the Filing and Payment Compliance Project Should be Revalidated" (Dec. 2005); see also Capital Asset Plan and Business Case, Business Systems Modernization, Exhibit 300 (2005).

<sup>37</sup>*Id.*

<sup>38</sup>Challenges to the procurement process have delayed implementation of the initiative. Dustin Stamper, "IRS Orders Private Debt Collectors to Stop Work", Tax Notes Today (March 24, 2006).

<sup>39</sup>Testimony of James R. White, Director of Tax Issues, General Accountability Office, Fiscal Year 2007 Budget Request, Committee on House Ways and Means Subcommittee on Oversight (April 6, 2006).

<sup>40</sup>By way of example, the IRS has undertaken several initiatives to hasten the issuance of taxpayers' Collection Due Process (CDP) notices in order to reduce collection cycle time. Pursuant to Code sections 6320 and 6330, taxpayers are entitled to a collection due process hearing after the filing of the first Notice of Federal Tax Lien and before the imposition of the first levy on a tax account. One such initiative, termed the "Initial Contact Initiative," required revenue

THE RETURN-ON-INVESTMENT OF THE PRIVATE DEBT COLLECTION INITIATIVE WILL  
PROBABLY BE LOWER THAN EXPECTED

The Private Debt Collection (PDC) initiative as envisioned under Phase I of F&PC is another example of a program that might not be undertaken, or would be approached differently, if its downstream consequences were considered. The premise of the PDC initiative is 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 PDCs 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. Once the program rolls out, the IRS estimates that only a small percentage of taxpayers—perhaps on the order of 15 percent—will be resolved by the PDC unit itself. The rest of the cases will be sent back to the IRS "Referral Unit" for additional actions that only the IRS can constitutionally take on the account. Keep in mind that these are cases that the IRS currently considers too unproductive to 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.

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 private collection agencies can take on a case so they can work higher dollar, more complex cases. This expansion would clearly raise constitutional concerns.<sup>41</sup>

Thus, the PDC initiative is a paradigm example of how looking at the narrow justification for a program can make it look brilliant, while viewing the program in its totality paints a very different picture.

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 1 marked my 5-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 91.6 percent through fiscal year 2005, up from 71.6 percent in 2001. They achieved this quality despite a 15 percent decline in case advocates in our statutorily mandated offices around the country, from 1,325 case advocates in March 2003 to 1,127 case advocates in February 2006. And these successes were achieved despite a slight increase in TAS case receipts from fiscal year 2003 to fiscal year 2005.<sup>42</sup>

In fact, TAS case receipts themselves provide an interesting study in downstream consequences. As IRS increases its enforcement activity, TAS compliance inventory increased to nearly 70 percent of our case receipts for the first quarter fiscal year 2006, up from 67 percent in first quarter fiscal year 2005. In fiscal year 2005, TAS cases involving liens and levies increased by 50 percent and 43 percent, respectively, over fiscal year 2004. During first quarter fiscal year 2006, TAS continued to see an increase in lien and levy cases. Lien and levy cases tend to involve economic urgency to the taxpayer. TAS procedures require case advocates to respond immediately to the taxpayer's request for assistance in these cases. With the increasing

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officers to issue CDP rights to taxpayers on initial contact with the taxpayers instead of when a levy was the next planned action. Because we believed this initiative makes CDP hearings less meaningful, we opposed the initiative. After discussions with the IRS, it was agreed that the Initial Contact Initiative would only apply to business taxpayers and to certain individual taxpayers who also have business tax delinquencies. Recently, the IRS planned to move the CDP notice up even further in the collection process to the second notice issued to business taxpayers. After discussion with my office, the IRS agreed that this latest initiative would not be undertaken at this time. We believe that the IRS has been attempting to implement broad collection initiatives because its current business systems do not adequately differentiate among taxpayers based on their compliance history.

<sup>41</sup> 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.

<sup>42</sup> In fiscal year 2005, TAS received a total of 197,679 cases. In fiscal year 2003, TAS received a total of 196,040 cases.

number, complexity, and urgency of our case load, TAS risks getting behind on cases that involve IRS system failure as we give priority to cases that involve economic harm. 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.

Significantly, 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 scores,<sup>43</sup> which have averaged about 4.35 on a scale of 5.0 for the last two fiscal years. Most importantly, 57 percent of taxpayers stated that they feel better about the IRS as a whole after coming to TAS. Even among taxpayers who did not obtain the result they sought, an astonishing 41 percent reported that they had a more positive opinion of the IRS because of their experience with TAS.

#### CONCLUSION

Compared with 10 years ago, the IRS 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 5 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.

Senator BOND. Thank you very much, Ms. Olson. You certainly shared my concerns about the funding, and I think that your points about research are well worth considering, because I think there are some opportunities here to improve it.

Before we turn to the questions, we have been joined by Senator Durbin. Senator, would you like to offer an opening statement, either orally or in writing?

Senator DURBIN. No. Proceed, Mr. Chairman.

Senator BOND. Okay. We will turn now to the questions.

#### TAX GAP

Mr. Commissioner, as I stated in my opening remarks, I believe the IRS needs more resources to effectively attack the tax gap. The budget request flat funds it. How does your budget request reduce the tax gap?

Mr. EVERSON. Well, Mr. Chairman, as I have indicated—we can maybe look at the tax gap map—we have several components. The budget request will continue the enforcement build that this committee and the Senate and the House provided for last year. We have been hiring or are in the process of hiring those people now. So there will be a time of training, and then you will see, as they become more effective, we will continue to bring up the number of audits, the number of collections, the document-matching activities. That will have an impact.

<sup>43</sup>Taxpayer Advocate Service customer satisfaction survey data for the period from October 2003 through September 2005, as collected by The Gallup Organization.

Beyond that, in the budget request, as I indicated, we have several legislative proposals that I think are terribly important. I would point out that they have been characterized by some as modest. I agree with that, but if you compare them to anything that has been done in 20 years, there have been no requests on additional third-party reporting. If we can agree that is required, as shown in the chart I showed a few minutes ago where you have the No. 1 and No. 2 noncompliance rates where you don't get any reporting, I think that will be an equally important step, sir.

#### ALLOCATION OF ADDITIONAL RESOURCES

Senator BOND. The IRS Oversight Board recommended additional funding of \$363 million. The Senate took the Oversight Board's recommendation. I know it is above the OMB budget request, but if you were to receive that additional funding, how would you propose to spend it?

Mr. EVERSON. Yes. I am aware of the Budget Committee action, and as you say, it is about \$330 million or \$340 million. We are looking at that now in the event that it should carry through. We would do two things. We would add bodies, of course, across a range of activities, but we would, and I think it would be permitted under the resolution, specifically add to the infrastructure and the systems money. At this stage, it is important for us to invest in technology on both the service, but particularly on the enforcement side of the house.

So I don't have a specific answer yet, but we are working on that.

Senator BOND. I would like to ask the others. I would like to ask Chairman Wagner what he would suggest and any comments from the others.

Mr. WAGNER. Thank you, Mr. Chairman, with the additional funding, of course I would agree with the Commissioner that adding additional FTE toward targeted areas would be warranted and would be contemplated by our recommendation. Certainly some of the additional resources would go toward the research that we have all talked about in order to best determine which area to allocate those additional resources, whether they are toward attacking the fraudulent payments dealing with the cash economy that was suggested in the Commissioner's chart, dealing with non-compliant enterprises and so on and so forth.

The other thing that we would hope would come from additional resources would be the development of more productive partnerships between IRS and tax professionals, more emphasis on the website communicating customer service opportunities toward the taxpayers and, of course, improving customer service through issues such as telephone service and so on.

Senator BOND. That is a heavy burden to put the little \$300-plus million.

Mr. George, any further comments?

Mr. GEORGE. Mr. Chairman, simply to state regarding the tax gap, there is no question that if the complexity of the tax code were simplified or erased, compliance would increase tremendously. I realize that is not within the jurisdiction of this committee. Nonetheless, that would certainly help close the tax gap.

As the chairman's chart showed, you have a major under-reporting within the small business community, and I think if you had third-party reporting, as he noted, of those tax receipts or the income receipts, that would also assist in closing the gap.

Senator BOND. I think everybody knows my commitment to small business. I want to see small business succeed, but we expect them to pay the taxes they owe.

Ms. Olson, any comment on additional dollars?

Ms. OLSON. Well, I think it would be wise to invest in the next phases of filing and payment compliance, particularly the risk-based assessment system of identifying how collection cases should be handled, who should get the touches, and my other point would be that additional personnel would enable the IRS to focus on some current projects that are being shelved because of our rightful focus on our big projects, but there is not a day that goes by that I say to the IRS, "Can't we solve this problem for this group of taxpayers?" and I am told, "We can't do that right now; we have to focus on this big project."

Senator BOND. Thank you very much, Ms. Olson.

Now we turn to the ranking member.

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

#### PRIVACY OF TAXPAYER DATA

Mr. Everson, I wrote to you on March 22 to express my opposition to the proposed regulations regarding the privacy of taxpayer information. In some respects, the proposed regulations I know tighten some of the restrictions, but in other ways, they really loosen them—I know there is taxpayer's sign-off—to allow them to sell that to unidentified unaffiliated third parties.

My view personally is this: taxpayers are not likely to want their information going to marketers at all. I would like you to share with this committee why you are providing any opportunity for tax preparers and their affiliates to use personal financial data to sell mortgages or mutual funds or IRA accounts or life insurance—don't taxpayers already have enumerable opportunities to shop for services like that without subjecting their personal tax returns to perusal by marketers?

Mr. EVERSON. I appreciate the question, Senator. This is an important subject, and I have testified on it several times already. The first thing I would like to say is we are taking a lot of comments on this. I have gotten a lot of letters. We have actually had hearings on this, which we do with important regulatory proposals. We are going to assess all of those.

What we are trying to do here is have a balanced approach. This piece of the law has been in effect for over 30 years, but the world has changed since that time. The regulation is prompted, as much as anything, by Congress in terms of inquiries on the outsourcing, the preparation of tax returns overseas in India where nobody was aware of that happening.

So we are trying to move to make better protections here. I guess the basic question is: "Whose information is it?" Is it the taxpayers' information or is it the Government's information? We at the IRS, as you know, don't share their information with anybody. So it is a question of preparers, and I guess we don't think that under cur-

rent law the IRS can say you as an individual don't have the right to share financial information with Kit Bond if you want to. That is—if I could just finish, I was trying to get to the dynamic here.

So what we are trying to do is provide a really clear protection that in the event that that arrangement starts to take place, that you have a clear detailed consent, a warning as to what could happen, but we don't think under statute now we could say you aren't free to share your information with that preparer.

Senator MURRAY. Do you think there is a critical mass of people in the country who want their information sold?

Mr. EVERSON. I don't. What I do think, though, is that this gets to Senator Dorgan's remarks. Certain firms, the big firms, they now have integrated services and they are providing a range of services, like IRAs or advice, to taxpayers. Other smaller firms who are the trusted real financial advisor of somebody, once a year they sit down and they get their health check-up financially, if you will, and they say how are you doing, and they could be able to maybe advise someone to get the IRA on behalf of a bank or whatever else is there.

The other thing I would point out to your staff, we are very concerned about the possible implication of this to the VITA sites. Those are programs that, as you are aware, operate around the country. Over 2 million returns were prepared this year. They are very exciting to communities because people come in. They file largely for the EITC. That money goes out into the community, but the coalitions that are out there also do other things. They share. They help get the people banked or into other benefit programs.

You may know, in your own State, 2.8 percent of the returns last year in Washington came through the VITA program as opposed to 1.6 percent nationally. Our people are very concerned if we move to outright prohibition of any sharing that you would kill that program and that all the good things that are happening for those people where there is a bundling of services wouldn't be allowed.

So it is a complicated issue, Senator.

Senator MURRAY. Look, I am very worried about this being abused. You know, we know how this works. It is 4 p.m. on April 15. You are signing the last piece of paper the tax preparer has put in front of you. You are signing everything as fast as you can, and I have heard that tax preparers actually want you to loosen this requirement that pertains to the way they get consent from taxpayers to sell their information.

Do you think there is any chance in the world that the final rule is going to loosen consent procedures under your proposed rule?

Mr. EVERSON. Loosen consent procedures? By that, you mean change the consent form that we propose?

Senator MURRAY. Yes.

Mr. EVERSON. I think that clearly the consent procedures are much tighter, but I don't want to say anything precise, because I think that would be wrong under the APA, for me to comment as to what the final rule will look like. I am not involved in that at this stage, but we are really honestly looking at this, and is it is a tough issue.

Senator MURRAY. Well, under your proposed regulation, you require written consent from the taxpayer if the tax preparer wants to process that overseas.

Mr. EVERSON. Yes.

Senator MURRAY. You justified that requirement because as the Commissioner, you don't have any enforcement authority to prosecute abuses overseas. If you don't have authority to protect taxpayers' privacy overseas, why are you allowing this information to go overseas at all?

Mr. EVERSON. I don't think that we have the authority to stop that. I think that that is something that is done by private parties. There is no law that says people can't contract out, or it is a far broader question. It is not any different than a company hiring a subcontractor to develop parts for an auto or something else.

Senator MURRAY. But the law says you have to enforce privacy.

Mr. EVERSON. Yes.

Senator MURRAY. So you are telling us you can't enforce the law? So why are we allowing this to go overseas?

Mr. EVERSON. Well, I think we are attempting to strengthen the control over the privacy through this proposal. The other thing I would indicate is we have increased our investigations of promoters of return preparers dramatically in the last 2 years. A year ago, we had 125 reviews taking place. This year, we have over 500 reviews taking place.

My understanding is, and perhaps this is a question for Mr. George, that the provisions of 7216 are actually largely enforced by TIGTA. So there is a shared responsibility here on this.

Senator MURRAY. My time is up, but, Mr. Chairman, I am deeply concerned about this privacy issue. I think most people assume their taxpayer information is private that goes to the IRS, and I think we have to be very, very careful that it doesn't become some kind of marketing program.

Senator BOND. I would agree with that, and I think I understand the point that the Commissioner is making. If you read "The World is Flat", you will find that there is a tremendous amount of, heaven forbid, legal research being done overseas too which threatens some of our professions as well as some taxpayers services being done overseas.

I turn now to Senator Durbin.

Mr. EVERSON. Mr. Chairman, could you indulge for me 1 minute? I want to say one thing. Of course, if the Congress looks at this to change the law, which I guess I believe would be necessary to really have an outcome, we, of course, will work with the Congress at looking at all these issues. So it is not beyond the regulation.

Senator BOND. Senator Durbin.

Senator DURBIN. Thanks, Mr. Chairman. Thank you all for being here today.

I have this notion that if every member of Congress was required to prepare their own income tax returns personally, we would see simplification of the tax code overnight. We turn, instead, to bookkeepers, accountants, lawyers to try to guide us through this thicket, and we can't blame anyone other than others. We write the law.

So I hope that as a result of this hearing and others, we will be inspired to make this a little more easily understood. Nobody likes

to pay taxes, but if they think that they are being taxed fairly, they are a lot more accepting of this responsibility.

#### INDEPENDENT CONTRACTORS

Speaking of paying taxes fairly and tax evasion, I recently had a group of bricklayers from Chicago meet with me in the basement of the Capitol, and they came in to complain. They said we understand that every contractor isn't a union contractor; we have to compete with non-union contractors, but we are concerned about another problem.

Too many of these so-called non-union contractors don't have employees. They have independent contractors working for them. The net result is taxes are not withheld from the wages or income that is paid to these workers, and so ultimately taxes are not paid, neither State, Federal, local taxes, unemployment compensation, and workers' compensation.

Mr. Wagner, you were former head of the Illinois Department of Revenue.

Mr. WAGNER. Yes, sir.

Senator DURBIN. In 2004 alone, misclassifying these workers as independent contractors when, in fact, they were employees was at a rate of 21 percent in the State of Illinois, 67,745 employers statewide, 7,478 in the construction industry. The State of Illinois alone lost \$158 million in income taxes not withheld from actual employees because they called themselves independent contractors.

So the bricklayers said to me, Senator, what are you going to do about this; we don't mind competing with people who are paying taxes as we are, but why should we have to try to compete with people for evading their taxes; where is the Internal Revenue Service?

So I would like to ask you where is the Internal Revenue Service?

Mr. EVERSON. Senator, you are covering a very important subject. Let me make a couple of points about it. As I indicated, we have five legislative proposals on strengthening tax administration. It is the most ambitious since the Reform Act of 1986, which had effect of where citizens, taxpayers, had to list the Social Security number of their dependents, and the next year, 5 million dependents vanished. So we know when you do more reporting, you get more compliance.

Why is this important? Take a look at this: Starting in 1978, all individual returns, the number of returns we have gotten, have increased by 50 percent. The number of Schedule C filers—these are the folks that are organized as independent contractors—they have increased by 175 percent, and as I indicated, I think before you came in—let us go back to this other chart—the noncompliance rate is 50 percent in this category of individuals where they organize as small businesses, but they are unincorporated, because basically they are not reporting all of their income.

There are issues on the employer side which you are talking about. I can assure you that the number of 1099 miscellaneous forms, the reporting they are supposed to do to us, that has not increased as rapidly as the number of Schedule C returns has increased.

So this is an important area. We have said beyond the five proposals that we want to look at the definition of independent contractor. This is the manual that our people have to go through to assess whether somebody is an independent contractor. We have been precluded by statute since 1978, I believe was the year, from addressing what is the definition of an independent contractor. We are going to study that and hopefully make some proposals, but it is terribly important because the world has changed, as those charts indicated and as your constituents indicate.

We do need to address this jointly.

Senator DURBIN. Let me ask you are you saying that it is a problem in definition or a problem in law or it is a lack of resources to investigate and enforce?

Mr. EVERSON. It is both, sir. We have been precluded from changing the standards by which we look at independent contractors for approaching 30 years now. That is because of the importance, which is legitimate, of small business in this country and a reluctance to look at that issue, but we have said as an administration that we want to study it and then work to get a better definition and more consistency so that people fall on the right side of the line just as you are indicating, because what happens is what you are saying. Somebody is paid as an independent contractor, as a business that isn't absorbing those employment taxes that they ought to be, and then the individual, as we have indicated here, is not reporting the gross income.

Senator DURBIN. How long is this going to take?

Mr. EVERSON. Well, we will be making the study over the course of coming months, and what is important now, I would suggest to you in a leadership position, it is very important to take a look at these five proposals that we have made right now on gross receipts, say for credit card issuers. That is a big start in this area.

Senator DURBIN. This is all well and good, and I support what you are doing, but let me suggest in the meantime a few cops on the beat wouldn't hurt. Sending some investigators out and starting to ask questions of contractors who are using so many independent contractors may put a chill on this practice while we are trying to come up with the modernization of the law and more resources for you to enforce it.

Mr. EVERSON. We are increasing our audits, sir.

Ms. OLSON. If I may.

Senator BOND. Go ahead.

Ms. OLSON. In this year's annual report to Congress, my annual report to Congress, I reported on this very issue. I reported on a program that the United Kingdom has to address this very issue that they have had for the last 30 years. They have focused on the construction industry because there is so much cash economy in underreporting, and they require workers who are independent contractors in the construction industry that when they are hired, they have to present to the person who is hiring them a compliance certificate from England Revenue that states that they are fully in compliance with the tax laws and with their payment, and if they are not in compliance, then the person who is hiring them has to do a withholding on the gross payments that they are making. They find that that approach has really helped with that cash econ-

omy and leveled the playing field between people who are treated as employees and independent contractors.

Senator DURBIN. Thank you.

#### PRIVACY OF TAXPAYER DATA

Senator BOND. Ms. Olson, you may want to comment on the proposed rules. I know you have been involved in the development on the rule on privacy, and for the record, I would like to get your comments on that.

Ms. OLSON. Thank you, sir. The 7216 rules have two categories of approaches, use and disclosure, and I think there are concerns with each one of those applications. I find the proposed rules, which I worked on very closely with the IRS, to be a vast improvement over the current rules, which I find very anti-taxpayer and provide very little consumer protection.

I want to make the distinction that “use” is the term that we use where the taxpayer is having a conversation with the preparer. The information doesn’t go outside the room, and the preparer is asking for permission to use the taxpayer’s information to peddle a product, but you are not talking with a third person at that point.

“Disclosure” is where the information is leaving the room with a preparer and going out to the taxpayer. Under the current rules, the taxpayer isn’t told the impact of that disclosure, isn’t told what might happen if the information goes overseas, isn’t told that that third party when you get that information can be disseminated and sold and reused by anyone for any amount of time. So the current rules really focus on a lot of restrictions and up-front notification.

Now, I am the first to admit that we could do more, but I think that we need legislation in this area. The current rules only apply to preparers. So we have no rules about what happens to people who receive this information if we don’t do an out-and-out ban. We have no criminal penalties against them. We have no civil fines against them.

So there are a number of things that we can do to improve it.

Senator BOND. Thank you, Ms. Olson.

#### BUSINESS SYSTEMS MODERNIZATION

I would like to ask the GAO witnesses to join us at the table because I want to talk about the BSM. We are hearing that BSM is making some progress, but the budget request, the OMB request for BSM, looks like they are, as I said, punishing good performance.

How do you see, Mr. Commissioner, the performance of BSM and how does it compare to the success 2 years ago?

Mr. EVERSON. Mr. Chairman, as you know from following this, we have made modernization of the IRS one of our three strategic priorities, and that relates to work processes and in particular the systems. I think we have made a great deal of progress on this. We downsized the portfolio a couple of years ago, provided greater focus to it, and inserted more business people into the process that had been done largely with just the tech folks. That has made a lot of difference. The CADE project is on sounder footing now. One huge success is the modernized E-filing.

It hasn't been mentioned yet, but in December 2004, we mandated the electronic filing of returns by corporations and nonprofit institutions over a certain size. We have received over 300,000 returns this year thus far. There was no technology to do that at the time that we did this. There was a lot of uproar from industry saying you can't do this, industry told us or the software people said, until you mandate it, we won't have the product. So it was a chicken and the egg thing.

We mandated it. The software was developed, and now we are moving forward. So there are successes.

Your point, drawing it down, I think that this is a minimal level for us to proceed. It is a complicated question, as you know, as to the overall funding levels. In those negotiations as we work with the administration, I spread the money to what I thought was the most responsible way, sir.

Senator BOND. Mr. Powner, if you would give us your full name and comments on the BSM performance, better or worse.

Mr. POWNER. I am David Powner with the Government Accountability Office. Performance has improved consistently over the years. Our work for you, Mr. Chairman, in looking at the expenditure plans on an annual basis has shown that is performance perfect? No, but when you compare this to past performance of other programs across the Federal Government, this is one of the better-run programs when you look at their performance over the past couple of years, if you look at the leadership of this program. Decreasing funding on the BSM at this point in time clearly, as our statement indicates, will decrease the pace and momentum and could affect the long-term delivery of systems such as CADE.

Senator BOND. I appreciate your good work, your very technical analysis of all of this. I have a former GAO worker, who can translate for me, who seems to indicate that you are saying we should provide more money to the BSM program. Is that an accurate assessment of your very good technical analysis?

Mr. POWNER. Yes. Mr. Chairman, at this point in time, if you inched up their budget, we are clearly in that camp given their past performance. I think they deserve that. I think it is an opportunity to keep the pace going. We are not in the camp with Chairman Wagner, looking at a doubling of the budget. There still are many risks associated with the program and contractor performance, we should report to you, last week, in looking at IRS's internal capacity to manage requirements.

So yes. I think it would be prudent to increase the budget slightly, but a doubling of the budget, we are clearly not in that camp today.

Senator BOND. Mr. George, do you have a comment on it?

Mr. GEORGE. I would just note, Mr. Chairman, that there is no question BSM has improved over the progress in the last few years. At the same time, as I noted in my oral statement, it is still behind schedule and it is also over budget. For example, the CADE system, if fully implemented, would certainly have expedited the return of refunds to taxpayers tremendously, and it is not yet fully implemented. So that is a problem, and then the modernized E-file system that the Commissioner averted to, they have had three re-

leases thus far. That too is 18 months behind schedule and is over \$37 million over budget.

So there is a recurring problem in that report, sir, and it is not limited solely to BSM. I think it is throughout the service. Again, progress has been made, but more needs to be done.

Senator BOND. Thank you very much, Mr. George.  
Senator Murray.

#### TAXPAYER ASSISTANCE CENTERS

Senator MURRAY. Mr. George, I wanted to ask you when you analyzed the data that the IRS used to justify their proposal to close the Taxpayer Assistance Centers, you found that IRS's data for as many as one-quarter of the TACs was found to be fraught with errors. You found that not all the data used was accurate or the most current available and some of the data was based on estimates and projections instead of actual data currently available. Those errors affected the ranking and overall selection of the TACs the IRS wanted to close.

Mr. EVERSON. I wanted to give you an opportunity to respond.

Mr. EVERSON. Sure. I was a little hurt by your strong statement earlier that this called into question anything the IRS ever said. I know I am exaggerating a little.

Senator MURRAY. I will let you rebut.

Mr. EVERSON. I don't think that is the case, and I think that we do our very best to be credible in any representation we make either to the public or, of course, to the Congress. Sometimes we make mistakes or information is incomplete.

On the TACs, the IG looked at it. We had something like 35 or 36 categories that went in to the model. The conclusion that was reached was that the model was a good one. It weighted appropriately a whole series of demographic and other cost factors. You are correct. There were individual data errors, but the model was not particularly sensitive to those conclusions. In something like—I can't recall the exact number—maybe 10 of the numbers would have changed the relative rankings, but it didn't take something that was No. 40 on the list and make it No. 380, if you will.

This was a tool that we wanted to use to identify the best candidates for reduction. It was never going to be so incredibly precise that we had overridden the criteria, the strict criteria for a couple of factors. You may recall we didn't want to eliminate more than half the TACs, in any State. We said the TACs had to be in the 35 major metropolitan areas no matter how they came out.

So I think perhaps that statement that the model produced nothing of value, I wouldn't agree with that. Can we do better? We always can do better on data integrity. So yes.

The last thing I will say is this did cause a lot of concern last year. We stood down in our proposal well before this report was ever done, as you know. We stood down on that proposal, oh, last July, I guess it was when I suspended it. Closing down those 68 centers is not a part of the current request. Both you and the chairman have talked about our savings proposals. We believe that we will be able to achieve those savings proposals without reducing services or closing any of these walk-in centers.

So I want to reassure that is not an active proposal at all. My concern would be the chairman is talking about adding money, potentially, to BSM. I want to make sure that we do fully fund the services piece, as is well within this budget. My worry would be if it was cut a little bit or, as you know, a lot of this is salary dollars. If the pay increase comes in above what is proposed, there could be pressure here.

Senator MURRAY. Well, in a briefing that we had last year by TIGTA on these Taxpayer Assistance Centers, I learned that some of the TACs have as little as one or two staff and what TIGTA called a critical staffing storage. Now, the House and Senate majority and minority said no to the proposal to cut back TACs until the TIGTA completed a study on the impact of the reductions, but are you, in fact, allowing these TACs to eventually close by just letting the staffs dwindle?

Mr. EVERSON. No, we are not. There were some employees who chose to move to other parts of the agency while this was currently before the Congress. So we had some storage shortages as the filing season approached, and what we did was we reassigned employees out of other pieces of the agency to make sure that we would keep the centers open.

A year ago, I had several inquiries from members of Congress about—

Senator MURRAY. Are you currently filling those vacancies?

Mr. EVERSON. Yes. We are moving to re-hire those people, and we don't have any plans for closing TACs at this time and would not draw them down. If what you are saying is just somebody leaves and we don't re-fill the position, no, we are not doing that.

Senator MURRAY. Mr. George or Ms. Olson, do either one of you want to comment?

Mr. GEORGE. Just briefly, Senator Murray. There is no question that the model that the IRS has developed, we determined it was sound. Some of the data was inaccurate. Other parts of it were not current, but all of the ranking of the TACs were not accurate as a result of having inaccurate or outdated information.

Ms. OLSON. I believe that regardless of what the actual architecture of the model looked like that it was based on flawed assumptions. It was based on the current status quo of what services the IRS was offering, and as we know, over the last year, it has been declining as a goal, the number of tax returns that they have prepared within the TACs. So when you say, well, usage is dropping, it is because we are turning people away at the door.

We never measured the number of people who were lined up outside the walk-in sites, and my employees in Federal buildings throughout the United States informed me that people were lined up during filing season outside the doors, blocking access to the Taxpayer Advocate Service doors for my employees.

Yesterday and the day before yesterday, I was in North Dakota. Senator Dorgan is not here, but I was in North Dakota, and I held a town hall meeting with taxpayers, and one person informed me that they drove quite a distance to the walk-in site to ask a question as an agriculture taxpayer, and that is determined out of scope. They said, I'm sorry; we don't answer those questions in the

TAC. And I think for States like North Dakota and Wyoming, that is silly.

So these are the sorts of things that we are using as base measurement for the services that we are offering in the TAC, and then saying taxpayers aren't coming there, no surprise there.

Mr. EVERSON. Could I make one comment?

Senator BOND. If you will forgive me, I am going to have to ask one complicated question for brief answers and then turn the rest of the hearing over to Senator Murray, because I was expected for an important Intelligence Committee meeting at 11:00, and I apologize, but I know that you can continue these discussions.

#### E-FILE

I would like to ask you, Mr. Commissioner and then Chairman Wagner and Ms. Olson, about the E-filing problem. Getting the 80 percent appears out of reach. One possible reason, there was a media report that due to the cost of the E-filing, more than a quarter of a million individual filers, some 36 million, prepared their tax returns on computer, printed them out and mailed them to the IRS.

Would you outline your current plans and what you see as the problem with E-filing? And also, Senator Grassley and other experts have suggested that the IRS develop a direct filing portal through the IRS website to increase E-filing, and I would like to hear you include that in your comments.

Mr. EVERSON. Yes. You have covered a lot of ground there. Electronic filing continues to increase. We think it will continue to do so. It is true that in terms of some of the software providers, you buy the package and then there is a built-on cost at the end to file, to actually make the electronic filing. I don't think that the Government regulates the price of products from private parties. So that is a question of the private participants.

The Free File Alliance, which has generated a lot of discussion, that was in existence for 3 years. The term of that agreement lapsed last year after the filing season. We then worked to conclude a new agreement. We had two objectives. One was to get more protections on these RALs, these predatory loans that take place, not a huge issue for the free file participants, but it is still something, and also we wanted to have as high a participation rate.

The consortium members were concerned because the program had moved toward where anybody could file. They didn't want that, and in the late stages of the negotiation, the number was around 70 percent. We wanted to get it higher as to eligibility. They wanted to get it lower.

Then I do have to say the Senate had a voice vote to an amendment to the appropriations bill that was moving, whenever it was, in November of last year or October, that the IRS couldn't develop software, that no free file software could be developed without the Alliance. That had the effect of gutting our negotiation position with the Alliance because we can't force private parties to provide free file services. The reason they do it is because of their concern that one day there would be a portal or that one day there will be—the government will provide the software and they will be out of business. That is why they do this.

So that dynamic is complicated one.

The final point I would make, Mr. Chairman, the question of developing a portal, that would be a very costly and complicated endeavor, I am informed, for the IRS to do that. Right now, it is only the top 20 filers. All these returns are bucketed, if you will, or grouped. They do 82 percent of the electronic filing. If we were to do this, you would have to compare companies like Intuit who are spending \$200 million a year in research. This would be a big effort. It sounds simple, but it would be a big effort is what I would say.

Senator BOND. Well, we tried to make it clear that the IRS and Free File should come together to make an agreement. We only took the floor amendment because there did not appear to be agreement and our amendment was not intended to restrict the IRS. So we need to continue to work on that.

Chairman Wagner.

Mr. WAGNER. Mr. Chairman, just a couple of points. I know you are in a rush. We too believe the E-filing objectives are very sound and very good. We are pleased that more people are choosing to file electronically these days and the rate is going up. We are troubled by the fact that it is increasing at a lower pace than it has in the prior years. We have concerns over the Free Filing Alliance and have expressed those concerns, in particular the caps.

The notion of a portal is something that ought to be considered on behalf of the taxpayers. Certainly I can access Government in so many other areas by going directly on line and submitting my information. There are two components of paying your taxes: preparing the return and filing the return. Certainly the IRS ought to do everything it can to facilitate the filing of the return.

The goal, the 80 percent goal by 2007, is not going to be met. We have recommended that that goal be extended to 2011, applying a statistical analysis to it because we do believe the goal is a motivator and that it does keep the IRS focused on the goal as well as preparers. There are additional mandates that might be considered by this committee, including mandated filing by preparers, extending the filing date for electronic-filed returns to perhaps April 30 to provide an additional incentive for consumers to file electronically and so on.

Senator BOND. Ms. Olson.

Ms. OLSON. Well, I believe that the lack of free electronic filing is a major barrier to reaching our 80 percent goal. I think contrary to what some may suggest, taxpayers want to provide their financial data directly to the Government without any intermediaries and certainly with no add-on charges, and in this way a portal is like telefile, which was a very successful program, was simple, was easy to use, and the information went directly to the IRS.

I note, as Chairman Wagner does, that on the education website, you can file your FASA, your Financial Aid Student Application, directly with the Government in a fill-in simple form and you push the button and it is there. I think it galls taxpayers who are giving over their hard earned dollars to have to pay to E-file, and that is why we have 40 million taxpayers who buy a software package and then they print out the returns. I am one of those 40 million taxpayers this year.

And the last thing I would note, because I have a visually impaired employee, and he attempted to go on to Free File, and because these are private products, they are not required to be accessible for people who visually impaired. Federal websites under section 508, we have this 508 rule that says that all of our websites have to be accessible for visually impaired persons, and I think that is another really significant thing that we have to think about. There is a whole population out there.

Senator BOND. Thank you, Ms. Olson and other witnesses, and now my apologies and my thanks to Senator Murray. I will turn the hearing over to the her.

Senator MURRAY [presiding]. Thank you, Mr. Chairman. I just have few questions and then I will close it out.

#### BUDGET CUTS

Mr. Everson, the fiscal year 2007 budget doesn't make any reference to specific reductions in taxpayer services, as you shared, but your budget does refer to \$84.1 million in savings and the elimination of more than 2,000 FTEs due to contemplated "program efficiencies". Can you share with us how much of these savings in FTE reductions is associated with taxpayer service cuts and how much is associated with enforcement cuts?

Mr. EVERSON. The \$84 million comes across three major categories. There are cuts. If you go to page 6 of my written statement, Senator, it sort of lays this all out. There are shared services, and one of the examples here is for a new telecommunications contract, we are going to save \$24 million. That doesn't have an impact. Obviously, it is just a cost reduction. That is a shared area between enforcement and services.

We have what we think will be \$35 million against enforcement programs in terms of efficiencies, and that is a wide variety of categories where we are working more efficiently—we are a big organization. We are spending \$7 billion on enforcement. As you would expect, each year we reassess our processes and we go through and we make changes to become more efficient. So we have laid out there a whole series of reductions ranging from 5 FTE to, you know, over a 100.

The services piece, if you will, is down to about \$18 million of reductions which we believe, again, we will get through improved performance, better use of technology, redesigning our processes in ways that won't have an impact on you as a taxpayer or anybody trying to do business with the IRS. These have been developed over months. We can share more details if the committee wants them, certainly, and we will continue to develop new opportunities as we go on.

We are always looking look at—my charge to my team is particularly to look at the reduction of overhead. I have conversations with Colleen Kelly, the head of the union, who says: "Look, you have got too many middle and other managers." We are working on the span of control to try and increase the span of control so that there are more employees per supervisor. That gives you the ability to hold down the cost and yet keep the number of employees on line who are either in walk-in centers or who are out there doing audits.

Senator MURRAY. Bottom line, can you ensure us on the subcommittee that none of those so-called efficiencies will negatively impact taxpayer services?

Mr. EVERSON. Yes, I can, again, as long as we get that funding level, you know, within a reasonable proximity. The problem you get to, Senator, as you are well aware, we come in with a request and it does get nicked from time to time, even through the rescission process, where 1 percent gets whacked. There is always space. If we are quite close to it, I think have no problems we will be able to cover this, but if something dramatic happens, then we have to revisit it.

Senator MURRAY. Okay. Well, Chairman Wagner, your fiscal year 2007 special report from the IRS Oversight Board states your belief that the \$84 million in program efficiencies may decrease performance. Can you tell me what specific IRS functions you are concerned would be eroded under this proposal?

Mr. WAGNER. Senator Murray, we did express in our 2007 report, the 2006 report, as well as my testimony that I have submitted today that this is one of the areas of risk. Accumulating savings of \$84 million just does seem to the board inherently to present a risk, and we are going to continue to watch it to ensure that customer services are not compromised and that the enforcement continues to stay on track. We are also concerned that it could impact the rate at which the systems modernization is proceeding and so on.

But to spread \$84 million across the entire organization could be done and hopefully will be done, as the Commissioner suggests, without any cut in services, any detectable noticeable cut in services, but on the other hand, it might very well cause some damage, and we will continue to monitor that as well.

Senator MURRAY. Thank you. Mr. Everson, you have cut some taxpayer services conducted through telephone or face-to-face contact and you propose to eliminate Telefile by arguing that it would be cheaper for the IRS if those citizens filed electronically. Now that Telefile is eliminated, taxpayers who used Telefile are not filing electronically. Instead, a significant number of those taxpayers are reverting back to paper filing, which is, as we know, a more expensive form to process. How do you explain that result?

Mr. EVERSON. Well, Senator, as you may be aware, the Congress in RRA 98 directed the IRS to have an advisory committee in this area. That was established, and they advised over a course of a couple of years that we eliminate telefile as a part of this overall program. So we did take that advice and we did it, as you indicate, largely through as a measure of cost savings. There may very well be, as you have indicated—I haven't seen the final data on this—migration into paper, but the Telefile piece was the most expensive way to process the returns. I don't have the precise figure. I certainly can get it to you, but we saved, I believe, something between \$15 million and \$20 million through the curtailment of that program, which we ramped down, as you know, over the course of fiscal year 2005 and took effect this filing season.

Senator MURRAY. I think we have to be very careful, when we cut back taxpayer services, of the unintended consequences.

Mr. EVERSON. Yes.

Senator MURRAY. Which I think we are seeing with that.

Ms. Olson, do you have any concerns in this area?

Ms. OLSON. Well, I think that this is an example where the IRS said that they were going to make some savings in the short run and incur longer-term costs and they also missed an opportunity to take those taxpayers and help migrate them to another electronic approach, and we just walked away from that. I just think if that is the wave of the future, we are going to have a real reduction in taxpayer services.

Senator MURRAY. So we need to help taxpayers find—

Ms. OLSON. Exactly. We have to help them, assist them. A good example is, again, from my visiting the United Kingdom, what they used were screeners that would greet taxpayers at the door, and they would say what are you needing. They would say: “Well, I would like to find an answer to a question”, and they would say: “Do you know that you can look this up on the computer?” and they would walk them over to a computer bank and they would stand there just like people in the airline industry, stand by you as you are trying to do those confusing screens as you get your ticket. But they walk you through. So you do that two or three times, you have learned, you have migrated.

Senator MURRAY. So we need an education process.

#### REFUND ANTICIPATION LOANS

Let me go back to Commissioner Everson. The Taxpayer Advocate recently highlighted refund anticipation loans, RALs, as a serious problem facing taxpayers, in her 2005 report to Congress. More than half of those RAL customers are EITC recipients despite the fact that the EITC recipients constitute only 15 percent of all of our taxpayers. The money that is received by EITC recipients is also often very minimal, but the paperwork isn't. So many of our EITC recipients often seek out paid tax preparers to help them and frequently they pay for tax preparer services by signing up for a RAL, never realizing that it is a loan and not the refund itself.

Can you share with us what you are doing to help reduce the number of taxpayers who fall victim to these predatory refund anticipation loans?

Mr. EVERSON. Well, the first thing is we try to cajole and work with the industry. I think these are distasteful vehicles, and I have said that publicly. It is not a direct regulatory role for us in the sense of a loan. It is not something that we are charged with monitoring.

At the same time, I do have real questions as to conflicts of interest where big preparers, they are in the tax preparation business, but then they are marketing other products. In part, it comes back to this question we started out with some time ago about what is the suite of services that are proper for a tax preparer to provide. What I find particularly concerning here is that some of the firms, they end up keeping an interest in the loan, if you will, over the life of the loan, and I think the banks want that because they want the preparer to make sure they are doing adequate fraud reviews and not providing the loans, if you will, to someone who is not going to get the money back.

I do think it is area of continuing inquiry, maybe mostly for the Congress. There is a lot more concern about paid preparers now, including the big chains. There was reference to the recent GAO report. What you see is if you look at, frankly, the tax gap figures we showed, you see the same problems within the returns prepared by a preparer than you do in the overall population. That is hardly surprising given the fact that over half of returns are prepared by preparers. They obviously have to be a part of those problems.

Senator MURRAY. I have spoken on this committee before about that. I am very concerned about that. I think it is a huge problem.

I just want to end, Ms. Olson, if you could, just what else can we do?

Ms. OLSON. Well, right now, the IRS in cooperation with my offices is working on a report about refund anticipation loans and the debt indicator and identifying alternatives to RALs. The Treasury Department has a banking initiative and is looking at alternatives to RALs, ways of getting people into the system, and I think that some of the things that we will be reporting on will be very helpful to Congress.

Senator MURRAY. When do you expect that?

Ms. OLSON. I think that the legislation says the conference report is June 30, and I think we are planning to deliver that on that date, and we are going out and talking to stakeholders, you know, the consumer groups to hear their concerns as well as members of the industry.

I do have to respectfully disagree with the Commissioner about the IRS's role in this. We do set the rules for the electronic return originators who are the people who are offering these RALs, and our rules allow up to a 49 percent ownership interest in these loans. So we could change those rules. We also could do much more oversight. I did cover that in my annual report to Congress. We don't do sufficient oversight on these electronic return originators, in my opinion, and I think that we could also impose some due diligence requirements on the banks, that they make sure that the retail outlets are doing what they are required to do now in terms of disclosure. We don't know that.

So I think there are some areas for improvement even in the current environment.

Senator MURRAY. Yes.

Mr. WHITE. Senator, if I could just add, my name is James White at GAO. I think this highlights the importance of systems modernization at IRS. Taxpayers use RALs because they are a vehicle for getting their refund money faster. To the extent that IRS can process refunds faster, that would reduce the demand for RALs.

Ms. OLSON. Absolutely.

Senator MURRAY. Okay.

Mr. WAGNER. Senator, that is exactly a point that I was about to make, that modernizing the system will allow the turnaround of refunds more promptly, within 2 to 3 days, and alleviate the need for the RALs. I might also add that I think the IRS has additional leverage in connection with these RALs in the process of the Free File Alliance and negotiating that.

Senator MURRAY. Okay. Mr. Everson, why don't we just lower the time?

Mr. EVERSON. Well, I think as the advocate indicated, we are actively continuing to look at all of these areas. I don't mean to say that we are precluded from doing anything. My remark was the principal regulation on the loans. So we are actively looking at this on a concerted basis, and we did do something in the Free File Alliance. We got additional protections in as to how people would be notified and what they would be told before a product like that would be offered. We focused on that very clearly in that negotiation. The RAL percentage there is not very high. I am hoping it is actually less than 1 percent. I am hoping that it goes away entirely maybe after this filing season.

So we continue to work on it, most recently on that area.

#### ADDITIONAL COMMITTEE QUESTIONS

Senator MURRAY. Well, thank you very much to all of our witnesses today.

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

#### QUESTIONS SUBMITTED TO MARK W. EVERSON

##### QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND

###### TAXPAYER ASSISTANCE BLUEPRINT

*Question.* As mandated by our appropriations act, the IRS recently issued the first phase of the Taxpayer Assistance Blueprint. I asked for this business plan so that the IRS and the Congress could plan strategically on developing future taxpayer services based on taxpayer needs. I also expected the plan to address demographic and geographic differences. Ultimately, this plan should help to improve voluntary compliance with the tax code. I expected the plan to focus beyond current IRS services and develop innovative approaches.

Please explain how the blueprint is meeting my needs, when we will receive the final plan, and how it will be integrated in the administration's future budget requests.

*Answer.* The Taxpayer Assistance Blueprint (TAB) team is conducting and reviewing extensive research regarding taxpayer expectations. The TAB Phase 1 report, delivered to Congress in April 2006, discussed initial findings, including an inventory of current services and service channels. Several new studies, including a 40,000 taxpayer survey, are underway to add to the knowledge base. When released, the TAB Phase 2 report will address differences in taxpayer demographics and geography based on empirical data and recommend changes in service delivery options. It will also include development of an implementation plan for its recommendations; integration of recommendations; integration of recommendations into the budgeting process; and integration of the blueprint into the IRS Strategic Plan. We anticipate delivery of the report to Congress in October 2006, at which time we will have completed integrating its findings into our strategic planning and ultimately assisting in improving voluntary compliance.

###### BETTER TAX GAP ESTIMATES

*Question.* While the IRS has done a commendable job in updating the tax gap estimates, there remain significant gaps in the gap. The IRS and others have expressed concerns with the certainty of the overall tax gap estimate in part because some areas of the estimate rely on old data (from the 1970's and 1980's) and it has no estimates for other areas of the tax gap. GAO, TIGTA, the Taxpayer Advocate, and the IRS Oversight Board also have all recommended greater and more frequent data collection and studies of the tax gap. I wholeheartedly agree.

What will it take in terms of resources to address these concerns? Should the IRS conduct research on how services affect compliance?

*Answer.* The difference between the amount of tax for a given tax year paid voluntarily and timely and the corresponding estimate of the true tax liability for that

tax year is the Tax Gap. The three components of the Tax Gap include underpayment, nonfiling, and underreporting.

The IRS regularly tabulates the underpayment tax gap from Master File data for each major tax and for major groups of taxpayers. This component of the Tax Gap is the only one that is actually observed; the rest must be estimated.

The IRS currently estimates the nonfiling gap only for the individual income tax and for the estate tax. We must overcome some conceptual and data issues before we can develop nonfiling gap estimates for the remaining taxes, which requires the successful completion of various research projects.

The underreporting gap has been estimated for various types of taxes (except excise taxes) and usually has been based on operational audits or audits of randomly selected returns. In general, the latter situation is believed to generate better estimates of the extent of underreporting in the population. The resources required to undertake a sufficient number of audits of randomly selected returns can be substantial. Therefore, much of the data underlying the underreporting gap estimates, for areas other than the individual income tax, date from the Taxpayer Compliance Measurement Program (TCMP) which conducted its last audits for Tax Year 1988.

When the IRS conducted compliance studies under the auspices of the TCMP in the 1970's and 1980's, it generally sought to conduct studies of several components of the tax gap simultaneously, and to repeat the reporting compliance studies as often as every 3 years. IRS examination resources are nowhere near the levels they were 2 or 3 decades ago, so a schedule along these lines is not feasible. In fact, for some groups of taxpayers, the IRS used to conduct a greater number of random audits under TCMP than the total number of operational audits conducted today on those taxpayer groups. This change in resource allocations has led the IRS currently to conduct these research audits at a measured pace, and to consider conducting studies over more than 1 tax year—for example, the IRS is currently conducting a reporting compliance study of S-Corporations over a 2-tax-year period, to spread out the workload.

Fully funding the President's budget request would be a start in establishing a resource base for undertaking reporting compliance audits on a recurring basis, with different types of reporting compliance being studied over time. As Congress increases the resource level the IRS can devote to operational audits, it becomes increasingly possible to use some of these resources for reporting compliance studies. Moreover, to the extent research resources permit, we will investigate alternative methodologies for estimating portions of the Tax Gap.

In the past, the IRS has attempted to determine the impact that our service activities have on compliance. However, this area is extremely difficult to evaluate, in part because there is no direct link between the level of service provided/received and the consequent level of taxpayer compliance. The relevant research in tax administration has focused much more attention on the link between enforcement activity and overall compliance levels (the so-called indirect effect of enforcement actions). The results have generally shown a positive effect on compliance of increased enforcement activity (such as more audits), but the magnitude of the effect is subject to some dispute.

The link between service and compliance has been even harder to define. Taxpayers who take advantage of service opportunities (asking tax law questions, searching the IRS website) generally cannot be linked to specific compliance outcomes. The IRS has had to look for indirect ways to detect this relationship. In some cases, the IRS has designed narrow studies to see if a particular intervention had a detectable effect. In other cases, it has meant devising complicated analytical approaches to establish the relationship (if any). However, these studies have not been comprehensive and have barely scratched the surface on understanding how provision of enhanced services affects overall compliance (both in the short and long term).

The Taxpayer Assistance Blueprint study (now underway) is an attempt to understand better the relationship between service levels and compliance (among other things). We expect this to be an integral part of laying out a future research strategy to enhance our understanding in this area.

#### BALANCE BETWEEN SERVICE AND ENFORCEMENT

*Question.* There continues to be questions and debate on the proper balance between taxpayer service and enforcement. But given the data limitations of the tax gap and the IRS's inability to measure quantitatively the return on investment on service or enforcement, it is a difficult question to answer.

What is known quantitatively about the impact of taxpayer service and enforcement on compliance? How much do IRS's service programs affect compliance? How

much do IRS's enforcement programs affect compliance? What is your analytical basis for deciding on the balance between service and enforcement? What evidence do you have that IRS is striking the correct balance between its taxpayer service and enforcement efforts? Do you believe that one approach is more cost-effective than the other?

Answer. We do not know the quantitative impact of taxpayer service and enforcement upon compliance. During TAB Phase 1, the IRS conducted interviews with private sector organizations and other governmental agencies to identify customer service leading practices and the impact of service upon business results. Most of the organizations acknowledge the inherent challenge in quantitatively linking customer services to business results. They indicate that current metrics used to measure business impact from customer services are predominantly how those organizations measure qualitative or quantitative proxies. However, we have eight distinct initiatives in the TAB research plan to evaluate whether establishing a quantitative link is possible.

It is not clear at this time whether the limited effects on compliance detected so far result from the difficulty in detecting this relationship between service and compliance (for example, the difficulty of disentangling all other potential effects), the design of the research studies or experiments, or the existence of a fairly weak relationship. We must do careful research in this area in order to support definitive conclusions about the strength and direction of the effect. Two papers presented at the IRS Research conference in June examined the link between service levels and compliance. One study found some service and education interventions led to modest improvements in compliance for some groups of taxpayers, and no improvements for other groups. Another paper noted that educational programs can have offsetting effects on compliance—on the one hand, they can inform taxpayers about potential ways to inappropriately report their tax liability, while on the other hand they can discourage this inappropriate behavior. At this point, the literature exploring the relationship between taxpayer service levels and compliance is in its infancy and there are few, if any, definitive results.

We know slightly more about how enforcement programs affect compliance levels. A few IRS and academic studies have addressed this issue (for example, Dubin, Graetz, and Wilde (1990), Plumley (1996), and Dubin (2004)). All these studies find that increased enforcement (measured, for example, by increased audit coverage) is associated with increased voluntary compliance levels (this is the so-called indirect effect). However, the magnitude of the effect estimated by these studies varies widely. Further research is needed to pin down the size of this relationship and to estimate how it varies for different types of taxpayers.

Ideally, the IRS would like to be able to estimate the cost-effectiveness of each enforcement program and service offering, and how the effectiveness varies with level of effort. Cost-effectiveness in this context would take into account both the direct revenue effect (e.g., payments of back taxes from taxpayers subject to audit) and the indirect effect (the increased voluntary compliance levels in the general population resulting from the enforcement action taken or service provided). The costs of the activity would include all the costs to the IRS, including any overhead costs. If all these benefits and costs could be quantified, then in principle, it would be possible to determine the appropriate mix of services and enforcement.

At this point, the IRS believes that a balanced program, maintaining service levels at those achieved in recent years while devoting any additional resources to enforcement activities is the best approach to improving voluntary compliance. However, ongoing research in several areas (such as the Taxpayer Assistance Blueprint project) will provide us with the data needed to determine if this is the correct balance or if we need to devote a greater or lesser proportion of resources to taxpayer service offerings.

#### INCREASING E-FILING

*Question.* The current growth rate of e-filing will not allow the IRS to reach the congressionally-mandated goal of having 80 percent of all tax returns e-filed by 2007. One possible reason is the lack of financial incentive for taxpayers. There are reports that due to the cost of e-filing, more than a quarter of individual filers (40 million) prepared tax returns on a computer, printed them out, and mailed them to the IRS.

What is your current plan on how and when you will achieve the 80 percent goal? When does IRS project that electronic filing will meet or exceed the IRS Restructuring and Reform Act of 1998 goal of 80 percent? What actions and strategies are most likely to facilitate increased electronic filing? What can IRS do to eliminate or at least reduce the cost to taxpayers of electronic filing? How does your plan address

the 40 million people that prepared tax returns on a computer, printed them out, and mailed them to the IRS so that they will be incentivized to e-file instead of mailing in paper returns? As suggested by the GAO, should the IRS consider expanding the use of electronic filing mandates?

Answer. The vision of IRS electronic tax administration is one in which we accomplish electronically any exchange or transaction that currently occurs in person, over the phone, or in writing. All taxpayers would have the option of conducting their transactions electronically. Taxpayers would have multiple choices in terms of how they interact with us and what value-added services (for example, Where's My Refund, and paying electronically via debit or credit card) they choose to use. Taxpayers would become e-customers.

Our e-strategy for growth outlines our plans to reduce taxpayer burden and increase electronic filing. Key strategies include:

- Making electronic filing, payment and communication so simple, inexpensive, and trusted that taxpayers will prefer them to calling and mailing.
- Substantially increasing taxpayer access to electronic filing, payment, and communication products and services.
- Aggressively protecting transaction integrity and internal processing accuracy.
- Delivering the highest quality products and services as promised.
- Partnering with States and other governmental entities to maximize opportunities to reduce burden for our common customer base.
- Encouraging private sector innovation and competition.

To achieve these strategic goals, we will continue to develop and implement e-file marketing strategies, expand the use of electronic signatures, and enhance our website services for both practitioners and taxpayers. Ultimately, our goal is to offer all taxpayers and their representatives the ability to conduct nearly all of their interactions with the IRS electronically.

We have collaborated with the private sector in developing a Free On-Line Electronic Tax Filing Agreement. The agreement makes available to 70 percent of taxpayers, at no cost, the tax preparation and filing services of 20 participating companies. In processing year 2005, more than 5.1 million taxpayers took advantage of the opportunity to file electronically at no cost.

Section 6011(e)(1) indicates that the Secretary may not require returns of any tax imposed by subtitle A on individuals, estates and trusts to be other than on paper forms supplied by the Secretary. The IRS does not support a general e-file mandate for individual taxpayers. There are too many individual circumstances that might make such a mandate a burden to some taxpayers and make it impossible to enforce. The IRS believes that there are approaches other than individual mandates that lessen the chance for burden on specific taxpayers. However, we strongly urge Congress to act on the administration's proposal to provide the IRS with additional authority to require electronic filing, short of blanket individual mandates. This proposal, on page 262 of the Analytical Perspectives, will allow the IRS to process more returns and payments efficiently.

Regarding the people who prepare their returns on a computer and then mail them to the IRS, a group of taxpayers whom we call "V-Coders," we have a plan, developed by our Stakeholder Partnerships, Education and Communications (SPEC) organization, to specifically target these filers and reduce these types of returns by using leveraged outreach through partner channels to market our full portfolio of electronic products and services.

#### PRIVATE COLLECTION AGENCIES

*Question.* One new tool that you have mentioned that will help in collections and enforcement is the use of private collection agencies (PCAs).

What is the status of the PCAs? What controls are you providing to protect taxpayer rights and privacy?

Answer. On June 14, 2006, the Government Accountability Office (GAO) denied protests of the IRS contract award of March 9, 2006 to three Private Collection Agencies (PCAs). GAO's resolution of the protests lifts the 100-day Suspension of Work Order and clears the way for IRS plans to begin placing cases with the PCAs by early September 2006.

The IRS has a variety of safeguards in place to protect taxpayer rights and privacy as the private debt collection initiative moves forward. Before they can receive delinquent taxpayer account information, PCA employees are required to undergo background investigations and complete all IRS-mandated training. Individual privacy will be protected by the confidentiality provisions of the Internal Revenue Code (IRC) Section 6103 and the Privacy Act of 1974, as amended. Private collection agency (PCA) employees will be held to the same ethical standards regarding disclo-

sure and privacy as IRS employees and are subject to the same penalties as IRS employees. Failure to adhere to these laws and regulations may subject employees to criminal penalties or to civil causes for action.

Additionally, PCA firms will be monitored for compliance with all applicable Federal and State laws, including the Fair Debt Collection Practices Act. The IRS established a Private Debt Collection Oversight Unit (OU) and a Referral Unit (RU) to: manage PCA inventory; monitor security and privacy requirements; monitor quality, and; evaluate PCA performance and compliance with contractual requirements. Through the OU and the RU, the IRS will ensure that the PCAs maintain taxpayer confidentiality at all times through a combination of training and strict oversight. The IRS will conduct on-site security reviews to ensure PCAs implement appropriate access controls to segregated areas where IRS work will be performed.

Failure to comply with the confidentiality safeguards will be considered a breach of contract. Contractors are not authorized to communicate with third parties (other than the taxpayer's designated representative) and are prohibited from soliciting direct receipt of funds from taxpayers. Unauthorized disclosure of confidential tax information by officers or employees of the firms will subject those individuals to felony charges punishable by up to \$5,000 and 5 years in prison.

#### E-FILING FOR CORPORATIONS

*Question.* Electronic filing is now required for corporations having assets of \$50 million or more. Next year, for 2006 returns, the threshold drops to \$10 million in assets.

Do you believe the corporate world will be ready for this filing requirement? What is your basis for your response? What steps are you taking to assist corporations to meet the new e-filing mandate? Along this same requirement, will the IRS have the capacity to handle what is likely to be a significant increase in corporate electronic filings?

*Answer.* We believe the corporate world will be ready for next year's e-filing requirement for several reasons. By June 18 of this year (which is relatively early in the corporate filing season) over 15 percent of the corporations required to e-file (those corporations with assets greater than \$50 million) had e-filed their 2005 tax returns. As has been publicly announced, General Electric (GE) successfully e-filed the Nation's largest tax return on May 18, 2006. On paper, GE's e-filed return would have been approximately 24,000 pages long. After filing, GE received IRS's acknowledgement of its filing in about an hour. The file was 237 megabytes.

The ability of these firms to meet the electronic filing requirements also clearly indicates the IRS Modernized e-File system is fully operational and is accepting and processing large and complex corporate tax returns. We also believe the necessary support for the corporations being added to the e-file requirement next year will be available. A few of the corporations that have e-filed so far this year used their own software and/or transmitted their own returns to the IRS. However, the clear majority of the corporations are using commercial tax preparation software and/or third-party transmitters to e-file their returns. Corporations with assets between \$10 to \$50 million will use the same software packages and return transmitters as are currently being used by those with assets over \$50 million.

Additionally, the vast majority of the corporations being added to the e-filing requirement next year generally rely on CPA's as their tax advisers. We are actively working with the AICPA on efforts to get their members knowledgeable about corporate e-filing and the related requirements. So far these efforts have included contacting the five largest CPA State Societies to work towards getting e-filing information and presentations as part of their 2006 CPE programs and, jointly developing an e-filing course to be available to all CPA CPE programs.

Lastly, with regard to the system being able to handle increased capacity demands because of the filing requirement dropping to \$10 million, since bringing the system online we have followed a continual program of monitoring filing patterns, adjusting our projections accordingly, and then developing and executing stress tests of the system to ensure its ability to respond to our return projections. Based on this program of stress testing and projections, we make the necessary adjustments to ensure that we have the infrastructure in place to support the anticipated volume. Thus, we believe we will be well positioned to handle next year's increase in corporate e-filed returns.

#### STRATEGIC PLAN FOR ADDRESSING THE TAX GAP

*Question.* As I stated at the hearing, the IRS is directed to work with the IRS Oversight Board, the National Taxpayer Advocate, and other stakeholders to develop a strategic plan for meeting the administration's stated goal of increasing vol-

untary compliance to 85 percent by 2009. The strategic plan should identify a wide range of goals, objectives, and strategies, at least some of which would be beyond the scope of the IRS, such as implementing tax code simplification, and providing new tax administration tools such as additional reporting requirements.

How will the IRS develop such a plan? How long will it take the IRS to complete such a plan?

Answer. We recognize that the best way to address the tax gap is to maintain a balance between service and enforcement. The IRS will consult with the Oversight Board, the National Taxpayer Advocate, and other stakeholders to ensure that our plan for improving voluntary compliance maintains the proper balance. While the IRS has restored credibility to its compliance programs over the last 2 years, additional enforcement alone is not the answer. Studies show that voluntary compliance is higher where there is third-party reporting and/or tax withholding. Therefore, our plan will likely involve both recommendations for improving voluntary compliance and tax administration efficiency, such as the legislative proposals for improving IRS operations submitted with the fiscal year 2007 IRS budget. The IRS will use also the results from its recent compliance studies to improve audit selection models, and we will continue to combat abusive tax shelters by corporations and high-income individuals and vigorously pursue those who promote these illegal schemes.

The IRS has already begun laying the groundwork for a strategic compliance plan that will improve voluntary compliance and reduce the tax gap. We intend to present a proposal for consideration this fall. Because this proposal may include administrative and legislative changes, we will need to coordinate the proposal with the IRS's budget submission.

#### LONG-TERM BSM PLAN

*Question.* The GAO has informed the subcommittee that the 5-year IT Modernization Vision and Strategy document should be supplemented with an additional plan that covers the remainder of the BSM program. GAO further recommended that the plan be tied to a known spending level, so that Congress can understand the funding requirements to implement the plan and the impact of funding delays.

Has the IRS begun to develop a plan for the remainder of the BSM program? How would you develop the plan? What information will it contain to give Congress the information it needs to monitor program execution?

Answer. In August 2005, the IRS embarked on a lengthy, comprehensive, and collaborative IT modernization planning effort involving more than 80 IRS employees from across the Agency. The resulting strategy, known as the Modernization Vision and Strategy (MV&S), will speak to the modernization of IRS's core tax administration functions and include BSM projects as well as smaller-scale system efforts.

Presented as a 5-year plan, MV&S will outline the projects that the IRS plans to carry out to meet the highest business priorities identified by individual business units. The plan will include all IT modernization investments (not just BSM) and ensure that the complete set of modernization initiatives is optimized and coordinated. The MV&S approach emphasizes enhancing existing systems in lieu of full replacement; full replacements are to be undertaken in those few cases where upgrade is impractical.

To keep the MV&S current, the IRS is instituting a planning process to annually update the 5-year plan. Further, the annual BSM Expenditure Plan will address major project enhancements emanating from MV&S planning. Congress will be able to assess and monitor program performance against the Expenditure Plan.

#### BSA DIRECT

*Question.* During our last hearing with the Treasury, we discussed the problems surrounding the BSA Direct system. I understand the IRS is helping FinCEN in ensuring continuity of service to users and is looking at how to meet other BSA Direct needs.

Please provide a status report on the IRS's work on BSA Direct in terms of the specific actions the IRS has taken to address the needs of FinCEN and how much money the IRS plans to spend on carrying out these actions.

Answer. To ensure continuity of service to FinCEN users, IRS and FinCEN IT representatives have met weekly since April 2006 to address FinCEN's unique Gateway (case information) requirements and develop connectivity, training, and conversion plans for their users to WebCBRS. The IRS implemented their unique Gateway processing requirements in the WebCBRS on June 1, 2006. FinCEN reimbursed the IRS for associated programming costs of \$300,000. FinCEN's internal users are connected and are testing WebCBRS, with plans to continue training and incrementally

converting their Regulatory and Law Enforcement users to WebCBRS by September 2006.

On June 7, 2006, the IRS and FinCEN met to discuss other BSA Direct needs that FinCEN is defining, including new and changed BSA forms, with estimated costs of \$750,000. The IRS's first priority is to ensure FinCEN users are connected, trained and converted by September 2006. Once this step is accomplished, the IRS will continue to partner with FinCEN to address specific BSA Direct requirements, along with estimated costs and proposed delivery dates.

#### ESTATE AND GIFT TAX

*Question.* I understand that the IRS is implementing a survey of the Estate and Gift (E&G) tax returns filed from 2000 to 2007.

What is the purpose of that survey?

Does the IRS have any plans to reduce the number of Estate and Gift Tax Attorneys? If so, what timeline are you considering?

*Answer.* The IRS is studying the projected volume of filings of estate and gift returns in light of the increasing filing threshold amounts. Furthermore, we are reviewing the staffing levels and audit coverage within the estate and gift program to effectively balance enforcement resources.

#### QUESTIONS SUBMITTED BY SENATOR PATTY MURRAY

##### CUTTING THE IRS OFFICE RESPONSIBLE FOR SERVICE WHILE EXPECTING MORE FROM VOLUNTEER PROGRAMS

*Question.* Mr. Everson, the IRS's Stakeholder, Partnership, Education and Communication (SPEC) office has overall responsibility for community partnerships such as the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs. In recent years, this IRS office has suffered cutbacks while the number of taxpayers seeking help from by VITA and TCE for tax preparation continues to increase dramatically. Moreover, you stated recently that you expect to rely heavily on VITA programs to improve taxpayer services.

How do you justify continuing to cut the SPEC office while giving it an increasing workload?

*Answer.* The IRS is devoting the necessary staff to support the Stakeholder Partnerships, Education and Communication (SPEC) business model that partners with external organizations to deliver volunteer return preparation (VITA/TCE), outreach/education, and asset building services. Since the reorganization of the IRS in 2000, the SPEC organization has evolved from 531 SPEC on-rolls (staffing) in fiscal year 2001 to 565 on-rolls (staffing) in fiscal year 2006.

We believe the community-based programs play an important role in improving taxpayer service and are critical in providing no-cost tax return filing assistance to underserved taxpayers, including low-income, elderly, disabled, and taxpayers with limited English proficiency. As such, the IRS has established partnerships with more than 60 national organizations representing financial institutions, educational institutions, tribal governments, community and volunteer organizations and many others. At the local level, the IRS has formed over 295 coalitions (up from six coalitions in fiscal year 2001), representing thousands of partners. As our experience, program knowledge, and relationships with external partners have grown and matured over time, our capacity to deliver more service through the leveraged business model has significantly increased. For example, as of June 17, 2006, community-based partners had prepared 2.24 million returns compared to 1.17 million returns for the entire fiscal year of 2001.

*Question.* Ms. Olson, what is your opinion on this matter?

The VITA program operates for only about 4 months of the year during tax season and receives limited support from the IRS. Ms. Olson, in your statement, you say that the IRS should concentrate on developing a fundamental support structure for the program and expand the program. You also say that the IRS should not let VITA or any other volunteer program serve as a substitute for IRS-provided service.

Ms. Olson, why do you take that position, and Mr. Everson, what is your response to this?

*Answer.* As previously stated, the assistance the SPEC organization provides through the support of its partners play an important role in improving taxpayer service and is critical in providing no-cost tax return filing assistance to underserved taxpayers, including low-income, elderly, disabled, and taxpayers with limited English proficiency. However, it is important to note that the success we have achieved each filing season, as outlined in the preceding paragraph, is largely predi-

cated on the rigorous planning effort that takes place throughout the fiscal year with national and local partners. A national program of this magnitude requires year-round support to incorporate planning, training, filing season assessment, partner recruitment activities and partner satisfaction improvement.

This support is essential to maintaining existing partner relationships and attracting new partners and the investment is substantial. It provides partners with tax law and software training, marketing materials, educational products, research data for optimal site placement and effectiveness, supplies, technology support (software, computers and printers) and the necessary products, procedures, and technical expertise for effective site operations. SPEC, with its partners, supports over 12,000 volunteer return preparation sites nationwide that are strategically placed to facilitate access for low-income taxpayers. Our annual research report on SPEC site coverage indicates 99 percent of low-income taxpayers have access to a free tax return preparation site within 45 minutes of their home. This coverage is a complement to, rather than a replacement of, IRS-provided services.

#### SETTING TAXPAYER ASSISTANCE CENTERS (TACS) UP TO FAIL

*Question.* In a briefing last year by TIGTA on Taxpayer Assistance Centers, I learned that some TACs have as little as one or two staff, what TIGTA calls a “critical staffing shortage”. The House and Senate, Majority and Minority, said no to your proposal to cut back TACs until TIGTA completes a study on the impact of such reductions on taxpayer compliance and taxpayer services.

Mr. Everson, are you, in fact, allowing these TACs to eventually close by letting the staffing levels dwindle? Do you believe that is consistent with the direction from this committee?

*Answer.* In response to the congressional directive received with our fiscal year 2006 budget appropriation, a concentrated effort was made to keep all of our 400 Taxpayer Assistance Centers (TAC) open during filing season. I am pleased to report that we not only kept all of these TACs open, but we addressed all potential critical staffing shortages in our one and two person TACs. Specifically, during the fiscal year 2006 filing season, we hired almost 60 critical permanent front line employees, returned seasonal employees and detailed back former TAC employees who were assigned to other IRS organizations. We also temporarily deployed technical employees as necessary from other TACs in an effort to keep every TAC open daily. We initiated a second wave of hiring after the filing season and expect to employ over 300 front line employees to fill behind attrition. These actions will bring our staffing levels at the end of fiscal year 2006 to the same on-rolls we had at the beginning of fiscal year 2006 (2,080), as well as position us to deliver services in fiscal year 2007 with a minimal amount of contingencies required.

While we expect the Taxpayer Assistance Blueprint (TAB) initiative to guide future decisions about the proper staffing levels for the TACs and the kinds of services we will offer, we are committed to achieving and maintaining an appropriate level of staffing and service in the TACs as demonstrated this fiscal year.

*Question.* Mr. George or Ms. Olson, do either of you care to comment?

Mr. Everson, your statement mentions the identification and elimination of non-critical vacancies as one of the means through which you intend to achieve efficiencies within taxpayer service programs and processes.

When it comes to staffing at the taxpayer assistance centers, are you trying to achieve through attrition what you couldn't achieve due to legislative restrictions?

*Answer.* As indicated in our above response, we are committed to achieving and maintaining an appropriate level of staffing and service in the TACs. The IRS demonstrated this commitment by the staffing actions taken to prepare for the 2006 filing season and the post-filing season actions to fill behind attrition. We expect to employ over 300 front line employees to address staffing vacancies caused by attrition. These actions will bring our staffing levels at the end of fiscal year 2006 to the same on-rolls we had at the beginning of fiscal year 2006 (2,080, including the 300 attrition hires), as well as position us to deliver the same level of services in fiscal year 2007 with little to no alternative staffing contingencies.

#### SERVICES OFFERED AT TACS

*Question.* Mr. Everson and Ms. Olson, why hasn't the IRS involved taxpayers who need or desire face-to-face assistance in determining what services are offered at the TACs?

*Answer.* Since September 2005, the Taxpayer Assistance Blueprint (TAB) team has been conducting extensive research directly with taxpayers to identify taxpayer needs and preferences for receiving services including those offered at our TACs. As you know, we delivered the TAB Phase 1 Report to Congress in April 2006. The

TAB Phase 2 report, which we expect to deliver to Congress in October 2006, will validate the service recommendations through extensive primary research with taxpayers. Current ongoing customer preference and needs research includes surveys, focus groups, and experimental research aimed at providing customer-centric information to decision-makers.

*Question.* Mr. George, your recent audit report says that prior to making decisions on closing any TACs, the IRS should ensure that it is known which taxpayers visit the TACs for assistance and why, so the IRS can determine the impact on these taxpayers and ensure alternative service delivery channels are effective in meeting the needs of these taxpayers.

Ms. Olson, I would imagine you agree?

Mr. Everson, TIGTA recently found that 8 of 11 stakeholder groups believe that closing the TACs may make it harder for their constituents to stay compliant with tax laws and file tax returns. TIGTA also found that 11 of 11 stakeholder groups believe their constituents are not currently likely to use alternative methods, such as the internet or email to obtain the services they need.

In light of your efforts to reduce face-to-face interaction between the IRS and the taxpayer and your efforts to increase compliance, have you re-thought some of your earlier decisions on reducing taxpayer services?

Answer. Balancing customer service with enforcement to achieve compliance has been and will continue to be a fundamental goal of the IRS. Currently there are no efforts underway to reduce face-to-face interaction between the IRS and taxpayers. However, we are optimistic that the TAB study, which includes comprehensive research around the needs and preferences of taxpayers, will not only identify more efficient and cost-effective service delivery channels, but also provide a business model that balances taxpayer preference with business values. Our goal is to make service investment decisions in order to reach the most taxpayers through their preferred service channel within available resources.

#### REDUCTION OF TAXPAYER SERVICES

*Question.* Mr. Everson, last year, you:

- eliminated “TeleFile”, the ability to file taxes by telephone;
- proposed the elimination of as many as one quarter of all walk-in Taxpayer Assistance Centers;
- proposed shortening phone assistance hours; and
- began the process to eliminate several telephone call-routing sites.

In a profile of online population, Census data indicates that in any given age group (ages 18–29; 30–39, etc.), not even one-third of adults are on-line. We know that the Nation’s large senior citizen, limited proficient English, and underserved populations are not as likely to use or have access to the internet as other forms of communication.

Given this and the digital divide at every generation, how do you rationalize the elimination of face-to-face and telephone interaction in favor of electronic communication?

Answer. The Taxpayer Assistance Blueprint (TAB) team is analyzing taxpayer needs, preferences and behaviors to determine the optimal delivery of service across all channels. As stated previously, the TAB Phase 2 report, which we expect to deliver to Congress in October 2006, will use extensive primary research with taxpayers to validate its service recommendations. Current ongoing customer preference and needs research includes surveys, focus groups, and experimental research aimed at providing customer-centric information to decision-makers. In this context, careful consideration is being given to those taxpayers facing a barrier to online self-service options. Again, our goal is to maintain a balanced service portfolio that meets the needs of the greatest number of taxpayers within limited resources.

We made our initial proposal to shorten phone assistance hours in an effort to more closely match our hours of operation to the hours of our customer’s greatest demand to ensure the most efficient usage of our scarce resources while providing the best service possible to our customers. We decided not to implement this change as planned due to language in the 2006 appropriation bill directing the IRS not to reduce services.

We made the decision to close three call sites (Boston, Chicago and Houston) because the IRS identified them as non-continuing sites in the early 1990’s. This decision was made after a nationwide study showed the benefits of reducing the number of call sites and the best locations for consolidating our telephone operations based on rent, cost of living, competitive salaries and similar factors. Throughout the intervening years, we did not fill vacancies in Boston, Chicago, and Houston because of our long-standing plans to close those sites. As the number of employees in Bos-

ton, Chicago, and Houston continued to shrink it was no longer fiscally responsible to rent large, underused offices. By closing these sites and consolidating call operations, the IRS saved a significant amount of rent and support costs and gain productivity efficiencies with no impact whatsoever on our telephone customers.

To further put this action in context, in the early 1970's we were operating 135 call sites. The IRS derived efficiencies from consolidating smaller sites into larger operations so that by 1975, the IRS had reduced the total number of sites to 85. By the early 1990's, the IRS had undertaken further consolidations toward achieving a 25-site footprint. We designated Boston, Chicago, and Houston as non-continuing, no-growth sites, along with others that have since closed including Anchorage, Brooklyn, Honolulu, Los Angeles, Milwaukee, Newark, Omaha, Phoenix and St. Paul.

We serve our telephone customers using an enterprise approach and a toll-free telephone network that now consists of 25 call sites nationwide. Since we manage toll-free traffic nationally, the calls previously answered in Boston, Chicago and Houston are automatically routed to other call sites without affecting overall telephone service. Regardless of our customers' geographic locations, when they call us, our system routes their call to an available assistor who can best answer their type of question at any of our 25 sites. This routing occurs within seconds and is transparent to callers.

HOW HAVE YOU SPENT THE ADDITIONAL ENFORCEMENT FUNDING YOU GOT IN FISCAL YEAR 2006?

*Question.* Mr. Everson, the fiscal year 2005 budget resolution included language that enabled our bill last year to provide an additional \$446 million to be used for enforcement. Your March 7, 2006 report on enforcement indicates that 40 percent of that funding will maintain your base costs and 60 percent of that funding will allow hiring of 1,146 new enforcement FTEs, which you have already begun.

At this point in time, how many of those positions have you hired?

*Answer.* As of June, we have hired 1,224 positions for our fiscal year 2006 enforcement initiatives. These positions include over 500 Revenue Agents, as well as additional front-line enforcement staff. The number of positions hired corresponds to 959 FTE.

*Question.* What is your time frame for the rest of these hires?

*Answer.* Several IRS business units are planning additional hires during the remainder of the fiscal year. Through the fourth quarter we will be hiring approximately 120 additional Revenue Agents and 60 additional enforcement staff, though some of these will be allocated to attrition hiring.

*Question.* How much money has not yet been obligated?

*Answer.* Approximately \$13.3 million in initiative enforcement funds remain to be obligated, primarily in salary and benefit resources that will be used to pay current and future staff costs through the balance of the fiscal year.

FREE FILE ALLIANCE

*Question.* Mr. Everson, recently, the Finance Committee found that taxpayers using the Free File on-line tax return preparation services are presented with surprise fees, expensive add-ons, loan solicitations and other marketing pitches. While there is no obligation to buy these services, the fees occur so late in the process that taxpayers may feel forced to pay them or completely redo their taxes with another vendor who may also charge fees. It is my understanding that the IRS has not conducted much research on how many taxpayers fall prey to these sales pitches.

What is the IRS doing to protect taxpayers from predatory sales pitches and do you plan to do more comprehensive research on these activities?

*Answer.* The new Free File Alliance agreement contains a number of program improvements meant to increase the overall quality of the program and customer satisfaction. For example, the new agreement contains enhanced standards for consumer protection if a refund anticipation loan (RAL) is offered by a Free File Alliance (Alliance) member. Also, Alliance members must disclose on the members' individual landing pages if State tax return preparation and filing services are available and, if so, whether a fee will be charged for such services. If a fee is charged for such services, the cost to the taxpayer must be clearly stated on the members' landing pages.

For the 2007 filing season, we will continue to be vigilant with the Alliance members to ensure that the companies are adhering to the terms of the agreement, including those provisions designed to ensure the protection of taxpayer rights and confidentiality of taxpayer information. We also acknowledge that the companies

may offer products and services which are closely related to the tax preparation process and are of beneficial value to taxpayers.

In order to conduct more research, we are conducting a Free File survey this year with the following objectives:

- To determine, among taxpayers using Free File in 2006, how they were introduced to Free File, their reasons for choosing this electronic product, how they used it, and how they perceived the product in terms of its ease of use, use of specific product features, and satisfaction with the usage experience.
- To provide results that can be used to assist the IRS with making policy decisions related to expanding the use of e-file.

#### ADDRESSING SHODDY WORK BY TAX PREPARERS AND PRACTITIONERS

*Question.* Just this month, GAO reported that there may be serious problems with the accuracy of the tax returns prepared by many of the private tax preparation companies. The GAO found that these companies often prepared returns that were incorrect, with tax consequences that were sometimes significant. Some of these mistaken returns could have exposed taxpayers to penalties for such things as negligence and willful or reckless disregard of tax rules. Furthermore, TIGTA found, this month, that the IRS is not taking the necessary disciplinary action against tax practitioners who have been convicted or had their licenses revoked by State authorities.

Mr. Everson, why aren't you taking a more aggressive approach to regulating these individuals?

Answer. I agree that all taxpayers should be able to receive accurate return preparation assistance. While most paid preparers do their best to provide their clients with tax returns that are fully compliant with our Nation's tax laws, preparers who violate this public trust should be identified and subjected to the full range of sanctions available. Although more can always be done, the IRS is aggressively pursuing those paid preparers who are negligent or encourage out-right fraud.

In 2006, the IRS developed a new multi-functional Preparer Strategy, improving our coordination of preparer-related workload and ensuring that we work preparer non-compliance issues consistently, timely, and effectively. More than 500 Program Action Cases (PACs) were in process at the end of the first quarter of fiscal year 2006, a 500 percent increase over the number in process for the same period in fiscal year 2005. PACs are one of the processes used to investigate appropriate return preparer penalties. The main preparer penalty provisions are § 6694, Understatement of Taxpayer's Liability by Income Tax Return Preparer, and § 6695, Other Assessable Penalties With Respect to the Preparation of Income Tax Returns for Other Persons. These two sections are exclusively applied to return preparers and range from \$50 to \$1,000 per offense.

In fiscal year 2005, the Department of Justice secured injunctions, based on IRS referrals, against more than 40 promoters/preparers, preventing these individuals from preparing returns and promoting abusive schemes. The IRS continues to make referrals and work with the Department of Justice on securing injunctions against additional promoters/preparers to prevent these individuals from further participating in unscrupulous conduct.

The Criminal Investigation Division (CI) initiated 248 return preparer investigations in fiscal year 2005, a 20 percent increase from the previous year. CI utilizes many techniques, including the use of the undercover program, search warrants, witness interviews; and contacts with informants, banks, and local law enforcement, to vigorously pursue investigations of unscrupulous return preparers.

#### INAPPROPRIATE COMPETITIVE SOURCING OF MAILROOM WORK

*Question.* Mr. Everson, the fiscal year 2004 Transportation-Treasury Appropriations Act included a prohibition on funding for the conversion of work performed by 10 or more Federal employees to a contractor without holding a public-private competition. At the time the bill was enacted (January 23, 2004), approximately 65 Federal employees, including those with disabilities, were performing mailroom work. Yet, in 2004, the IRS permitted a private contractor to replace the RIF'ed mailroom employees.

How is it that the IRS did not conduct a public-private competition for its mailroom operations?

Answer. In fiscal year 2003, the IRS made the decision to directly convert the mailroom positions and selected a contractor under the Javits-Wagner-O'Day Act Program, which provides greater employment opportunities for people with disabilities. The IRS chose to conduct an A-76 Direct Conversion to a NISH (formerly the National Institute for the Severely Handicapped) provider because fewer than 25

employees would be affected and because of the proven past performance with IRS mailrooms (the IRS already contracted 10 mailrooms through NISH). In October 2003, the IRS signed the contract with 4 option years with ServiceSource for mail delivery in 33 locations. ServiceSource is a Community Rehabilitation Partner which creates opportunities for individuals with disabilities, is certified by NISH and has over 30 years of experience providing mailroom services to Federal and State agencies in both on-site and off-site facilities. The contract provided the capability for IRS and the contractor to incrementally on a site-by-site basis issue task orders to phase-in contractor performance. This phase-in approach afforded the IRS greater opportunity to work with employees on mitigation strategies to reduce the number of potential employees facing a reduction-in-force.

The IRS had previously begun reduction-in-force negotiations with the National Treasury Employees Union (NTEU) and offered assistance to impacted employees—voluntary early retirement and voluntary separation incentive, some placement opportunities within IRS for other positions, and potential employment with the contractor. The IRS issued the reduction-in-force notices to 12 employees in October 2004. The IRS placed two of the employees in other agency positions and most of the remaining 10 employees went to work for the contractor.

*Question.* Furthermore, I'm told that the Federal employees performed administrative and support activities, in addition to their mailroom responsibilities, such as opening mail and delivering mail to employee desks. I understand that the contract employees would not have done these additional duties, yet the IRS used the same assumptions when comparing these costs.

How do you explain that?

*Answer.* The IRS addressed the duties of opening and subsequent desktop delivery of mail during the data gathering phase of the Business Case Analysis for this Competitive Sourcing Initiative. That data indicated that desktop delivery of mail was not being performed in 94 percent of the sites impacted by the study before the conversion to contract delivery. We retained that desktop delivery feature at those locations (2 of 32) when the Contractor took over this operation. As for opening of all mail, these duties were not identified as being performed in any sites.

The process of researching mail where the delivery point was unidentifiable by the address provided was reflected in the data gathering phase as being performed at all locations. This research task did require the opening of this small percentage of correspondence by IRS mail clerks, and this practice has continued within the statement of work for the contractor.

*Question.* A lawsuit was filed against the IRS, challenging the legality of the conversion of the mailroom employees. Subsequently, an IRS spokesperson said in mid-March that the IRS is currently reviewing the judge's decision.

What is the result of that review?

*Answer.* The interim court ruling concluded that even though the IRS had signed a contract prior to the enactment of the fiscal year 2004 appropriations, the IRS could have exercised discretion on whether or not to issue the individual task orders, and therefore, violated the provisions of the 2004 appropriations. Both parties (NTEU and IRS) are currently exchanging proposals of remedy for the former employees who were involuntarily separated.

#### TAX GAP

*Question.* Mr. Everson, at a recent Senate hearing on the tax gap, you testified that the IRS could collect an additional \$50–\$100 billion each year without changing the way the Government interacts with the taxpayer. However, the five legislative proposals in your budget, aimed at reducing the tax gap, are estimated to raise only \$3.5 billion over 10 years, or \$350 million per year.

Mr. Everson, with a requested budget increase of 0.2 percent next year—basically a flat budget—how will the IRS be able to collect this \$50–\$100 billion?

*Answer.* The collection of an additional \$50 to \$100 billion each year is a possibility without significant change in IRS interactions with taxpayers, however, the IRS cannot accomplish this alone. The IRS cannot audit its way out of the tax gap. Tax simplification must accompany any meaningful effort to reduce the tax gap, and would allow the IRS to further streamline its operations and increase the effectiveness of its compliance strategies. Additionally, legislative proposals such as those requiring increased information reporting in certain sectors, as well as the increase in information-sharing from other agencies, will further contribute to reducing the largest element of the tax gap—underreporting. Admittedly, the five proposals included in the fiscal year 2007 budget request are only first step toward addressing the quarter-trillion dollar tax gap. But they are a step in the right direction, and represent one critical element of a successful strategy.

*Question.* Individuals have long been evading the payment of taxes by hiding income in other countries. The IRS recently won court approval to ask PayPal, a popular on-line payment service, to turn over customer records as part of an investigation into tax cheats who hide money overseas. This would involve those who sent money to a bank or credit card account in more than 30 foreign countries and would cover the past 8 years.

What is the latest about whether PayPal will comply?

*Answer.* We expect compliance, but the disclosure restrictions of IRC § 6103 prohibit us from further discussion about the status of our efforts at this time. However, the Offshore Credit Card Project (OCCP), in furtherance of which the court issued the PayPal summons, is a continuing effort. The IRS has requested and the courts have issued prior John Doe summonses to major credit card companies, third-party credit card processors, and over 100 merchants in an effort to identify individuals who have evaded tax by moving money offshore. The IRS has completed several thousand examinations and over 1,200 are currently in process. In addition, the OCCP has provided leads and other information which has led to numerous successful criminal prosecutions.

*Question.* What else are you doing to prevent offshoring of taxpayers' money?

*Answer.* The IRS has several other initiatives to address this concern:

*Broker Initiative.*—The IRS is identifying withholding agents for Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons) examinations. The dual purpose of these examinations is to assess the withholding and information reporting compliance of the withholding agent, as well as that of the U.S. beneficial owners of accounts established in the names of entities domiciled in secrecy jurisdictions. The IRS is currently examining several withholding agents, with more planned.

*Seven Country Initiative.*—Although this initiative was originally formed under the auspices of the Pacific Association Tax Administrations (PATA), the group's members currently consist of Australia, Canada, France, Germany, Japan, United Kingdom and the United States. The purpose of this group is to enhance each country's capacity to deal with compliance risks associated with offshore secrecy jurisdictions, share best practices and approaches addressing abusive offshore arrangements and their promoters. These discussions will provide opportunities for bilateral action and exchange of information. To further expand its compliance initiatives, the group formed subgroups to address non-compliance facilitated through the brokerage and banking industries and International Business Corporations (IBC). The Seven Country Initiative is focused on high wealth individuals and closely-held entities involved in abusive offshore arrangements using tax secrecy jurisdictions.

*Promoter Program.*—The IRS has made significant strides in combating the offshoring of taxpayers' money through its efforts on promoters of offshore schemes and transactions. Based on referrals, the IRS has authorized investigations pursuant to I.R.C. § 6700 (Promoting Abusive Tax Shelters) for various promoters of offshore schemes. When appropriate, the IRS has referred these promoters to the Department of Justice for potential pursuit of penalties and injunctions. This process prohibits the promoter from continued marketing of abusive schemes and assists the IRS in identifying participants in offshore transactions for compliance purposes.

#### IS THE IRS COMPLYING WITH SECTIONS 205 AND SEC. 204 OF THE TTHUD BILL?

*Question.* The Fiscal Year 2006 Transportation-Treasury Appropriations Act included a provision (Sec. 205) stipulating that no funds may be used to reduce taxpayer services as proposed in fiscal year 2006 until TIGTA completes a study detailing the impact of such proposed reductions on taxpayer compliance and taxpayer services, and the IRS's plans for providing adequate alternatives services, and submits such study and plan to us for approval. Despite this language and the provision Sec. 204 stating that funds shall be available to improve and increase 1-800 help line service, you decided to decrease those telephone hours last year after enactment of our bill. We had to add clarifying language in the Supplemental Appropriations Act last year so that you would not reduce telephone service hours.

So, Mr. Everson, I'd like to ask you: Is the IRS complying with Sec. 205 and Sec. 204?

*Answer.* Yes. We continue to provide the same number of daily hours of service as in fiscal year 2005 with our toll-free telephone lines open from 7:00 a.m. to 10:00 p.m. Monday through Friday (local time) and limited service on Saturdays during the filing season. In January 2006, we actually extended the operational hours of service from 7:30 a.m. to 6:00 p.m. Monday through Friday (local time) to 8:00 a.m. to 8:00 p.m. Monday through Friday (local time), for the Practitioner Priority Service telephone line.

Our proposal to change the operational hours in fiscal year 2006 was another step towards providing our customers with the highest level of service as we continue to identify ways to improve our toll-free operation. To put our proposal to reduce hours of service into context, in 1999, we increased our operational hours to 24 hours a day, 7 days a week in an effort to expand service to our taxpayers. However, after identifying periods of low call demand (assistors were available and waiting for incoming calls) and alternate periods of excess demand (we did not have enough assistors on the phones to handle incoming call traffic during specific hours), we re-evaluated our decision to provide service around the clock. In October 2001, we reduced our operating hours to 7:00 a.m. to 10:00 p.m. Monday through Friday (local time) with limited service on Saturdays during filing seasons. This reduction afforded us the most efficient usage of our scarce resources while providing the best service possible to our customers.

However, despite our attempt at providing coverage during the right periods of time, we continued to experience periods of low call demand, primarily before 8:00 a.m. and after 8:00 p.m., resulting in assistors sitting idle during these times. After further evaluation of incoming call demand and available assistor resources, we proposed a reduction to our fiscal year 2006 hours of service. However, we did not implement this change, in accordance with Sec. 205.

#### BUSINESS SYSTEMS MODERNIZATION (BSM)

*Question.* Over the long-term, Business Systems Modernization (BSM) has suffered numerous project delays and cost overruns, which has warranted oversight and recommendations from GAO. On an encouraging note, in the past 2 years, progress has been made. GAO's No. 1 concern is that since the BSM vision and strategy is no longer current given project delays, the IRS must develop brand-new long-term program goals and strategies. Although the IRS is developing a 5-year plan, GAO still believes further longer-term goals are necessary.

Mr. Everson, how do you respond?

Answer. We appreciate the Senate Appropriations Committee's acknowledgement of BSM's improved performance.

The MV&S team specifically chose a 5-year planning horizon for two reasons. First, given the rapid pace of technological change, it is increasingly difficult to predict what technology will become commonplace over longer planning horizons. Second, IRS's business emphasis can likewise change over longer planning periods. Recognizing these issues, the IRS believes that the key element is not the planning horizon, but rather the commitment to institutionalize an annual planning process that reassesses and updates the MV&S 5-year plan based on IRS's current technology environment, foreseen future technology enablers, and the current IRS strategic focus.

Given this context, longer-term goals have provided a meaningful backdrop to MV&S planning. The first goal is to make investments in technology that will have a demonstrable impact on lowering the \$300 billion-a-year tax gap. IT initiatives that both support increased voluntary compliance (through better IRS service) and enforcement (through improved compliance productivity) are vital to lowering the tax gap over time. Second, given the explosion of the Internet, the IRS needs to leverage its power to offer better service to our constituents while lowering our own costs (chiefly by offering self-assist/self-correct capabilities). Finally, we recognize that true IT modernization will only come about when the IRS can finally retire our aging master files and the Integrated Data Retrieval System (IDRS)—systems built originally in the 1960's and 1970's. These systems are the core of the U.S. tax administration system today, but hamper the IRS's ability to provide real-time, accurate, and complete data to our constituents. The IRS must place continued focus on replacing these systems with modernized systems, including the Customer Account Data Engine (CADE) to replace the master files and projects to replace IDRS.

#### QUESTIONS SUBMITTED BY SENATOR BYRON L. DORGAN

##### PROPOSED DISCLOSURE REGULATIONS

*Question.* Mr. Commissioner, I am deeply concerned about the disclosure regulations proposed by the Internal Revenue Service (IRS) last December. I believe these regulations put at risk rampant distribution of private taxpayer information by tax return preparers for all kinds of unrelated marketing purposes.

You point out that tax return preparers can currently seek consent from customers to use tax return information to solicit their customers to purchase products by the tax preparer or its affiliated group. The approach taken in the regulations

now expands this by allowing tax preparers to solicit their customers to purchase products from third parties including marketers and data brokers—risking even further dissemination of taxpayer information.

Do you believe that this proposed change provides additional disclosure protections for taxpayers?

Answer. I want to assure you that protecting taxpayer privacy by preventing return preparers from improperly disclosing or using tax return information is of utmost importance. The proposed rules represent a significant improvement over existing regulations in protecting taxpayer privacy interests and would strengthen taxpayers' control over their tax information in the hands of tax preparers and tax preparation software companies. Specifically, the proposed rules provide that tax return preparers must give all taxpayers clear warnings and consent notices that allow taxpayers to make a knowing, informed, and voluntary decision over the disclosure or use of their tax information by their preparer.

In addition, Congressional concerns and inquiries led to proposed changes to the rules requiring written taxpayer consent before a return preparer may outsource preparation services or send tax return information outside the United States. This protection does not exist under the current regulations. The proposed rules also retain the requirement that tax return preparers obtain written consent from taxpayers to "use" tax return information. The current rules, however, do not define "use," creating uncertainty in a number of areas, including whether the term includes targeted advertising. The proposed rules eliminate this uncertainty by expressly defining "use" to include return preparers' reliance upon tax return information to target advertising to their customers.

Under the proposed regulations, return preparers must still obtain customer consent before using any information gleaned from tax returns as a basis for marketing any product or service. The consent must identify each specific type of product or service that may be solicited. If the taxpayer declines to execute the consent, the information cannot be used and the return preparer cannot ask for the taxpayer's consent again.

*Question.* You appear to justify this particular change because you believe that such solicitations may be for products that positively affect taxpayers' financial lives.

Answer. Our primary focus in proposing the regulations was to update existing rules, promulgated in the early 1970's, that do not provide adequate guidance to protect taxpayers' return information in an era of electronic return preparation and filing. While the IRS is sensitive to the impact that these rules may have on taxpayers' finances, our primary concern is protecting taxpayer privacy. Other reasons for publishing the proposed regulations include concern about whether return preparers were engaged in practices not contemplated when the regulations were originally promulgated, including outsourcing preparation services or sending tax information outside the United States. Congressional inquiries about the appropriateness of outsourcing preparation services and sending tax return information overseas without the knowledge of the taxpayer contributed to prioritizing the project.

Additionally, there has been a misunderstanding regarding the proposed rules with respect to the difference between "disclosure" and "use" of tax return information that has led to confusion over how the proposed rules relating to the disclosure of tax return information have been strengthened. The misunderstanding of the proposed rules stems from a proposed change relating not to preparer disclosure of information to third parties, but rather to a return preparer's own use of tax return information to solicit additional products and services for itself or other parties. Currently, return preparers may seek consent from customers to use tax return information to solicit their customers to purchase current products or services offered by the preparers or their "affiliated group." Since few return preparers are organized in a corporate structure, much less an "affiliated group," this provision has little current relevance or application. Moreover, notwithstanding the "affiliated group" limitation on "use" of return information, the existing regulations do not limit the permissible "disclosure of return information to third parties with the taxpayers' consent." Such disclosures may be for products that positively affect taxpayers' financial lives or participation in government benefit programs.

As before, the regulations afford taxpayers the ability to control and direct the disclosure or use of their own tax return information. Under the proposed regulations, return preparers must still obtain customer consent before using information gleaned from tax returns as a basis for marketing any product or service. The consent would need to identify each specific type of product or service that may be solicited and if the taxpayer says no, the information cannot be used and the return preparer cannot ask again.

*Question.* Do you think that when Section 7216 was enacted and imposed a stiff fine and possible jail time for tax preparers who make unauthorized disclosures of taxpayer return information that Congress intended to allow sweeping exceptions for widespread marketing?

Answer. Neither the current regulations, which have been in place since 1974, nor the proposed regulations, contain sweeping exceptions for widespread marketing. To the contrary, the existing regulations require taxpayer consent for most disclosures and the proposed regulations tighten the applicable consent provisions to help ensure that the consents are informed. That is, the taxpayer, and only the taxpayer, can control and direct the disclosure or use of tax return information by a tax return preparer. Section 7216 as enacted in 1971, provides the Secretary with the authority to prescribe regulations governing the disclosure or use of tax return information. It was clear at that time that Congress understood that there would be circumstances when the disclosure or use of tax return information by tax return preparers for purposes other than tax return preparation would be permissible. Consistent with this understanding and the long-standing regulations, it has been common industry practice to solicit taxpayer disclosure consents for a variety of purposes other than tax return preparation.

*Question.* You indicate that in both the current regulations and the proposed regulations tax return preparers have been permitted to disclose their customers' tax return information to affiliates and third parties if the customers consent.

Do you have the authority to prohibit such disclosures to affiliates or third parties if such disclosure is not for purposes relating to the preparation of a taxpayer's return? Would legislation be required to prohibit such disclosures?

Answer. Congress provided broad authority to the Secretary under Section 7216(c) to prescribe regulations permitting the disclosure or use of tax return information. By giving the Secretary this broad authority, it is clear Congress understood there would be circumstances when the disclosure or use of tax return information by tax return preparers for purposes other than tax return preparation would be permissible. The regulations implementing Section 7216(c) have been in place for more than 30 years. Given the long-standing existence of the current regulations under Section 7216, the absence of virtually any controversy with respect to consensual disclosures under the current regulations, and the fact that the current controversy is the result of a mischaracterization of the nature and scope of both the current regulations and the proposed regulations, I believe that legislation would be the way to completely prohibit the types of disclosures to affiliates or third parties that you reference.

#### TAX HAVEN ABUSES

*Question.* We have known for many years that some very profitable U.S. multinational businesses are using offshore tax havens to avoid paying their fair share of U.S. taxes. In fact, recent evidence suggests that the tax-haven problem is getting much worse and may be draining the U.S. Treasury of tens of billions of dollars every year.

According to an investigative report written by David Evans with Bloomberg News, there is a building called the Uglund House in Grand Cayman that is used as the address of 12,748 companies. In my judgment, it is the hood ornament of the growing tax haven abuse problem.

I have authored legislation with Senator Levin that we believe would put an end to the tax benefits for U.S. companies that shift income to offshore tax-haven subsidiaries. The Joint Tax Committee says our legislation to close this tax avoidance scam would save U.S. taxpayers some \$15 billion over the next decade.

Do you agree that the use of offshore tax havens by large multinational firms to park profits that would otherwise be taxed in this country is a problem? If so, what is the IRS doing to tackle it?

Answer. As I stated in my testimony of June 13, 2006, we recognize that certain taxpayers seek to shift significant profits offshore. These taxpayers manipulate the price of related transactions so they can claim that the income is earned outside the United States, preferably in a low- or no-tax jurisdiction. Further, the transfer of intangibles outside the United States has been a high risk compliance concern for the Service and we have seen a significant increase in such transactions in recent years. Cost-sharing arrangements are often the method for this activity. The buy-in amount in cost-sharing arrangements is frequently troublesome. It is often understated, resulting in the improper shifting of income offshore.

In response to the compliance risks of pricing issues, the LMSB Commissioner issued guidance to all field examination personnel regarding potential transfer pricing issues and we require all field examination personnel to request and review tax-

payer transfer pricing studies. As a subset of the transfer pricing issue category, a section 936 Termination Strategy issue has been identified for additional compliance coordination. Associated with the sunset of section 936, taxpayers have created structured transactions to transfer U.S. intangibles that were used in Puerto Rico to other low tax jurisdictions. An Issue Management Team (IMT) has been established to identify, coordinate, and propose resolution alternatives for this issue.

As part of our response to the cost-sharing arrangements issues, we proposed a comprehensive set of cost-sharing regulations in August 2005 to ensure that such arrangements do not facilitate a disguised transfer of intangible assets outside the United States in a manner inconsistent with the arm's-length standard. We intend to finalize these regulations this year.

We have also established a cost-sharing IMT to improve Service-wide coordination in the identification, development, and resolution of cost-sharing issues. The IMT issued a cost-sharing audit checklist in 2005 that provides guidance to field examiners for developing potential cost-sharing audit issues and ensuring consistency. The team has completed its efforts to identify and review cases with a cost-sharing issue to determine the impact and compliance risk. The team is developing a coordinated issue paper that will provide the basis and support for examining issues and to assist with potential Appeals Settlement Guidelines.

*Question.* What action did the IRS take when the Uglund House matter was reported in the press?

*Answer.* The IRS has recognized that companies are using entities such as international business corporations (IBCs) in offshore financial secrecy jurisdictions. Depending on the offshore jurisdiction, shareholders of the IBC may remain confidential. When the article you cited came out in 2004, we canvassed a number of offshore jurisdictions (including the Cayman Islands) and requested they provide a list of their registered IBCs. At that time the jurisdictions we contacted could not provide the information due to their financial secrecy laws. If we have a name or IBC number we are able to contact public registries directly and get information on companies incorporated or registered in the jurisdiction, but that information is limited to IBC name and number, name and address of registered agent, authorized capital, and status of the IBC (whether it is active or inactive.) The public registries do not contain ownership information or shareholders. That information is held by registered agents (RA) and is often subject to the secrecy and privacy laws.

Over the past few years, the IRS and Treasury Department have been negotiating Tax Information Exchange Agreement (TIEAs) with these jurisdictions. We can now make requests under these TIEAs for the ownership information. The Cayman Islands TIEA became effective March 10, 2006 for civil tax issues. If we have a valid tax administration purpose, the TIEAs enable us to request information such as books and records, minutes of meetings, and analysis of functions a company performs to determine whether they have complied with U.S. tax provisions. This is predicated upon the fact that such documentation exists in the jurisdiction.

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QUESTION SUBMITTED BY SENATOR BARBARA A. MIKULSKI

*Question.* I remain very concerned about any proposals to reduce taxpayer services or close any of the 68 Taxpayer Assistance Centers (TACs) across the country, including 4 of 8 in my home State of Maryland. According to a recent Treasury Inspector General for Tax Administration (TIGTA) report (Reference Number: 2006-40-061), management does not have reliable data on the Taxpayer Assistance Centers (TACs) to make decisions about TAC operations. TIGTA also points out that 47 of the 400 TACs nationwide—nearly 12 percent—are “critically” understaffed, meaning that they would be in danger of closing were it not for the dedicated IRS employees who are filling in from nearby TACs and through the use of seasonal employees. In its first report, TIGTA sharply criticizes the business model the IRS used to justify the TAC closings last year (see TIGTA Reference Number: 2006-40-067). These two reports strongly indicate that the IRS lacks the management information necessary to provide adequate oversight of its TAC operations, much less make a decision to close any of them.

How does IRS plan to report to Congress with reliable and verifiable data on the status of taxpayer services and explain how cuts to customer services would affect underserved populations such as the elderly, low-income taxpayers, minorities, those with language barriers and those without access to the Internet? How will you measure the affect of such closures on taxpayers when TIGTA points out that the IRS does not track this data?

*Answer.* We have taken a number of steps to improve both the data capture methodology and the reliability of management information discussed in the TIGTA re-

ports you mention. Efforts include automating a previously manual process of capturing the number of taxpayers served in the Taxpayer Assistance Centers and development and piloting of a web-based Management Information System that provides critical program planning and control data at the local and national levels. Input data from all of these sources will be incorporated in future iterations of the TAC Business Model.

In addition, the research and initiatives currently underway in the Taxpayer Assistance Blueprint (TAB) will significantly enhance collection of customer information and customer characteristics. As you know, we delivered the TAB Phase I report in April 2006. The TAB Phase II report, which we expect to deliver to Congress in October 2006, will use extensive primary research with taxpayers to validate its service recommendations. Current ongoing customer preference and needs research includes surveys, focus groups, and experimental research aimed at providing customer-centric information to decision-makers. The service-related research includes the underserved taxpayers identified in your question. We intend to continue extensive research initiatives in future years to enrich and refine our understanding of these taxpayers' needs.

Finally, we do not envision that taxpayer services will be reduced. Careful consideration is being given to those taxpayers facing a barrier to online self-service options and how to best meet those needs. The goal is to maintain a balanced service portfolio that meets the needs of the greatest number of taxpayers within available resources.

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QUESTIONS SUBMITTED TO RAYMOND T. WAGNER, JR.

QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND

BSM FUNDING

*Question.* As noted at our hearing and as recommended by the Board, the IRS's Business Systems Modernization (BSM) program should receive more funding for fiscal year 2007 above the budget request.

If additional funding were to be provided to the BSM account, which projects could most benefit from additional funding? How would additional funding benefit the BSM program?

*Answer.* Two BSM projects would particularly benefit from additional funding during fiscal year 2007: the Customer Account Data Engine (CADE) and Modernized e-Filing (MeF). The CADE project is so central to IRS modernization that any additional money spent on speeding up the replacement of the 40-year-old Individual Master File (IMF) by CADE would offer many benefits to taxpayers. The legacy IMF system limits the IRS to weekly updates, but CADE will give the IRS the ability to update taxpayer records daily, and provide the IRS with the capability to serve taxpayers much like modern financial institutions serve their customers. On the other hand, using additional BSM funding in fiscal year 2007 on the Modernized e-Filing project would allow the IRS to begin the modernization of the e-filing platform for Form 1040 tax returns a year earlier than currently planned. Such modernization is a prerequisite for the IRS to offer a direct filing portal to individual taxpayers. The Electronic Tax Administration Advisory Committee (ETAAC), in both its 2005 and 2006 annual reports has stressed the importance of modernizing the system for receiving individual tax returns.

Based on consultations with IRS BSM personnel, the Board believes that the MeF project would be a better choice for additional funding in fiscal year 2007. The CADE project is already funded in fiscal year 2007 but the MeF project is not. Funding MeF in fiscal year 2007 would allow this project to start a year earlier, and bring the benefits of improved electronic filing systems to taxpayers a year earlier. The Board believes this would be of more benefit to taxpayers than spending additional money on the CADE project, which is already underway.

BETTER TAX GAP ESTIMATES

*Question.* While the IRS has done a commendable job in updating the tax gap estimates, there remain significant gaps in the gap. The IRS and others have expressed concerns with the certainty of the overall tax gap estimate in part because some areas of the estimate rely on old data (from the 1970's and 1980's) and it has no estimates for other areas of the tax gap. GAO, TIGTA, the Taxpayer Advocate, and the IRS Oversight Board also have all recommended greater and more frequent data collection and studies of the tax gap. I wholeheartedly agree.

What will it take in terms of resources to address these concerns? Should the IRS conduct research on how services affect compliance?

Can your office conduct research on the impact of taxpayer service on compliance?

Answer. The IRS Oversight Board believes additional research will provide the IRS with better data on taxpayer compliance, which will help the IRS better identify areas of non-compliance and ultimately provide some feedback on how IRS service and enforcement programs are affecting taxpayer compliance. This belief is consistent with recommendations from the National Taxpayer Advocate, who recommended that the IRS undertake a research-driven taxpayer needs-assessment that will identify services taxpayers need and how best they should be delivered.

For these reasons, the Board recommended that the following research initiatives be included in the fiscal year 2007 budget: (1) Improve Tax Gap Estimates (+\$46 million); and (2) Additional Customer Service Research (+\$15 million).

The first initiative, Improve Tax Gap Estimates, will establish permanent staffing for the National Research Program (NRP) and put the IRS on a path to conducting research annually, without affecting the existing examination staff in place within the operating divisions. Currently it takes too long to conduct research that can be used on a timely basis; the tax gap estimates released by the IRS in 2006 are based on an analysis of 2001 tax returns. Prior estimates were based on extrapolations of 1988 data.

As part of an overall strategy to conduct more research and use it to guide IRS service and enforcement efforts, the Board believes the IRS would be well-served to develop a long-range strategic plan for research that is separate from its overall IRS Strategic Plan and goes beyond the current 2009 end date for that plan, covering approximately a decade. In such a plan, the IRS should describe how it will bring its research on all taxpayer segments up to date, and perform a limited sample every year so that its research on all segments will be as current as possible.

The GAO was particularly supportive of this approach during its testimony to the committee. It testified that “doing compliance studies once every few years does not give IRS or others information about what is happening in the intervening years. Annual estimating of the compliance rate could provide information that would enable IRS management to adjust plans as necessary to help achieve the goal in 2009. One option that would not increase the cost of estimating compliance would be to use a rolling sample. IRS Oversight Board officials and we agree that instead of sampling, for example, once every 5 years, one-fifth of the sample could be collected every year.”

The Board believes the availability of up-to-date research data will allow the IRS to focus more effectively its service and enforcement programs on areas that have the greatest impact on taxpayer compliance, and use the changes in taxpayer compliance rates as feedback to evaluate the effectiveness of IRS’s service and enforcement program on actual taxpayer compliance. Achieving such a capability will be a vast improvement over the current situation in which the lack of data makes it virtually impossible to evaluate the effectiveness of IRS activity on taxpayer compliance and make informed decisions.

The second research initiative recommended by the Board is to add \$15 million to begin research on the impact of customer service on voluntary compliance and the service needs of taxpayers. The need for such research is also consistent with recommendations made by Treasury Inspector General for Tax Administration and the National Taxpayer Advocate in testimony last year to the Senate Appropriations Committee.

In response to the Board’s request, the IRS has said that it could extend and update research efforts in two major areas: evaluating the service needs of taxpayers and estimating the effect of customer service on taxpayer compliance. Additional resources in fiscal year 2007 would be used to further evaluate the service needs of taxpayers and to scope and design the data gathering and analysis capability to estimate the effect of customer service on taxpayer compliance.

With respect to your question on whether the Board could conduct research on the impact of customer service on compliance, please see the answer to question 4. The Board has a limited budget for survey work, but did conduct a survey of customer service needs and channel preferences, which has been provided to the IRS.

#### DIRECT FILING PORTAL

*Question.* Some experts have suggested that the IRS develop a direct filing portal through the IRS website to increase e-filing. To be clear, this is not about the Government preparing tax returns but to simply provide an easier, cheaper way for taxpayers to file their returns.

What are your thoughts on the direct filing portal? Do you believe it would significantly increase e-filing? Would this approach be more cost-effective for the IRS than continuing to use an extremely labor-intensive approach to processing paper returns?

Answer. As your question noted, the concept of a direct filing portal has received considerable attention lately, although much of the expert commentary has not been based on a common definition of a direct filing portal. The best way to explore these differences is to start by differentiating the act of tax preparation from the act of tax filing.

Commercial tax software products, including products available through the Free File Alliance, typically perform both functions. They guide the taxpayer through the process of tax preparation by using a series of questions, checklists, interview techniques, and reference material to ensure that all tax obligations have been identified, critical choices explained, relevant decisions made, and all calculations completed accurately. At the end of this process, most programs provide a summary review of the process to let the taxpayer know that preparation is complete.

At the completion of the tax preparation phase, the program then presents the taxpayer with filing and payment options. The taxpayer may choose to print the completed return and mail it to the IRS, or file it electronically. Payment or refund options, both paper and electronic, are also presented to the taxpayer.

If a taxpayer elects to file electronically, an output file is sent, not to the IRS, but to the tax software company, which combines individual returns into large batches, and sends these batched returns to the IRS. The IRS receives the batched returns and notifies the transmitter, usually the software company in the case of self-prepared returns, if the return has been accepted. Returns prepared by professional tax preparers go through a similar process, except that professional preparers may use a third-party transmitter instead of the software company to transmit batched returns to the IRS. A direct filing portal would allow taxpayers to file their already completed returns directly to the IRS without going through a third-party intermediary.

There has been some confusion because there are different interpretations of the term "direct filing portal." Many experts, when speaking of a direct filing portal, only refer to the capability of the IRS to receive a completed output file in what is known as Extensible Markup Language (XML). The creation of the output file must still be accomplished by a separate software package that assists the taxpayer to perform tax preparation. The developers of the tax preparation software must ensure that the output file created is compatible with IRS's direct filing portal. However, the software gives the taxpayer the opportunity to send the output file directly to the IRS instead of the software company. This feature relieves the software company of the responsibility to receive the output files created by its software product, batch them, send them to the IRS, and maintain and protect them. The elimination of this responsibility reduces cost to the software developer and consequently is expected to remove a barrier to entry of new tax preparation software companies from the marketplace.

However, other experts have used the term direct filing portal to refer to the capability for a taxpayer to access an IRS site where the taxpayer may do both elementary tax preparation as well as electronic tax filing, all in a single operation. Under this definition, tax preparation is combined with electronic filing, both of which are performed under the auspices of the IRS. Some States (e.g., Maryland) offer direct filing portals that offer taxpayers the opportunity to fill in a simple tax form and file it directly with the State department of revenue.

The Oversight Board believes that the IRS should explore the possibility of developing a direct filing portal that is capable of receiving output files produced by commercial tax preparation packages. The Modernized e-File program for 1120 tax returns offers the taxpayer the option of filing the return directly with the IRS. The Board believes that individual filers would benefit if offered such a choice, and that the availability of such a choice would promote electronic filing. A recent survey completed by the Board indicated that many taxpayers have concerns about security on the Internet, and the availability of a direct filing portal may alleviate some of these concerns. However, a complete cost benefit analysis should be conducted to determine if the benefits of developing this capability justified the development costs. The Board encourages further evaluation of this important issue.

On the other hand, the Board has reservations about the development of a direct filing portal to perform both tax preparation and filing functions, except for possibly the simplest of tax returns, as was the case with the TeleFile program. The IRS Restructuring and Reform Act of 1998 states that it is Congress's intent for the IRS to offer a comparable program to Telefile on the Internet. However, such a development involves complex public policy issues, such as the appropriate role for govern-

ment in tax preparation. The Act encourages the IRS to cooperate with the private sector and encourage competition in the private sector. The Board believes that creation of a direct filing portal strictly to receive output files from commercial tax software products would be one effective method to promote private sector competition. Again, the Board encourages further evaluation of this issue.

TAXPAYER ASSISTANCE BLUEPRINT

*Question.* As mandated by our appropriations act, the IRS recently issued the first phase of the Taxpayer Assistance Blueprint (TAB). I asked for this business plan so that the IRS and the Congress could plan strategically on developing future taxpayer services based on taxpayer needs. I also expected the plan to address demographic and geographic differences. Ultimately, this plan should help to improve voluntary compliance with the tax code. I expected the plan to focus beyond current IRS services and develop innovative approaches.

Since the IRS is mandated by the act to work with the Board on the TAB, please explain how the Board has been involved with this project and if the Board believes the TAB is addressing my needs and expectations.

*Answer.* The IRS has provided the Oversight Board with several opportunities to participate in the process of developing the Taxpayer Assistant Blueprint (TAB). The Board Chairman has been asked to become a member of the TAB Executive Steering Committee (ESC), and has participated both directly and through representation in a number of ESC teleconference meetings.

The IRS has also provided to the Board access to its working documents and plans, and has invited Board members and staff to participate in TAB in-process planning and review meetings. Board staff have attended several meetings in Atlanta during the development of the Phase I report as well as a Phase II planning meeting.

The Board has recently completed its own survey of taxpayer service needs and channel preferences. The survey results were recently presented to the full Board at its last meeting, and the full results provided to the IRS. The Board Staff Director and survey company Project Director traveled to Atlanta to present and discuss the results of the Board's survey with IRS's complete TAB project team, which lead to a comprehensive discussion of the results and how the IRS might incorporate the results into the Phase II report.

The Board is currently preparing a public report on the results of its survey, but would be pleased to present the results to you and your staff at any time.

QUESTIONS SUBMITTED BY SENATOR PATTY MURRAY

SERVICES OFFERED AT TACS

*Question.* Mr. Everson and Ms. Olson, why hasn't the IRS involved taxpayers who need or desire face-to-face assistance in determining what services are offered at the TACs?

Mr. George, your recent audit report says that prior to making decisions on closing any TACs, the IRS should ensure that it is known which taxpayers visit the TACs for assistance and why, so the IRS can determine the impact on these taxpayers and ensure alternative service deliver channels are effective in meeting the needs of these taxpayers.

Ms. Olson, I would imagine you agree?

Mr. Everson, TIGTA recently found that 8 of 11 stakeholder groups believe that closing the TACs may make it harder for their constituents to stay compliant with tax laws and file tax returns. TIGTA also found that 11 of 11 stakeholder groups believe their constituents are not currently likely to use alternative methods, such as the Internet or email to obtain the services they need.

In light of your efforts to reduce face-to-face interaction between the IRS and the taxpayer and your efforts to increase compliance, have you re-thought some of your earlier decisions on reducing taxpayer services?

Mr. Wagner, the IRS Oversight Board has recommended budget increases in customer service and toll-free telephone service in particular.

Would you care to comment?

*Answer.* Based on the belief that good customer service leads to fully-informed and satisfied taxpayers who understand their tax obligations and experience few problems in complying with the tax code, the Board recommends funding an increase in customer service to restore customer service to fiscal year 2003/4 levels and investing in telephone infrastructure. The rationale behind these recommendations is that it is less expensive to prevent problems before a taxpayer files than

to correct it later. While some IRS services have continued to improve, others have not and should be restored to their prior levels.

To restore the level of service in fiscal year 2007 to those achieved during fiscal year 2003 and fiscal year 2004, the Board recommends adding \$32 million to the IRS's service budget. The Board also recommends an \$8.7 million investment in telephone infrastructure to expand services to callers and provide telephone representatives with a more state-of-the-art call center environment. The IRS predicts this investment would result in lower queue times across the enterprise for all applications and would counter a negative trend in telephone service. (Wait time on hold for taxpayers has been increasing in the last 3 years. It has gone from 158 seconds in fiscal year 2004 to 258 seconds in fiscal year 2005, and the fiscal year 2006 target is 300 seconds.)

With respect to taxpayers' needs for in-person services, I would note that the Board has recently completed its own survey of taxpayer service needs and channel preferences. The survey results were recently presented to the full Board at its last meeting, and have been presented and discussed with the IRS's complete Taxpayer Assistance Blueprint project team. The Board's survey resulted in an innovative approach to segmenting taxpayers by attitude, behavior, and need, which led to a comprehensive discussion of the results and how the IRS might incorporate them into the Phase II report.

The Board is currently preparing a public report on the results of its survey, but would be pleased to present the results to you and your staff at any time.

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QUESTIONS SUBMITTED TO J. RUSSELL GEORGE

QUESTIONS SUBMITTED BY SENATOR PATTY MURRAY

ADDRESSING SHODDY WORK BY TAX PREPARERS AND PRACTITIONERS

*Question.* Just this month, GAO reported that there may be serious problems with the accuracy of the tax returns prepared by many of the private tax preparation companies. The GAO found that these companies often prepared returns that were incorrect, with tax consequences that were sometimes significant. Some of these mistaken returns could have exposed taxpayers to penalties for such things as negligence and willful or reckless disregard of tax rules. Furthermore, TIGTA found, this month, that the IRS is not taking the necessary disciplinary action against tax practitioners who have been convicted or had their licenses revoked by State authorities.

Mr. George, do you think the IRS is doing an adequate job here?

Answer. Recently, the IRS has placed a greater emphasis on the oversight of tax practitioners. To help ensure adequate resources are devoted to provide this oversight, the IRS substantially increased the budget and staffing of the Office of Professional Responsibility (OPR). In fiscal year 2002, the OPR had a budget of \$1.8 million and a staff of 15. By fiscal year 2005, it had a budget of \$5 million and a staff of 56.

During this time, the number of disciplinary actions by the OPR also increased, primarily because of expedited suspensions, which are generally used by the OPR in response to action already taken by Federal or State Government agencies to convict or disbar a tax practitioner or to revoke a practitioner's license.

Notwithstanding the increases in enforcement activity, there are still a significant number of tax practitioners whose conduct appears to warrant disciplinary action by the IRS but who have not been identified by the OPR. TIGTA believes the OPR needs to improve its ability to identify such practitioners so it can take appropriate disciplinary actions. Some tax practitioners who have been convicted of tax-related crimes or whose licenses have been suspended or revoked by State authorities have not been suspended from practice before the IRS.

In March of this year, TIGTA reported that the IRS does not have an adequate method to notify the OPR of tax practitioners who are not compliant with their own tax obligations. In a statistical sample of 750 of the approximately 407,000 licensed tax practitioners, there were 34 (4.5 percent) who were not compliant with their individual tax obligations. These 34 practitioners had a total of 81 tax periods with balances due of \$826,709 and 34 tax periods for which required tax returns had not been filed. Based on this sample, TIGTA estimates that there are approximately 22,500 licensed tax practitioners who are not compliant with their tax obligations but who have not been identified for referral to the OPR.

TIGTA previously reviewed the OPR in 2001 (the OPR was then known as the Office of the Director of Practice) and reported problems with the lack of informa-

tion needed to assess or manage the resources used for the disciplinary proceedings program. During the March 2006 review, TIGTA found that the OPR had not implemented some of the recommendations from 2001. Consequently, the problems reported in 2001 still existed. The OPR still does not have the information needed to effectively monitor program activities and resources, and the case management system still contains unreliable information.

In March 2006, TIGTA recommended that the Director, OPR: (1) work with other law enforcement agencies, including the Department of Justice, to improve the referral process and develop a process to obtain relevant information on State disciplinary actions by coordinating with State licensing authorities such as State bar associations and boards of accountancy; (2) coordinate with other IRS functions to identify practitioners who are not compliant with their individual tax obligations; and (3) implement the recommendations from the 2001 report. The IRS agreed to take corrective actions on our recommendations.

*Question.* In a briefing last year by TIGTA on Taxpayer Assistance Centers, I learned that some TACs have as little as one or two staff, what TIGTA calls a "critical staffing shortage." The House and Senate, Majority and Minority, said no to your proposal to cut back TACs until TIGTA completes a study on the impact of such reductions on taxpayer compliance and taxpayer services.

Mr. Everson, are you, in fact, allowing these TACs to eventually close by letting the staffing levels dwindle? Do you believe that is consistent with the direction from this committee?

Mr. George or Ms. Olson, do either of you care to comment?

Answer. During the 2006 Filing Season, TIGTA auditors visited 70 TACs from January through April 2006. The 70 TACs consisted of 10 TACs in each of the IRS's five geographical areas, plus 20 TACs in areas heavily affected by Hurricanes Katrina and Rita. TIGTA did not identify or report any significant concerns relating to staffing or wait times. All TACs that TIGTA visited were open and their addresses and hours of operations matched the addresses posted on the IRS's Internet site ([irs.gov](http://irs.gov)) and provided through the IRS's toll-free telephone numbers.

TIGTA plans to audit the Taxpayer Assistance Blueprint in fiscal year 2007 and also plans to monitor the 2007 Filing Season.

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#### QUESTIONS SUBMITTED TO NINA E. OLSON

#### QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND

#### BALANCE BETWEEN SERVICE AND ENFORCEMENT

*Question.* There continue to be questions and debate on the proper balance between taxpayer service and enforcement. But given the data limitations of the tax gap and the IRS's inability to measure quantitatively the return on investment on service or enforcement, it is a difficult question to answer.

Based on your expertise, what are your views on the balance between service and enforcement? Do you believe that one approach is more cost-effective than the other? Since most revenue is collected voluntarily, should the IRS invest more in service than enforcement?

Answer. Without a doubt, voluntary compliance is more cost-effective than enforced compliance. When a taxpayer complies voluntarily, the Government incurs no costs beyond the cost of processing the taxpayer's return. When a taxpayer fails to comply, the Government must spend funds identifying errors on a return if submitted, locating the taxpayer, and seeking to collect the balance due. The IRS is spending billions of dollars to audit and collect balances from substantially less than 1 percent of taxpayers. Even if we were somehow able to double the examination rate, more than 98 percent of taxpayers would not be examined each year. So we need to focus on maximizing voluntary compliance by simplifying the tax laws, increasing third-party information reporting, and improving IRS outreach and education efforts, while reserving targeted enforcement actions to combat clear disputes or abuses and send a message to all taxpayers that noncompliance has consequences.

As it is, Congress seems likely to appropriate nearly \$5 billion for enforcement and only about \$2 billion for taxpayer services for fiscal year 2007, and the IRS seems inclined to continue to seek a higher proportion of resources for enforcement in the future. I am concerned that the IRS is emphasizing stepped-up enforcement over stepped-up taxpayer service without data to support this approach.

To arrive at an optimal allocation of resources to close the tax gap, the IRS needs to do a better job of understanding the reasons why the tax gap exists.

At the risk of oversimplifying matters, let me suggest that we consider three types of taxpayers: (1) taxpayers who will go to great lengths to comply with whatever requirements exist; (2) taxpayers who view taxes as one of many burdens they face in everyday life and who will comply if doing so is straightforward and not time-consuming; and (3) taxpayers who willfully seek to evade their tax obligations.<sup>1</sup>

For each type of taxpayer, what is the reason for noncompliance and what is the optimal government response?

—For taxpayers who generally will go to great lengths to comply, the likely source of noncompliance is the complexity of the tax code. Thus, our approach should be to emphasize simpler laws and better explanations.

—For taxpayers who will comply if doing so is easy enough, our main emphasis should also be simpler laws and procedures, and better outreach and education. Here, though, we might also want to incorporate gentle enforcement action in our approach to try to persuade taxpayers that paying taxes must be a higher priority. In doing so, the IRS should incorporate taxpayer service within its enforcement actions. That is, at the same time that the IRS conducts audits or seeks to collect unpaid tax liabilities, the IRS should be courteous and should focus on trying to teach taxpayers how to avoid getting into trouble in the future. The IRS also must be careful to avoid creating noncompliance by imposing unrealistic procedural burdens on taxpayers who are trying to comply.

—For taxpayers who willfully seek to avoid paying taxes, enforcement is required—although even for these taxpayers, I think IRS employees generally should focus on trying to induce the taxpayers to comply prospectively.

What percentage of taxpayers falls into each of these three categories? I suspect that the middle category is largest, although it is impossible to know with precision. But we need to know more. Determining the reasons for noncompliance and measuring the impact of taxpayer service on compliance and the indirect impact of enforcement actions on compliance (i.e., the increase in compliance that results from taxpayers not subject to audits when word of the IRS's increasing audit coverage spreads) is admittedly difficult research to do, but that is not an adequate reason not to do it. At present, the IRS has very little hard data to compare the return on investment of a dollar spent wisely on enforcement against the return on investment of a dollar spent wisely on taxpayer service. Indeed, there is very little hard data that has been developed to show what a "wise" expenditure would be on either the service or the enforcement side.

I believe this committee and the IRS itself would benefit considerably if more research were conducted in this area to help guide us in making intelligent resource allocation decisions.

#### DIRECT FILING PORTAL

*Question.* Some experts have suggested that the IRS develop a direct filing portal through the IRS website to increase e-filing. To be clear, this is not about the government preparing tax returns but simply provide an easier, cheaper way for taxpayers to file their returns.

What are your thoughts on the direct filing portal? Do you believe it would significantly increase e-filing? Would this approach be more cost-effective for the IRS than continuing to use an extremely labor-intensive approach to processing paper returns?

Answer. I believe the IRS should provide a direct filing portal to enable taxpayers to e-file their returns directly with the IRS for free. In fact, I made exactly this recommendation in my 2004 annual report to Congress.<sup>2</sup>

E-filing brings benefits to both taxpayers and the IRS. 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 to easily capture return data electronically, and enables the IRS to process and review returns more quickly. For these reasons, Congress in 1998 directed the IRS to set a goal of having 80 percent of all returns filed electronically by 2007.<sup>3</sup>

<sup>1</sup>Analysis has been conducted on types of noncompliance that is more detailed and subdivides taxpayers into narrower categories. See Leslie Book, "The Poor and Tax Compliance: One Size Does Not Fit All", 51 U. Kan. L. Rev. 1145 (2003).

<sup>2</sup>See National Taxpayer Advocate 2004 Annual Report to Congress 471–477 (Key Legislative Recommendation: Free Electronic Filing for All Taxpayers).

<sup>3</sup>Internal Revenue Service Restructuring and Reform Act, Public Law No. 105–206, § 2001(a)(2), 112 Stat. 685 (1998).

To its considerable credit, the IRS has succeeded in raising the e-file rate above 50 percent. That is a significant achievement, but the rate remains substantially below 80 percent. In addition, the IRS reports that nearly 40 million returns are currently prepared using software—which means they are generally in a form that could be easily transmitted electronically—yet are printed out and mailed into the IRS on paper.

If the IRS could persuade these nearly 40 million taxpayers to file these returns electronically, it would achieve its 80 percent e-filing goal. Under the current system, there are two significant reasons why taxpayers shy away from e-filing. First, some taxpayers are unwilling to pay a separate fee to third-party software providers to file their tax returns. This is an understandable sentiment. As it is, taxpayers are filing tax returns to comply with the requirement that they pay a high percentage of their income—often 33 percent or more—to the Government. The notion that they should have to pay a fee in order to pay over all this money is unpalatable to many. Second, some taxpayers have concerns from a security standpoint about routing personal financial and tax information through third parties. In focus groups, taxpayers have said they would be comfortable transmitting this information directly to the IRS, but they are concerned that the risk the data could be improperly accessed increases when routed through third parties.

A direct filing portal would address concerns about fees and security. For that reason, I believe it could help the IRS considerably in its efforts to boost the e-filing rate.

#### BETTER TAX GAP ESTIMATES

*Question.* While the IRS has done a commendable job in updating the tax gap estimates, there remain significant gaps in the [data]. The IRS and others have expressed concerns with the certainty of the overall tax gap estimate in part because some areas of the estimate rely on old data (from the 1970's and 1980's) and it has no estimates for other areas of the tax gap. GAO, TIGTA, the Taxpayer Advocate, and the IRS Oversight Board also have all recommended greater and more frequent data collection and studies of the tax gap. I wholeheartedly agree.

What will it take in terms of resources to address these concerns? Should the IRS conduct research on how services affect compliance?

Can your office conduct research on the impact of taxpayer service on compliance?

*Answer.* Determining the resource commitment required to update all components of the tax gap is a complex problem. Given the information, planning assumptions and analyses required, TAS cannot provide an accurate estimate in response to this question. The actual cost would vary greatly depending on the methods chosen to address the various tax gap components, the time frames in which the research would be done, and the commitment made to periodically refresh information to assure continued accuracy. For example, where the IRS relies on examinations to identify underreporting for a particular class of returns (e.g., individual income as reported on the Form 1040 series of returns), costs would vary depending on a variety of factors, including:

- The total number of examinations (increasing the number of examinations allows the IRS to study more subsets of the taxpaying population in isolation—e.g., EITC taxpayers, self-employed taxpayers, etc.);
- The number of examinations conducted face-to-face (as opposed to via correspondence);
- The number of issues that would not have to be addressed during the examination because they could be resolved using data available through electronic means;
- The number and kinds of analyses conducted once examination results became available (which would depend on the purposes for which the information is to be used).

This question could probably best be addressed by the IRS, based on experience to date with the National Research Program (NRP), and current planning assumptions. I do believe, however, that conducting such research is vital to increasing IRS productivity and taxpayer compliance. Each year, the IRS should identify a particular category of taxpayers—individual, pass-through, corporate, or tax-exempt—and dedicate a unit of its auditors to examining a random sample of returns. The revenue resulting from the improved selection of returns for audit should more than offset the minor reduction in audit resources used to conduct these studies. The IRS must learn to view this type of research as part of its regular tax administration activity instead of as a special activity that “distracts” its auditors from their “real” work.

Concerning the need to conduct research on how services affect compliance, as I stated above in my response to question No. 1, the IRS has very little hard data to compare the return on investment of a dollar spent wisely on enforcement against the return on investment of a dollar spent wisely on taxpayer service. In addition, the data that is available suggests that a substantial percentage of noncompliance is inadvertent. Additional research is needed to develop better information on the underlying causes of noncompliance and the degree to which different approaches, including enhancements to customer service, can improve compliance.

TAS is working with the Taxpayer Assistance Blueprint (TAB) team to develop and conduct research projects that will help identify the impact customer service has on taxpayer compliance. Several studies are currently underway that are exploring various facets of this issue, including:

- The impact of IRS return preparation on compliance;
- The impact of other customer service options on compliance; and
- The impact of high-end account resolution services on compliance.

We will be in a better position to assess the need for additional research once we have reviewed the results of these studies.

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#### QUESTIONS SUBMITTED BY SENATOR PATTY MURRAY

##### CUTTING THE IRS OFFICE RESPONSIBLE FOR SERVICE WHILE EXPECTING MORE FROM VOLUNTEER PROGRAMS

*Question.* Mr. Everson, the IRS's Stakeholder, Partnership, Education and Communication (SPEC) office has overall responsibility for community partnerships such as the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs. In recent years, this IRS office has suffered cutbacks while the number of taxpayers seeking help from by VITA and TCE for tax preparation continues to increase dramatically. Moreover, you stated recently that you expect to rely heavily on VITA programs to improve taxpayer services.

—How do you justify continuing to cut the SPEC office while giving it an increasing workload?

—Ms. Olson, what is your opinion on this matter?

*Answer.* I strongly support the VITA Program, and commend the tireless efforts of its volunteers in assisting an underserved segment of taxpayers. If the IRS wants to retain responsibility for VITA and set the standards that sites must meet, however, it must be willing to give the sites more assistance than it currently provides. The IRS must be willing to change its relationship with VITA from one that is merely supplementary, where VITA sites are providing a service the IRS is unwilling to provide, to a relationship that is complementary, where the IRS and VITA sites work together to provide a service and achieve specific goals. As the IRS considers the future of VITA, it must take a hard look at the needs and concerns of local and national partners, without whose continued support the program will cease to exist.

The IRS must also provide adequate funding for the VITA Program. From 1999 to 2004, the number of VITA sites grew dramatically from 6,000 to nearly 14,000, an increase of 8,000 sites.<sup>4</sup> From 2001 to 2004, the amount of technology support provided to the VITA Program increased only modestly, from \$2.9 to \$3.3 million, an increase of \$400,000.<sup>5</sup> In combination, technology support decreased from \$483.00 per site to \$236.00 per site on average, a decrease of more than 50 percent. Thus, aggregate funding and support provided by the IRS have not been increasing at a rate sufficient to keep up with the growth of the program. The IRS needs to determine the growth limit of the VITA Program and how to respond when that limit is reached. It must also undertake more comprehensive strategic planning regarding the future of the VITA program and the support it is providing before it continues to increase the amount of assistance it expects these sites to provide.

*Question.* The VITA program operates for only about 4 months of the year during tax season and receives limited support from the IRS. Ms. Olson, in your statement, you say that the IRS should concentrate on developing a fundamental support structure for the program and expand the program. You also say that the IRS should not let VITA or any other volunteer program serve as a substitute for IRS-provided service.

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<sup>4</sup>Stakeholder Partnerships, Education and Communication, "VITA Celebrates Its Thirtieth Year of Service"; additional information provided by the IRS.

<sup>5</sup>Information provided by the IRS. It is important to note that budget information is not available for years prior to 2001 when the VITA Program operated under the Taxpayer Education function.

Ms. Olson, why do you take that position?

Answer. As the IRS struggles with limited resources to meet the service needs of all taxpayers, we have already begun to reduce free tax preparation assistance previously provided to taxpayers. Over the past 3 years, the IRS has reduced the number of tax returns prepared in Taxpayer Assistance Centers (TACs) from 665,868 tax returns in fiscal year 2003 to a proposed 305,000 tax returns in fiscal year 2006.<sup>6</sup> To fill the gap, the IRS has increased its reliance on the VITA Program to provide free tax preparation assistance to taxpayers.

Clearly, partners are very important to effective tax administration, and I applaud the efforts of dedicated professionals and volunteers in assisting taxpayers. However, this reliance raises several concerns. First, when the IRS relies on partners to deliver a message, we need to study what happens to the message in the course of delivery. Does the message change over distance and time? Is it less accurate? Second, we need to measure the downstream consequences of this trend. What are the true costs of effective oversight over these partners? Who conducts such oversight and bears the cost? Will the IRS actually realize any savings or will it incur more expense through additional enforcement activity that could be avoided if the IRS itself delivered the assistance?

On the other hand, if we begin to rely more heavily on our partners for the delivery of services, we must also ensure that we are providing our partners with adequate support and assistance. Without a sufficient support system in place, we cannot expect our partners to act as a delivery channel for services we are unable or unwilling to provide.

While the service VITA provides is critical, the IRS cannot rely entirely on these volunteers to provide a service the IRS has deemed too costly or time-consuming to provide itself. Instead of concentrating on expanding the VITA Program, the IRS should concentrate on developing a fundamental support structure for the program, including site management, training, and quality review. Once the IRS has developed a strong infrastructure for the VITA Program and has established consistent quality in the returns prepared by volunteers, then the IRS can work to expand the program. However, the IRS must remain cognizant that VITA, or any volunteer program, cannot and should not be expected to serve as a substitute for IRS-provided service. Taxpayers have the right to expect some level of assistance from the tax agency they fund with their tax dollars.

#### SETTING TAXPAYER ASSISTANCE CENTERS (TACS) UP TO FAIL

*Question.* In a briefing last year by TIGTA on Taxpayer Assistance Centers, I learned that some TACs have as little as one or two staff, what TIGTA calls a “critical staffing shortage.” The House and Senate, Majority and Minority, said no to your proposal to cut back TACs until TIGTA completes a study on the impact of such reductions on taxpayer compliance and taxpayer services.

Mr. Everson, are you, in fact, allowing these TACs to eventually close by letting the staffing levels dwindle? Do you believe that is consistent with the direction from this committee?

Mr. George or Ms. Olson, do either of you care to comment?

Answer. The IRS is facing a challenge. It has limited resources yet also has the responsibility to serve all taxpayers. Thus, it must decide by taxpayer segment how to deliver needed services in the most effective and efficient manner possible, and in a way that does not negatively impact taxpayers’ ability to comply with the tax laws. Toward this end, the IRS must gather data and develop criteria to make those decisions. The Phase I report of the Taxpayer Assistance Blueprint (TAB) is the first step toward developing a comprehensive 5-year plan for taxpayer service that will establish a long-term strategy for delivering needed taxpayer services within existing resource limitations.

The IRS must take a close look at what services taxpayers need and want. The status quo is not necessarily what taxpayers want—it is merely what the IRS has been willing (or able) to deliver. Instead the IRS must conduct research to develop a baseline of services. Only after this research is completed will we be able to measure how effective we are in improving our ability to meet taxpayer needs and begin to study how any changes to our current service offerings will affect taxpayer compliance.

<sup>6</sup>Wage and Investment, “Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2006”; Wage and Investment, “Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2005”; Wage and Investment, “Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2004”; Wage and Investment, “Business Performance Review, Wage and Investment Operating Division, Fiscal Year 2003.”

## SERVICES OFFERED AT TACS

*Question.* Mr. Everson and Ms. Olson, why hasn't the IRS involved taxpayers who need or desire face-to-face assistance in determining what services are offered at the TACs?

*Answer.* The Taxpayer Assistance Blueprint Team (TAB), as part of its work developing a 5-year plan for taxpayer service, conducted a number of research projects designed to identify the needs and preferences of taxpayers. As part of these studies, the IRS is looking specifically at taxpayers who use the TACs to determine what services these taxpayers need. This data will hopefully allow the IRS to structure the TACs in order to best meet the needs of the taxpayers who require face-to-face assistance.

*Question.* Mr. George, your recent audit report says that prior to making decisions on closing any TACs, the IRS should ensure that it is known which taxpayers visit the TACs for assistance and why, so the IRS can determine the impact on these taxpayers and ensure alternative service deliver channels are effective in meeting the needs of these taxpayers.

Ms. Olson, I would imagine you agree?

*Answer.* Before the IRS makes any decision about altering the current services offered to taxpayers, it should study the trends in taxpayer service in order to understand the impact of taxpayer service on compliance and how taxpayers need services to be delivered. The Taxpayer Assistance Blueprint Team (TAB) conducted a number of research projects designed to identify the needs and preferences of taxpayers. One research study involves interviews with taxpayers who sought TAC services, including those who were not actually served or did not receive the service they requested. This information will be invaluable in determining taxpayer needs and preferences. However, additional research must be conducted to determine the impact of taxpayer service on compliance. This research would allow the IRS to determine how changes to taxpayer service will potentially impact compliance.

## REDUCTION OF TAXPAYER SERVICES

*Question.* Mr. Everson, last year, you:

- eliminated “TeleFile”, the ability to file taxes by telephone;
- proposed the elimination of as many as one-quarter of all walk-in Taxpayer Assistance Centers;
- proposed shortening phone assistance hours; and
- began the process to eliminate several telephone call-routing sites.

In a profile of online population, Census data indicates that in any given age group (ages 18–29; 30–39, etc.), not even one-third of adults are on-line. We know that the Nation's large senior citizen, limited-proficient English, and underserved populations are not as likely to use or have access to the internet as other forms of communication.

Given this and the digital divide at every generation, how do you rationalize the elimination of face-to-face and telephone interaction in favor of electronic communication?

Ms. Olson, does this concern you?

*Answer.* I believe the IRS should work harder to identify the best channels through which to deliver services to taxpayers. While electronic and self-assistance channels may be growing in popularity, mere use or access to these services does not necessarily mean that taxpayers are computer literate and can conduct website searches for complex tax information—much less understand how to apply that information once they find it.

Moreover, we need to understand why certain taxpayer segments have difficulties with our existing services and why they are reluctant to use lower cost channels (if indeed they are). Only then can we develop effective “migration” strategies to encourage and educate taxpayers about appropriate lower cost channels—ones that will not ultimately increase noncompliance and lead to greater downstream costs. Additionally, we must always remain cognizant that there is a segment of the population that cannot and will not avail itself of self-service options. However, by providing more self-service opportunities for taxpayers, the IRS should be able to reserve its in-person (face-to-face or telephone) interaction for those issues and taxpayers that need such engagement.

## FREE FILE ALLIANCE

*Question.* Mr. Everson, recently, the Finance Committee found that taxpayers using the Free File on-line tax return preparation services are presented with surprise fees, expensive add-ons, loan solicitations and other marketing pitches. While

there is no obligation to buy these services, the fees occur so late in the process that taxpayers may feel forced to pay them or completely redo their taxes with another vendor who may also charge fees. It is my understanding that the IRS has not conducted much research on how many taxpayers fall prey to these sales pitches.

What is the IRS doing to protect taxpayers from predatory sales pitches and do you plan to do more comprehensive research on these activities?

Ms. Olson, do you have a view on this?

Ms. Olson, you've advocated for free tax preparation on the IRS website.

Do you believe that is the only way the IRS will achieve its goal of having 80 percent of taxpayers filing electronically?

Answer. I have significant concerns about the Free File Program. It is very confusing for taxpayers to navigate, some of the participating companies subject taxpayers to an array of confusing sales pitches, and it has done very little to achieve the IRS's objective of increasing the e-filing rate. On this latter point, I note that only about 4 million taxpayers used Free File during the 2006 filing season out of approximately 135 million individual income tax returns filed—and IRS data from the prior year shows that the significant majority of Free File users filed their returns electronically in prior years,<sup>7</sup> which means that Free File's success at creating new e-filers is limited at best. As I have recommended previously, I believe the IRS and taxpayers would both be much better off if the IRS were to create a direct filing portal and to make available a basic electronic filing template on its website for those taxpayers who are unwilling to pay fees to purchase fully functional software products.<sup>8</sup>

As for navigating Free File, several experienced attorneys in my office tested each of the Free File sites in March 2006 seeking to prepare returns reflecting four fact patterns on each site. We conducted the tests partly to follow up on testing my office performed in 2004 and partly in response to a request from the staff of the Finance Committee. The goal of the testing was to determine the experience of taxpayers as they attempt to navigate the sites and prepare and file their returns through Free File products accessible through the official IRS website. The results of our tests, in my view, were disappointing.<sup>9</sup> We found that Free File is not generally an easy service for taxpayers to navigate, and it can even result in inaccurate returns. As structured during the 2006 filing season, Free File amounted to a Wild, Wild West of differing eligibility requirements, differing capabilities, differing availability of and fees for add-on products, and many sites were difficult to use.<sup>10</sup>

From an IRS perspective, the rationale for creating the Free File program was to make e-filing more accessible to taxpayers and thereby help it to achieve the congressionally-mandated goal of having 80 percent of all taxpayers filing their returns electronically. However, the relatively low usage of Free File, the remarkably low usage by new e-filers, and the decline in usage in 2006 as compared with 2005 indicate that the program is not meeting its objectives. Taking into account the additional concerns about cross-marketing of other products, the appearance that the IRS is endorsing the Free File products (notwithstanding disclaimers, taxpayers start out from the official IRS website), and taxpayer concerns about the confidentiality of their tax data, I see little justification to continue with Free File and every justification for the IRS to develop a tax preparation template and to provide free e-filing for all taxpayers—just as it does for paper filers. If the IRS template and direct filing portal are simple, accurate, and confidential, I think both the IRS and taxpayers will benefit enormously and the e-file rate will increase.

#### SUBCOMMITTEE RECESS

Senator MURRAY. This subcommittee is recessed until Thursday, May 4 when we take testimony from the Federal Aviation Administrator.

<sup>7</sup> IRS Wage & Investment Research Group 6, "Final Report: Free File Survey Analysis, Research Project 6-05-08-2-038N" 12 (Aug. 31, 2005).

<sup>8</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 471-477 (Key Legislative Recommendation: Free Electronic Filing for All Taxpayers).

<sup>9</sup> The objective of our study was to determine the existence and extent of limitations and problems that a user of the Free File sites would encounter. In some instances, the tax attorneys testing the sites found them very difficult to navigate and were unable to locate forms or answers that later testing was able to locate. Therefore, the results we describe reflect simply what our attorneys experienced and not necessarily what a site was capable of accomplishing.

<sup>10</sup> For a detailed discussion of the tests, see "Preparing Your Taxes: How Costly Is It? Hearing Before Senate Comm. On Finance", 109th Cong., 2nd Sess. (Apr. 4, 2006) (statement of Nina E. Olson, National Taxpayer Advocate, IRS).

Thank you very much.  
[Whereupon, 11:25 a.m., Thursday, April 27, the subcommittee  
was recessed, to reconvene subject to the call of the Chair.]

**DEPARTMENTS OF TRANSPORTATION, TREASURY, THE JUDICIARY, HOUSING AND URBAN DEVELOPMENT, AND RELATED AGENCIES APPROPRIATIONS FOR FISCAL YEAR 2007**

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**THURSDAY, MAY 4, 2006**

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

The subcommittee met at 9:36 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Christopher S. Bond (chairman) presiding.

Present: Senators Bond, Bennett, Stevens, Burns, Murray, Durbin, and Dorgan.

**DEPARTMENT OF TRANSPORTATION**

**FEDERAL AVIATION ADMINISTRATION**

**STATEMENT OF HON. MARION C. BLAKEY, ADMINISTRATOR**

**ACCOMPANIED BY:**

**DAVID DOBBS, ASSISTANT INSPECTOR GENERAL FOR AVIATION AND SPECIAL PROGRAM AUDITS, OFFICE OF INSPECTOR GENERAL, DEPARTMENT OF TRANSPORTATION**

**OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND**

Senator BOND. Good morning. The Senate Appropriations Subcommittee on Transportation, Treasury, Judiciary, HUD and related agencies will come to order.

It is a pleasure to welcome FAA Administrator Marion Blakey and thank her once again for appearing before us today to testify on the Federal Aviation Administration's budget request for fiscal year 2007.

Madame Administrator, no matter what concerns I raise, I want you to know that I respect your dedication and commitment to the success of FAA. There are no simple issues. I know you have committed yourself to making the FAA a model agency. I want that to be on the record, because we will have many areas of difficult questions that we need to raise and I want everybody to understand how much we support your efforts.

The administration's budget proposes \$13.7 billion in new spending commitments for the FAA, a \$560 million decrease from fiscal year 2006. While the FAA operational activities would see a 3.2

percent increase over the amount provided last year, the budget would impose a dramatic cut in Federal airport construction investment, most in funding reductions in the Airport Improvement Program.

In addition, facilities and equipment would receive \$2.5 billion which is a 0.5 percent decrease from last year, and \$607 million below the authorized level.

Nevertheless, the real cut comes from the Airport Improvement Program, which would only get \$2.57 billion, down \$765 million from last year or a 22 percent decrease and \$950 million below the authorized amount.

We have tried to make the case to the Office of Management and Budget, and anybody else who would listen, that the AIP program is critical to the future of commercial aviation in the Nation. My colleagues and I are ones who understand and use the airport services around the country and we know how important they are to the successful economic growth of our communities and the businesses, employers and employees who depend upon them.

Unfortunately, this cut means increased funding for salaries and expenses, and the hiring of air traffic controllers and safety inspectors comes at the expense of funding needed for airport investment improvements under the AIP program.

If the administration were to follow the blueprint of VISION-100, the authorizing legislation for aviation, in the same manner in which we funded needed highway improvements under SAFETEA, the AIP number for 2007 would be \$3.7 billion rather than the \$2.57 billion requested. Consequently, I need to understand the justification for this funding cut and how the administration and OMB intends to maintain a world class commercial aviation industry.

In particular, I am very much concerned about what cuts to the AIP program formula will mean specifically to the construction needs of airports, especially small airports since larger airports tend to rely on per capita passenger facility charges or bond issues to pay for their capital development.

As I understand it, the formula entitlement for primary airports would be cut by 44 percent under the budget request which would result in a drop from \$1 million to \$650,000 for primary airports.

The formula entitlement for general aviation would also cut funding for general aviation airports by 29 percent, resulting in the elimination of the current \$150,000 annual minimum per airport. In fact, many general aviation airports would lose funding altogether.

In addition, and more importantly, the Aviation Trust Fund is slowly going broke and needs real reform. This is a key issue facing Congress and I urge the administration to announce its proposal on the funding of the Trust Fund as soon as possible. These are complex issues that deserve comprehensive consideration over a significant period of time. There are no quick or easy answers.

In particular, the poor economic condition of the aviation industry has had a negative impact on the Trust Fund. Trust Fund revenues more than doubled from \$4.9 billion in 1990 to \$10.7 billion in 2000. The trend changed in fiscal year 2001 when revenues fell slightly to \$10.2 billion. In 2003 revenues again dropped slightly to

\$10.1 billion. Because aviation has remained constant, there has been a steady decline in the uncommitted balance in the Trust Fund, which stood at \$4.8 billion at the end of 2002. Over the next 2 years these funds, and any other collections, are expected to be fully spent on aviation activities.

Also, over the next 15 years, passenger boarding is expected to grow by some 15 percent, including a 30 percent growth in air transport and commercial operations. At the 35 busiest airports in the Nation, total operations are expected to grow by more than 34 percent by 2020.

While the administration is expected to propose new ways to fund the Aviation Trust Fund, we cannot afford to shortchange our commercial air needs in the meantime. We need answers to all these issues but more importantly we need adequate funding.

The bottom line is there needs to be a new approach to the Aviation Trust Fund to ensure the long-term stability and growth of the airline/aviation industry. First, all taxes that go to the Trust Fund will expire on September 30, 2007. As a result, I expect and understand the FAA has been doing outreach on alternative funding options, although I expect taxes and other fees to remain a significant part of any proposal.

While there has been a lot of pressure by the major air carriers to balance out the funding of the Trust Fund, we need to ensure that we develop a healthy balance that supports the economic viability of all aspects of the aviation industry, from small planes and general aviation to the large carriers.

This is a fragile industry, as you well know, and it must be respected. As a matter of perspective, the air traffic control system in fiscal year 2005 served some 739 million passengers and over 39 billion ton miles of freight, a number that is very difficult to comprehend because of its size.

The FAA also maintains a system of some 70,000 facilities and equipment. There are FAA operated or contract operated towers at 500 airports with the FAA responsible for inspection and certification of 220,000 aircraft and 610,000 pilots. The size and the magnitude of the aviation industry is huge and we must balance how we pay and support the industry. This is critical to the economic vitality and the growth of our Nation and its economy.

The FAA is facing many other important issues regarding oversight and administration of a number of contracts designed to modernize equipment. In particular, and this is an area of major concern to me, the FAA IG reviewed 16 major acquisitions in 2005 and found projects experience a growth cost of over \$5.6 billion from \$8.9 billion to \$14.5 billion. In addition, 9 of 16 projects had schedule delays ranging from 2 to 12 years, and 2 other projects were deferred pending further evaluation. Since the last report on these projects, the estimated cost of 6 of the 16 has increased by nearly \$1.7 billion.

More importantly, the IG recently raised concern about the FAA Telecommunications Infrastructure Contract where the FAA intends to replace seven existing FAA-owned and leased telecommunication networks with a single network that would cost less to operate. Unfortunately, we understand that costs are growing, which means that the expected savings are eroding. I think this is

a critical issue requiring your complete attention. The network needs to be implemented quickly and at a fair price if we are to make the change to save money.

In addition, there are a number of other important issues facing the FAA, including the current impasse over the air traffic controller contract. Obviously, this is a tough issue. We have a fine group of air traffic controllers who are responsible for the management of our airways and we depend upon them for safety in our flight activities. They do a great job which places them under substantial stress.

#### PREPARED STATEMENT

Nevertheless, I understand the FAA has tried to balance the contract needs of the air traffic controllers with the skyrocketing costs that have occurred under the last contract. I do not think the FAA contract proposal is a perfect document, but it appears the FAA has attempted in good faith to find a balance that is fair and equitable and ultimately this will mean savings that will free up funds for other staffing, redevelopment and capital needs. These are critical funds in a time of tight budgets.

Again, I thank you for your hard work and I look forward to hearing your testimony. I now turn to my ranking member, Senator Murray.

[The statement follows:]

#### PREPARED STATEMENT OF SENATOR CHRISTOPHER S. BOND

The Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, HUD, and Related Agencies will come to order. We welcome FAA Administrator Marion Blakey and thank her for appearing before us today to testify on the Federal Aviation Administration's budget request for fiscal year 2007. Ms. Blakey, no matter what concerns I raise, I want you to know that I respect your dedication and commitment to the success of the FAA. There are no simple issues, and I know you have committed yourself to making the FAA a model agency.

The administration's budget proposes \$13.7 billion in new spending commitments for the FAA, a \$560 million decrease from fiscal year 2006. While the FAA operational activities would see a 3.2 percent increase over the amount provided last year, the budget would impose a dramatic cut in Federal airport construction investment, mostly in funding reductions in the Airport Improvement Program (AIP). In addition, Facilities and Equipment would receive \$2.5 billion, which is a half percent decrease from last year, and \$607 million below the authorized level. Nevertheless, the real cut comes from the Airport Improvement Program, which would only get \$2.75 billion, down \$765 million from last year, or a 22 percent decrease, and \$950 million below the authorized amount.

As the administration knows, the AIP program is critical to the future of commercial aviation in the Nation. This cut means increased funding for salaries and expenses and the hiring of air traffic controllers and safety inspectors at the expense of funding needed for airport investment improvements under the AIP program. If the administration were to follow the blueprint of VISION-100, the authorizing legislation for aviation, in the same manner in which they funded needed highway improvements under SAFETEA, the AIP number for fiscal year 2007 would be \$3.7 billion, rather than the \$2.75 billion requested. Consequently, I need to understand the justification for this funding and how the administration intends to maintain a world-class commercial aviation industry.

In particular, I am very concerned about what cuts to the AIP program formula will mean specifically to the construction needs of airports, especially small airports since larger airports tend to rely on per capita passenger facility charges or bond issues to pay for their capital development. As I understand it, the formula entitlement for primary airports would be cut by 44 percent under the budget request which would result in a drop from \$1 million to \$650,000 for primary airports. The formula entitlement for general aviation would also cut funding for general aviation airports by 29 percent, resulting in the elimination of the current \$150,000 annual

minimum per airport. In fact, many General Aviation Airports would lose funding altogether.

In addition, and more importantly, the Aviation Trust Fund is slowly going broke and needs real reform. This is a key issue facing Congress and I urge the administration to announce its proposal on the funding of the trust fund as soon as possible. These are complex issues that deserve comprehensive consideration over a significant period of time. There are no easy or quick answers.

In particular, the poor economic condition of the aviation industry has had a negative impact on the trust fund. Trust fund revenues more than doubled from \$4.9 billion in fiscal year 1990 to \$10.7 billion in fiscal year 2000. The trend changed in fiscal year 2001 when revenues fell slightly to \$10.2 billion. In fiscal year 2003, revenues again dropped slightly to \$10.1 billion. Because aviation has remained constant, there has been a steady decline in the uncommitted balance in the trust fund, which stood at \$4.8 billion at the end of fiscal year 2002. Over the next 2 years these funds and any other collections are expected to be fully spent on aviation activities.

Also, over the next 15 years, passenger boarding is expected to grow by some 15 percent, including a 30 percent growth in air transport and commercial operations. At the 35 busiest airports in the Nation, total operations are expected to grow by more than 34 percent by 2020. While the administration is expected to propose new ways to fund the aviation trust fund, we cannot afford to shortchange our commercial air needs in the meantime. We need answers to all these issues, but more importantly, we need adequate funding.

The bottom line is there needs to be a new approach to the Aviation Trust Fund to ensure the long-term stability and growth of the airline/aviation industry. First, all taxes that go to the Trust Fund will expire on September 30, 2007. As a result, I expect and understand that the FAA has been doing outreach on alternative funding options although I expect taxes and other fees to remain a significant part of any proposal. While there has been a lot of pressure by the major air carriers to balance out the funding of the Trust Fund, we need to ensure that we develop a healthy balance that supports the economic viability of all aspects of the aviation industry, from small planes in general aviation to the large carriers.

This is a fragile industry that must be respected. As a matter of perspective, the air traffic control system in fiscal year 2005 served some 739 million passengers and over 39 billion ton miles of freight. FAA also maintains a system of some 70,000 facilities and equipment. There are FAA-operated or -contract towers at 500 airports with FAA responsible for the inspection and certification of about 220,000 aircraft and 610,000 pilots. The size and magnitude of the aviation industry is huge and we must balance how we pay and support the industry. This is critical to the economic vitality and growth of the Nation.

The FAA is facing many other important issues regarding oversight and the administration of a number of contracts designed to modernize equipment. In particular, the FAA IG reviewed 16 major acquisitions in 2005 and found projects experiencing a growth cost of over \$5.6 billion, from \$8.9 to \$14.5 billion. In addition, 9 of the 16 projects had schedule delays ranging from 2 to 12 years and 2 other projects were deferred pending further evaluation. Since the last report on these projects, the estimated cost of 6 of the 16 projects has increased by nearly \$1.7 billion.

Most importantly, the IG recently raised concern about the FAA Telecommunications Infrastructure contract where the FAA intends to replace 7 existing FAA-owned and -leased telecommunications networks with a single network that would cost less to operate. Unfortunately, costs are growing which means any expected savings are eroding. This is a critical issue requiring your complete attention. This network needs to be implemented quickly and at a fair price.

In addition, there are a number of other important issues facing FAA, including the current impasse over the Air Traffic Controller contract. Obviously a very tough issue. We have a fine group of air traffic controllers who are responsible for the management of our airways. They do a great job which places them under substantial stress. Nevertheless, the FAA has tried to balance the contract needs of the air traffic controllers with the skyrocketing costs that have occurred under their last contract. I do not think the FAA contract proposal is a perfect document but I do believe that the FAA has attempted in good faith to find a balance that is fair and equitable, and ultimately this will mean savings that will free up unneeded funds for other staffing needs, redevelopment and capital needs. These are critical funds in a time of tight budgets.

Again, I thank you for your hard work and look forward to hearing your testimony. I now turn to my ranking member, Senator Murray.

## STATEMENT OF SENATOR PATTY MURRAY

Senator MURRAY. Thank you very much, Mr. Chairman, for calling this hearing and I join you in welcoming our FAA Administrator, Marion Blakey, before the subcommittee this morning.

Commercial aviation is a critical part of our national economy and our future. In 2004, the U.S. civil aviation sector generated \$1.37 trillion of output, supported 12.3 million jobs, and created \$418 billion in personal earnings. That represents almost 9 percent of overall employment in this country, and in my State that percentage is even higher.

Having a strong aviation sector requires a strong FAA that guarantees safety for all users. The FAA must ensure the safety of every flight, of every airplane part, and of the system overall. That requires a well-trained and fully staffed workforce of safety inspectors and air traffic controllers, and modern equipment.

As I review the current status of the FAA and the agency's financial needs, I am sorry to say this Department deserves a much better budget. It also needs strong leadership and closer attention from this Congress.

The Bush administration is seeking to cut the FAA by more than \$560 million, almost 4 percent in direct appropriations. When you include all of the proposed funding rescissions in the President's budget, that cut rises to \$937 million or 6.8 percent. The biggest cut proposed by the administration is a whopping \$750 million cut in capital investment in our Nation's airports.

We know that passenger boardings are expected to grow by 60 percent over the next 15 years. That means we should be investing more. But instead, the Bush administration wants to cut our support for America's airports.

Mr. Chairman, thanks to your leadership, we have rejected cuts in airport capital investments in the past but we have not been successful in fending off all cuts within the FAA's budget, such as cuts to modernize our outdated air traffic control system.

This year the Bush administration seeks to cut modernization by \$50 million, and that comes on top of much larger cuts in prior years. If we accept the President's level for air traffic control modernization, we will have cut modernization by \$518 million, or 17 percent, in just the last 5 years.

I must confess to being enormously frustrated with the way this administration has handled the FAA and its budget needs. My frustration stems in part from the administration's effort to play a continuing game of hide the ball when it comes to the budgetary realities of this agency.

For the last several months, I have been asking for very simple answers to some very simple questions. It was not until this subcommittee actually scheduled hearings with the Transportation Secretary and the FAA Administrator that we have been able to get any answers. And then the Secretary's answers have contradicted the administrator's answers.

For example, I have been asking, of the hundreds of aircraft safety inspectors that are expected to retire this year, how many will the agency be able to hire to fill those vacancies? Those safety in-

spectors represent some of the most critical air safety positions in the entire agency.

We have received numerous reports from the Inspector General and the Government Accountability Office that we need more inspectors and better training because more domestic airlines are doing their aircraft maintenance overseas. It is a sad fact of life that at the present the FAA does not even have the manpower or ability to inspect some of the facilities that are conducting these critical maintenance activities.

When I asked this question of Secretary Mineta back on March 16, he told me the Department was going to be in a position to hire the 238 safety inspectors that we called for in our appropriations bill. But just this past Friday the Administrator told us to expect about 30 percent fewer inspectors to be hired.

So with all the requirements placed on our flight safety inspectors, their number will still be well below the level the Agency had back in 2003.

Similarly, for months I have been asking how many air traffic controllers the FAA will be able to hire to make up for the hundreds of controllers that are expected to retire this year. Here again the Secretary gave me one number, the Administrator gave me another. The Secretary told me he would be funding the 1,249 controllers that were called for last year. The Administrator is now telling me that we should only expect 930.

These disconnects highlight my concern that the administration does not have a real plan for dealing with the looming retirement crisis both in the inspector and controller workforce.

Back in December 2004, the FAA released this multi-year controller staffing plan. At the time, the FAA assured us that this plan would be renewed annually and updated for market conditions and actual retirements. We were assured this plan would not be ignored by OMB and would not grow dusty sitting on a shelf. We were told the administration was committed to updating the plan every year and funding it.

Well, now it is May 2006. The annual update for this plan was due more than 6 months ago and we still do not have it. The absence of this plan cannot be blamed on the fact that the FAA and the controllers do not have a contract. That should not influence this plan. To me, it is simply inexcusable that this critical safety plan is being ignored.

The fact that the agency cannot afford to hire enough inspectors or controllers does not come as a complete surprise to me. There are a number of funding shortfalls that undermine the FAA's ability to hire enough staff. A small part of the problem is that Congress approved a larger pay raise than the agency budgeted for.

A much larger part of the problem is that despite my efforts and the efforts of several other Senators, the Congress imposed a 1 percent across-the-board cut on all agencies, including the FAA's operation accounts. These across-the-board cuts have become some kind of annual ritual and they occur because the Republican budget resolutions impose an unrealistic ceiling on agency funding.

Last year was no different. Despite the fact that the Transportation Treasury Bill included enough funding to hire enough controllers and inspectors at the level called for by our subcommittee,

the Defense Appropriations Bill then cut all accounts by 1 percent. With the large operating account the FAA has, that 1 percent cut had a real impact.

I must commend the FAA Administrator for sounding the alarm on this possibility. She sent me and the other managers of this bill a letter expressing her worry about the potential impact of another across-the-board cut. I was sufficiently concerned that I took to the Senate floor in December to warn my colleagues against imposing an across-the-board cut. I specifically cited the potential impact of this cut on the FAA's ability to hire sufficient safety staff.

In fact, I put Administrator Blakey's letter into the record for all of my colleagues to see. Unfortunately, my speech and the Administrator's letter were not sufficient to spare the FAA from the across-the-board cut. And now we are seeing the results when it comes to critical safety staffing.

So Congress is part of the problem here, but not all of the problem. A large share of the responsibility lies with the way the FAA has failed to manage major procurement projects. The FAA has had a long history of wasting millions and sometimes billions of dollars on mismanaged procurement for which the taxpayer and the flying public have gotten very little or inadequate results.

Recently we received an Inspector General's report indicating that this pattern still persists. The report made clear that the FAA's efforts to modernize its telecommunications infrastructure are way behind schedule and over budget. And I will discuss that in greater detail later.

The IG found that if the FAA had managed these projects effectively it would have saved \$33 million last year in operating funds and more than \$100 million this year. Those operating savings would have been more than enough to fully fund the FAA's controller staffing plan and would have hired enough safety inspectors to get us back to the 2003 level. But because the FAA mismanaged these projects, it never enjoyed the savings and its critical safety needs are now being shortchanged.

#### PREPARED STATEMENT

So Mr. Chairman, I believe this agency deserves a better budget, it deserves better leadership from the Secretary on down, it needs better management when it comes to these multimillion dollar procurements, and it needs better attention from this Congress. Only then will the flying public know that this system is truly safe.

I look forward to working with you to achieve all of these objectives. Thank you, Mr. Chairman.

[The statement follows:]

#### PREPARED STATEMENT OF SENATOR PATTY MURRAY

Commercial aviation is a critical part of our national economy and our future. In 2004, the U.S. civil aviation sector generated \$1.37 trillion of output, supported 12.3 million jobs, and created \$418 billion in personal earnings. That represents almost 9 percent of overall employment in this country, and—in my State—that percentage is even higher.

Having a strong aviation sector requires a strong FAA that guarantees safety for all users. The FAA must ensure the safety of every flight, of every airplane part, and of the system overall. That requires a well-trained and fully-staffed workforce of safety inspectors and air traffic controllers and modern equipment.

As I review the current status of the FAA and the agency's financial needs, I am sorry to say that this department deserves a much better budget. It also needs strong leadership and closer attention from this Congress.

The Bush Administration is seeking to cut the FAA by more than \$560 million—almost 4 percent in direct appropriations. When you include all of the proposed funding rescissions in the President's budget, the cut rises to \$937 million or 6.8 percent.

The biggest cut proposed by the administration is a whopping \$750 million cut in capital investments in our Nation's airports. We know that passenger boardings are expected to grow by 60 percent over the next 15 years. That means we should be investing more. But instead, the Bush Administration wants to cut our support for America's airports.

Mr. Chairman, thanks to your leadership, we have rejected cuts in airport capital investments in the past, but we have not been successful in fending off all cuts within the FAA's budget—such as cuts to modernize our outdate air-traffic control system.

This year, the Bush Administration seeks to cut modernization by \$50 million. That comes on top of much larger cuts in prior years. If we accept the President's level for air traffic control modernization, we will have cut modernization by \$518 million or 17 percent in just the last 5 years.

I must confess to being enormously frustrated with the way this administration has handled the FAA and its budget needs. My frustration stems in part from the administration's effort to play a continuing game of "hide the ball" when it comes to the budgetary realities of this agency.

For the last several months, I have been seeking very simple answers to some very simple questions. It was not until this subcommittee actually scheduled hearings with the Transportation Secretary or the FAA Administrator that we have been able to get any answers. And then, the Secretary's answers have contradicted the Administrator's answers.

For example, I've been asking: Of the hundreds of air safety inspectors that are expected to retire this year, how many will the agency be able to hire to fill those vacancies? These safety inspectors represent some of the most critical air safety positions in the entire agency. We have received numerous reports from the Inspector General and the Government Accountability Office that we need more inspectors and better training because more domestic airlines are doing their aircraft maintenance overseas.

It is a sad fact of life that, at present, the FAA does not even have the manpower or ability to inspect some of the facilities that are conducting these maintenance activities.

When I asked Secretary Mineta about this back on March 16, he told me the department was going to be in a position to hire the 238 safety inspectors that we called for in our appropriations bill. But just this past Friday, the Administrator told us to expect about 30 percent fewer inspectors to be hired. So with all the requirements placed on our flight safety inspectors, their number will still be well below the level the agency had back in 2003.

Similarly, for months I have been asking how many air traffic controllers the FAA will be able to hire to make up for the hundreds of controllers that are expected to retire this year. Here again, the Secretary gave me one number, and the Administrator gave me another. The Secretary told me he would be funding the 1,249 controllers that were called for last year while the Administrator is now telling me that we should only expect 930.

These disconnects highlight my concern that the administration doesn't have a real plan for dealing with the looming retirement crisis both in the inspector and controller workforce. Back in December 2004, the FAA released this multi-year controller staffing plan. At the time, the FAA assured us the plan would be renewed annually and updated for market conditions and actual retirements. We were assured this plan would not be ignored by OMB and would not grow dusty sitting on a shelf. We were told the administration was committed to updating the plan every year and funding it.

Well, it is now May 2006, the annual update for this plan was due more than 6 months ago, and we still don't have it. The absence of this plan cannot be blamed on the fact that the FAA and the controllers still do not have a contract. That shouldn't influence this plan.

To me, it is simply inexcusable that this critical safety plan is being ignored. The fact that the agency cannot afford to hire enough inspectors or controllers does not come as a complete surprise to me. There are a number of funding shortfalls that undermine the FAA's ability to hire enough staff.

A small part of the problem is that Congress approved a larger pay raise than the agency budgeted for. A much larger part of the problem is that, despite my efforts, and the efforts of several other Senators, the Congress imposed a 1 percent across-the-board cut on all agencies, including the FAA's operations account.

These across-the-board cuts have become an annual ritual. They occur because the Republican budget resolutions impose an unrealistic ceiling on agency funding. Last year was no different. Despite the fact that the Transportation, Treasury bill included enough funding to hire enough controllers and inspectors at the level called for by our subcommittee, the Defense Appropriations bill then cut all accounts by 1 percent. With the large operating account that the FAA has, that 1 percent cut had a real impact.

I must commend the FAA Administrator for sounding the alarm on this possibility. She sent me and the other managers of this bill a letter expressing her worry about the potential impact of another across-the-board cut. I was sufficiently concerned that I took to the Senate Floor in December to warn my colleagues against imposing an across-the-board cut.

I specifically cited the potential impact of this cut on the FAA's ability to hire sufficient safety staff. In fact, I put Administrator Blakey's letter into the record for all my colleagues to see. Unfortunately, my speech and the Administrator's letter were not sufficient to spare the FAA from this across-the-board cut. Now, we are seeing the results when it comes to critical safety staffing.

So Congress is part of the problem here, but not all of the problem. A large share of responsibility lies with the way the FAA has failed to manage major procurement projects.

The FAA has had a long history of wasting millions and sometimes billions of dollars on mismanaged procurements for which the taxpayer and the flying public have gotten very little or inadequate results.

Recently, we received an Inspector General's report indicating that this pattern still persists. The report made clear that the FAA's efforts to modernize its telecommunications infrastructure are way behind schedule and over budget. I will discuss this in greater detail later.

The IG found that if the FAA had managed these projects effectively, it would have saved \$33 million last year in operating funds and more than \$100 million this year. Those operating savings would have been more than enough to fully fund the FAA's controller staffing plan and would have hired enough safety inspectors to get us back to the 2003 level. But because the FAA mismanaged these projects, it never enjoyed the savings, and its critical safety needs are now being shortchanged.

So in summary, Mr. Chairman, I believe this agency deserves a better budget, it deserves better leadership from the Secretary on down, it needs better management when it comes to these multi-million dollar procurements, and it needs better attention from this Congress. Only then will the flying public know that the system is truly safe. I look forward to working with you to try to achieve all of these objectives.

Senator BOND. Thank you very much for your candid comments, Senator Murray.

I will see if our other colleagues have brief opening statements. Senator Bennett.

Senator BENNETT. I do not, Mr. Chairman.

Senator BOND. Senator Burns.

Senator BURNS. No, sir. Proceed.

#### STATEMENT OF SENATOR BYRON L. DORGAN

Senator BOND. Senator Dorgan.

Senator DORGAN. Mr. Chairman, I will be very brief.

I wanted to mention, we have an Energy Committee hearing that I have to attend, but to Administrator Blakey, we have an issue in Bismarck, North Dakota with respect to the movement of the radar.

As you know, the original FAA plan was to purchase the ASR-11 radar in 2003 and deploy it by 2006. As a result of that, Bismarck took a number of actions. We have a blind spot in the radar in Bismarck that was to be updated with the ASR-11 order.

They also took action to begin developing the Northern Plains Commerce Center, which has an impact on the radar. And so they took action expecting that radar to be deployed by 2006.

Now we are stuck and that has slipped. I would like to continue to work with you and your staff to find a way to solve the peculiar problem that exists in Bismarck.

Let me mention one other point, if I might. I am concerned about this issue of the air traffic controller situation and the contract dispute. I know that you have sent it to the Congress on April 5. If no action is taken then you impose your own set of circumstances.

I do not like the way that is set up. I know that is set up in law, but I also know they have indicated they want to come back and continue to negotiate on the three items that you said were at an impasse.

I want a good air traffic control system. I want the controllers to be fairly paid, and I want them to be professional, and I want that system to work well. I think the American people do as well.

I would much prefer to see a circumstance that it go to binding arbitration with a good panel to take a look at it.

But however this ends up, I think the current circumstance is pretty well stacked against the controllers. I expect Congress will likely not take action. I expect there is plenty of energy here to block action. So the result is you will end up simply imposing your decision to begin cutting salaries. And that troubles me a great deal. I do not think that is the way we are going to end up with a good system.

So Administrator Blakey, I want you to succeed in your job. But I wanted to mention both of these issues, both of which I am concerned about.

Senator BOND. Thank you very much, Senator Dorgan. As I understand it, the FAA recommendation is a generous increase in salaries and not a cut, but we will allow the Administrator to make her opening comments.

And then I am going to turn to my ranking member for her questions because she has to go to the floor and I will allow her to ask her—

Senator MURRAY. I am happy to have you go first on questions and I can go second.

Senator BOND. No, no, I want you to get your questions out there first.

Senator MURRAY. He wants the supplemental out on the floor.

STATEMENT OF HON. MARION C. BLAKEY

Senator BOND. Madame Administrator, thank you.

Ms. BLAKEY. Thank you.

Chairman Bond, Senator Murray, Senator Dorgan, Senator Bennett, Chairman Burns of our Aviation Subcommittee, I am delighted to see all of you this morning. And thank you very much for the opportunity this represents to talk about the FAA's fiscal year 2007 budget request.

You are absolutely right, Mr. Chairman, the aviation industry is facing numerous challenges at this time and we strive to maximize our resources so that we can continue to operate and maintain the

very safest and most efficient air transportation system in the world. And we are very proud of doing that.

#### SAFETY

Our safety record is impressive by any standards. In terms of sheer numbers alone, over 2 billion passengers have traveled on our system over the last 3 years. That is seven times the population of this great Nation.

In fact, the fatal accident rate is at an all-time low. It is the diligence of the entire aviation community and the oversight of committees such as this one that make all of this possible. Our pilots, flight attendants, mechanics, inspectors, controllers, engineers, technicians, they all have contributed to this really phenomenal achievement.

The President's \$13.7 billion budget for 2007 addresses our needs. About 70 percent of that money goes to maintain and advance the safety of the system. You will also be pleased to know that the vast majority of our capital investment programs are on track and on budget. I sense we need to do a better job communicating with this committee about recent achievements on that front and we will do so. We are running the FAA much more like a business and we are seeing real results.

#### PROMISING TECHNOLOGY

Our 2007 budget provides significant increases for two promising technologies that will serve as critical platforms for the next generation air transportation system, Automatic Dependence Surveillance Broadcast or ADS-B, and Systemwide Information Management or SWIM.

The capabilities of ADS-B have already been demonstrated in the field. It provides the automatic broadcast of aircraft position, altitude, velocity and enhanced visibility not just of aircraft but of vehicular traffic, for pilots and air traffic controllers alike. It also uses GPS, which further reduces our reliance on ground-based infrastructure.

Another innovative program is our Systemwide Information Management, SWIM for short. In essence, we are creating an aviation Internet to move information within the FAA and to other Government agencies faster, better, cheaper. Much like the world wide web revolutionized American commerce, SWIM lays the aviation information superhighway. It is going to lead to dramatic improvements in air transportation safety, security and capacity.

#### AVIATION TRUST FUND

However, just as the chairman has noted, the FAA must remain focused on a much larger issue, and that is the Aviation Trust Fund. It is a constant reminder that unless we address this challenge and provide the Agency with a funding mechanism that is both reliable and consistent we will be unable to meet the needs of the flying public.

Simply put, we need a funding stream that is linked directly to the actual cost of what it takes the Federal Government to serve the business of aviation. Right now we are tied to the Airport and

Airway Trust Fund. The Trust Fund receives revenue from aviation excise taxes, including a domestic segment tax, an international passenger tax, and commercial and general aviation fuel taxes.

But the primary source of income for the FAA's operations and capital accounts is a 7.5 percent tax on the price of commercial airline tickets. Obviously, with the advent of the low-cost carriers, low-cost tickets are great for all of us. But the price of those tickets has fallen dramatically. Competition has increased. And our revenue stream has suffered.

At the same time, we see rising passenger levels and more planes in the sky as airlines fly a greater number of smaller jets and the workload of the FAA will go up accordingly. Our costs go up without a corresponding boost in revenues.

As I have said before, we might as well tie our funding to the price of a gallon of milk.

The taxes that fuel the Trust Fund will expire on September 30, 2007. That may sound a bit of a way off at this point but history shows otherwise. Secretary Mineta and I continue to place a very high priority on finalizing our proposal. It is undergoing review right now at the most senior levels of the administration and I am confident resolution is just around the corner.

#### MORE LIKE A BUSINESS

As you know, in striving to operate more like a business, we are constantly pushing to stretch our resources. Our business plans mirror the industry we serve. We have reorganized our entire air traffic services organization, cutting multiple levels of senior management, reducing our executive ranks by 20 percent. We have streamlined operations, eliminating and consolidating administrative staffs and support functions.

Perhaps the single greatest impetus to operate like a business is our need to design, deploy and pay for the next generation system. Our existing infrastructure will not be able to handle the doubling or even potentially tripling of traffic that we know is coming.

Under the leadership of Secretary Mineta, we are building a plan for the future system with four Cabinet-level agencies all combining their expertise. Unless a consistent and cost-based revenue stream is established to pay for it, this effort will likely be for naught. As it is, the agency is headed toward a balancing act among competing resources. Do we cut back on air traffic services? Do we slow the course of modernization? Do certification efforts for new aircraft take a slow roll? Those are choices none of us want to make.

#### NATIONAL AIR TRAFFIC CONTROLLERS ASSOCIATION

Now I would be remiss if I did not mention one of the largest issues on our plate currently, and that is our contract with the National Air Traffic Controllers Association, NATCA. Over 9 months of negotiation, including 4 weeks of mediation, the controllers union consistently refused to offer meaningful changes in the current pay structure to address the long-term affordability of their contract. Our proposal protects the existing workforce. It grandfathers the salaries and benefits of controllers already on board and preserves 82 percent of their premium pay, on average.

We also bring the salaries of new controllers into line with other employees of the agency, reversing a trend that under the current contract has caused the pay differential to more than double.

At the end of 2005, the average compensation package for our existing controllers, salary plus premium and benefits, is about \$166,000 a year. Our proposal? Our proposal pushes that to \$187,000 by the end of the agreement.

New hires in training start at an average of just under \$37,000 in base and locality pay, but get to over \$93,000 with premiums in 5 years. Quite a generous pay package by anyone's standards.

In 1996 Congress put in place the law that requires any contract impasse to be sent to the Hill before the agency can implement its proposal. As much as we did not want to do that, when NATCA refused to address the core issues our proposal was sent to Congress for a 60-day review. Unless Congress chooses to act, on June 5 we will be in a position to implement our proposal.

As I have said before, we cannot and will not sign a contract we simply cannot afford.

In closing, with the broad scope of the issues that face the agency, the Trust Fund, modernizing the system, safety, the new contract for our controllers, it is clear that the FAA must continue to find new ways operate more like a business.

#### PREPARED STATEMENT

You have my firm commitment that we will continue to deliver the world's safest and most efficient form of transportation while doing so.

Thank you very much.  
[The statement follows:]

#### PREPARED STATEMENT OF MARION C. BLAKEY

Chairman Bond, Senator Murray, members of the subcommittee, it is my pleasure to appear before you on behalf of the men and women of the Federal Aviation Administration (FAA) on our fiscal year 2007 budget request. Before discussing the request and the agency's short-term needs, I would like to highlight briefly our efforts to ensure the agency's long-term financial viability.

The FAA's long-term financial outlook depends largely on the Airport and Airway Trust Fund (AATF or Trust Fund). Each year, the FAA receives appropriations drawn from the Trust Fund and from the General Fund. This year, about 82 percent of FAA's total budget will come from the Trust Fund and 18 percent from the General Fund. The Trust Fund receives revenues from several aviation excise taxes—including a domestic segment tax, an international passenger tax, and commercial and general aviation fuel taxes. However, the primary source of income for the Trust Fund is a 7.5 percent tax on the price of commercial airline tickets. While the sharp decline in airline ticket prices has been good news for consumers over the last several years, it has made the Trust Fund vulnerable due to its heavy reliance on the ticket tax. At the same time, FAA's workload and operating costs continue to rise due primarily to operational changes in the aviation industry. These changes include the increased use of smaller regional jets and business jets, both of which generate less revenue per flight for the Trust Fund than larger airline jets. Consequently, there is currently no nexus between the workload of providing air traffic services and how they are funded.

In recent years, appropriations from the Trust Fund have been funded not only from the annual revenue and interest going into the Trust Fund, but also from drawing down the uncommitted balance of the Trust Fund, which was over \$7 billion in 2001. In fiscal year 2005, the uncommitted balance of the Trust Fund was \$1.9 billion and the President's fiscal year 2007 budget projects that it will dip to about \$1.7 billion at the end of this fiscal year, less than 2 months of FAA spending at our current rate.

As you know, all the taxes that go to the Trust Fund will expire on September 30, 2007. During the past year, we have worked closely with our stakeholder community to explore other financing alternatives. Under Secretary Mineta's leadership, we conducted a broad outreach to the aviation community to explore funding options that would be in the long-term best interest of the traveling public, the aviation industry, and the FAA. In my view the comments we received have greatly informed our decision-making. I look forward to discussing the specifics of the administration's funding proposal as soon as it is finalized.

As I've often stated over the past year during our outreach, our belief in the need for funding reform for the FAA is not fundamentally about generating more money for the FAA. It is about creating a stable and predictable funding system that provides appropriate incentives to users and to the FAA to operate more efficiently and facilitating modernization of the aviation system on a more rational, equitable, and predictable basis.

#### PERFORMING LIKE A BUSINESS IN FISCAL YEAR 2007

The FAA operates 24 hours a day, 7 days a week, 365 days a year. We run a multi-billion dollar air traffic control system that in fiscal year 2005 served 739 million passengers and over 39 billion cargo revenue ton miles of freight. We operate and maintain a system comprised of more than 70,000 facilities and pieces of equipment. There are FAA-operated or contract towers at 500 airports, and we are also responsible for inspection and certification of about 220,000 aircraft and 610,000 pilots. We have some 43,000 dedicated government employees working to serve the traveling public and the businesses that depend on a reliable air transportation system.

When Congress mandated the FAA to realign its operations and manage more like a business, we rose to the challenge. The FAA's efforts over the past 3 years have paid real dividends, not just to the flying public but to the taxpayer as well. By implementing improved management tools, including better cost accounting systems and instituting a pay-for-performance program, we have made more efficient use of our resources. The tangible results are reflected in our fiscal year 2007 budget request of \$13.7 billion. This is a reduction of \$561 million, or 4 percent less than the fiscal year 2006 enacted level. The request upholds our commitments to increase the safety, capacity, and efficiency of the national aviation system.

The fiscal year 2007 budget provides \$8.4 billion for our Operations account and reflects the FAA's rising labor costs and aviation industry challenges. Most of the funds requested for FAA operations in fiscal year 2007 support our paramount goal of maintaining and increasing aviation safety. It also reflects our continuing efforts to control our operating costs while maintaining the safest aviation system in the world.

#### CONTROLLING COSTS

Our business and budget planning activities are more closely aligned than ever, and they both include explicit cost savings initiatives. Each organization must include at least one cost reduction activity in its annual business plan, which is then reviewed by the management board monthly for progress. These identified cost savings and avoidance initiatives are integral to FAA's strategy to absorb budget shortfalls (e.g., unfunded pay raises and rescissions).

The agency's emphasis on bottom-line results has not been easy. The FAA has slashed costs where possible and slowed the rate of growth of our labor costs through productivity improvements and reducing overhead, as well as reducing management layers. We also continue to apply effective management and financial principles to our labor negotiations. The simple fact of the matter is that we cannot and will not sign a contract the taxpayer cannot afford. As you know, we are at an impasse with NATCA, the union representing our controller workforce. Since 1998, the first year of the current NATCA contract, the increasing imbalance in compensation between NATCA and the rest of the agency has cost the taxpayer a total of \$1.8 billion. Neither the FAA nor the taxpayer can afford a repeat performance.

The FAA and NATCA began negotiations to replace the current agreement in July 2005. Despite extensive negotiation over 9 months, including 4 weeks of mediation with the Federal Mediation and Conciliation Service, we failed to reach agreement on several of the key proposed articles affecting compensation, benefits, and work rules. Therefore, as required by law, we transmitted our proposal, along with NATCA's proposals and objections, to Congress on April 5, 2006.

Long-term affordable pay structures are only a part of the equation. In addition, we are taking steps to achieve savings of 10 percent by fiscal year 2010 in controller staff costs through productivity improvements. We achieved the first 3 percent of

this goal in fiscal year 2005 which avoided about \$23 million in costs last year. This fiscal year and in fiscal year 2007, we project a minimum of a 2 percent productivity improvement each year.

In December 2004, the Agency submitted our Air Traffic Controller Workforce Plan to Congress. We are updating the Plan, which will be released soon. This plan provides a comprehensive 10-year strategy to make sure we have the right number of controllers in place at the right time to address the controller retirement bubble. Our funding request of \$18.2 million is consistent with the targets being developed for the updated staffing plan and will enable us to meet the future needs of the National Airspace System.

#### A-76 COMPETITION

This year, we completed the largest non-military A-76 competition in Federal Government and will see the first installment of cost savings—\$66 million—in fiscal year 2007. The Agency's network of automated flight service stations, which provide weather guidance and other assistance to the pilots of small airplanes, will be reduced from 58 to 20. The contract not only saves money, it also commits the vendor to modernize and improve the flight services we provide to general aviation pilots. In addition, the employees who left Federal service as a result of this transition were given offers to work for Lockheed Martin, the successful bidder of the contract.

#### PRIORITIZING FACILITIES AND EQUIPMENT (F&E) NEEDS

We are requesting \$2.5 billion for F&E to improve and modernize the airspace system. We are also scrutinizing our capital investments, revisiting business cases, and eliminating programs whose benefits no longer justify the costs. We are increasing our emphasis on programs that will save the agency money.

We are making similar inroads with equipment. In fiscal year 2005, we removed 177 obsolete navigation aids from service, which saved the taxpayer about \$2.7 million. This year, we plan to remove 100 more, followed by another 100 in 2007. We are taking steps to save wherever possible. The removal of these land-based navigation aids is consistent with our long-term goal of transitioning to satellite-based navigation.

#### KEEPING PACE WITH TODAY'S CHALLENGES

Our resources and activities are closely linked with the dynamic industry we oversee and serve. The pace and depth of change in aviation is unparalleled. Business models evolve as rapidly as the technology changes: markets once dominated by wide body aircraft are now giving way to smaller jets. Entrepreneurs now are marketing microjets, which may one day become the "personal taxi" of the sky. Fractional ownership is making it easier for businesses to own and operate aircraft.

Although our recent forecasts show a decline in operations from last year to this year, air travel now exceeds pre-September 11 levels and remains on track to carry more than 1 billion passengers by fiscal year 2015. Even with the financial shake-up in the airline industry, all major forecasts project the long-term demand for air travel will outstrip existing capacity. After a temporary drop this year in projected operations at airports with FAA or contract towers, we forecast an average annual growth of 2 percent in terminal and a 3 percent growth for en route/oceanic operations from 2005–2017.

#### ENSURING A PATHWAY TO THE FUTURE

The future portends a wide range of aircraft with divergent infrastructure, air traffic management, regulatory, and procedural requirements. We must be prepared to support a system that includes the Airbus Double Decker A380 and the microjet (and everything in between). We must be able to support airlines, large and small, national and regional. Recognizing that aviation represents about 9 percent of the U.S. Gross Domestic Product, we must provide this infrastructure in time to keep the Nation's economy growing while controlling the costs of that system.

We are laying the foundation for our future with a commitment to increasing the system's capacity to accommodate the air transportation system's predicted growth. We will meet these future needs by harvesting new technologies that will support the Integrated National Plan for the Next Generation Air Transportation System (NGATS). This plan, submitted to Congress in December 2004, brings together four cabinet-level agencies and NASA in the Joint Planning and Development Office (JPDO) to eliminate duplication and wasted resources. The plan is a road map that will leverage Federal funds and allow us to provide the national aviation system that can handle the safety, capacity and security needs of the future. For the FAA,

the plan will drive discussions about the: (1) size, role, and training needs of our workforce; (2) number of facilities maintained by the FAA; (3) transition from ground-based to satellite-based systems; and (4) redesign of airspace. For the FAA, the plan is already being incorporated into our budget. Specifically, the 2007 budget supports two cornerstones to the next generation air transportation system and begins to build this new infrastructure by committing to Automatic Dependent Surveillance Broadcast (ADS-B) and System Wide Information Management (SWIM).

The budget requests \$80 million for ADS-B—a technology that has already provided benefits in the field. ADS-B provides: (1) automatic broadcast of aircraft position, altitude, velocity, and other data; (2) enhanced “visibility” of aircraft and vehicle traffic for pilots and air traffic controllers; and (3) use of Global Positioning Systems, allowing us to reduce our reliance on ground-based infrastructure. Implementation of ADS-B throughout the national airspace system will reduce infrastructure costs, increase capacity and can have significant safety benefits as shown in the Alaska context, where this technology has already been fielded as part of a demonstration project. Some safety improvements result because ADS-B provides more complete coverage in remote and mountainous terrain than traditional radar-based surveillance systems.

The backbone for the future system is an information network that can provide better data to more decision-makers—whether it be the controller, the pilot or the other agencies dealing with security or national defense. The FAA’s request of \$24 million for SWIM will begin to make these advanced information distribution and sharing capabilities possible. Every year, FAA builds applications for air traffic management systems that require unique interfaces between the new application and existing systems. SWIM will replace those unique interfaces with a reusable interface and provide many operational benefits (e.g., common situational awareness, standardized information security, and more cost-effective security implementation).

#### FLIGHT PLAN 2006–2010

One of the major reasons we are confident in our stewardship of the FAA is our Flight Plan. The Flight Plan is FAA’s rolling 5-year strategic plan that we first undertook in 2004. As scheduled, we updated it last fall, with input from our internal and external stakeholders. The Flight Plan is organized around the agency’s primary goals: increased safety; greater capacity; increased U.S. international leadership; and organizational excellence. It is our blueprint for managing the agency. It serves to focus our efforts on what is most important to our stakeholders.

The plan has made the FAA more businesslike, more performance-based, more customer-centered and more accountable. It is dynamic, adaptable, and cost-driven. Most “strategic plans” are distinguished only by their place on a dusty bookshelf. Our Flight Plan is costed out and contains specific measures and targets that we track monthly at the most senior levels of our agency. It has become our marching order toward success. Our goal is to become more accountable to the taxpayer, and we work hard every day to reach it.

As part of our Flight Plan, each FAA organization now has its own individual business plan. Each of these plans is linked to the Flight Plan, budgeted and tied to what the customers need. The agency’s business plan goals have been built into a performance-based tracking system that are posted to the FAA website each quarter. It lists each of the agency’s goals, performance targets, who is responsible, and the status of each. Using this data, the senior management team conducts a monthly review of our performance. When used with other cost and performance data, the Flight Plan information clearly and precisely identifies the effectiveness of a program across the entire agency. With this perspective, the agency is able to capitalize on successful strategies. Let me address our performance and budget requests under each of our goals.

#### INCREASED SAFETY

As I noted earlier, safety remains our No. 1 priority and our No. 1 success story, with the trends in both commercial and general aviation showing consistent improvement. The safety record we have achieved for air carriers is a remarkable accomplishment, which our entire workforce—inspectors, engineers, technicians, and controllers—shares with the broad aviation community. Over the past 4 years, 3 billion people have traveled safely in the air transportation system—that’s 10 times the population of the United States.

Safety is not only a top public interest priority, it is also an economic necessity. People fly only if they feel safe. They must trust the system and their trust must

be upheld. Although commercial aviation is in the safest 3-year period in transportation history, safety requires more than no accidents.

The fiscal year 2007 budget reflects the agency's steadfast commitment to safety. Out of a total request of \$13.7 billion, about 70 percent, or \$9.6 billion, will contribute to our efforts to improve our already historic safety record. This includes further progress in reducing commercial and general aviation fatality accidents, and the number of runway incursions and HAZMAT incidents. Our overarching goal is to constantly improve aviation safety.

To increase aviation safety oversight commensurate with expanding activity and the introduction of new aviation equipment and business practices, the budget requests \$18.5 million for additional staff and technical training. Within this total, \$8 million is requested to add 101 aviation safety inspectors to strengthen our safety oversight of the aviation industry. The request also funds 32 additional positions for the Air Traffic Safety Oversight office—a recently established office under the Associate Administrator for Aviation Safety with the responsibility for providing an independent safety oversight and review of the Air Traffic Organization (ATO) operations.

Our efforts to run the FAA in the most effective and efficient manner are further reflected in our NAS Plan Handoff Program. Under this program, we transition capital assets from their deployment under the Facilities and Equipment (F&E) appropriation to operation and maintenance under the Operations appropriation, in accordance with generally accepted accounting principles (GAAP). Full funding for NAS Plan Handoff in our Operations appropriation allows us to provide for the operations, maintenance, and training for these new capital assets, and addresses congressional and GAO criticisms about covering the operating costs for new systems in F&E for an indefinite period.

#### INCREASING CAPACITY

While safety is our primary concern, our mission includes expanding capacity throughout the aviation system—both in the air and on the ground. The fiscal year 2007 budget requests \$3.1 billion to expand capacity and improve mobility. This request supports expansion of capacity on the ground with new runways, as well as the continued deployment of new technologies for increasing the efficiency of the existing system.

Beginning in fiscal year 2005, FAA worked with our industry and government partners to deliver two key technologies: Domestic Reduced Vertical Separation Minimum (DRVSM) and Advanced Technologies and Oceanic Procedures (ATOP). DRVSM alone, by increasing en route capacity and the ability to avoid severe weather, is expected to result in savings for the airlines that could reach \$5 billion through 2016. These two technologies helped operators participate in reduced separation standards and will allow them to fly more aircraft in a given airspace and the most fuel-efficient route safely.

FAA continues to develop criteria and guidance materials that will be used for new area navigation (RNAV) and required navigation performance (RNP) routes and procedures. Use of RNP permits greater flexibility and standardizes airspace performance requirements. By adopting RNAV and RNP and leveraging existing and emerging cockpit capabilities, the FAA in collaboration with the aviation community will be able to improve airspace and procedures design, leading to increased capacity and improved efficiency.

The fiscal year 2007 budget also includes \$375.7 million to continue the En Route Automation Modernization (ERAM) initiative. This is a critical program that replaces obsolete hardware and software of the main host computer system that is the backbone of en route air traffic operations. The most significant ERAM benefits are improved efficiency, capacity, and safety by providing controllers with newer, faster, and more capable technology to manage the continuing growth in air traffic. The modern en route automation system will also accommodate the development of functions that are expected to provide significant savings to users through more fuel efficient routes, reduced flight times and delays, and increased controller productivity.

In today's challenging budget environment, we have been forced to take a long hard look at all of our funding requirements. Our fiscal year 2007 budget request for Grants-in-Aid to Airports is \$2.75 billion, which is lower than recent authorized and enacted levels. Nevertheless, under our proposed budget, FAA will be able to support all high priority safety, capacity, security and environmental projects. There will be adequate funds to meet all current and anticipated Letter of Intent (LOI) commitments, which relate to high priority, multiyear projects within the national system. The President's fiscal year 2007 budget includes support of major capacity projects such as the Chicago O'Hare redesign, a new runway at Washington Dulles

International Airport and major projects at Atlanta-Hartsfield International. We will also be able to fund projects to meet the FAA's Flight Plan goal for improving runway safety areas (RSAs), help airports obtain security equipment and facilities required to meet their Transportation Security Administration (TSA) security requirements, and continue work on phased projects.

#### INTERNATIONAL LEADERSHIP

Today, the FAA has operational responsibility for about half of the world's air traffic. We certify nearly three-quarters of the world's large jet aircraft. We have provided assistance to more than 100 countries to help them to improve their aviation systems. Safety may be our most important export. Even so, we still must become even more globally focused to ensure that U.S. citizens can travel safely around the world. We also must continue to be a catalyst for the harmonized implementation of safety and capacity enhancing technology around the world. The fiscal year 2007 budget requests \$35.5 million to support international leadership and global connectivity.

It is clear the FAA's role in advancing the international leadership of the United States in aviation goes well beyond the borders of the Far East and Latin America. The numbers and the activity point to the need for a global approach to aviation and we are working to shape that destiny. We are working together with all our key regional partners to identify the next generation of air traffic management technologies and practices. The agency believes that together we can create a road map for the global community. To give us the safety tools that we need, we are working to negotiate and sign Bilateral Aviation Safety Agreements with key countries around the world. These agreements benefit everyone—passengers, the Agency, and the aviation industry. Also, through our efforts with other International Civil Aviation Organization members, we will continue to develop and implement global safety and certification standards to improve efficiency and trade.

#### ENVIRONMENTAL STEWARDSHIP

As we increase capacity, we've been careful to ensure environmental responsibility. The fiscal year 2007 budget requests \$391.2 million to support environmental stewardship for noise mitigation, fuel efficiency enhancements, and a comprehensive approach to addressing both noise and emissions.

#### SECURITY

While the U.S. Department of Homeland Security's TSA now has primary responsibility for transportation security, the FAA still retains responsibility for the security of its personnel, facilities, equipment and data. FAA provides financial and other assistance to help airports meet security requirements. Security projects required by statute or regulation carry the highest priority for AIP funding. The agency works closely with TSA and other Federal agencies to support aviation security, transportation security, and other national security matters.

FAA insures the operability of the national airspace system through the facilities, equipment, and personnel of the air traffic control system, which is essential to the rapid recovery of transportation services in the event of a national crisis. The budget request includes \$173 million to continue upgrading and accrediting facilities, procure and implement additional security systems, and upgrade Command and Control Communications equipment to meet the increased national security demands since the September 11 attacks.

#### ORGANIZATIONAL EXCELLENCE

To fulfill our mission the FAA must become a world-class organization. The agency is committed to finding and eliminating barriers to equity and opportunity. We believe that fairness and diversity fortify our strength. Further, we must give our staff the tools and resources they need to overcome the challenges we face and to become more accountable and cost-efficient. In turn, our employee compensation and salary increases are becoming increasingly performance-based. This allows the agency to pay for results and reward success.

In simple terms, our objectives are to: strategically manage our human capital; improve our financial performance; and control costs while delivering quality customer service. The fiscal year 2007 budget requests \$437 million for organizational excellence initiatives.

In support of the President's Management Agenda (PMA), we're making significant strides in improving our financial management. Over the past several years, we have made increased progress in making cost control a priority throughout FAA.

We have implemented information tools and processes to manage costs and productivity. Last year marked our fifth year of receiving a clean audit from the Department of Transportation's Office of the Inspector General. For the third consecutive year, the FAA has received the Certificate of Excellence in Accountability Reporting. This year we are wrapping up the consolidation of nine separate accounting operations into a single Finance Center located in Oklahoma City, Oklahoma. The benefits we see from this effort include annual cost savings on accounting operations, standardization of accounting practices, and improved quality and timeliness of financial information.

Ongoing improvements in financial performance will focus on providing more timely and accurate financial information used by management to inform decision-making and drive improved results in FAA operations. Planned business process improvements will focus on quicker capitalization of our projects, streamlined processes for managing agency reimbursable agreements, and training and improvement efforts to reduce financial data quality problems.

In particular, the FAA is planning to improve the utilization of information from Delphi, the DOT financial management system. Delphi gives the FAA more accurate financial data and allows the agency to better manage its spending on operations as well as capital investments in assets that will ensure the safety of the airways. To improve operational efficiency in accounting operations, imaging capability for invoices will be added to the Delphi system for fast and efficient payment processing.

Each year, the FAA procures more than \$1.3 billion in contract services. The newly created Office of Financial Controls will implement increased controls over agency procurements. It will ensure that funding used for contract services reflect wise investments, duplication of effort is avoided, and excessive labor rates are not included in contracts. Any procurement request resulting in contract award or increase in the scope of an existing contract, where the total value of the contract or added work exceeds \$10 million, will be thoroughly reviewed by the Office of Financial Controls before it is processed.

#### CLOSING

In closing, let me assure you that we continue to make difficult choices and take decisive steps to ensure that we manage the taxpayer's investment wisely. We are running more like a business and delivering the world's safest transportation system while doing so. I thank you for your time and look forward to discussing these issues in greater detail.

Senator BOND. Thank you very much, Madame Administrator. And now we turn to Senator Murray for her questions.

Senator MURRAY. Mr. Chairman, thank you so much for accommodating me and I do have a few questions I want to get in before I head to the floor.

#### AIR TRAFFIC CONTROLLER WORKFORCE PLAN

Administrator Blakey, the FAA, as I said in my opening remarks, published an air traffic controller workforce plan back in December 2004. And at that time you promised in very clear terms that this workforce plan would be updated annually.

It is now May and we have yet to see an update of that annual plan. And if we receive one at all this year it will be at least now 6 months late. How are we to believe that the administration has an updated workforce plan when it is unwilling to release it? And can you tell me why we have not received it yet?

Ms. BLAKEY. Well, there are a couple of things about this. No. 1, it is going to be an annual plan. There is about 4 months' slippage. We had said we would bring one out for this year. And it is in final clearance right now. So there is no issue about providing an annual plan.

What I do think makes sense though is this: as you know, the plan last year was the first time we had done that. And you learn a lot from these things. One of the things that we determined was

that that plan was based on a forecast that now is more than two forecasts back. It is very dated data that was in that plan because of the timing of the way we did it.

Senator MURRAY. Which is why we are waiting for one.

Ms. BLAKEY. Because the annual forecast comes out in March and we have revised the controller staffing plan and all the models based on that. As I say, it is in final clearance. So as you can appreciate, we are talking about a couple of months after the forecast.

We will try to make it closer to March next year but right now you should see it shortly.

Senator MURRAY. When is the date that we will see that then?

Ms. BLAKEY. I do not know an exact date because, again it is in final clearance within the administration. But I think—

Senator MURRAY. Are we talking days or weeks?

Ms. BLAKEY. Something like that, yes.

Senator MURRAY. Not months?

Ms. BLAKEY. I cannot, again, commit other people. But I can tell you that it is certainly a matter of weeks, at most.

Also, as you know, we have provided you a lot of the key data out of the plan. So I do not think there are any surprises there.

#### AVIATION SAFETY INSPECTORS

Senator MURRAY. In March, Secretary Mineta testified before us that the FAA would be able to hire an additional 238 safety inspectors, in spite of the 1 percent across-the-board cut and in spite of the unfunded pay raise. But last week you told us the FAA would actually be able to hire only 171 inspectors.

If the FAA is going to be hiring 171 additional inspectors this year, your staffing level is going to be below the level we had in 2003. Are you comfortable with that level of staffing?

Ms. BLAKEY. I think it is important to look at the way we are approaching this because, as you know, you pointed out yourself, that we were handed a 1 percent across-the-board rescission in December, well after all those figures were developed and planned. Plus, of course, the unfunded pay raise.

It is important to look at how much money was involved there because the rescission itself was overall for the FAA \$144 million. The unfunded pay raise was not a small thing. It was \$37.9 million, almost \$38 million, and it resulted in a shortfall of \$182 million.

Now we have been scrambling since that occurred. And again, that was at the end of year on the rescission, to try to figure out: Are there any ways that we can reallocate funds and we can try to address what is clearly a shortfall?

There are no if, ands or buts about it. This does not surprise anyone. We would love to have made that 238 figure, if we could have. And we tried very hard. But the best we could do was to ask you all, and the request is now coming up to you, the Secretary has just signed off on this, that we have reprogrammed or are requesting to reprogram monies from all of our other small staff offices. And we are using the authority that you all have granted us for unobligated funds from previous years, which would give us the ability to pull the number up to 171 for this year.

Senator MURRAY. Let me ask you that again. I know all the reasons why. But as Administrator of the FAA, are you comfortable with the staffing of safety inspectors for the flying public?

Ms. BLAKEY. You will see, again, that we are requesting more for 2007. And that certainly tells all of us, we need more safety inspectors.

Senator MURRAY. So I take it your answer is no?

Ms. BLAKEY. I am simply saying there is a very strong reason we are going to continue to increase the safety inspector ranks. And a lot of that is the dynamic that we see growth in a number of key areas that are really coming at us and we have to address that.

Senator MURRAY. The DOT IG testified earlier to us this year that the staffing gains over the next couple of years are unlikely to offset the number of safety inspectors that are eligible to retire. By 2010, in fact, half of the inspector workforce is going to be eligible for retirement.

You claim you have a comprehensive staffing plan to handle the retirements of air traffic controllers, even though we have not seen it yet. I wanted to know if you have a similarly comprehensive plan to handle the retirements among inspectors? And is OMB committed to funding that?

Ms. BLAKEY. OMB has been very responsive and cooperative on the issue of our safety inspectors and that workforce, the manager of our safety programs has a very exact idea about how many we need to hire of what. So we have those figures. We have it on paper.

It is not a large published plan in the same way that the controller staffing plan is. But we can make it a more formal document if that would be helpful to this committee.

Senator MURRAY. I think we need that information.

Ms. BLAKEY. Absolutely. We have the information and we can turn it into a formal plan if that would be helpful.

#### FAA TELECOMMUNICATIONS INFRASTRUCTURE (FTI)

Senator MURRAY. Okay. And you mentioned in your opening statement the replacement of the telecommunications infrastructure, and that you needed to update us. I want to give that opportunity.

Because as I said in my opening statement, that program was supposed to achieve hundreds of millions of dollars in savings that would have helped us with much of the current situation. And at the start of the program in 1999 it was supposed to cost \$1.9 billion. We are now being told it is going to be 27 percent higher than that at \$2.4 billion. And the DOT IG has told us it is going to cost even more. So we are not going to receive any savings on this in the foreseeable future, as I can see it.

What can you tell us to give us your personal assurance that we are not going to continue to see this story?

Ms. BLAKEY. The FTI contract, which is the capital investment program that you are referring to, of course, is the notable exception to the success we are having across the board in staying on schedule and on budget on all of our major capital investment projects. So I would point that out.

That said, it is a contract to convert all of the FAA's legacy telecommunications networks to a network that is based on a service rather than an owned and operated business and pull it all into one unified system.

It is a major logistics challenge, I will be straight up about this. And it has proven challenging to us.

Now, we have put in place a recovery plan that we are seeing good results on. It still has a way to go. I will not make any bones about that. And I am as disappointed as anyone that we are not going to be seeing the cost savings over the existing contract that we had hoped and expected to this year. But that is what we are talking about here. We are talking about savings over the existing contract. These are savings that are deferred.

What we are doing at this point is putting in place new metrics to start measuring all four stages. This is just as the IG has requested that we do. You referenced the fact that the IG has just brought out a report with recommendations. I think they are very good recommendations. They have given us very good advice on ways to more precisely track and measure the exact progress we are making on all four stages of the implementation.

We were looking at it initially on the first stage, and I think we need to track all four in a master plan that we are putting in place.

Senator MURRAY. You will probably get asked about this again. If you could get us really solid information, so we can see that we are not going to continue to see the same line going up on that, I would appreciate it.

Ms. BLAKEY. We will work very hard. As I say, this is a challenging contract. But we are working very hard to hit the numbers.

#### MORE LIKE A BUSINESS

Senator MURRAY. Let me ask you, in your testimony you said that you are operating more like a business in part because you have instituted a pay-for-performance program. And you have also proposed eliminating automatic pay raises for air traffic controllers, arguing that their pay increases should depend on performance on their job.

Last year, however, the FAA awarded performance bonuses to 11 senior employees based, in part, on their work on this FTI program. These bonuses were awarded at the same time the program was falling behind schedule and racking up costs. Can you explain why you gave these executives performance bonuses for deficient work product?

Ms. BLAKEY. Well No. 1, the bonuses that were there were only in part, only 15 percent, related to the FTI contract. As I mentioned before, we are hitting our numbers on our major acquisition projects, which these executives are responsible for as well. There are a number of major capital investment programs that I am very proud, such as ERAM, that are absolutely on track and on schedule. So the bonuses are related to a much larger body of work than FTI.

I also would point out that the contract initially was set up in tracking metrics on site acceptances. That is the very first stage of four stages of the FTI program. In that regard, we put in place a

recovery plan. And as of August 2005, we really began hitting our numbers on that.

Now, I do not think that is the key metric. What we have done, because I think the issue of performance in regard to the FTI contract, needs to be measured on all four aspects: site acceptance, service acceptance, when you actually cut over to the FTI network, and when you disconnect the legacy system. So all four of those benchmarks, if you will, are now built in to these executives' performance for this year.

#### NATCA

Senator MURRAY. Let me ask one final question here.

The negotiations with NATCA has been mentioned several times here, and I believe that Congress should not be the venue for settling these kinds of contracts. But my objections do not change the fact that if Congress does not act to reverse your action in the next few weeks, your proposal for the final contract will be automatically put in place.

That, in fact, will be the second time the FAA will have succeeded in resolving a dispute by those means, and I am concerned that we see a pattern emerging here where if the FAA does not get what it wants at the bargaining table it just submits it to Congress and counts on us not acting.

FAA negotiates with 43 different bargaining units and many of these employees do not make six-figure salaries. Can you tell us, are we going to expect to see all of our future labor negotiations handled this way?

Ms. BLAKEY. I certainly hope not. It is one reason why I feel so strongly that it is important that the mechanism that Congress rightly put in law for how an issue of this sort is resolved is one that Congress and all of us involved see through because it is an important way to balance what is an extraordinarily unusual privilege in government, and that is that the FAA is virtually unique in negotiating for pay with its employees.

Other Federal agencies throughout the Government all are under the Civil Service or pay systems that involve no opportunity to negotiate for pay.

Senator MURRAY. I assume you can understand that the morale of many of the employees is directly impacted by the fact that—

Ms. BLAKEY. Senator Murray, I would refer you to a couple of things. Our pay scales at the FAA, on average, and I am going beyond the controllers, are somewhere between 8 and 14 percent above market. That is something that is worth being aware of because it is reflected. When we have our employee attitude surveys, 70 percent of the FAA's employees across the board are very satisfied with their pay.

Senator MURRAY. I appreciate the remarks and I do have other questions I would like to submit for the record. Mr. Chairman, thank you so much for accommodating me so I can get to the floor. And thank you, Administrator Blakey.

Senator BOND. Thank you, Senator Murray. We will submit those questions for the record.

Now we will turn to my colleagues; first, Senator Bennett.

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

Madame Administrator, welcome. Thank you for your service.

AVIATION TRUST FUND

I am impressed with your ability to respond to questions and your control of the detail. I have to get nostalgic for just a minute with your conversation about the Aviation Trust Fund, Airport Airway Trust Fund. It was my responsibility, as a member of the team under Secretary Volpe, to convince the Congress to pass the creation of the Airport Airways Trust Fund back in 1969. I was the head of Congressional Relations at the Department of Transportation and that was my first responsibility.

I remember the glee with which Secretary Volpe called Secretary Nixon to tell him that we had succeeded in getting that passed, the first item of President Nixon's must-do list of legislation to pass the Congress. I went to the White House, had got my pen, and my picture taken with the President, and all the rest of it.

Now I come back, basking in that nostalgia, to have you tell me it is not working anymore.

I am perfectly willing to agree that it is not working anymore and the question is: "What are we looking at as a replacement?" You say, in your prepared testimony, that you have reached out to the industry and you are getting suggestions. Can you share with us some of the suggestions? Because I, with that background, and listening to you also, share the idea that the FAA should have a reliable source of funding. That was the whole idea behind setting up the Trust Fund in the first place, not have it subjected to the whims of the appropriations process.

Now that I am an appropriator, I guess I like the appropriations process better than I did. But tell us what avenues you are pursuing as ways to go and places to look for some kind of stability in this situation.

Ms. BLAKEY. The Trust Fund, as you and others set it up, I think very wisely at that point in time, worked very well for a long time. We have to remember that was before deregulation. And I do not think anyone could have anticipated at that point the dramatic changes in the airline industry and the plummeting price of tickets. So tying it to the price of a ticket at that point had a lot of relationship, I think, in those days to traffic volume and a variety of things.

The situation now, I think, that we are faced with is one that virtually all of the stakeholders do acknowledge that the lack of relationship between costs and revenue produces a lack of accountability on both sides. The stakeholders ask for whatever they think they need but there is no issue of really how much it costs and that would affect, therefore, what they are charged and vice versa.

So what I am seeing as the general aviation community, as the airlines, as the manufacturers, cargo folks all come in, is I think a real acknowledgment that we do need reform in terms of the Trust Fund.

Senator BENNETT. I understand all of it. Now where are we looking? You say facetiously it could be tied to the price of a gallon of milk. I am sure you are not looking at that as a way to do this. What specifics are people suggesting to you as a way to go?

Ms. BLAKEY. I think what a number of people are suggesting is this: for parts of the community, a system that takes into account all of the activity in the system, numbers of flights, the usage of the air traffic control system, there are several ways to measure that. But you can run that activity data and you can show the usage of it by individual carrier or by stakeholder group. So there is a way which is done all over the world in a variety of ways to tie it to fees. And a fee-based system can be a part of the answer.

Taxes, fuel taxes are also not as direct a measure of costs. But they work well for the general aviation community. I think there is much more support for fuel taxes coming from that group.

Senator BENNETT. Let me ask you one very parochial question, and this comes up every time we have an FAA Administrator before the subcommittee, so it is not going to surprise any of your staff.

We are looking for an additional ASR radar system in Utah County, just south of Salt Lake County, to cover the blind spot. And we finally convinced the FAA to put one in during the Olympics, when we had a tremendous number of general aviation flights coming in. And because of the horror of having an accident occur in the Olympics, with that kind of traffic, they put one in.

Now I advised them this may be a temporary radar, sink it as deep in concrete as you possibly can and surround it with a high fence. But it has disappeared now and we still need it. There is an increased use of regional jets that you are talking about. Salt Lake International Airport has seen an increase in traffic volume. This is a blind spot that we still need to have filled. And I take advantage of this opportunity to mention it to you once again and ask you to take a look at it.

Ms. BLAKEY. Thank you very much. I certainly will.

Senator BENNETT. Thank you, Mr. Chairman.

Senator BOND. Thank you very much, Senator Bennett.

Now we will turn to Senator Stevens.

Senator STEVENS. Thank you very much. Administrator Blakey, it is nice to be here with you again.

#### SAFETY IN ALASKA

I am constrained to say it looks as if this budget was prepared before the current attack on earmarks commenced. Let me just lay out a little problem I have.

When the deregulation of CAB took place, Senator Cannon was chairman of the Commerce Committee and we reached an understanding. Before that time the FAA managed all of the airports in Alaska. We took over a considerable number of them. But the rural airports, roughly 160 of them, who serve small native villages were to receive under \$150,000 annually for maintenance and light control and that sort of thing.

This is the first time that those funds have not been requested. There is a reduction of \$22.9 million, which adds up to \$150,000 for 159 small airports.

Secondly, our skies, as you know, have been the most dangerous skies in the world. Previously, in Alaska one out of 11 pilots have died annually. We put into effect several safety programs and I do commend you. You certainly have been one of those who has helped

us considerably. But the Medallion Program, which you and I helped establish, and which the Federal contribution was \$5 million last year, has been zeroed out.

In the period of time right at the beginning of this administration, you recall that a foreign airliner coming towards Alaska intersected the dust from one of the volcanoes along our chain and dropped about 20,000 feet before one of the engines was started. We established an Alaska Volcano Observatory. It is not only for local Alaska. It is for the planes that fly over our State. Your agency has contributed \$5 million a year to that observatory. That has been zeroed out.

We have the Loran-C system for the northwest coast of the Pacific. Again, it is not really for Alaskans. It is for all the users of the North Pacific. This is the last station to be upgraded in that system, the Loran-C system. It has been zeroed out. There was \$17.5 million last year for that.

Now my problem is, all of those are aviation-related, aviation safety-related. But when I add the money back in, if I can be successful in convincing this subcommittee to do that, it is an earmark and it is going to be attacked as an earmark. And none of them really—well just the one, the first one, with 159 small villages are Alaska-specific. Those are very important to Alaska. The rest are national expenses that are necessary to meet our United States' obligation to those who fly into or out of our airspace.

I am really worried about the prospect that puts upon those of us who represent Alaska the duty of trying to reverse those budget cuts and be under attack again about earmarks.

I really cannot ask you questions. I basically know where you are coming from. You had no alternative. But we have no alternative either to find some way to get that money back in there.

There have been other cuts, one of them is the Capstone Program which again I thank you for your visit. You have come up and helped us recognize those people who have been part of that technology-focused safety program that have reduced the deaths in our State to where we are about the average now of aircraft accidents, despite the fact that 70 percent of our cities can be reached only by air. The Federal Government's assistance to that air system is less than any one city in the United States gets from the Highway Fund. We do not get money from the Highway Fund up there. We only get money from aviation.

And I want to urge you to go back and talk to someone in the OMB and ask them if they understand that.

Our people contribute rather heavily to the aviation funds because every time we get in an airplane we pay another \$5 towards that safety fund. And I have not heard very much reason why we should do it when we are flying planes that do not ever come near the size of the planes that were used in 9/11.

But in any event, I really cannot justify the cutting of these Alaska-related aviation programs that are essential to safety. I would urge you, and I cannot even ask you a question, but I would urge you to talk to them about this. Even our Aid to Airports Program this year, it dropped \$21.3 million in 2006 and now it is going to drop another \$10 million in 2007. And yet, as I said, we have the

greatest demand on the aviation system per capita of any Americans.

I just leave it before you and before the record. I do not know the answer to my questions. The only answer to my questions really is money. I do not see much leeway in this budget to even ask my friend from Missouri to take money from somewhere else and put it in these funds. The funds are safety-related, I think. It is the worst example of budget cutting I have seen in 38 years.

I think unless there is a budget amendment coming up here, it is going to be impossible to restore that money. And I predict without the Alaska Observatory for Volcanoes, we are going to be right back where we were to start with. Those volcanoes are active right now as we speak. And one of them, as you know, just stopped spewing out its smoke and debris just last month.

I would hope you would go back and ask them to review what is going to happen to Alaska under this program.

And I would tell the chairman, I really do not think I am going to be too cooperative as far as this bill is concerned until there is some change made in the FAA budget that affects my State.

Senator BOND. Thank you very much, Senator Stevens, for that good news. As we said earlier, I am very much concerned about this budget and on a number of issues and I think this is an area where the Office of Management and Budget has not dealt well with what is very important to all of us, and that is air safety. Having flown in Alaska, on occasion, I understand the concerns you have there.

Madame Administrator, Senator Bennett raised the question about getting something other than the Airport Trust Fund. It looks like the administration is trying to find some way to raise money that is outside the appropriations process. Obviously, those of us who are appropriators have a lot of issues that are very important and we would miss this opportunity to discuss those with you.

What is the official administration position on why you would want to get out of the appropriations process?

Ms. BLAKEY. I will tell you, Mr. Chairman, there is not an official administration position on this. If there were, we would have a proposal before you right now that we could be discussing.

As you can appreciate, trying to restructure the taxes and fees that support the Aviation Trust Fund is difficult to do, particularly if we are trying to make very substantial changes. I cannot tell you that there is consensus on this right now or that there is a position with regard to the specific issue you raise.

I can absolutely put forward the fact that it would be my expectation that the appropriators will have a very healthy role in whatever system is put forward. I think there is no question about the fact that that would be the view of this administration.

Senator BOND. Obviously, we are just going on the Wall Street Journal article of February 4, so I am glad to know there is no official position.

Ms. BLAKEY. Not at this point.

## AIRPORT IMPROVEMENT PROGRAM

Senator BOND. Would you explain the rationale for the part of the budget that would minimize the funding for airports, especially small airports, which would lose the majority of funding? What is the justification for the proposed cuts that would impact both small and large airports? And will this not result in projects underway being stopped or reduced?

Ms. BLAKEY. Yes, and I would appreciate it if the record could show that we are very supportive of the safety programs in Alaska, as Senator Stevens listed those, and the needs of small airports all over the country. Particularly Alaska has some real safety challenges that we hope to address in other ways.

What we are faced with on the AIP funding is simply the reality of the budget climate overall. It was extremely difficult to continue to match the levels of authorization that were put forward several years ago for the Airport Improvement Program without continuing to reduce the funding in F&E, which is the capital investments and modernization.

And at this point we are doing everything we know to control our operating costs, which of course goes to the importance of the contract negotiations. But they still continue to escalate. So, in that universe, where we have real demands on the Federal budget because of broader issues that I know you all know all too well, we had to make some tough choices. And that is really what this comes down to.

In terms of the reason for the drop, and for the smallest airport elimination, of the \$150,000 a year, it is because the way the program is set up in statute when you drop below \$3.2 billion appropriation, \$3.2 billion, the formula changes. And at that point it does eliminate funding for the smallest airports on a formula basis.

Now last year, when we were in a position where that was an issue, we suggested that the Congress, in fact, could change the law on that and therefore not have the small airports drop below the salt if you will.

The other thing I would point out is this, that we do have, of course, discretionary funding available for airports of all sizes. And safety programs take the highest priority for those discretionary funds. So there is a mechanism for the very small airports to come in and request support for various safety needs that they do have.

Senator BOND. I am very much concerned over this and I understand the situation that you are in. But the low cost and regional carriers have 43 percent share of the air traffic market, while regional carriers represent 37 percent of the traffic at the Nation's 35 busiest airports. Yet the top 35 airports are nearing capacity. They handle 73 percent of aviation passengers, a significant percentage of instrument operation. And the costs and delays are going to increase without a major growth in capacity.

## INCREASED CAPACITY

Is there anything you can do to increase capacity? And without increased funds in the AIP program, is there any way to meet the growing needs? And what do you see as the overall funding need to meet the anticipated growth of the airline passenger traffic?

Ms. BLAKEY. Well, I will certainly say this, that the very strong record of funding for AIP has resulted in a remarkable number of new runways coming on board. The capacity that those runways have generated is certainly serving to relieve a great deal of the congestion at major places such as Atlanta, Cincinnati, and Miami. I could tick through the major runways. And of course, the major project that is now going on at O'Hare. This will certainly make a big difference.

I would say that the AIP funding that we have put forward will continue to be able to honor all of those major letters of intent for these big projects and the runway projects that are planned currently.

That said, there are several things that we are doing or have done that make a big difference procedurally. I would reference the fact that we are changing the way we use the airspace and that is generating huge fuel savings for the carriers.

Just in this last year, we reduced the vertical separation in the upper airspace. This was a major leap forward. The airspace now is 1,000 feet vertical separation as opposed to 2,000, which created a lot more lanes in the sky.

What this has meant is that carriers now have much more efficient routing. They are able to be in the optimal points in terms of jet stream and direct routing that they could not have before. As we look at this over time, over the next 10 years, that is conservatively worth over \$5 billion in fuel saving.

The new system we put in over the Atlantic and Pacific, over the oceans, is reducing separation, and we have new airspace routes in places like Atlanta, which again are giving enormous fuel savings to carriers like Delta because they are able to fly very precise routes in and out.

So all of that is immediate, near-term, and it is mattering. And then, of course, the next generation system that we are bringing on, and we have requested before this committee funding for both ADS-B and SWIM, which are going to be backbone technologies for really achieving a satellite-based system, which will be highly efficient.

Senator BOND. Thank you. I will turn now to Senator Durbin for questions.

Senator DURBIN. Thank you, Mr. Chairman.

Administrator Blakey, thanks for being here and thank you for your service to our country.

I said when you came by my office, and I would like to say publicly, I think you do an exceptionally good job.

Ms. BLAKEY. Thank you.

Senator DURBIN. You are hard-working and skillful and bright and responsive. And you answer phone calls and I appreciate that very much.

Ms. BLAKEY. Thank you.

#### MIDWAY ACCIDENT

Senator DURBIN. So thank you for your service.

Let me ask you first about Midway Airport. We had a terrible accident there last December where a plane skidded off the runway in a snowstorm and killed a young boy in a car that rode nearby.

We love that little airport. It is not so little, but we love that airport and it is surrounded by neighborhoods. And we are trying to make it safer.

I have worked with the city of Chicago on an EMAS technology, a soft concrete technology that would slow an aircraft down if it overruns the runway. They have an application before you at the FAA. Can you tell me what the status is?

Ms. BLAKEY. I can tell you that we are working very closely with Midway on this. We have just received the final aspects of the specs on that proposal for the EMAS system and I expect us to move very expeditiously on it.

EMAS has proven its worth in a number of airports around the country where you do not have as much land for the runway safety areas. I think Midway will be a very good application of that. So we are glad that you have worked with the city and we have that before us, so we will work very quickly on resolving it.

#### NATCA

Senator DURBIN. Let me talk about air traffic controllers, which we did in my office, and we had a long conversation about your concerns and the state of negotiations.

I can recall a time when my predecessor in the Senate, Paul Simon, created the concept of incentive pay because we could not find air traffic controllers to take certain positions. And so we created salary incentives for them to move to areas where the job might be a little more demanding. And now I understand you are phasing out the incentive pay as part of your budget proposal.

I am concerned about it in this respect. When we talked in our office about hiring future air traffic controllers, I believe you told me that you were going to try to return to 1997 salary levels. Is that a figure that you recall?

Ms. BLAKEY. The 1998 Civil Service spectrum that adjusted for all of the increases that have occurred in the civil service salaries since then. So it is not those levels. It is a framework.

It also is tied to professional salaries for people like engineers, pilots, et cetera, at the FAA. So there is some adjustment on that, but yes, that is roughly closely approximate.

Senator DURBIN. Let me show you a chart that I am going to give you a copy of so that you can take a look at it and perhaps get back to the committee.

I took a look at some of those 1997 levels for facilities around Illinois and see that there is a rather substantial cut that has been proposed, in terms of the pay structure, that is even lower than the 1997 levels.

If you can see, for Moline for example, the \$55,360 and the proposed salary level was \$44,750. And the list goes on. My concern, I want you to take a look and see if there is something missing here, if there is an element that we should be considering in this.

But my concern goes back to my original point. I do not think we should assume automatically that there are lots of people who want to be air traffic controllers and have the skills to do the job and want to take the toughest assignments. We found in the past that sometimes that is not the case. I worry if the starting salaries

that we are talking about here are a cutback from levels that we had 8 or 9 years ago.

I would like you to address that, if you would.

#### CONTROLLER PAY

Ms. BLAKEY. I cannot speak to exactly those without doing the analysis and which I would be very happy to do. I can tell you that salaries that we have proposed are ones that begin for the entry-level, developmental controllers, coming in with the salary and locality pay on average, base salary \$31,700. Put in the locality pay and you are up to about \$37,000, which by most people's standards, for someone coming right out of school with no experience is good—and by the way, as you know, for the first several years of a controller's service, it is mostly about training. So you have that prospect there.

But after 5 years, on average, the base salary for controllers, with locality pay, is going to be about \$84,000 a year. Now that is a pretty generous wage by almost anyone's standards. You put on the premium pays, and I am just talking about average premium pays here, and you are well up into the \$90,000's.

You put on the benefits, because as you know there is an enhanced retirement plan for controllers, average compensation for the new hires—and this is average—is \$127,000 a year.

Now I have not had anyone suggest to me so far that we will have any difficulty recruiting and retaining the best and brightest. I was anecdotally just at one of the collegiate schools up at La Guardia Airport that trains new controllers to come into our academy. And when I explained the proposal and what the benefits were, the only questions I got was were: "Are you sure you are going to keep up the hiring? How quickly are you going to be hiring more? And we are really looking forward. Where can we expect to be positioned?"

That is the nature of the questions.

Senator DURBIN. Has there not been a period over the last several years where we did not hire though?

Ms. BLAKEY. There was. And therefore they are hoping that we are going to keep up a steady state of hiring. And I was able to assure them that we absolutely will, that they are looking forward to a boom in hiring at the FAA on an ongoing basis for many years.

#### NATCA

Senator DURBIN. As I said to you in my office, and I will say in closing here, I really hope that there is a way that you can work out a negotiated settlement with the air traffic controllers. I think it would be a terrible outcome if this is dumped in the lap of Congress to decide. There are too many factors involved in this, and frankly the information from both sides conflicts in some areas and it is tough for us to sort it out.

It would be far better if you could reach agreement with a group that the FAA needs to work closely with for the years to come. So I hope that that happens.

Ms. BLAKEY. We would very much have liked to have had a voluntary agreement on this, believe me. I wish that there had been a way to close this gap because it was a very difficult one, \$600

million just in the 5 years of the contract. But most importantly, the ability to adjust our pay scale for the new hires. We keep the existing controllers financially whole. But for the new hires, so that they have a fair wage that we can provide salary increases as the years go on, and they are equitable to the rest of the FAA's workforce.

Senator BOND. Thank you very much, Senator Durbin.

Senator DURBIN. Thank you.

#### FAA TELECOMMUNICATIONS INFRASTRUCTURE

Senator BOND. We have unfortunately just a few more minutes. I want to go into several questions I raised earlier, for example, the FAA Telecommunications Infrastructure.

The FTI is critical. I understand that it consists of 25,000 telecommunications services at over 4,400 FAA sites. The Harris Corporation is a prime contractor and the contract has a minimum value of \$303 million.

But the FAA is critical to the management of this program. According to the IG, the major problem with the program is that the FAA did not develop a detailed master plan or an effective transition plan. And they suggest that the FAA would have to exercise its 1-year option to extend the Verizon contract and maybe retain those services at a substantial cost.

Has the FAA responded to the IG recommendation? And are you looking at having to pick up the Verizon 1-year option and perhaps a possible second year option on this? What are the costs that you see in this?

Ms. BLAKEY. Basically, we are looking at the fact that we had hoped to be seeing substantial cost savings, in other words, reduction in what we are paying right now on the existing legacy contract through this FTI contract. We have not yet. And cost savings, for example, this year if we had hit our numbers, would have been \$100 million. That is real money by anyone's standards.

Believe me, we are working as hard as we know how with Harris and its subcontractors. Verizon is the incumbent contractor, and also a subcontractor to Harris, as are a number of others on this contract.

We do expect at this point that we are going to be adopting the recommendations from the Inspector General. I think the idea of a much more detailed master plan with all of the metrics that they recommend will help us keep this contract, will help us get the contract back on track and then help us monitor it very precisely. So we are doing that and that plan will be out in June.

We also are going to look at the extension. We have already sat down with Verizon to start talking about an extension. So we have the latitude at the end that we probably will need.

Senator BOND. What do you expect the savings to be from this changeover?

Ms. BLAKEY. The savings in the long run on the contract, and this goes out to 2017, I believe, is somewhere over \$600 million. So it is a very big sum of money.

We are trying, we are on the track for a recovery plan here, and have begun on a number of fronts to hit the numbers again. But we still have a hill to climb here. There is no question about it.

This is a little like stacking bricks, I hate to tell you, because it is all logistics. It is all start stacking them faster and in better order to make it all work.

And we have learned a lot over the first couple of years of this contract. So we are trying to work a lot smarter and make it work.

Senator BOND. My family used to be in the brick business and I used to stack bricks, and I understand. That is why I went to law school.

I would like a quick comment—I believe Mr. Dobbs, the Assistant IG for Aviation is here. Mr. Dobbs, do you have anything additional to add on this? If you would please come up. Obviously this is a major concern and we want to do what we can help you get it right.

Mr. DOBBS. Administrator Blakey explained—

Senator BOND. For the record, give your full name, would you please?

#### REMARKS OF ASSISTANT INSPECTOR GENERAL FOR AVIATION

Mr. DOBBS. I am David Dobbs, Assistant Inspector General for Aviation and Special Program Audits, Office of Inspector General, Department of Transportation.

Senator BOND. Thank you, Mr. Dobbs.

Mr. DOBBS. I think the Administrator's testimony was correct. Our audit focused on FAA's management structure of running a program. And as she said, they focused only on site acceptance. That is initially just putting equipment in.

Because of that they were still paying for the legacy systems and they had to pay for Harris. And that is why costs eroded.

FAA has agreed with our recommendations to develop a realistic master schedule and improve their transition planning. And the results of that, as the Administrator just said, are supposed to be out in June. That will give us and FAA, of course, a better idea of when the project can get done and what the savings will be. But until that happens, until you get a master schedule, I do not think anybody can tell you with any certainty what the savings will be or when it will get done.

#### NATCA AND RETIREMENTS

Senator BOND. Thank you very much, Mr. Dobbs.

Let me return to questioning for the Administrator.

There are lots of charges going back and forth. You have talked about the salary under the proposal for the controllers' contract. Each side has various assessments of whether there will be waves of retirements. What do you foresee as retirements if the FAA proposal becomes law without further negotiations? Do you see any significant number of controllers retiring?

Ms. BLAKEY. We know that because there are a large number of people who will be retirement-eligible and then hit the mandatory retirement age of age 56, that we are going to see significant numbers of retirements over the next 10 to 12 years. That has been true all along. That is a structural thing because of the number of controllers that were hired right after the PATCO strike. We have got a huge generation that is moving on. That is why this issue of the salary structure for new hires is so important to get right.

But I was very surprised that the union suggested that there would be retirements that would be triggered by the contract proposal we put forward. No. 1, we certainly do not see any. I can tell you that, and I check in with HR.

Senator BOND. Under your proposal again, what will the existing controllers get? What kind of increase would they get over their current salary if the FAA proposal were to go into effect, which it appears it would?

Ms. BLAKEY. Average compensation and benefits right now are \$166,000 a year. It will go to \$187,000 a year.

Senator BOND. That includes benefits?

Ms. BLAKEY. It includes benefit as well, that is correct. So when you take the benefits off, which I think are about 30 percent, you can ratchet that down. But the key point is that our proposal does allow for locality increases every year. It also includes performance-based increases every year of the contract. And this is something that therefore will and can increase the existing controllers' salary and benefits as they move forward.

The other thing I would point out is this, that the controllers' retirement is based on two things. It is not just based on their high three, which by the way can be any high three but their salaries are going up so this will benefit them.

But that said, it is also based on years of service. It does not, in any way, incentivize people to leave early because every year that they go forward the years of service add 1 to 2 percent to their overall retirement package.

Senator BOND. And they would be getting a pay increase, which would be the basis of the last 3 years on which their retirement is based; is that—

Ms. BLAKEY. Every year they would be—

Senator BOND. So if they work an extra year they not only get the additional year's service, but they get a higher base number in the salary? For the computation of retirement?

Ms. BLAKEY. The controllers that are within the pay bands, because we work on a pay band basis—I am sorry, thank you very much.

Benefits are 20 percent, I was wrong, rather than 30 percent. So I am exaggerating the difference there. Cash compensation goes to \$140,000 at the end of the 5 years, so that is the figure that we are working with here.

But let me go back to this issue of increases. The increases for the bonuses, if you will, if they are within the salary caps they go to base pay and they do therefore ratchet up for retirement. If they are above the salary caps, they are given as lump sum increases. So it depends on how high your salary is as to how much that increases your retirement. But your retirement, as I say, in addition to being based on an already very high salary level will also be based on the number of years of service.

And when you realize that annuities—just think about \$120,000, for example, as the salary for an existing controller, just pick that as an average. If they retire tomorrow, their annuity is going to be somewhere around half that. Now these are people in their late 40's, early 50's. There is not much incentive to turn around and leave the kind of money on the table that they would be on the

basis of a contract which, as I say, continues to increase and continues to benefit them. Our controllers are a very smart work group and I know they are going to sit down and do the math.

#### WRIGHT AMENDMENT

Senator BOND. One final question. This committee has had some activities involving the Wright Amendment which limits flights from Love Field to Texas and now eight other States. One of the things that we hear is that DFW is the second busiest airport in the United States and the sixth busiest in the world. From an air traffic control standpoint, is there any reason why more flights should not come out of Love Field to lessen the congestion at Dallas? Does that cause any air traffic control problems?

Ms. BLAKEY. This is something that we have looked at a couple of times and obviously it depends a little bit on what kind of traffic is planned and all of the specifics of that. So I will not put out any kind of blanket assertions.

But I will say this. A while back we had Mitre, who does a lot of work for us in terms of air space analysis, look at it. And I think that the flights that, at that point, they analyzed could be handled. They are doing another study right now and I will have some results on that relatively shortly, which I would be very happy to share with the committee as soon as I have that.

Senator BOND. Would you do that?

Ms. BLAKEY. But the one that they did before was only a partial basis.

#### ADDITIONAL COMMITTEE QUESTIONS

Senator BOND. Thank you very much, and I think that we may have one or two more questions but we appreciate your time. And we thank you very much for being here, and Mr. Dobbs as well.

[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 PETE V. DOMENICI

##### UNMANNED AERIAL VEHICLES AND THE NATIONAL AIRSPACE SYSTEM

*Question.* What information or test data does your organization need to allow expanded UAV border security flights beyond Arizona's borders?

*Answer.* The Federal Aviation Administration has not received a request for expanding border security flights along the southern border using Unmanned Aircraft Systems (UAS). However, the FAA is prepared to work with the Department of Homeland Security (DHS) if it requests to expand the critical mission of patrolling our borders. In the short-term, we will use Certificate of Authorizations and Temporary Flight Restrictions (TFRs) to meet mission needs. This will mitigate the risk to the public as we gain experience with UAS operations and develop standards for the necessary command, control, and communication systems and detect, sense, and avoid systems.

UAS do not yet have proven levels of reliability that would provide an equivalent level of safety to today's aviation regulations contained in Title 14 of the Code of Federal Regulations (CFR 14). Compliance with the general operating rules, in CFR 14 part 91, would be especially difficult for this emerging technology's civil applications. Technology to solve critical functions, such as the ability to see and avoid other aircraft, does not yet exist. To mitigate this critical weakness in system development and to protect the flying public, the FAA established a TFR that extended over 340 miles in support of the DHS mission.

*Question.* When do you expect to have a plan to allow UAVs to patrol the entire northern and southern international borders, and in particular New Mexico's southern border, where commercial flights are not routine?

Answer. The Department of Homeland Security has not informed the Federal Aviation Administration of any plans or made any requests to expand its Unmanned Aircraft Systems (UAS) operations beyond the currently negotiated Temporary Flight Restriction (TFR).

Although the impact to commercial traffic in this TFR may be minimal, it is likely the impact to general aviation (GA) aircraft will be significant. GA aircraft are not normally equipped with many of the safety features that are common on commercial aircraft, such as Traffic Collision and Avoidance System. Also, many of the GA aircraft operating in that area are not required to have an operating transponder, which makes them virtually invisible to ground-based and aircraft-based surveillance systems.

*Question.* When do you expect to have a plan to allow UAVs to fly during and after national emergencies like Hurricane Katrina?

Answer. The Federal Aviation Administration currently allows use of Unmanned Aircraft Systems (UAS) in response to national disasters through a Certificate of Authorization (COA) to the Northern Command Joint Forces Area Combatant Commander, signed on May 18, 2006. This COA, specifically for Department of Defense use in response to national disasters, allows deployment of Global Hawk or Predator UAS to the disaster area.

*Question.* When do you expect to have a plan to allow UAVs to interoperate with manned aircraft in the National Airspace?

Answer. The Federal Aviation Administration has processes that already allow many Unmanned Aircraft Systems (UAS) to operate in the National Airspace System (NAS). These processes, Certificates of Authorizations and Experimental Airworthiness Certificates, allow the FAA to set appropriate limitations to mitigate any technical risks in system design and operation while still maintaining the safety of the flying public.

The FAA has tasked the Radio Technical Commission for Aeronautics (RTCA), an industry advisory committee, to develop regulatory standards in the areas of detect, sense and avoid and command, control and communication. The committee is expected to provide standards within 3 to 5 years. Full integration of UAS into the NAS will require a significant effort in the areas of safety analysis, risk modeling, technology development, and policy changes. The FAA expects to complete a road map by the first quarter of 2007 that will outline, in detail, the work necessary for UAS to "file and fly" in the NAS.

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#### QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

*Question.* Administrator Blakey, in 2000, Congress phased out the High Density Rule that slot-controlled O'Hare International Airport. The FAA has issued an NPRM that contemplates rules substantially similar to the HDR. When are you planning on coming back to the Congress to get authority to re-impose a slot system?

Answer. The FAA has broad authority under 49 U.S.C. 40103 to regulate the use of the navigable airspace of the United States. This section authorizes the FAA to develop plans and policy for the use of navigable airspace and to assign the use that the FAA deems necessary to its safe and efficient utilization. It further directs the FAA to prescribe air traffic rules and regulations governing the efficient utilization of the navigable airspace.

The proposed temporary rule is intended to relieve the substantial inconvenience to the traveling public caused by flight delays and congestion at O'Hare International Airport (O'Hare). After the phase-out of the HDR at O'Hare, carriers had the opportunity to add flights and adjust schedules as they saw appropriate, which resulted in extensive delays for all operators at O'Hare and wide-ranging effects on the National Airspace System (NAS).

This proposed rule provides a temporary regulatory solution necessary to maintain an acceptable level of operations at O'Hare without congestion and delay impacting the entire NAS until additional capacity becomes available to meet the persistent demand at O'Hare. There are significant differences between the HDR and the proposed rule that reduce restrictions to the minimum levels needed to address congestion, improve the potential for greater competition and access by carriers, and permit an increase in hourly limits under the rule consistent with any realized capacity increases.

*Question.* The existing temporary flight caps were targeted to reduce delays by 20 percent. In the city's original comments to the proposed flight reductions they stated that the arrival rate was too low and would leave capacity on the table. Now, the FAA's own data shows that the FAA has over shot the reduction goal by 20 percent

to 35 percent. In addition, one carrier, Independence Air, has ceased operations at the airport leaving 10 slots unused. Yet, the FAA has not granted the city request to not leave capacity on the table and increase the arrival rate. Why is the FAA allowing valuable capacity to remain unused and starving the economic engine of my State and the surrounding region?

Answer. FAA explained in the March 13, 2006 show cause order, to extend the August 2004 order which caps Arrivals at O'Hare, the 10 arrival authorizations previously operated by Independence Air are not excess capacity. The FAA does not consider Independence Air's arrival authorizations to be excess capacity, because when negotiating schedule reductions expecting the August 2004 order, the FAA had to allocate arrival authorizations in some peak afternoon and evening hours at levels that exceed the peak-hour target of 88 scheduled arrivals per hour. In addition, the number and timing of international flights by foreign air carriers has not been limited by the FAA's order and these flights are also operated above the hourly cap.

The Independence Air arrival authorizations, particularly in the peak afternoon and evening hours, if unused, would help offset these periods of continued scheduling over the operational target. At the same time, the daily, average operational performance for O'Hare was better than modeled. This is due in part to some carriers not fully utilizing their authorized arrivals under the order. The current order, which limits flights at O'Hare, does not have a minimum usage requirement. However, the proposed rule considers implementing a usage requirement, as well as a method for reallocating any arrival authorizations that are not being utilized (e.g. Independence Air). Until currently authorized flights are better utilized, it may not be practical to significantly change the scheduling limits.

However, it is possible that air traffic procedural changes or other enhancements will result in a limited increase in arrival capacity over the duration of the proposed rule. Therefore, the FAA proposes to periodically reexamine the level of available capacity at O'Hare. Under the proposed rule, every 6 months, the FAA would review the level and length of delays, operating conditions at the airport and other relevant factors to determine whether more arrivals can be allowed.

*Question.* The proposed NPRM has a sunset provision in 2008. But, some of the text leaves doubt in my mind whether that is absolutely true. Will you state for the record that if the NPRM were implemented, that the rule would absolutely sunset in 2008?

Answer. As stated in the NPRM, FAA proposes a 2008 sunset date for the temporary rule. The city of Chicago's O'Hare Modernization Program will adequately increase airport capacity and reduce levels of delay. The first phase of the O'Hare Modernization Program, a new north runway, is expected to come on line in late 2008. In addition, recent improvements to the Instrument Landing Systems for runways 27L and 27R will also improve performance in adverse weather conditions.

The 2008 sunset date for the FAA's proposed rule would address the present conditions at O'Hare until the benefits of any interim capacity enhancements are realized.

*Question.* I am very excited about some recently implemented and impending improvements to Chicago's Airspace. The implementation of Category II/III operations on Runways 27-left and 27-right at O'Hare, the new MACE Routes in Cleveland Center, the Airspace Flow Program, and the impending addition of two new east-bound departure routes out of O'Hare should all go a long way towards increasing airspace capacity for the Chicago region and the Nation. I'd like to thank the Administrator for the dedication to improving Chicago's airspace.

With the airspace and procedural improvements that have been implemented in the last couple of years at O'Hare and the upcoming improvements, how does the FAA plan to deal with this increase in capacity?

Answer. The changes referenced above will improve efficiency in the airspace surrounding the greater Chicago Metropolitan Area. Included in these changes is the Midwest Air Space Enhancement (MASE) routes, implemented on June 8, 2006; the Chicago Airspace Project, with planned implementation starting in early 2007; and other non-airspace projects such as AFP.

These efficiency improvements focus on enhancing how the airspace is used to reduce delays and restrictions, but not necessarily changing the airport capacity. Airport capacity improvements are more closely tied to airfield programs, i.e. the O'Hare Modernization Plan (OMP).

When implemented, the airspace design changes in the Chicago Airspace Project will have significant impact on the airspace capacity supporting the Chicago metropolitan area. The Chicago Airspace Project will implement new departure routes and sectors, and new arrival procedures to complement the planned OMP runways. The FAA projects that the Chicago Airspace Project will reduce delays by 20 percent

as the result of new departure routes and sectors. Eventually, delays will be reduced by 65 percent with the addition of the first new runway and the associated arrival route changes.

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QUESTIONS SUBMITTED BY SENATOR BYRON L. DORGAN

*Question.* When can Bismarck Airport expect its ASR-11 upgrade?

*Answer.* A thorough study of ASR-8 lifecycle costs and upgrade benefits is underway to define the best value approach for continuing safe surveillance service at the 37 airports with ASR-8 radars, including Bismarck, ND. As directed by the Senate, FAA has thoroughly investigated the operational conditions at Bismarck Airport, and has concluded that there are no service or safety issues related to its current ASR-8 radar system. Given that, it is likely that deploying an ASR-11 radar at Bismarck may not be justified by the business case analysis. FAA expects to have final determination of what sites justify the significant expense of installing new ASR-11 radar systems by the end of fiscal year 2006.

The ASR-8 radar system at Bismarck is performing well and provides safe surveillance service. Because the ASR-8 radar system is a good, highly reliable radar, it's likely the FAA will continue to rely on them at many airports for many years to come.

*Question.* Are you ignoring this clear mandate from Congress by delaying the Bismarck upgrade?

*Answer.* The FAA has ensured Bismarck continues to have safe and capable radar coverage. As stated in the previous response, the FAA is awaiting the results of the business case analysis for Bismarck. A thorough study of ASR-8 lifecycle costs and upgrade benefits is underway to define the best value approach for continuing safe surveillance service at the 37 existing ASR-8 radar sites, including Bismarck. The results are expected by the end of fiscal year 2006. Surveillance service safety will be maintained either through sustainment of the existing ASR-8 systems; installation of an ASR-11 radar system if the benefits exceed the costs; or by using other technologies pending definition of the future architecture of ground based surveillance.

The FAA has investigated the operational conditions at Bismarck Airport, including radar coverage provided by the existing ASR-8, and determined that there are no shortfalls in the air traffic service currently being provided.

*Question.* What has the FAA done since this Congressional directive in fiscal year 2005 to move the Bismarck Airport closer to its ASR-11 radar upgrade? Please provide me a detailed overview of your actions and communications with Bismarck Airport since the report language.

*Answer.* The FAA has verified that safe surveillance services are currently being provided at Bismarck Airport. The FAA understands that the local landowner of the existing radar site and the airport wants to develop the land where the current ASR-8 radar system is located. Bismarck Airport is aware that the analysis is underway to determine which sites justify the expense of deploying new ASR-11 radar systems.

While a detailed log of all communications between the FAA and the airport has not been maintained, the regional FAA representatives and the Bismarck Airport Manager have had numerous communications on this matter. The most significant of these communications are described below:

—On 8/17/05, in response to an email inquiry, the FAA informed Mr. Greg Haug, Airport Manager, that an ASR-11 program reassessment was underway, and that Bismarck may not be approved for an ASR-11 radar system acquisition.

The FAA also stated its intent to conduct further analyses to determine the business case for acquisition of additional ASR-11 radars.

—On 10/6/05, in response to an email inquiry, the FAA informed Mr. Haug that the ASR-11 program rebaseline had been approved and Bismarck was not scheduled to receive an ASR-11 radar. The FAA also informed him that a business case analysis would be performed to determine need for additional ASR-11 radars and that the results would be expected by the end of fiscal year 2006.

*Question.* That said, is the FAA jeopardizing the safety of the American traveling public by not following through on its commitment on the Bismarck Airport radar upgrade?

*Answer.* The ASR-8 provides safe, reliable coverage at Bismarck and 36 other airports.

*Question.* How long does the FAA expect to rely on ASR-8 radars? How long can we expect the ASR-8 radars to work without compromising safety?

*Answer.* The decision whether to replace ASR-8 radars is expected by the end of fiscal year 2006. If the FAA decides it is cost-effective to continue using the ASR-8s, it will continue to ensure they provide safe surveillance service at those locations, including Bismarck. There are no service or safety issues related to Bismarck's current ASR-8 radar system. The overall class of ASR-8 radars has been exceeding the availability target goal of 99.5 percent. Bismarck specifically has achieved an availability target of 99.87 percent over the past 2½ years. Only one unscheduled outage has occurred at Bismarck during that time, lasting approximately 4 hours.

*Question.* Can you guarantee the safety and effectiveness of these aging ASR-8 radars by using parts cannibalized from decommissioned radars?

*Answer.* The costs and risks associated with maintaining these radars are being considered as part of the ongoing business case analysis. If the decision is made to retain the ASR-8 radar systems, the FAA will continue to ensure they provide safe surveillance service at Bismarck Airport and other facilities where they are in use. The FAA expects the effectiveness of the ASR-8 radars to continue meeting the agency's availability standards. The overall class of ASR-8 radars, on average has been achieving a 99.67 percent availability in recent years. This exceeds the availability target metric of 99.5 percent. Using spare parts from radars in storage will support the further use of these radars if a decision is made to retain them.

*Question.* When does the FAA expect all airplanes, including the ones that service Bismarck Airport, to be equipped with this technology?

*Answer.* The current program schedule calls for a Notice of Proposed Rulemaking (NPRM), to identify equipment required to operate in a designated airspace, to be issued in 2007. The specific provisions of the NPRM are still under development. However, when the NPRM is published it will specify the exact date that all aircraft will have to be equipped.

*Question.* Can you guarantee that the ADS-B transition won't be delayed and plagued by problems like you have experienced with the ASR-11 upgrade and many other FAA programs?

*Answer.* The ADS-B management team has an integrated safety risk management program. It identifies risk at an early stage, and enables the FAA to implement a timely mitigation plan. The mitigation plan spells out the actions needed to minimize the potential adverse impacts that might delay the program.

In addition, the ADS-B team will be developing and employing a detailed earned value management system. This system also supports the early identification of potential trouble spots and gives the management team an opportunity to implement solutions early enough to avoid major set backs.

*Question.* Madam Administrator, in your letter dated April 24, you denied the National Air Traffic Controllers Association's formal request to reopen contract negotiations. You cited three reasons why a voluntary negotiated agreement could not be reached. These areas were reductions in new hire pay bands, performance-based compensation, and work rules. John Carr formally responded by offering "... to meet you unconditionally at the bargaining table" and that he would direct his contract team to "bring you real and significant progress on these three important issues." If this is indeed the case, then why would you not make another attempt to negotiate an agreement at the bargaining table where this dispute should be solved?

*Answer.* The Parties' negotiators made significant progress during the negotiations, especially in the area of work rules, where they reached a number of significant agreements, and I laud them for it. In the economic realm, however, the Parties were too far apart for further negotiations to be fruitful. The Parties began negotiations in July 2005 and reached impasse in April 2006—a period of 9 full months. A mediator from the Federal Mediation and Conciliation Service (FMCS) assisted with the negotiations during the last 4 weeks. From the outset of negotiations, the FAA made clear to the Union the Agency's bargaining objectives: (1) meaningful reduction in new hire salaries; (2) introduction of a true performance-based compensation system; and (3) reform of work rules to allow the FAA to operate an efficient air traffic system. The FAA's negotiators communicated these objectives to the Union's negotiators at the bargaining table from the beginning and all of the agency's contract proposals reflected them. In addition, I reiterated these objectives publicly on numerous occasions. NATCA had 9 months to make a serious, detailed proposal on compensation that addressed the agency's real needs. Instead the Union chose to wait until negotiations were almost over to do so and even then its final proposal did not result in a cost effective new hire pay structure.<sup>1</sup> Parties

<sup>1</sup> NATCA's final proposal was to raise the existing pay band minimums by 0.8 percent and then lower them by 3 percent, resulting in an effective decrease of only 2.2 percent, far short

reach impasse when one has no more room to move on its proposals. The FAA reached that point in April 2006 and the Union did when it submitted the dispute to the Federal Service Impasses Panel (FSIP).<sup>2</sup>

Returning to the bargaining table and delaying the implementation of the new contract would be extremely costly. Even a reasonably short delay—through January 2007—would cost American taxpayers an estimated \$214 million and a continued delay beyond that would jeopardize the entire \$1.9 billion in savings. Most of the \$214 million relates to a pay increase that would take effect in January 2007, the costs associated with which would be locked in and compound over time with future locality pay, premiums, benefits and raises tied to a larger base salary. NATCA's demands to return to the bargaining table appear designed principally to perpetuate the current, costly agreement. NATCA's president admitted as much in a March 31, 2006, press release: "There is absolutely no reason for NATCA to end talks. The current contract is better than our last, concession-laden contract proposal at the bargaining table, and our current contract stays in effect until there is a new contract. We could literally talk forever and continue to enjoy the contract we currently work under." NATCA has absolutely no incentive to conclude negotiations.

*Question.* It is expected that 73 percent of the current air traffic controller workforce will be eligible to retire by 2015. In order to address this issue, the Federal Aviation Administration needs to hire 11,500 air traffic controllers in the next decade. How do you expect to attract qualified candidates when you are proposing to create a lower pay scale for newly hired controllers that will limit their earning potential?

*Answer.* The salaries provided for in the new pay system will be more than sufficient to attract and retain air traffic controllers in order to meet the FAA's staffing demands over the next decade. Under the new pay system, controllers hired in 2007 will earn an average of \$93,400 in cash compensation by 2011 after 5 years on the job. Cash compensation includes base salary, locality pay, and premium pay such as overtime, Sunday pay, holiday pay, and night differential. In calculating the \$93,400 average, the FAA used a system-wide average for locality and premium pay rates across all facilities. Applying actual locality and premium pay rates historically paid at specific facilities instead results in a higher weighted average cash compensation of \$94,207 after 5 years. Regardless of the method used to calculate average cash compensation, under the FAA's new pay plan, air traffic controllers will continue to be one of the most highly compensated groups of employees in the Federal Government.

#### CONCLUSION OF HEARINGS

Senator BOND. With that, this hearing is recessed.

[Whereupon, at 11 a.m., Thursday, May 4, the hearings were concluded, and the subcommittee was recessed, to reconvene subject to the call of the Chair.]

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of what is needed to create a long-term, cost-effective, and fair new hire controller pay structure at the FAA.

<sup>2</sup>NATCA submitted the dispute to the Federal Service Impasses Panel (FSIP) for resolution on April 7, 2006, 2 days after impasse was declared. Presumably the Union would not have done so if it did not believe that the Parties were at impasse. The FAA's position is that the FSIP is not the proper forum for the dispute and argued to the FSIP that it did not have jurisdiction over the matter. The Parties are currently awaiting the FSIP's decision on jurisdiction. In a similar dispute in 2003 involving other NATCA bargaining units, the FSIP declined to assert jurisdiction.



**DEPARTMENTS OF TRANSPORTATION, TREASURY, THE JUDICIARY, HOUSING AND URBAN DEVELOPMENT, AND RELATED AGENCIES APPROPRIATIONS FOR FISCAL YEAR 2007**

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

**MATERIAL SUBMITTED BY AGENCIES NOT APPEARING FOR FORMAL HEARINGS**

[CLERK'S NOTE.—The following agencies of the Subcommittee on Departments of Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies did not appear before the subcommittee this year. Chairman Bond requested these agencies to submit testimony in support of their fiscal year 2007 budget request. Those statements submitted by the chairman follow:]

PREPARED STATEMENT OF HONORABLE JULIA S. GIBBONS, CHAIR, COMMITTEE ON THE BUDGET, THE JUDICIAL CONFERENCE OF THE UNITED STATES

INTRODUCTION

Chairman Bond, Senator Murray 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 present the following testimony on the judiciary's fiscal year 2007 appropriations requirements. In doing so, I will also apprise you of some of the challenges facing the Federal courts.

At the outset I want to note that we have enjoyed a productive relationship with the subcommittee and its staff from the time the judiciary was placed within your jurisdiction last year. We are extremely appreciative that you made us a funding priority in the fiscal year 2006 appropriations process.

DIRECTOR MECHAM'S RETIREMENT

Also submitting testimony today is Leonidas Ralph Mecham, Director of the Administrative Office of the United States Courts. This will be Director Mecham's final testimony before this subcommittee. After 21 years at the helm of the Administrative Office, he is taking a well-deserved retirement. He is the longest-serving director of the Administrative Office and is only the sixth person to head that unique organization, which was established in 1939.

Director Mecham led the Administrative Office during two decades of unprecedented change in the Federal courts. In 1985, when Director Mecham began his tenure, the Federal courts still relied on electric typewriters. The operating budgets for the nearly 400 court units across the 94 judicial districts were largely managed from Washington, DC Federal court facilities were in poor shape due to decades of neglect and deferred maintenance. And the Administrative Office itself was scattered in multiple locations across Washington, DC.

Twenty years later, the picture is quite different. The use of information technology has fundamentally changed the way the courts operate. Today we have a judiciary-wide data communications network that provides a secure infrastructure for numerous systems and applications. The judiciary's case management/electronic case files system has been implemented in nearly all district and bankruptcy courts and is now moving into our appellate courts. Electronic courtroom technologies such as electronic presentation of evidence, digital court reporting, and videoconferencing are now routinely used.

Today, under the judiciary's budget decentralization policy, courts have the flexibility to address their unique needs and priorities at the local level. Yet they are also accountable for managing these funds wisely.

Under Director Mecham's leadership, 90 court building projects have been approved, providing space needed by the courts to house judges and support staff required to manage the judiciary's growing workload needs. The Administrative Office finally consolidated its scattered offices when it received its own building in 1992—the Thurgood Marshall Federal Judiciary Building—which, in addition to the Administrative Office, houses the Federal Judicial Center, and the United States Sentencing Commission.

Director Mecham's superb leadership and vision have contributed significantly to the Federal judiciary's management progress. We in the Third Branch will miss his dedicated service to the courts.

#### IMPROVED FISCAL YEAR 2006 OUTLOOK FOR THE COURTS

As you may recall, last year at this time the courts were reeling from the steady downsizing of probation and clerks' office staff in the 18-month period between October 2003 and March 2005, during which on-board court staffing levels declined by 1,800 positions, or 8 percent. The need to fund must-pay expenses such as judges' salaries and GSA rent, within the constrained appropriations provided to the judiciary in fiscal years 2004 and 2005, resulted in essentially flat funding for the courts in those years. In fiscal year 2004, the courts lost 1,350 staff and in fiscal year 2005 additional positions were left vacant due to the delay and uncertainty surrounding the fiscal year 2006 congressional budget. These funding constraints forced courts to fire and furlough staff, offer early retirements, and leave vacant positions unfilled in order to pay basic operating costs like telephone and electric bills. Unfortunately, these staffing reductions came at a time when the courts, especially those along the southwest border, were experiencing historically high workload levels.

Now, a year later, I am happy to report that the financial outlook for the courts has improved. I raised our budget concerns with the subcommittee last year, and you responded by making the judiciary a high priority. We recognize that many agencies in your bill received little or no growth in fiscal year 2006, and yet you provided the courts' operating account with a 4.5 percent increase in appropriations for fiscal year 2006, after applying the government-wide 1 percent across-the-board rescission and excluding supplemental funding. This increase is consistent with those received in fiscal years 2004 and 2005 of 4.7 percent and 4.3 percent, respectively, and approximates the minimum amount we required to maintain on-board staffing levels in fiscal year 2006.

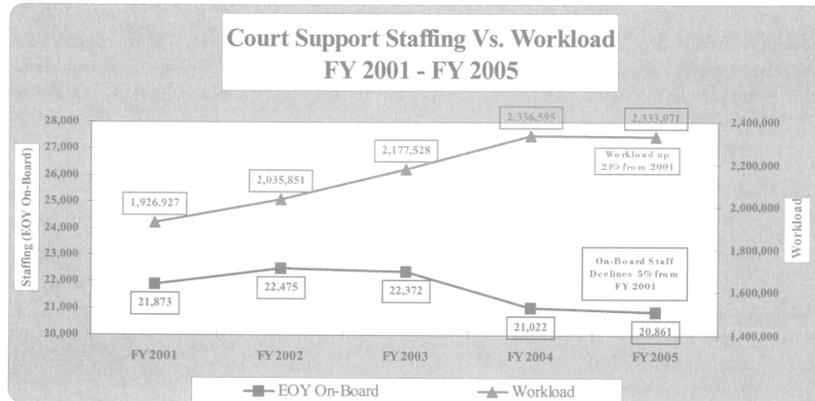
Fortunately, in addition to the appropriations provided by Congress, several other unanticipated factors made more funds available for the courts in fiscal year 2006. Actions outside the judiciary's control (e.g., fewer than anticipated judgeship confirmations), along with cost containment initiatives, such as the effort in New York to identify and recover GSA rental overcharges—which I will discuss in more detail later in my testimony—resulted in higher than anticipated carryover from fiscal year 2005 and reductions in fiscal year 2006 must-pay requirements. These unanticipated, and likely one-time, factors resulted in the courts receiving an overall 6.9 percent increase in their funding allotments in fiscal year 2006, the first above-inflation increase for the courts since fiscal year 2002. This puts the courts in a position to backfill nearly half of the 1,500 probation and clerks' office staff lost over the last 2 years.

The favorable outlook for fiscal year 2006 requires some perspective and a word of caution, however. After several years of operating under extremely tight funding levels, an increase in fiscal year 2006 funding for the courts in real terms (above inflation) is considered a significant achievement. While the courts are in better shape financially than in recent years, court staffing is still well below the level needed to address all workload requirements imposed on the courts. In fact, even with the enhanced funding provided to the courts in fiscal year 2006, we still anticipate end-of-year staffing levels in probation and clerks' offices to be more than 800 positions below the benchmark of 22,372 staff that were on-board in October 2003,

the level just prior to the courts having to downsize due to budget constraints. The emphasis placed on increased immigration enforcement efforts as well as other factors caused overall workload to increase 8 percent during this same period.

#### COURT STAFFING LEVELS LAG BEHIND WORKLOAD GROWTH

Although caseload in the Federal courts has begun to stabilize, it nonetheless remains at historic highs in most categories. While caseload has grown sharply in recent years, not only have court staffing levels failed to keep pace with that workload growth, but the courts have, in fact, been falling farther behind. As illustrated in the following chart, from fiscal year 2001 to fiscal year 2005 the courts' aggregate workload increased 21 percent while on-board court staffing levels declined by a net 5 percent. The judiciary has made extensive use of electronic case management and case filing systems to make clerks' offices more efficient, but reduced staffing levels and budget constraints have resulted in 30 percent of our district and bankruptcy clerks' offices having to reduce the office hours they are open to the public.



Reduced staffing levels have also changed the way probation officers do their work. Probation officers have had to prioritize their supervision caseload to focus on higher-risk supervision cases and reduce the amount of supervision they provide to lower-risk offenders. This may be impacting public safety, as evidenced by a recent review of national data which revealed that the number of removals from supervision due to new criminal conduct increased by 9.4 percent in fiscal year 2005 over the number in fiscal year 2004. We are very concerned that any continued decline in court staffing may harm the public.

In evaluating our need for staff to accommodate workload growth, we have requested only the number of staff that can realistically be hired over the course of the year, not the number of staff that our workload statistics say we need. This is because we recognize that it takes more time to add staff than to reduce staff. Eliminating staff, while traumatic for managers and employees alike, can be done in a relatively short amount of time. Early retirement and buyout offers attract sizeable numbers of volunteers willing to leave the court rolls. Unfortunately, often these individuals are the most experienced and seasoned court employees. In other more difficult instances, staff have to be laid off due to funding constraints. For courts that are downsizing, staff need to be off the payroll early in the fiscal year in order to maximize budget savings. On the other hand, backfilling these positions takes much longer. With continuing resolutions and the hiring freezes that may accompany them, coupled with the lead-time it takes to advertise, interview, and make a selection, it can take months—and well into the fiscal year—to fill a vacancy. Candidates for probation officer positions require extensive background security checks and can take up to a year to bring on board.

The judiciary's budget request includes funding for 464 new probation and clerks' office staff to address the immediate workload needs of the courts. A request based on the full requirements identified by our staffing formulas would have resulted in an increase of more than 2,000 staff in fiscal year 2007.

It is vital that Congress understand that, while the courts require additional staff in order to perform their statutory duties, many have been reluctant to hire those staff for fear they will have to fire them almost immediately in fiscal year 2007. What the court community needs now is a clear message that, at the very least,

funds will be available in fiscal year 2007 to maintain fiscal year 2006 year-end staffing levels and ultimately to address the recent workload growth that was not matched with additional staffing resources.

#### WORKLOAD IN THE COURTS

As I just mentioned, after years of steady growth the workload in the courts has begun to stabilize. I would like to highlight some areas of the judiciary's workload for the subcommittee, but before I do so, I would like to discuss how judiciary work plays an indispensable role in our Nation's homeland security efforts.

##### *The Judiciary's Role in Homeland Security*

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, this workload all ends up on 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. Non-defense homeland security spending has more than tripled since 2001. In sharp contrast, appropriations for the courts' operating budget have increased by 29 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 2007 budget, which includes an 8 percent increase in non-defense homeland security spending. The judiciary cannot absorb the additional workload generated by homeland security initiatives within current staffing and resource levels.

##### *Immigration Enforcement*

Funding for border security and immigration enforcement has nearly doubled since 2001, and we have seen a direct impact on our workload as a result. Since the September 11, 2001 terrorist attacks, nearly 1,200 additional border patrol agents have been hired, and Congress recently funded an additional 1,500 agents. Furthermore, the President proposes to add 1,500 border patrol agents in fiscal year 2007 for a potential increase of more than 4,000 new agents since September 2001. This large influx of new border patrol agents has and will continue to generate considerable additional workload for judges and probation and clerks' offices, especially in the five judicial districts along the southwest border with Mexico. Costs in our Federal defender services program will increase as well. These southwest border courts currently account for nearly one-third of all criminal cases nationwide, up from 27 percent in 2001, and criminal immigration cases in these courts have increased by 68 percent since 2001.

The immigration-related workload also affects other areas of the judiciary. Criminal appeals involving immigration issues increased 64 percent from 2004 to 2005. Over this same period, nearly 12,000 appeals from decisions by the Department of Justice's Board of Immigration Appeals were filed in Federal courts of appeals, a 19 percent increase. Furthermore, these immigration appeals are up nearly 600 percent since 2001. The President's fiscal year 2007 budget includes funding for the Department of Justice to increase the number of immigration judges and immigration appeal attorneys in order to adjudicate a larger percentage of detained immigrant cases and appeals. If funded, this will further increase the number of immigration appeals that will end up in the Federal courts.

##### *Bankruptcy Filings*

Passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 resulted in a massive workload increase for bankruptcy courts as individuals rushed to file before the mid-October 2005 effective date of the legislation. Fiscal year 2005 bankruptcy filings totaled 1,782,643, an all-time record and a 10 percent increase over fiscal year 2004. In October 2005 alone, more than 600,000 bankruptcy cases were filed nationwide; by comparison, filings in October 2004 totaled 130,679. Managing this unprecedented level of filings required a truly Herculean effort on behalf of bankruptcy clerks offices around the country. There are countless examples of clerks' office staff working nearly around the clock to ensure that those wishing to file for bankruptcy before the new law took effect could do so.

Given the landmark nature of this legislation, it is difficult to predict what filing patterns will emerge in 2006 and 2007. Bankruptcy filings are expected to decrease in the short-term, but the decline in filings will likely be due, in part, to the large number of people who filed just prior to the effective date of the new bankruptcy law. Filings are expected to return in significant numbers as attorneys and debtors become more familiar with the requirements of the new law. In addition, the new legislation creates additional duties for the bankruptcy courts. New duties were

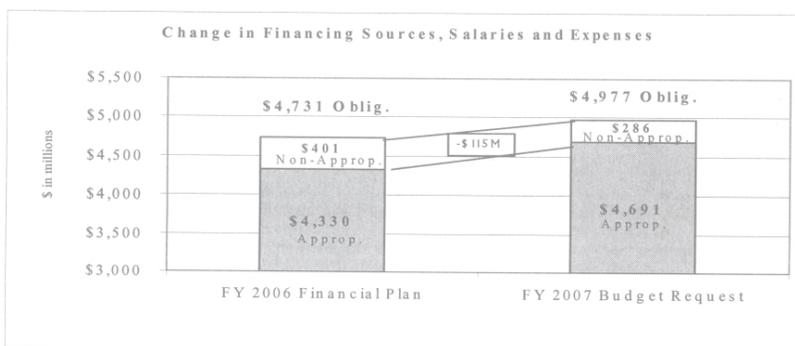
added in many areas including credit counseling, means testing, financial management, tax returns, reaffirmations, lease payments, and automatic discharges. Many of these areas have required the creation of new processes and operations in the clerks' offices. In addition, clerks' offices are experiencing a surge in motions and related activity and inquiries from the bar and public. As a result of the new demands imposed by the law on clerks' offices, it is unclear at this time whether reductions in bankruptcy filings will translate into reductions in workload and staff. Given these uncertainties, the fiscal year 2007 budget request does not include any change in bankruptcy clerks' office staffing levels.

#### *Booker/Fanfan—Sentencing Guidelines*

The judiciary is also facing the effect of the U.S. Supreme Court's decision in the consolidated cases, *United States v. Booker* and *United States v. Fanfan*. In fact, the courts began receiving increased filings almost 6 months before *Booker* was decided—immediately after the earlier Supreme Court decision in *Washington v. Blakely*. Since that decision in June 2004, the courts have received over 14,500 cases affected by issues raised in the *Booker* case, about 7,500 of these in the courts of appeals and the remaining 7,000 in the district courts, and the effects are not yet over. Habeas corpus petitions raising *Booker* issues filed between October 1, 2005 and January 12, 2006, when the statute of limitation for filing these petitions expired, are not yet reflected in the statistics. Nor do they include most *Booker*-related petitions that the Federal courts may receive from prisoners sentenced in the State courts, as those prisoners must first exhaust all options in the State courts before they can bring their cases to the Federal courts. The Federal courts will likely continue to receive an increased level of State habeas corpus petitions for the next 3 or more years.

#### FISCAL YEAR 2007 BUDGET REQUEST

The Federal judiciary is approaching a crossroads in fiscal year 2007 and Congress will determine which direction the courts take. It is imperative that Congress provide the courts with appropriations sufficient to build on the gains achieved in fiscal year 2006. It would be unfortunate to re-create the funding problems that the judiciary and Congress have worked so hard to remedy. We greatly appreciate that Congress made the Federal courts a high priority in fiscal year 2006 and respectfully request that you continue to do so. An appropriations increase of 4 to 5 percent in fiscal year 2007—although consistent with recent increases—will not achieve that goal. In fact, such an increase will not provide for a current services operating level in fiscal year 2007 and would likely require the courts to return to their downsizing ways of the last 2 years. The reason for this is reflected in the following chart and discussion.



The high carryforward balances utilized in the fiscal year 2006 financial plan were, in part, the result of rent credits from GSA and other one-time windfalls outside the judiciary's control that will likely not be available to finance fiscal year 2007 requirements. A lower amount of non-appropriated sources of funding, from \$401 million to a projected \$286 million, means that the courts' Salaries and Expenses account requires a higher appropriation increase in fiscal year 2007 just to stay even—about 7.7 percent over fiscal year 2006 to maintain current services—and an increase of 8.3 percent to fund our full request.

While the courts' Salaries and Expenses account requires an 8.3 percent increase for fiscal year 2007, the judiciary is requesting a 9.4 percent overall increase above fiscal year 2006 available appropriations. A summary table detailing fiscal year 2007 requirements by account is included at Appendix A. 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 put forth by the administration, the judiciary does not have the flexibility to eliminate or cut programs as the executive branch does to achieve budget savings. The judiciary's funding requirements essentially reflect basic operating costs which are predominantly for personnel and space requirements. Of the \$540 million increase being requested for fiscal year 2007:

- \$160 million of the requested increase is needed just to pay for 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., health benefits) for currently funded judiciary employees. The amount budgeted for the cost-of-living adjustment is 2.2 percent for 2007.
- \$6 million is associated with increases in the number of active and senior Article III judges.
- \$140 million is a technical adjustment to cover the projected loss in non-appropriated sources of funding (\$115 million of which is for the courts' salaries and expenses account). In addition to appropriations, the judiciary receives revenue from fees and other items that can be used to offset appropriation needs in the next fiscal year. Revenue not needed during the year collected may be carried over. As I mentioned, the high carryforward balance from fiscal year 2005 and the rent credits from GSA will likely not be available as financing sources in fiscal year 2007, so the judiciary requires appropriated funds to replace them. The projected 20 percent decline in filing fee revenue in fiscal year 2007 due to fewer projected bankruptcy filings is also reflected in this requested increase. We will keep the subcommittee apprised of any changes to these fee or carryforward projections as we move through fiscal year 2006.
- \$50 million is needed for space rental increases, including inflationary adjustments and new space delivery, and for court security costs associated with new space. An additional \$7 million is needed to pay for Federal Protective Service security equipment and building-specific surcharges for court facilities.
- \$43 million is required to support, maintain, and continue development of the judiciary's information technology program, which has allowed the courts to "do more with less" in absorbing workload increases while having to downsize staff.
- \$18 million is required to cover 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.
- \$14 million is necessary to pay costs associated with Criminal Justice Act representations. The Sixth Amendment to the Constitution guarantees that all criminal defendants have the right to counsel. The Criminal Justice Act provides that the courts shall appoint counsel for those persons who are financially unable to pay for their defense. The number of representations is expected to increase by 5,500 in fiscal year 2007, as the number of defendants for whom appointed counsel is required increases. An additional \$12 million will fund deferred panel attorney payments and shortfalls in fiscal year 2006 requirements.
- \$12 million of the increase will provide for several smaller base adjustments such as continued investments in the Supreme Court building modernization program and general inflationary increases for judiciary programs.

The increases described above total \$462 million, or 86 percent of the requested increase, and represent must-pay items for which little to no flexibility exists. This leaves a much smaller increase of \$78 million to address workload increases and for other program enhancements. Of this amount:

- \$24 million is requested for additional staff and associated expenses. The bulk of this increase (464 positions) would fund the most critical and immediate workload needs of the courts, which as I previously noted, is primarily immigration-related workload along the southwest border where those five district courts currently account for nearly one-third of criminal cases nationwide. The judiciary uses statistically-based formulas to determine the number of positions needed to address adequately the workload of the courts. In an effort to hold down the required increase in staffing, the judiciary's cost-containment measures included a reduction to the formula-driven staffing levels. As a result of these efforts, the judiciary's calculations for full staffing requirements were lowered by nearly 900 positions, or 4 percent. Even after this adjustment, based on the courts' projected workload, the staffing formulas indicate more than

2,000 additional positions are needed in probation and clerks' offices over the level funded in fiscal year 2006. Recognizing that the courts would have great difficulty hiring that many new staff in a single year, the judiciary has reduced its staffing request to reflect a number that can realistically be hired in fiscal year 2007 (464) in order to address the most critical workload needs of the courts.

- \$24 million to increase the non-capital panel attorney rate to \$113 per hour. I will discuss this requested increase in more detail in a moment.
- \$23 million would provide for critical security-related requirements.
- Of the remaining \$7 million, \$1.2 million would provide for three additional magistrate judges and associated staff, \$2 million would fund information technology enhancements, and the remaining \$3 million is for smaller requirements in other judiciary accounts.

Appendix B includes an account-by-account description for accounts under the Courts of Appeals, District Courts and Other Judicial Services heading which includes Salaries and Expenses, Defender Services, Fees of Jurors, and Court Security.

#### INCREASE IN NON-CAPITAL PANEL ATTORNEY RATES

We believe that one program enhancement in our budget request deserves strong consideration in order to ensure effective representation for indigent criminal defendants. We are requesting \$24 million to increase the non-capital panel attorney rate to \$113 per hour effective January 2007. 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 compensated at an hourly rate of \$92 for non-capital cases and up to \$163 for capital cases.

The judiciary requests annual cost-of-living adjustments—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 and maintain its purchasing power and, in turn, enables 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 has recognized the importance of annual cost-of-living adjustments by providing one to panel attorneys in fiscal year 2006, and we are very grateful for your help.

Our request to increase the non-capital hourly rate amounts to a catch-up increase, which, as I just mentioned, we would prefer to avoid. The non-capital rate was increased to \$90 in May 2002 (from \$75 per in-court hour and \$55 per out-of-court hour in most districts) but no adjustments were made to that rate until this past January, when it was raised from \$90 to \$92. In comparison, since May 1, 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. There is a substantiated need for our requested increase for panel attorneys. 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. In the first statistically valid, nationwide survey conducted of individual CJA panel attorneys 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. The surveys also confirmed that panel attorneys are reluctant to accept appointments in complex, high-cost representations at the \$90 rate.<sup>1</sup> 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.

The requested increase to \$113 per hour reflects the 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 being requested is well below the \$131 rate that

<sup>1</sup> 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.

a full catch-up increase would permit. I urge you to give this rate increase strong consideration.

#### SECURITY OF FEDERAL JUDGES

Mr. Chairman, I would like to update you on an issue in which I know the subcommittee shares a strong interest: the security of Federal judges and their families. As you recall, in February 2005 a Federal district judge's husband and mother were killed in their Chicago home by a disappointed civil litigant. A month later, a judge, court reporter, and deputy were killed in the Fulton County, Georgia courthouse by a defendant in a criminal case. In response to this violence, Congress acted quickly and provided \$11.9 million in fiscal year 2005 supplemental appropriations to the United States Marshals Service (USMS) for the installation of an intrusion detection system in the homes of all 2,200 Federal judges, and for additional positions in the USMS's Office of Protective Intelligence to improve the process of assessing potential threats against judges. Over 1,700 judges have indicated that they wish to participate in the Home Intrusion Detection System Program.

In September 2005, Congress approved the USMS's financial plan for spending the \$11.9 million, and in December 2005 the USMS awarded a contract to ADT to begin system installations. Subsequently, Congress approved an amended financial plan in which the USMS agreed to assume responsibility for the post-installation maintenance and monitoring of these systems. We are very appreciative of the efforts of John F. Clark, Director of the USMS, in moving this critically important project forward.

#### THE JUDICIARY'S RENT BURDEN

I now turn to an issue that has been a concern of the Judicial Conference for over 15 years: the rent that the judiciary pays to GSA. Before I do so, I would like to take a moment on behalf of our courts along the Gulf Coast to thank GSA for its prompt action in helping those courts to recover from last year's hurricanes. The courts and GSA worked well together, and GSA's help was essential.

While we appreciate GSA's hard work on our behalf, we do have serious concerns about its rental pricing policies for courthouses. Courthouses serve a critical role in our Nation's system of jurisprudence. They enable the Federal judiciary to ensure the swift, fair, and effective administration of justice, as is required by the Constitution. Our space needs are unique and unlike those of any other Federal entity. One of our primary concerns is that courthouses are currently treated as commercial office space by GSA for rent assessment purposes when, in reality, there is no building that is commercially equivalent to a Federal courthouse. The fact that the judiciary has added significantly to its space inventory over the last 10 years does not fully justify or explain our sharply escalating rent payments to GSA, which are expected to consume 20 percent of the courts' budget in fiscal year 2006 and will soon top \$1 billion per year.

The need to reduce the judiciary's enormous rent burden, which threatens judicial independence, is critical to the courts' financial well-being. Chief Justice John G. Roberts, Jr., in his "2005 Year-End Report on the Federal Judiciary", identified the GSA rent issue as one of ". . . two areas of concern that have come to the fore and now warrant immediate attention and action." Despite numerous appeals, GSA has repeatedly declined to provide the judiciary with any measure of rent relief, although in 2005 it provided rent relief to 14 other Federal entities. As the Chief Justice stated, "The disparity between the judiciary's rent and that of other government agencies, and between the cost to GSA of providing space and the amount charged to the judiciary, is unfair. The Federal judiciary cannot continue to serve as a profit center for GSA."

In the absence of any changes to GSA's current rent pricing structure for court-occupied space, the judiciary over the last year has been meeting with appropriations and authorizing committees in Congress to raise awareness of the detrimental impact GSA's rent pricing policies have had on the judiciary's core mission of administering justice. In those meetings, we have stressed that the judiciary's recent budget problems, particularly in 2004 where the courts lost 1,350 probation and clerks' office staff, were due at least in part to GSA's rent pricing policies that diverted to rent funds needed by the courts to perform their essential functions.

In the absence of rent relief, the judiciary has assumed the burden of minimizing its rent payments to GSA by scrutinizing rent bills and identifying overcharges. In New York, court staff spent months examining GSA billings and identified space rent overcharges, the cumulative effect of which resulted in savings or cost avoidance over 3 fiscal years totaling \$30 million. GSA has corrected these errors through rebates and rent credits. This was a time-intensive effort by the New York courts

that involved 2,000 staff hours—the equivalent of one person working full-time for a year. The real impact is that it took clerk's office staff away from core duties of processing the court's caseload in order to validate, and eventually correct, the billings from another Federal entity.

Because these overcharges may be happening elsewhere, the judiciary is expanding its effort to identify billing errors and has launched a nationwide initiative to train clerks' office staff on how to research and detect errors. Again, this effort will come with a cost. It is estimated that this nationwide effort will require a minimum of 13,000 staff hours—equivalent to six people working full-time for a year—in addition to \$4.3 million for training, travel, and contractor support costs, including professional real estate appraisal services. This is not work that clerks' office staff should have to do, and surely Congress did not intend that we would have to devote scarce resources to finding rent overcharges. But we are left with no choice. Given the judiciary's austere budget situation, we must pursue savings and economies whenever possible, even if we have to divert valuable court resources in order to do so. I would conclude my remarks on this topic by again quoting Chief Justice Roberts who said in his year-end report “. . . the judiciary must still find a long-term solution to the problem of ever-increasing rent payments that drain resources needed for the courts to fulfill their vital mission.” The judiciary stands ready to work with Congress and the administration on this very important issue.

#### COST-CONTAINMENT STRATEGY FOR THE JUDICIARY

The judiciary fully recognizes the fiscal situation facing the Congress and has made cost containment a major priority. As was reported to Congress last year, the Judicial Conference of the United States approved in September 2004 a cost-containment strategy of identifying and implementing measures to economize and reduce costs while not adversely affecting the delivery of justice. Director Mecham will be discussing cost-containment efforts in more detail in his testimony, but I would like to emphasize that these cost-containment efforts are having a real and immediate impact on our resource requirements. As an example, the fiscal year 2007 budget request was lowered by \$80 million principally due to cost-containment efforts and productivity improvements in clerks' and probation and pretrial services offices. The judiciary is preparing a report, for release this spring, to update Congress on the status of various cost-containment initiatives.

#### RESPONSE TO RECENT HURRICANES ALONG THE GULF COAST

Director Mecham will be discussing emergency preparedness activities in his testimony today, but I would like to talk briefly about the recent hurricanes along the Gulf Coast and their impact on Federal court operations. First, and most importantly, I am happy to report that the Third Branch suffered no loss of life due to the hurricanes, although some judges and court staff did lose their homes in Hurricane Katrina. I would also like to thank you for the \$18 million in fiscal year 2006 supplemental appropriations that was provided to help the courts deal with the aftermath of these natural disasters. This funding has paid for travel and per diem expenses for judges, court staff, and their dependents who were displaced by the hurricanes as well as for security, furniture, and operating expenses for the affected courts. If Congress had not provided this emergency funding, the judiciary would have been forced to absorb these expenses which in turn would have reduced the funding available to the courts in fiscal year 2006 for court support staff.

The hurricanes, particularly Katrina, caused significant disruption to court operations along the Gulf Coast. The damage caused by Hurricane Katrina forced the Fifth Circuit and its personnel to move to temporary duty locations in Houston, Texas, and Baton Rouge, Louisiana. District court personnel in the Eastern District of Louisiana were moved from New Orleans to temporary duty locations in Houma, Baton Rouge, and Lafayette, Louisiana, and in the Southern District of Mississippi, district court personnel were moved from Gulfport to temporary duty locations in Hattiesburg and Jackson, Mississippi. Hurricane Rita impacted court operations in the Eastern District of Texas. In that district, court personnel were moved from Beaumont to temporary space in Tyler and Lufkin, Texas. All of the courts affected by the hurricanes have resumed normal operations with the exception of the district court in Gulfport, which is expected to reopen in June 2006. Of course, for those who lost their homes in the hurricanes, a return to normalcy may be delayed for some time.

Quick action helped to minimize the cost of both bringing up court operations at the temporary locations and restoring operations at permanent locations. For example, court personnel in the Eastern District of Louisiana entered the courthouse in New Orleans soon after Hurricane Katrina hit and, under U.S. Marshals Service

guard escort, retrieved computer and office equipment and transported it to temporary duty locations, thus reducing the need to replace equipment. GSA quickly moved into affected court facilities to repair damages and restore power and air conditioning. This saved millions of dollars that would have been needed to replace furnishings damaged by mold and mildew. After Hurricane Rita hit, courts around the country sent used computer equipment to the Eastern District of Texas district court for judges and staff to use at temporary duty locations, again minimizing the need to purchase new equipment.

The disruption caused by the hurricanes—especially Katrina—presented unique challenges, particularly for probation officers who had to locate displaced offenders under their supervision. I would like to relate one story for you in particular that exemplifies the quick thinking and dedication of Federal probation officers across the country.

Following Hurricane Katrina, probation officers in the Eastern District of Louisiana scrambled to locate all the offenders under their supervision, but gave special attention to convicted sex offenders. I am pleased to say that all were found and are again in treatment and under supervision. In one such case, however, an offender fled to his mother's house in Alabama, which happened to be next door to an elementary school. He did not contact his probation officer or local police as required of convicted sex offenders. He was found, however, thanks to the good work of a Federal probation officer from the Northern District of Alabama. That officer recalled having briefly supervised a serious sex offender from the Eastern District of Louisiana while that offender was in Alabama, and, on a hunch, took it upon herself to drive by the offender's mother's house. There in the driveway was a car registered to the offender. Along with another officer, she confronted the offender who admitted he had not registered as a sex offender and had not tried to call his Louisiana Eastern probation officer. The probation officer called local police who took the offender into custody for failing to register. The offender is now back in Louisiana in a community corrections center.

This is only one of many stories I could give you that would demonstrate the commitment and dedication of our probation officers—not just during a crisis—but in the day-to-day conduct of their law enforcement duties.

#### CONTRIBUTIONS OF THE ADMINISTRATIVE OFFICE

The Administrative Office (AO) of the United States Courts has served and supported the courts in an exemplary manner in a very difficult fiscal year. The more the courts have to do, and the fewer resources with which they have to do it, the more challenging is the job of the AO. With only a fraction (1.2 percent) of the resources that the courts have, the AO does a superb job of advising us and supporting our needs.

The AO continues to serve as the central support agency for the Federal courts, with key responsibility for judicial administration, policy implementation, program management, and oversight. It performs important administrative functions, but also provides a broad range of legal, financial, management, program, 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. Time spent on new initiatives and on assisting the courts in operating under fiscal constraints means basic support and infrastructure work has to be deferred.

Last year was a particularly challenging one. In 2005, 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 deal with the myriad of space, travel, technology, and personnel issues that had to be addressed. The commitment of significant resources to these and other initiatives over the last year further stretched the AO's already strained resources.

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 fundamental role in supporting this country's system of justice.

The fiscal year 2007 budget request for the Administrative Office is \$75.3 million, representing an increase of \$5.8 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 with appropriated funds in fiscal year 2007.

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 pro-

vide program leadership and administrative support to the courts, and lead the efforts for them to operate more efficiently.

#### CONTRIBUTIONS OF THE FEDERAL JUDICIAL CENTER

I also urge the subcommittee to approve full funding for the Federal Judicial Center's request, which is only 7.5 percent over its 2006 level.

The Center's director, Judge Barbara Rothstein, has laid out in greater detail what the Center needs and why it needs it in her written statement. I want to 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 the judges, the judiciary, and Congress and the public, depend in reaching important decisions relating to litigation and court operations. Likewise, the Center's educational program for judges and court staff are vital in preparing new judges and employees to do their jobs, and in keeping them current so that they can better deal with rapid 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 more information and education to more people, more quickly. The relatively small investment you make in the Center each year (less than one-half of 1 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 2007 is going to be another tight budget year, perhaps the tightest ever. With the gains you helped us achieve in fiscal year 2006, we are on the brink of setting a new course that will restore the financial health of the Federal court system. But it will take the resources we seek in our fiscal year 2007 budget request to accomplish that goal and to avoid a repeat of the staffing losses that occurred in fiscal years 2004 and 2005. I know that you agree that a strong, independent judiciary is critical to our citizens, our economy, and our homeland security. I urge you to fund this request fully in order to enable us to maintain the high standards of the United States judiciary. Failure to do so could result in a significant loss of existing staff, dramatic cutbacks in the levels of service provided, and a diminishment in the administration of justice.

I would be happy to answer any questions the subcommittee may have.

#### APPENDIX A

#### JUDICIARY APPROPRIATION FUNDING

[Dollars in thousands]

Appropriation Account	Fiscal Year 2006 Available <sup>1</sup>	Fiscal Year 2007 Request	Change Fiscal Year 2007 vs. Fiscal Year 2006	Percent Change Fiscal Year 2007 vs. Fiscal Year 2006
U.S. Supreme Court:				
Salaries & Expenses .....	\$60,143	\$63,405	\$3,262	5.4
Care of Building and Grounds .....	5,568	12,959	7,391	132.7
Total .....	65,711	76,364	10,653	16.2
U.S. Court of Appeals for the Federal Circuit .....	23,783	26,300	2,517	10.6
U.S. Court of International Trade .....	15,342	16,182	840	5.5
Courts of Appeals, District Courts & Other Judicial Services:				
Salaries & Expenses:				
Direct .....	4,308,395	4,687,244	378,849	.....
Supplemental .....	18,000	.....	(18,000)	.....
Vaccine Injury Trust Fund .....	3,795	3,952	157	.....
Total .....	4,330,190	4,691,196	361,006	8.3
Defender Services .....	709,830	803,879	94,049	13.3
Fees of Jurors & Commissioners .....	60,705	63,079	2,374	3.9

## JUDICIARY APPROPRIATION FUNDING—Continued

[Dollars in thousands]

Appropriation Account	Fiscal Year 2006 Available <sup>1</sup>	Fiscal Year 2007 Request	Change Fiscal Year 2007 vs. Fiscal Year 2006	Percent Change Fiscal Year 2007 vs. Fiscal Year 2006
Court Security .....	368,280	410,334	42,054	11.4
Subtotal .....	5,469,005	5,968,488	499,483	9.1
Administrative Office of the U.S. Courts .....	69,559	75,333	5,774	8.3
Federal Judicial Center .....	22,127	23,787	1,660	7.5
Judiciary Retirement Funds .....	40,600	58,300	17,700	43.6
U.S. Sentencing Commission .....	14,256	15,740	1,484	10.4
Direct .....	5,698,588	6,256,542	557,954	.....
Supplemental .....	18,000	.....	(18,000)	.....
Vaccine Injury Trust Fund .....	3,795	3,952	157	.....
Total .....	5,720,383	6,260,494	540,111	9.4

<sup>1</sup> Fiscal year 2006 appropriated funds include the effect of the 1 percent across-the-board discretionary rescission where applicable (Public Law 109-148).

## APPENDIX B—SUMMARY

The fiscal year 2007 appropriation request for the Courts of Appeals, District Courts, and Other Judicial Services totals \$5,968,488,000, an increase of \$499,483,000, or 9.1 percent, over fiscal year 2006 available appropriations. In addition to appropriated funds, the judiciary utilizes other funding sources to supplement our appropriations including fee collections, carry forward of fee balances from a prior year, and the use of no-year funds. When all sources of funds are considered, the increase in obligations for fiscal year 2007 is \$362,506,000 or 6.2 percent.

Of the \$499,483,000 increase in appropriations, 85 percent (\$425,742,000) is adjustments to the fiscal year 2006 base associated with standard pay and other inflationary increases as well as other adjustments that will allow the courts to maintain current services in fiscal year 2007. The remaining 15 percent (\$73,741,000) is needed to respond to increased requirements for magistrate judges, Federal defender offices, an increase in panel attorney non-capital rate increases, court security systems and equipment, digital video equipment in all new courthouses, information technology upgrades and to fund additional court staff required to handle the most critical workload, particularly along the southwest border.

The requests for the principal programs are summarized below.

*Salaries and Expenses*

The salaries and expenses of circuit, district, and bankruptcy courts and probation and pretrial services offices account for most of our request. A total of \$4,691,196,000 in appropriations is required for this account, including funding for the Vaccine Injury program, an increase of \$361,006,000 above the fiscal year 2006 available appropriation. Funding totaling \$285,892,000 is expected to be available from other sources, including fee collections and carryforward balances to fund Salaries and Expenses requirements. Combined with our appropriations request, this results in obligations of \$4,977,088,000.

Of the \$361,006,000 increase in appropriations, 93 percent (\$335,553,000) is needed to fund adjustments to the fiscal year 2006 base including: pay and benefit increases for judges and chambers staff (\$13,168,000); increase in the number of senior, Article III, and magistrate judges and associated staff (\$5,771,000); pay and benefits for court personnel and programs (\$106,694,000); GSA space rental and related services (\$46,886,000); information technology related adjustments (\$42,595,000); financing adjustments to replace non-appropriated sources of funds with appropriated funds (\$115,082,000); and other operations and maintenance costs that are uncontrollable in nature (\$5,357,000).

The remaining 7 percent (\$25,453,000) will fund 3 additional magistrate judges and their staff to help Article III judges handle civil cases and the record number of criminal cases facing the courts (\$1,282,000); 257 court support FTE to address fiscal year 2007 workload requirements (\$22,109,000); and increases to support new information technology projects and upgrades (\$2,062,000).

*Defender Services*

An appropriation of \$803,879,000 is required for the Defender Services program to provide representation for eligible criminal defendants in fiscal year 2007. This is an increase of \$94,049,000 above the fiscal year 2006 available appropriation.

Of this increase, 74 percent (\$69,133,000) is needed for adjustments to the fiscal year 2006 base for inflationary and workload increases. Included in these adjustments are standard pay and inflation increases for Federal defender organizations (\$19,310,000); a cost-of-living adjustment to the capital and non-capital panel attorney rates (\$1,717,000) and annualization costs of the 2006 panel attorney non-capital and capital rate adjustments (\$1,535,000); and other inflationary increases (\$2,849,000); increase in the projected number of representations (\$14,214,000); funding adjustments to replace carryforward funding with appropriated funds (\$17,644,000); funding for deferred panel attorney payments from fiscal year 2006 and unfunded fiscal year 2006 base requirements (\$12,464,000); and a reduction in non-recurring costs (-\$600,000).

Twenty-five percent (\$23,676,000) is requested to provide funding for the costs associated with increasing the panel attorney non-capital rate to \$113 per hour, effective January 1, 2007.

The remaining increase of 1 percent (\$1,240,000) will fund an increase for six new positions at the Administrative Office (\$640,000); and start-up costs of two new Federal defender organizations expected to be opened in fiscal year 2007 (\$600,000).

*Fees of Jurors and Commissioners*

For the Fees of Jurors program, an appropriation of \$63,079,000 is required, an increase of \$2,374,000 from the fiscal year 2006 available appropriation. The Fees of Jurors request is a current services budget for fiscal year 2007 with no program increases. The adjustments to the fiscal year 2006 base include a net decrease in the projected number of juror days (-\$722,000); an inflationary adjustment (\$832,000); and a financing adjustment to replace carryforward funding with appropriated funds (\$2,264,000).

*Court Security*

For the Court Security program, an appropriation of \$410,334,000 is required, which is an increase of \$42,054,000 above the fiscal year 2006 available appropriation. Of this increase, 44 percent (\$18,682,000) is for adjustments to base including an increase for standard pay and benefit increases (\$292,000); a fiscal year 2007 Department of Labor wage rate adjustment for court security officers (CSOs) (\$10,250,000); annualization costs for 37 new fiscal year 2006 CSOs (\$889,000); 34 additional CSOs for new and existing space (\$2,626,000); inflationary adjustments (\$1,200,000); an increase for Federal Protective Service security charges (\$7,371,000); and a reduction for non-recurring security systems and equipment (-\$3,946,000).

The remaining increase of 56 percent (\$23,372,000) will fund security systems and equipment enhancements (\$16,778,000); the installation of digital video recorders (\$6,569,000); and a United States Marshals Service server replacement initiative (\$25,000).

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PREPARED STATEMENT OF LEONIDAS RALPH MECHAM, DIRECTOR, ADMINISTRATIVE  
OFFICE OF THE U.S. COURTS

## INTRODUCTION

Chairman Bond, Senator Murray, and members of the subcommittee, I am pleased to present my final testimony before the Senate in support of the fiscal year 2007 budget request for the Administrative Office of the United States Courts (AO). I will soon be retiring as Director of the Administrative Office. I have served three Chief Justices, thousands of judges and court staff, and directed the AO during two decades of unprecedented change. I have worked closely with members and staff of the various committees of Congress with jurisdiction over the judiciary and am extremely proud of what we have accomplished together. I am grateful for the opportunity afforded me to head what I believe is the finest agency in the Federal Government.

I especially want to thank you and your committee for the support provided to the judiciary during our first year under the purview of this subcommittee. Only weeks after the Appropriations Committee reorganization last year, you supported emergency supplemental funding to enhance the protection of judges in their homes, and language ensuring sufficient fees would be available to support the judiciary's implementation of the new Bankruptcy law. Then, during consideration of the fiscal

year 2006 Transportation-Treasury Appropriations Act, you made funding for the judiciary a priority, recognizing the uncontrollable nature of the workload in our Nation's courts. And, as the year drew to a close, you supported emergency supplemental funding to assist Gulf Coast courts in their recovery efforts in the aftermath of Hurricanes Katrina, Rita, and Wilma. Your leadership in support of the Judicial Branch during these times of tremendous budget pressures is deeply appreciated.

#### CONTAINING COSTS THROUGH RENT RELIEF

As you may recall from my visit with you last year, I am deeply concerned about the adverse impact the judiciary's rent bill has had on court operations. As Chief Justice John Roberts stated in his 2005 Year-End Report, "The Federal judiciary cannot continue to serve as a profit center for GSA." While the judiciary has taken steps of its own to control its rent bill by undertaking a comprehensive review of its courthouse construction program, including a moratorium on new construction projects, it is the so-called "market-based" or commercially equivalent rent we are paying for existing facilities that is exacerbating our budget difficulties.

During the 18-month period from October 2003 through March 2005, budget shortfalls and delayed appropriations forced the judiciary to reduce court staffing by 8 percent or 1,800 employees. Yet, during this same time period, the rent bill paid to GSA increased and was paid in full. Faced with the choice of paying an even higher rent bill or firing additional court employees, all during a period of historically high workload, the judiciary tried unsuccessfully to seek a rent exemption from the GSA—similar to those the GSA provided at the same time to 14 other executive branch entities. Each request by the judiciary was turned down or GSA offered alternatives that, in the long term, would not save money. Unable to sustain any further staffing reductions, and without cooperation from GSA, the judiciary had no choice but to engage in a detailed, and costly, technical review of rent bills at the local level to try to identify rent discrepancies that would result in a lower rent bill.

Judge Gibbons describes this effort in her testimony and shares the success we have had in identifying inaccuracies and errors in the rent bills for the Northern and Southern Districts of New York, which resulted in a savings of \$30 million to the judiciary through rebates and rent credits. Certainly we are pleased with this result as the unanticipated return of funds has helped to offset the impact of the 1 percent across-the-board rescission to our fiscal year 2006 appropriation. But, the rebates provide only short-term rent relief. As Chief Justice Roberts stated in his 2005 Year-End Report, ". . . the judiciary must still find a long-term solution to the problem of ever-increasing rent payments that drain resources needed for the courts to fulfill their vital mission." Unless judiciary appropriations keep pace with the increase in our rent bills, we will be unable to sustain the staffing levels necessary to carry out the mission of the Judicial Branch. Despite the aforementioned rebates, rent paid to GSA in fiscal year 2006 is expected to consume over 20 percent—nearly \$1 billion—of the courts' operating budget. In contrast, the Executive Branch as a whole spends less than two-tenths of 1 percent of its budget on GSA rent—in part because many agencies have managed to become totally independent of the GSA.

On February 8, 2006, Congressman Sensenbrenner introduced H.R. 4710, the Judiciary Rent Reform Act of 2006. A similar bill, S. 2292, was introduced in the Senate by Senator Specter on February 16, 2006. The purpose of this bipartisan legislation is to ensure that the rent paid by the Federal judiciary is fair and equitable, and is related to the actual costs of providing court facilities. Enactment of the legislation would change existing practice by requiring the judiciary to pay only for the GSA's direct expenses associated with the operation and maintenance of federally-owned space occupied by the courts, as well as applicable indirect GSA expenses, which principally entail GSA's administrative overhead at the field office, regional and central office levels. The judiciary would be required to pay only the underlying contract rent for any court-occupied leased space and would be exempt from paying for components of GSA's current pricing policy, which are above and beyond its actual costs of operating and maintaining federally-owned space.

With regard to future courthouse construction or major repair and alteration projects undertaken by GSA on behalf of the judiciary, under this proposed legislation, the judiciary would request appropriations directly from Congress and transfer appropriations approved by Congress to GSA for deposit into the Federal Buildings Fund. The amounts transferred would be designated specifically for those projects. This legislation will not change the current congressional process for authorizing new courthouse construction and repair and alteration projects, nor will it change appropriations subcommittee jurisdiction. It simply will ensure that the judiciary pays a fair and equitable amount to GSA to lease, operate, and maintain court facilities. Furthermore, it will ensure that all funding deposited in the Federal Build-

ings Fund by the judiciary is used to support and build judiciary facilities, and is not used by the administration to fund Executive Branch projects instead.

Modifying the funding mechanism for judiciary facilities will improve the process for both the judiciary and Congress, and will preclude the situation the judiciary finds itself with respect to fiscal year 2007 and, in fact, 5 of the past 10 years. The Judicial Conference has identified to GSA and the administration the need for five courthouse projects, at a cost of \$307 million for fiscal year 2007. The President's budget has included no funds whatsoever for courthouse construction projects. OMB has included no funds for projects funded out of the Federal Buildings Fund. Yet, the judiciary will pay approximately \$1 billion in rent to GSA in fiscal year 2007, which is about \$500 million more than is needed to pay for the cost to lease and operate court facilities. While there is \$148.6 million in the fiscal year 2007 request for three courthouse Repair and Alteration projects, the vast majority of the "rent profit" realized by GSA from the judiciary goes to support Executive Branch projects.

Mr. Chairman and members of the subcommittee, I hope you will support the judiciary's efforts to address the burden that excessive rent costs are placing on the judiciary by co-sponsoring S. 2292. Especially during these times of limited resources, I fear that our ability to carry out the basic functions of the judicial branch are at stake if rent relief is not obtained.

#### ROLE OF THE ADMINISTRATIVE OFFICE

The Administrative Office of the U.S. Courts was created by an Act of Congress in 1939 and is devoted to helping the courts fulfill the judiciary's mission—administering justice to the citizens of this country. Neither the Executive Branch nor the Legislative Branch has a comparable organization that provides the broad range of services and functions that the Administrative Office does for the Judicial Branch. My successor will be only the seventh Director of this unique institution in almost 70 years.

The AO provides administrative, legal, financial, management, program, security, and information technology services to the 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 is also the focal point for judiciary communication, information, program leadership, and administrative reform. 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, providing information on pending legislation and congressionally mandated reports.

As I prepare to retire from this extraordinary organization, I want to take this last opportunity to appeal for sufficient resources to sustain the AO's staffing level, which has not been increased in over 10 years despite many new work demands. In the past few years, we have been forced to maintain high vacancy rates due to funding shortages. I hope the following examples of recent challenges and achievements will illustrate the critical role the employees of the Administrative Office play in supporting the Federal judiciary.

#### *Implementing the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*

The most sweeping changes to bankruptcy law in the past 20 years were enacted on April 20, 2005, with the signing of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Public Law 109-8). The Act's impact on judiciary resources, including AO and court staff, has been monumental. The 500-page Act made many substantive changes to the Bankruptcy Code that required significant amendments to the judiciary's bankruptcy rules and forms. It also established a host of new procedures and proceedings that are adding to the work of bankruptcy judges, bankruptcy clerks, bankruptcy administrators, and staff here at the AO. Most of the Act's provisions took effect October 17, 2005, just 180 days after enactment, requiring the AO, Judicial Conference committees, and the bankruptcy courts to undertake an enormous effort to meet the tight deadline. Moreover, implementing the Act required the AO to quickly develop a new version of CM/ECF, the case management and electronic filing system, used by the courts.

To coordinate the AO's national implementation of the Act, I formed a Bankruptcy Act Implementation Working Group, which met three times a month to identify all implementation tasks and issues and to coordinate all phases of implementation of the provisions of the Act. Over 100 employees representing a minimum of 15 pro-

gram offices at the AO were involved in this tremendous effort—all of which had other principal duties.

I also approved the creation of a Bankruptcy Legislation Working Group, comprising judges, unit executives, and deputy clerks, who worked many hours, in conjunction with my staff, to address many of the new issues raised in the Reform Act. This Group created a “grid” of information, addressing various areas of the law, including means testing, credit counseling, and tax returns. This grid, which included procedural and legal guidance, statutory cites, and CM/ECF information, proved an invaluable resource for the courts as they prepared to implement the new law.

In addition, the Advisory Committee on Bankruptcy Rules, the Committee on the Administration of the Bankruptcy System, and court working groups devoted substantial hours and effort to ensure compliance with the Act. Beginning with an organizational meeting the day after enactment of the law, the Advisory Committee conducted more than 20 conference calls, held three subcommittee meetings, and two full committee meetings. Members of the Committee, the Committee’s consultants—four law professors—and AO staff spent countless hours conferring, drafting, and re-drafting the new and revised rules and forms. As a result of this work, on August 11, 2005, the Executive Committee of the Judicial Conference approved eight new rules, amendments to 35 existing rules, amendments to 33 existing forms, and nine new official forms, and authorized the distribution to the courts of interim rules with the recommendation that the courts adopt them by local order. In the meantime, the Standing Rules Committee is proceeding with permanent changes to the Federal Rules of Bankruptcy Procedure, following the normal procedures of the Rules Enabling Act.

Administrative Office staff posted these Interim Rules and official forms on the judiciary’s internet website. From October 2005 to January 2006, the new forms had nearly 362,000 visitors and the interim rules had almost 100,000 visitors. AO staff have responded to thousands of inquiries about the rules and forms, the new procedures and the amended Bankruptcy Code in general, and have participated in many meetings on the interim rules and amended forms, including dozens of national and local seminars and teleconferences, and a satellite broadcast with bankruptcy judges, clerks, and other court staff.

AO staff also completed major revisions to the case management software, the courts’ electronic docket and case management system, to incorporate the many procedural changes in bankruptcy cases and proceedings that took effect on October 17. This updated version of the software enabled the courts to comply with the means test, as well as the new noticing requirements. Currently, AO staff are working on the development of a new statistical database and analysis system to enable the courts to meet the Act’s data reporting requirements, which will become effective 18 months after the enactment. The enhanced statistical infrastructure needed to produce the new statistics will be in place by October 1, 2006.

Later in my statement, I will discuss the overall impact our electronic case management system has had on the courts, but I would like to point out here that without this system, the bankruptcy courts would have been paralyzed during the period preceding the October 17, 2005, effective date. During the 16 days preceding the Act’s effective date, over 625,000 bankruptcy cases were filed, more than would normally be expected over a 5-month period. In paper form, if an average no-asset Chapter 7 case file measures three-eighths of 1 inch thick, then those 625,000 cases would have required a shelf almost 4 miles long, to support a weight of 208 tons. With a lot of hard work and overtime, and with the incredible performance of CM/ECF, our bankruptcy clerks were able to begin processing this avalanche of cases—which are still in progress—with minimal adverse impact on the courts.

#### *Disaster Response—Hurricane Recovery Efforts*

In 2001, after the terrorist attacks of 9/11, I created a Judiciary Emergency Preparedness Office at the AO to ensure that the courts have the capability to perform essential activities and function without extended delays in the event of natural disasters, terrorist attacks, or civil emergencies. It is led and staffed by individuals who have other duties during non-emergency periods. The AO’s leadership role for the judiciary in disaster response was demonstrated and tested during the hurricanes of 2005. The staff of the AO met the challenge with commitment, dedication, expertise, and above all—success.

In the wake of Hurricane Katrina, the AO launched an immediate and intensive effort to assure that judges, court staff, and their families were safe, and to return court operations to normal as quickly as possible. Seventy court units from Houston to Miami experienced some break in telecommunications and more than 1,500 court employees were affected. Here in Washington, AO staff from 18 program offices formed the Judiciary Emergency Response Team (JERT) to coordinate information

and assistance to the affected courts in the areas of procurement, space and facilities, technology, travel, finance, human resources, legislative affairs, public affairs, and legal counsel. The JERT met for nearly 7 weeks to assess the situation and provide advice and assistance to the courts, to include site visits to the affected areas.

Staff contacted banks in Louisiana and Mississippi to ensure paychecks were received and processed, negotiated with benefit providers to expedite payments, and made available phone and electronic communication services for courts unable to access their long-distance carriers. At the direction of the Judicial Conference, legislation was pursued by the AO and quickly enacted to allow courts to convene outside their regional jurisdiction during times of emergency. Memoranda were also issued to affected judges and court unit executives addressing areas of key concern such as: relocating judges and court employees; providing guidance on temporary duty travel and related expense reimbursement; allocating funds to cover disaster expenses; delegating certain procurement authority for the immediate replacement of furniture, supplies, and equipment; and reestablishing information technology systems.

Throughout September, teams of experts from the AO were deployed to Jackson in the Southern District of Mississippi, Baton Rouge, Houma, and Lafayette in the Eastern and Western Districts of Louisiana, and to the Hurricane Rita-impacted Southern and Eastern Districts of Texas. The AO staff provided on-site assistance in human resources management, temporary duty travel, information technology, procurement, space and leasing, security, and coordination with other assisting government agencies.

Court operations are running fairly well in the districts affected by the hurricanes of 2005. Mr. Chairman, we owe a debt to you and your subcommittee, which was especially supportive of our emergency supplemental request. Our funding needs were primarily to recover costs associated with per diem, travel expenses, and replacing lost equipment. Fortunately, through quick action and the personal dedication of our court staff, we were able to avoid hundreds of thousands of dollars in equipment replacement costs. I am proud of the work of the AO's Judiciary Emergency Preparedness Office, and the judiciary employees across the country who were instrumental in the judiciary's swift recovery from these natural disasters.

#### *Continuity of Operations Plans (COOPs)*

Since its creation, a principal focus of the AO's Judiciary Emergency Preparedness Office has been to assist each court in the development of continuity of operations plans (COOPs). During the last several years, courts have been testing and validating their COOPs.

Before Katrina hit, and throughout the disaster recovery period, the affected courts used their Continuity of Operations Plans to safeguard staff, court files, and property. At both the circuit and the district court levels, the intensive efforts to develop and test COOPs paid off in the aftermath of Katrina. Court employees knew their space and equipment requirements, knew which employees were critical to the resumption of operations, and the employees themselves knew their roles. Ten days after Katrina hit, the courts affected felt that they were much further ahead than they would have been if Hurricane Katrina had struck 4 years ago.

#### *Cost-containment Initiatives*

Supporting the judiciary's overall cost-containment initiatives has been a top priority of the AO during the past year. Led by Judicial Conference Committees, and working closely with court advisors, AO staff is currently engaged in more than 50 cost-containment initiatives related to space and facilities cost control, workforce efficiency, review of compensation costs, effective uses of technology, program changes in defender services, court security, and law enforcement, and adjustments to fees. To date, initiatives that have already yielded savings include the moratoria on space projects, reductions to probation and pretrial services work requirements, reductions and elimination of Federal Protective Service contract guard services that were deemed to be redundant and/or unnecessary, and productivity adjustments to court staffing formulas.

The AO is also leading by example. During 2005, the AO continued implementation of internal cost-control measures—staffing vacancies were closely monitored and controlled. Because of funding limitations, the AO maintained a vacancy rate of nearly 10 percent also, all operations, projects, and functions were closely examined to identify cost reduction opportunities. Only limited travel and training were allowed, and orders for all other contracts, services, supplies, and equipment were restricted to those essential to basic operations and to supporting Judicial Conference committees, continuing court operations, and implementing information technology projects previously approved. While such restrictions may be acceptable

for a short period, over the longer term, they begin to adversely affect the AO's ability to support the courts. For example, having a properly trained workforce is absolutely critical to maintaining legal, financial, human resources, and technology support for the courts. It is also necessary to maintain up-to-date information technology and office equipment if we are to communicate with the courts effectively. Lastly, it is essential that AO staff travel to the courts in order to perform program reviews and audits, and to assist in the implementation of more cost-effective practices which will benefit the taxpayers in the long run. Later, I will discuss how our fiscal year 2007 budget request will meet these needs.

We also sought and secured, thanks to your subcommittee, changes to judiciary procurement authorities which will allow us to enter into multi-year contracts that are more competitive and cost-efficient. The Executive Branch already had these authorities and we appreciate your extending them to the judiciary as part of the fiscal year 2006 appropriations act.

#### INCREASING PRODUCTIVITY IN THE COURTS 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. During 2005, the AO focused on continuing to strengthen the judiciary's information technology infrastructure.

##### *Electronic Case Filing*

By the end of 2005, the Federal courts' Case Management-Electronic Case Files (CM/ECF) system was operating in virtually all district and bankruptcy courts. The prototype system was launched in 1995 when a team from the AO helped the U.S. District Court in the Northern District of Ohio cope with more than 5,000 document-intensive maritime asbestos cases. That court faced up to 10,000 new pleadings a week, and 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 megabankruptcies, and was drowning in paper. Since those early efforts, the system has processed more than 24 million Federal court cases and served hundreds of thousands of attorneys and litigants nationwide.

The implementation of CM/ECF is the largest system development and implementation effort ever undertaken in the judiciary. Virtually all bankruptcy and district courts are now using this system, and the appellate courts are testing a version for deployment later this year. The reach of the project is almost staggering. More than 400,000 attorneys have registered and been trained in CM/ECF and in 1 month alone—August 2005—4.6 million docket entries were made using CM/ECF. In coordination with the Public Access to Court Electronic Records System (PACER), it 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.

##### *Bankruptcy Noticing Center*

The AO's Bankruptcy Noticing Center (BNC) electronically retrieves data from bankruptcy courts' case management systems and prints, addresses, batches, and mails the resulting notices. The Bankruptcy Code and Federal Rules of Bankruptcy Procedure require bankruptcy courts to send these notices to all interested parties in a bankruptcy case. The BNC not only eliminates local preparation and mailing of notices by deputy clerks, it also generates notices in a fraction of the time and at a far lower cost than local noticing. The BNC, now in its eighth year, is estimated to have saved nearly \$36 million for the judiciary since its inception.

As bankruptcy courts across the country handled long lines of bankruptcy filers, the Bankruptcy Noticing Center also was generating a flood of notices. In the weeks prior to and immediately after October 17, 2005—the law's effective date—the BNC produced up to 1.7 million individual notices per day, over triple its normal workflow. By the end of October, the BNC was still churning out over 1 million notices a day.

*Probation and Pretrial Services Automated Case Tracking System*

The Probation and Pretrial Services Automated Case Tracking System (PACTS) is a case tracking and case management tool that demonstrated its value in the days and weeks that followed the destruction on the Gulf Coast. PACTS collects case-related information, produces statistical and workload reports, and provides efficient retrieval of case information by probation and pretrial services officers. An interface between PACTS and personal digital assistants (PDAs)—as well as laptop computers—allows officers field access to information in all districts. The system is now implemented in all 94 districts and in the aftermath of the hurricanes, we are working to provide PDAs to as many officers as possible.

Without access to their offices, and in many cases, computers of any kind, probation officers were able to use their PDAs and PACTS to locate and check-up on supervised offenders who were displaced from their homes after the hurricanes hit. One particular lesson learned in our disaster recovery is the need to expedite the provision of PDAs to all probation officers nationwide. At your direction, funding in the Courts' fiscal year 2006 financial plan will allow us to do that.

## ADMINISTRATIVE OFFICE BUDGET REQUEST

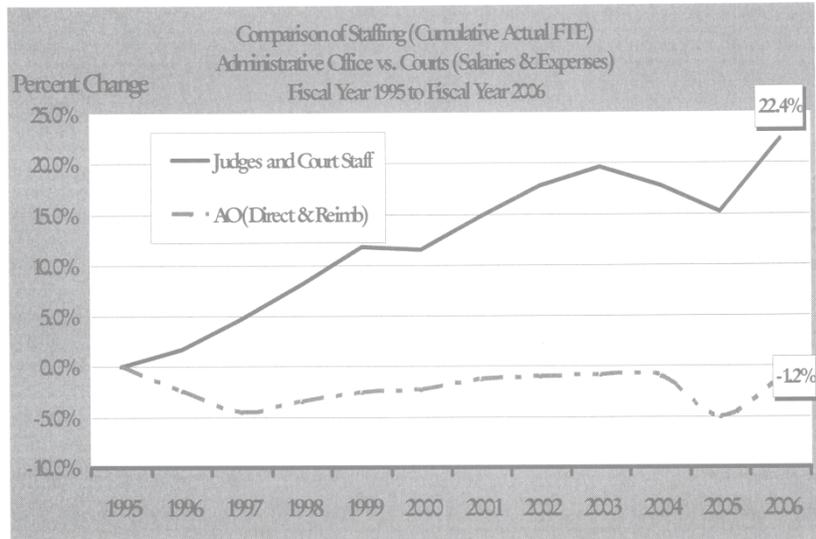
The fiscal year 2007 appropriations request for the Administrative Office of the U.S. Courts is \$75,333,000, representing an increase of \$5,774,000, or 8.3 percent, over fiscal year 2006 available appropriations. While the percentage increase in appropriations we are seeking may appear significant, overall it represents a current services budget request. The primary reason for this large increase in appropriations is to replace non-appropriated funds (fee/carryover) that were used to finance the fiscal year 2006 financial plan, but which are expected to decline in fiscal year 2007.

Specifically, the increases needed to maintain current services include \$1.1 million for standard pay and other inflationary increases and a \$4.7 million financing adjustment associated with a projected decline in fees and carryforward in fiscal year 2007 from what was available in fiscal year 2006. Should our current declining fee and carryover projections come to pass, and they are not replaced with direct appropriated funds, we will be forced to reduce current on-board staffing. This will adversely affect our ability to serve the courts. We will, of course, keep you apprised of actual fee collections and carryover estimates as the year progresses. Should collections surpass our estimates, the amount we are requesting could be reduced.

## AO RESOURCES ARE STRETCHED THIN

The AO's funding situation is extremely tight. Without enough funds to maintain a full complement of staff, the agency and its managers and staff are under enormous strain. As demonstrated by some of my earlier examples, unanticipated events over the past several years have required us to provide greater support to the courts in the areas of security, emergency preparedness and disaster recovery, financial management and planning, technology, and the development and implementation of new business practices resulting from changes in Federal law. Without adequate staff resources, the AO struggles to meet these challenges head on—we have been forced to pull people away from their daily duties to handle the crises as they arise but cannot continue to do this on a long term basis.

As illustrated in the following graph, staffing levels at the AO have actually declined since fiscal year 1995, while during the same time period, the number of judges and court staff being supported by the AO have grown by 22 percent. This widening disparity between staffing and support of the courts has been a hardship for the AO and could be crippling in fiscal year 2007 if the non-appropriated sources of funding available to the AO in fiscal year 2006 are not replaced with direct appropriations.



#### CONCLUSION

Chairman Bond, Senator Murray, members of the subcommittee, I hope that I have conveyed the wide array of responsibilities vested in the AO and the seriousness with which we undertake them. For every issue that affects the judiciary, every new piece of legislation that expands or alters Federal jurisdiction, every administration initiative that impacts Federal law enforcement, every congressional request for information, personnel at the AO must quickly master the subject area and render expert advice and support to the courts.

During these times of fiscal constraint and limited discretionary spending, the AO takes the lead in assisting the courts in developing new, innovative, and cost-effective ways to carry out the business of the judiciary. I am proud of the AO's record of service to the courts in this regard and know that the staff will continue to work tirelessly to ensure the administration of justice is able to be carried out efficiently and effectively. While I recognize that fiscal year 2007 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 to consider the significant role the AO plays in supporting the courts and the mission of the judiciary. Once again, our budget request is one that will require the staff at the AO to do more with less—it 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. It has been a privilege for me to serve the Federal courts for the past 21 years. I have particularly enjoyed working with the Appropriations Committee.

I would be pleased to answer your questions.

#### PREPARED STATEMENT OF THE UNITED STATES SENTENCING COMMISSION

Chairman Bond, Ranking Member Murray, members of the committee, the United States Sentencing Commission thanks you for the opportunity to submit this statement in support of the Commission's appropriations request for fiscal year 2007.

In the Commission's statements in support of its fiscal year 2005 and 2006 appropriations requests, the Commission detailed for the committee the impact the Supreme Court's decisions in *Blakely v. Washington*<sup>1</sup> and *United States v. Booker*<sup>2</sup> were having not only on the Commission, but the entire criminal justice community.

<sup>1</sup> 542 U.S. 296 (2004).

<sup>2</sup> 543 U.S. 220, 125 S. Ct. 738 (2005).

The Commission continues to feel the impact of these decisions but remains firmly committed to meeting all of its statutory obligations.

The Commission continues to be the central agency for the collection, analysis, and reporting of Federal sentencing statistics and trends, and it is dedicated to continuing this critical role. The Commission also continues to develop appropriate guideline penalties for a vast array of new and existing crimes, respond to Congressional directives and inquiries regarding sentencing policy generally, provide education on sentencing issues to the judiciary and other participants in the criminal justice community, and conduct research activities that help to shape the future of sentencing policy.

The preceding fiscal years have been extraordinarily busy for the Commission, and it anticipates that fiscal year 2007 will be equally so. Full funding of its fiscal year 2007 request will ensure that the Commission can continue to meet all of its statutory obligations and, most importantly, continue to provide the criminal justice community with the most comprehensive and timely sentencing information available.

#### RESOURCES REQUESTED

The Commission is requesting \$15,740,000 for fiscal year 2007, representing a 9 percent increase over allotted funding for fiscal year 2006. The Commission recognizes that the fiscal year 2007 budget cycle is extraordinarily tight, and it does not seek this increase lightly. The Commission's request is backed by significant resource demands, including increased demand for Commission work product.

#### JUSTIFICATION FOR COMMISSION'S APPROPRIATION REQUEST

The statutory duties of the Commission include, but are not limited to: (1) promulgating sentencing guidelines to be considered, determined, and calculated in all Federal cases; (2) collecting sentencing data systematically to detect new criminal trends, determine if Federal crime policies are achieving their goals, and serve as a clearinghouse for Federal sentencing statistics; (3) conducting research on sentencing issues and serving as an information center for the collection, preparation, and dissemination of information on Federal sentencing practices; and (4) providing training to judges, prosecutors, probation officers, the defense bar, and other members of the criminal justice community in the application of the guidelines.

The *Booker* decision had a dramatic impact on the Federal sentencing system, but it did not change these core missions. In fact, the Supreme Court 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."

#### *Sentencing Policy Development and Guideline Promulgation*

The Commission has maintained an active policy cycle in the wake of *Blakely* and *Booker*, despite the resource drain responding and adapting to these cases has caused. In fiscal year 2006, for example, the Commission has promulgated proposed amendments and issues for comment in 14 areas of criminal law, including: immigration, steroids, terrorism, transportation, and firearms offenses. With regard to immigration offenses which now make up almost one-quarter of the entire Federal caseload—the Commission has held one round table discussion (in Washington, DC) and two regional hearings (one in San Antonio, Texas and one in San Diego, California) at which it received expert testimony from judges, prosecutors, defense attorneys, probation officers, and others about issues related to immigration offenses. The Commission also met with key congressional staff to advise them of the Commission's findings and actions, and provided them with a detailed staff report on immigration reform and the Federal sentencing guidelines.

The Commission took a similar approach with regard to its consideration of steroids offenses. The Commission held a roundtable in Washington, DC that brought in practitioners, scientists, and other academics to discuss these offenses and their associated harms. Commission staff also met with congressional staff and worked with staff from the Government Accountability Office on this very important topic. As part of its amendment process, the Commission also produced a detailed report on steroids use and abuse.

The Commission anticipates another active amendment cycle in fiscal year 2007. In addition to its own policy priorities (which it identifies each spring and finalizes each fall), the Commission expects to address issues related to terrorism, transportation, sex offenses, and drug offenses, as well as implementation of other pending crime legislation from the 109th Congress warranting a Commission response. The Commission believes that the multi-faceted approach it took with regard to its con-

sideration of immigration and steroids offenses should continue to be the model for its future amendment cycles. As such, the Commission will have to devote more staff (and Commissioner) resources to the planning and execution of this type of outreach, including associated travel costs. This approach to the amendment process also will require greater resources to synthesize the information received into meaningful sentencing policy. Full funding of our fiscal year 2007 request will allow the Commission to meet this key statutory obligation in the most complete manner possible.

#### *Collecting, Analyzing, and Reporting Sentencing Data*

As detailed previously, recent Supreme Court activity has had a major impact on the Commission's workload, primarily in the area of data collection, analysis, and reporting. Immediately after *Blakely* and *Booker*, the Commission realized that the most critical role it could play as the criminal justice community assessed the impact of these decisions was the reporting of the most timely and accurate sentencing data available.

The Commission extracts information from five documents—in every Federal case—that the courts are required to send to the Commission under the 2003 PROTECT Act. On average, the Commission receives 70,000 cases annually, so the number of documents and pages that must be collected, analyzed, and then reported by the Commission is voluminous. Beginning in fiscal year 2005, the Commission refined its entire data collection and reporting process so that it could provide “real time” data about the effects of *Booker* on national sentencing to the criminal justice community. The Commission now reports national sentencing data on an almost monthly basis, a monumental task for any Federal agency, let alone an agency as small as the Commission. This refinement of our data collection and reporting efforts has resulted in very significant demands on the Commission's resources, particularly personnel. The Commission's fiscal year 2007 funding request is designed to increase personnel in the key areas of data collection and analysis, and research. Increased funding during fiscal year 2007 also will allow the Commission to keep up with both the time and volume demands on its data collection and analysis resources it now faces.

#### *Information Technology Issues Associated With Data Collection, Analysis, and Reporting*

As important as meeting the Commission's personnel needs in the area of data collection and analysis, full funding will allow the Commission to continue moving forward with its plans to collect, analyze, and report data in an all-electronic format. Proceeding with these efforts will allow the Commission to work with members of the criminal justice community to gather information efficiently and in a manner that promotes cooperation and efficiency, avoids unnecessary duplication of efforts, and ensures that the entire criminal justice system is operating at optimum levels.

To enhance the Commission's ability to process cases in a quick and cost-efficient manner, it has developed and implemented an electronic document submission system that enables sentencing courts to submit electronically the five required sentencing documents directly to the Commission, as opposed to having to spend court resources on copying, bundling, and mailing hard copies. Currently, 64 districts are using the electronic document submission system. The Commission anticipates that all 94 districts will be using the system by the end of fiscal year 2007.

The Commission also is moving to a fully automated document collection and data analysis system so that by the end of fiscal year 2007, all document receipt and data extraction and analysis will be done electronically. The Commission has spent the last several months building the foundation of this process and expects to have a completed system running by the end of fiscal year 2007. Becoming fully automated is critical to the success of the Commission's statutory missions and offers significant benefits to the entire criminal justice community. First, our electronic document submission system already has reduced personnel and resource burdens on the courts and probation offices, and updating this system so that all aspects are automated will allow for even more efficiencies. Second, by becoming fully automated, the Commission anticipates being able to provide even more detailed and accurate data on national sentencing trends to the criminal justice community at an even more expedited pace. Third, a fully automated system will allow the Commission to work closely with members of the criminal justice community in creating an unparalleled system of document receipt and data reporting that avoids unwarranted duplication of efforts and promotes best practices throughout the system. Finally, by increasing internal efficiencies, the Commission will be able to dedicate more resources to research-oriented tasks that, in the preceding fiscal years, have been curtailed.

Full funding of the Commission's fiscal year 2007 request will ensure that the Commission can meet its information technology needs and continue to work with members of the criminal justice community in a technologically efficient, non-duplicative manner.

*Increased Demands for Commission Work Product from Congress*

In addition to the new demands for national data placed on the Commission by the *Booker* decision, the Commission also is experiencing increased demands for work product from Congress. In addition to providing its monthly reports on national sentencing practices, the Commission is required to assist Congress in assessing the impact proposed crime legislation will have on the Federal prison population. These assessments often are complex, time-sensitive, and require highly specialized Commission resources. In addition, in fiscal year 2005 and 2006, the Commission responded to a number of more general requests from Congress on issues such as gangs, drugs, immigration, and sex offenses. These requests are not expected to diminish during fiscal year 2007, and the Commission must ensure that it has adequate resources to address the needs of Congress.

*Conducting Research*

Research is a critical part of the Commission's overall mission. As such, the Commission has undertaken in fiscal year 2006 to prepare a number of internal and external reports that provide a detailed examination of key policy areas such as immigration, drugs, and firearms offenses. These reports are crucial to the Commission's overall objective of promulgating reasoned and well-informed guideline and policy statement amendments. Also during fiscal year 2006, the Commission released a detailed report on the *Booker* decision and its impact on national sentencing.

The Commission anticipates undertaking a number of new research projects in fiscal year 2007. In addition to reports associated with its policy work, the Commission expects to continue its comprehensive review of recidivism. The Commission is in the midst of a multi-part series on recidivism in the Federal system that is the most comprehensive study of its kind to be undertaken. The Commission also anticipates undertaking other coding projects and research initiatives of interest to the criminal justice community. Full funding of its fiscal year 2007 request will allow the Commission to devote the resources necessary to accomplish its research mission.

*Training and Outreach*

The Commission continues its commitment to providing specialized guideline training and technical assistance to Federal judges, prosecutors, defense attorneys, probation officers, staff attorneys, and law clerks. The Commission provides intensive training sessions throughout the year, and has increased its efforts since the *Booker* decision. In calendar year 2005, the Commission trained over 9,700 people. Commissioners and staff traveled to, and provided training in, 59 districts and all 12 circuits. Commissioners and staff also participated in numerous academic programs and symposia across the country as part of the ongoing debate about the future of Federal sentencing. Commission representatives also attended a number of circuit court conferences, meetings of the Criminal Law Committee of the Judicial Conference of the United States, and the judiciary's National Sentencing Institute. The Commission also held its own annual national training seminar with over 500 representatives of the criminal justice community in attendance.

The Commission expects its training and outreach efforts to continue at this accelerated pace in fiscal year 2007. As a result, the Commission will continue to incur increased personnel and travel demands, including more demands on Commissioners to travel. Full funding of the Commission's request will ensure that these increased demands can be met.

SUMMARY

The Commission is uniquely positioned to assist all three branches of government in ensuring the continued security of the public while providing fair and just sentences. 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. 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 efforts of this committee. Meeting the Commission's fiscal year 2007 funding request will ensure that the Commission continues to: develop aggressive and timely policy agendas; collect, analyze, and report accurate and comprehensive sentencing data; train members of the criminal justice com-

munity; and engage in meaningful research projects. The Commission urges Congress to support fully our fiscal year 2007 appropriation request of \$15,740,000 so that it can continue its role as a leader in Federal sentencing policy.

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

I am Barbara Rothstein. I have been the Center's director since 2003, and a district judge since 1980. I am pleased to submit the Center's 2007 budget request on behalf of the Center's Board, which the Chief Justice chairs, and which approved this request.

Our 2007 request is for \$23,787,000, a \$1,660,000, or 7.5 percent increase, over 2006. The increase includes \$868,000 for standard adjustments to base, and \$792,000 for 9 full-time equivalent positions (12 positions for 9 months).

Before providing more detail on this request, let me provide you with a little background on the Center and its activities. I hope to convey to you the important contribution that the Center makes to the effective and efficient functioning of the Federal courts; the Center's careful, cost-effective use of the money Congress has provided us; and my concern about the effects of having received less than full adjustments to base for 9 of the last 10 years.

THE CENTER'S CONTRIBUTION TO THE COURTS

Speaking not only as the Center's director but also as a judge, I can attest to the importance of the Center to the courts. The Center's mission is to provide objective, well-grounded empirical research and balanced, effective educational programs for the courts.

The courts, and particularly the Judicial Conference of the United States, as well as Congress and the public, are regular consumers of the Center's research projects. They rely on the Center for thorough, unbiased, well-documented research. Examples include: examining the impact of the Class Action Fairness Act of 2005 on the resources of the Federal courts; providing information to assist judges in handling capital cases; surveying the use of visiting judges that resulted in a guide on how to make effective use of this cost-efficient judicial resource. Not only do projects such as these help judges decide cases efficiently and fairly, they also help the judiciary and Congress make better informed decisions about policies and procedures affecting the courts.

Center education programs are vital to judges and court staff. For new judges, orientation programs enable them to assume their new responsibilities quickly. Continuing education programs bring judges up-to-date on topics ranging from case-management techniques to new statutes and case law. (For example, last year the Center produced for judges and court staff 11 different programs on the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, using in-person workshops, satellite and video-streaming television programs, and audio conferences. We also posted dozens of summaries, reports, articles, and analyses on the Act on our intranet site.)

Court staff, who play a critical role in supporting judges and ensuring the efficient operation of the courts, rely on the Center for educational programs and materials that help them do their jobs better, for example, integrating new technologies and executing cost-containment strategies. The Center's Professional Education Institute, which provides basic and advanced programs on leadership and management for managers and supervisors at all levels in the courts, is a key component of court staff training.

The Center uses a wide range of tools to deliver education. One reality of the information age is that people can (and expect to) receive information in many different ways. Twenty years ago the Center relied almost exclusively on in-person programs, audiotapes, and hard-copy publications to reach judges and court staff. Around 10 years ago we were expanding into satellite television broadcasting, teleconferencing, and use of the Internet and the courts' intranet. In just the last 3 years we have moved into web-conferencing and streaming video. And all the while we kept—and enhanced—all the earlier modes of delivery. All these delivery means are needed to meet the diverse needs of a diverse population of judges, managers, and staff.

The importance of the Center's educational programs is reflected in their use by the courts. All Center training is voluntary; large numbers of judges and court staff choose to participate in Center programs and use its services because they know the Center's products will help them do their jobs better. In 2005, nearly 11,500 employees of the courts (including over 2,000 judges) attended Center programs in person—

over 60 percent of these did so in their own districts. Another 4,000 participated in Center video, audio, and web conferences. Thousands more watched Center television programs, downloaded materials from the Center's intranet site, and used Center publications.

#### THE CENTER HAS MANAGED ITS APPROPRIATION RESPONSIBLY

Understanding the need for fiscal responsibility, the Center has made careful use of its appropriation each year. As I noted earlier, we use a wide variety of cost-effective delivery tools to provide education and information to judges and staff efficiently. The various delivery tools we use have enabled us to reach a larger and larger audience for far less money than we could with only one or two of these media—but they also require a highly professional staff with diverse skills in order to take full advantage of these media and to identify and implement newer technologies as they emerge.

In-person programs remain a vital part of our education efforts. Here we economize in several ways. Most staff training (and some judge education) is done by bringing faculty to the courts for local training. Most programs to which participants must travel are conducted in hotels in large cities where we can negotiate reasonable rates and take advantage of competitive airfares. We also conduct smaller seminars in collaboration with several outstanding law schools, enabling us to avoid faculty and overhead costs.

We also stretch our appropriation by working closely with our sister agencies, the Administrative Office of the U.S. Courts and the U.S. Sentencing Commission. We regularly consult with them to avoid duplicative efforts, and we often provide them an opportunity to convey their information to the courts at Center-sponsored programs.

Internally, the Center held to a hard hiring freeze for over 3 years: 22 full-time employees retired or left the Center in 2003–2005 without a single replacement, reducing our staffing level from 147 to 125. We can no longer sustain this attrition, and in late 2005 we hired two full-time employees to fill key vacancies. We will continue to fill only selected vacancies.

Since 2002, the Center has closely controlled pay raises and bonuses for staff. While we have followed the Executive Branch and the rest of the courts in granting the annual ECI and locality pay increases, we have limited additional pay raises each year to 1 percent of total Center salaries, and bonuses to one-quarter of 1 percent of total Center salaries, each year. While this has helped to control costs, it causes us concern over our competitiveness with public and private employers in hiring and retention.

#### BUDGET SHORTFALLS WILL ADVERSELY AFFECT OUR SERVICE FOR THE COURTS

The Center is grateful for the efforts of Congress to provide \$903,000 in adjustments to its 2006 base. After the application of the 1 percent rescission, however, the Center was again, as in prior years, forced to absorb \$223,500 (25 percent) of those important funding dollars. As I mentioned earlier, the Center has suffered shortfalls in its adjustments to base in all but 1 of the last 10 years. This has effectively reduced our spending power by 17 percent. As described above, in the past 3 years alone, we have had to compensate for shortfalls by not filling 22 positions that became vacant during that time, thus reducing our staffing level from 147 to 125. Even as the Center's staff has declined by 15 percent during that time, the courts' needs for its services have continued to grow.

The continued shortfall in our appropriation will erode our ability to provide the quality education and research that the courts need. The tools we have used the last several years—a hiring freeze, salary limits, and other reductions in spending—cannot go on indefinitely without degrading the quality and quantity of work we can perform.

#### THE CENTER'S FISCAL YEAR 2007 REQUEST

Our request for 2007 is modest—standard adjustments to our 2006 base and a small amount to enable us to fill 12 of the most necessary of the 22 vacancies (6 devoted to our education and distance learning efforts; 3 to our ever-increasing number of research projects; and 3 to our automation and technology function). These few positions will return the Center to its fiscal year 2005 staffing level of 134. That is still far below the 158 staff employed by the Center in the early 1990's, but with these resources we can continue to help the courts prepare for and meet the many substantive, procedural, and operational challenges they face.

Thank you for your careful consideration of our request. I would be pleased to respond to any questions you may have.

## 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 2007 budget request.

Our request totals \$26,300,000, an increase of \$2,517,000 over the fiscal year 2006 approved appropriation of \$23,783,000, after a 1 percent across-the-board rescission. Although this represents an overall increase of 10.6 percent, 63 percent of that increase, \$1,591,000, is for necessary adjustments to the base appropriation. The remaining \$926,000 (37 percent of the requested increase) is for funding for information technology security upgrades, development and maintenance of a disaster recovery plan for electronic information, and courtroom technology implementation.

Along with the mandatory adjustments, we have included in our base request \$496,000 for off-site leased space for senior judges and their staffs. The court has one judge who took senior status in February 2006 and four other judges who currently are eligible for senior status. The court has no additional space in the courthouse for chambers for these judges when they take senior status as they are expected to do. Keeping these judges working is essential in order to keep up with the caseload handled by the judges of this court which nearly has doubled since its creation in 1982. In the last month the Administrative Office of the United States Courts has directed GSA to begin to negotiate a lease for off-site space for the senior judges.

The \$926,000 requested for program increases includes the following three items previously requested:

- (1) Information technology upgrades account for \$87,000 of that amount to provide the computer security software and hardware required for the detection and prevention of electronic computer attacks and intrusions into the court's network computers and data. This equipment is necessary to provide a secure computer environment which we now lack. For example, court data stolen from unsecured equipment could greatly affect stock market prices of corporate securities if obtained before the court's decisions are made public.
- (2) Disaster recovery of information accounts for \$255,000 of the requested increase to cover the cost of establishing a telecommunications infrastructure and client computer equipment to connect to appropriate services to overcome destruction of the court's electronic communications systems. This would include remote dial-in access; file backup and restoration; and electronic database support, among other emergency access services that would be needed in the event of a disaster at the courthouse.
- (3) The remaining \$584,000 requested covers the large, nonrecurring start-up cost of providing for modern video conferencing technology in two of our three courtrooms. As you know, the judiciary has 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. This is especially critical to our court because of its Nation-wide jurisdiction. The court requests this funding to implement this program. The amount requested is based on recommendations from the Administrative Office of the United States Courts to provide two-way video and audio transmission between the court and remote sites. We have begun this process in one of our courtrooms by reprogramming money from last year's appropriation as the subcommittee suggested. Further such reprogramming would, however, compromise core court functions. This funding will enable us to proceed with the upgrades in the remaining two courtrooms.

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 once again thank you for providing me the opportunity to submit this statement on behalf of the United States Court of International Trade, which is 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 budget request for fiscal year 2007 is \$16,182,000, which is \$840,000 or 5.5 percent over the fiscal year 2006 available appropriation of \$15,342,000. This

request will enable the Court to maintain current services and provide for standard pay and other inflationary adjustments to base. The request also includes funds to pay for increases in costs paid to GSA for rent and to the Federal Protective Service for building basic and building-specific security surcharges. These surcharges provide for the Court's pro-rata share of installing, operating and maintaining the systems for the critical and necessary security of the Federal Complex in lower Manhattan. The Court continues, as it has done for the past 12 years, to budget conservatively and request funds that will provide for mandatory increases in pay, benefits and other inflationary factors, as well as to fund the essential on-going operations and initiatives of the Court.

Within the funds requested, the Court continues to meet the objectives set forth in its Long-Range Plan through the use of its annual appropriation and the Judiciary Information Technology Fund (JITF). These objectives promote access to the Court through the effective and efficient delivery of services and information to litigants, bar, public, judges and staff. As a national court, this access is critical in realizing the Court's mission to resolve disputes by: (1) providing cost-effective, courteous and timely service by those affected by the judicial process; (2) providing independent, consistent, fair and impartial interpretation and application of the customs and international trade laws; and (3) fostering improvements in customs and international trade law and practice and improvements in the administration of justice.

Technology is a critical component of the Court's commitment to service delivery to its varied constituencies. As such, in fiscal year 2005, the Court: (1) purchased new servers for and upgraded the database used in connection with the Federal Judiciary's Case Management/Electronic Case Files (CM/ECF) System; (2) cyclically upgraded, replaced and supported desktop computers and vital existing software applications; (3) purchased new software applications that enhance computer security and ensure the efficient deployment of software updates to all computer systems at the Court; and (4) purchased a fire wall server and software to ensure the security of the Court's network and help build a secure identity management system. Additionally, in fiscal year 2005, the Court continued its cyclical maintenance program by refurbishing its trial courtrooms, robing rooms and jury rooms, and replacing aging furniture.

For fiscal year 2006, the Court plans to expend funds to: (1) implement the new operating system for the CM/ECF System and migrate the attendant database; (2) continue the support of its upgraded data network and voice connections and Virtual Private Network (VPN) System; (3) replace the servers for the Court's library on-line cataloging and acquisition system and for the Court's Internet web site; (4) replace desktop computer systems, laptops and printers in accordance with the Judiciary's extended cyclical replacement program; (5) upgrade and support existing software applications; (6) purchase new software applications to ensure the continued operational efficiency of the Court; (7) support Court equipment by the purchase of yearly maintenance agreements; and (8) upgrade the Court's digital recording equipment. Additionally, the Court will expand its efforts to provide the developmental and educational programs for staff in the areas of job-related skills and technology. In the same vein, the Court will further its work with bar associations and law schools to provide continuing legal education programming to raise the quality of practice in the area of customs and international trade law.

In carrying out its mission in fiscal year 2007, the Court remains committed to enhancing the administration of justice to the litigants, bar, Court family and public. In so doing, the Court will continue its information technology initiatives. Among the technology projects to be supported by the Court's fiscal year 2007 budget request and the carry-forward balance from its JITF are: (1) continuing the deployment of its CM/ECF System and training the bar in its use; (2) supporting and maintaining all technical equipment and systems; (3) supporting new software applications that enable judges and staff to view instructional videos at individual workstations and integrates the Federal Judiciary's Training Network with the Court's local area network; and (4) upgrading the Court's wiring closets with switches and fiber modules.

Additionally, the Court intends to continue its cyclical replacement and maintenance program for equipment, furniture and building maintenance. 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 2007 request includes funds for the support and maintenance of the upgraded security systems implemented by the Court in fiscal years 1999 through 2005, and the Court's COOP. Lastly, the Court again will participate in efforts to address the educational needs of the bar and the Court staff.

As I stated last year, maintaining security systems and ensuring the protection of those who work in and visit the Courthouse continue to be top priorities. In July

2005, GSA received Senate approval for fiscal year 2006 funding for the construction of a security pavilion for entry into the Courthouse. The Court is working closely with GSA in the design and construction of this entrance pavilion. To that end, the Court, in fiscal year 2005, entered into a Reimbursable Work Authorization with GSA for a non-prospectus project for replacing the present entrance doors to the Courthouse with blast resistant glass and for installing video-surveillance cameras in strategic locations in the new pavilion that will further secure the Courthouse and its environs. GSA expects construction of the new pavilion to begin in the fourth quarter of fiscal year 2006. The Court will continue to work in full partnership with GSA to ensure the success of the security pavilion project.

I would like to emphasize that the Court remains committed, as it has in the past, 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 has engaged 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 will continue into fiscal year 2007 and beyond.

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.

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PREPARED STATEMENT OF MARILYN L. GLYNN, ACTING DIRECTOR, U.S. OFFICE OF  
GOVERNMENT ETHICS

Thank you for the opportunity to present this statement in support of the request of the U.S. Office of Government Ethics (OGE) for fiscal year 2007 resources of \$11,489,000 and 80 FTEs. This request, as reflected in the President's fiscal year 2007 budget, represents a 3 percent increase over the amount appropriated for fiscal year 2006.

The Office of Government Ethics is responsible for overseeing the ethics program of the executive branch, a program designed to help prevent conflicts of interest and promote integrity in government. OGE sets the requirements of the program, develops executive branch-wide policies, serves as a resource/consultant to agency ethics officials and monitors agency programs to help ensure that the agencies are carrying out their responsibilities effectively. While each executive branch agency is responsible for carrying out many of the day-to-day functions of the program, OGE's specific role includes: reviewing and certifying the financial disclosure forms filed by Presidential nominees requiring Senate confirmation; reviewing and certifying annual financial disclosure reports filed by senior executive branch employees; serving as the primary authority on executive branch conduct and financial disclosure issues; conducting evaluations of agency ethics programs; training agency ethics officials and developing employee training materials used by agencies in their ethics training; offering direct support to agencies through a desk officer program, under which OGE staff serve as ethics liaison to executive branch departments and agencies; and providing interpretative guidance on the criminal conflict of interest laws.

The ethics program that OGE directs is part of the basic infrastructure that supports good governance within the executive branch of the Federal Government. The resources expended by OGE to help promote integrity and prevent conflicts of interest are small compared to the resources expended by investigators and prosecutors who enforce ethics and conflict of interest rules and laws. Moreover, our preventive efforts help guard against the loss of government resources through inadvertent or deliberate misuse. We believe the resources we have requested are those necessary to support a strong ethics program.

FISCAL YEAR 2007

In order to enhance our ethics program and continue to foster public confidence in government programs and operations, OGE established three strategic goals as outlined in our new strategic plan for fiscal years 2007–2011. OGE's three strategic goals are: (1) strengthening the ethical culture, and promoting an ethical workplace within the executive branch, (2) preventing conflicts of interest, and (3) promoting good governance. What follows is a summary of the major programs OGE is planning to implement to achieve these goals during fiscal year 2007.

OGE expects that there will continue to be a significant number of Presidential nominees to positions requiring Senate confirmation during the third year of the

current administration. OGE performs a key role in clearing these nominees, a process which is designed to help them understand the application of the conflict of interest requirements to their government service and to secure their agreement to take the necessary steps to resolve potential conflicts of interest. Our goal is to review nominee financial disclosure statements in a timely manner to avoid any unnecessary delay in the nomination and confirmation process. Once an individual is appointed, OGE follows through to see that any agreements made by an appointee to address potential conflicts of interest are carried out. In addition, over this period, OGE will continue to conduct a second level review of over 1,000 annual and termination financial disclosure statements filed by Presidential appointees each year.

Through the use of improved technology OGE will enhance the financial disclosure reporting and review process by developing a confidential financial disclosure form that can be filed electronically. In addition, OGE will modify the confidential financial disclosure form in order to make the reporting process more streamlined and user friendly. OGE will also partner with the Department of the Army to develop an electronic filing system for public financial disclosure filers. During fiscal year 2007, this electronic filing system will be available to those agencies within the Department of Defense that meet the web-based security requirements set by the Department of the Army. OGE will continue to partner with the Department of the Army in an attempt to make the electronic filing of public financial disclosure forms more widely available.

OGE prepared and submitted two reports to Congress in fiscal years 2005 and 2006 pursuant to the Intelligence Reform and Terrorism Prevention Act of 2004 (Public Law 108-458). The first report, which was delivered in March 2005, evaluated the executive branch financial disclosure requirements. The second report, which OGE compiled in consultation with the Department of Justice, and delivered in January 2006, examined the criminal conflict of interest laws as they pertain to the executive branch. OGE will work with the Office of Management and Budget and the Congress on any Congressional efforts to consider and implement any changes identified by these two reports. OGE will take the necessary steps to revise its financial disclosure forms and regulations to implement any changes in existing law. In addition to implementing any changes in legislative mandates, OGE also plans to improve the effectiveness of ethics policy by publishing a proposed regulation revising the Standards of Conduct for Executive Branch Employees.

OGE expects to purchase some new computer hardware and software. This includes security software to protect our network and keep it FISMA compliant, software necessary to keep our network up to date, and hardware to replace computers that fail. In addition, OGE will implement a comprehensive update to its web site making the information contained on the site more accessible to a variety of users including, designated agency ethics officials, Congress, the media, and the public.

OGE will continue to provide international technical assistance in the areas of anti-corruption and good governance programs in support of international agreements and regional initiatives of the United States in general and the Departments of State and Justice in particular. For example, during the fiscal year, OGE will, as a principal member of the U.S. delegation, represent the United States before the Group of States Against Corruption (GRECO) in the plenary discussion and adoption of a report on GRECO's evaluation of the U.S. adherence to certain of the adopted Guiding Principles in the Fight Against Corruption. OGE will also assist the State Department in the mutual evaluation mechanism that is a follow-up to the Inter-American Convention Against Corruption and with regional good governance/anti-corruption initiatives such as Good Governance for Development for the Middle East and North Africa states (MENA) and the Asian Pacific Economic Cooperation (APEC). Primarily at the request of the State Department, OGE continues to provide briefings to about 40 foreign delegations visiting Washington each year.

As part of our ongoing education and training efforts, OGE will prepare and conduct ethics training for agency ethics officials. To reach ethics officials outside the Washington area, OGE plans to offer three regional symposia. In addition, OGE will hold the fifteenth National Government Ethics Conference for approximately 700 ethics practitioners. These events provide an introduction to the ethics rules and laws for new agency officials and advanced updates and refresher sessions for those who are more experienced. Attendees will include ethics practitioners, trainers, counselors, financial disclosure reviewers, and enforcement officials. In addition, we also plan to develop a 2-day orientation program for new ethics officials and offer the program at OGE headquarters as well as on a regional basis as needed.

OGE desk officers will maintain their day-to-day communications with agencies assigned to them. This continuing liaison between OGE and agency ethics staffs enables OGE to respond to the needs of the agencies in a timely and accurate manner,

as well as provide OGE with an early warning that an agency ethics program is deficient or has problems that require specialized attention. OGE plans to conduct employee surveys regarding individual agency ethics programs, and the information gathered through these surveys provides OGE with a better basis on which to judge the effectiveness of the individual agency programs under review and of the overall ethics program. We also plan to conduct ethics program evaluations in 35 Federal agencies, regional offices and military commands. In addition, OGE will develop a program of self-assessment for agencies to use in years that OGE is not scheduled to perform a program review.

OGE also plans to increase the effectiveness of our support to agencies' ethics programs by raising awareness of ethical issues arising from the presence of contractors in the Federal work place. For example, during fiscal year 2006, OGE participated in and contributed to a National Academy of Public Administration working group on the issues presented by the multi-sector workforce. We will continue to expand our outreach activities to Federal agencies and contractors by providing educational materials and presentations on ethics issues that arise when contractors work side-by-side with Federal employees. Finally, we will also expand our educational and outreach activities to Federal agency procurement officials in order to increase their awareness of various ethical issues that arise from interacting with contractors.

The programs and activities we have described are just some of those envisioned for fiscal year 2007. We are pleased with the past success of the executive branch ethics program and look forward to the challenge of maintaining and enhancing the quality of the program.

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PREPARED STATEMENT OF JOHN E. POTTER, POSTMASTER GENERAL/CEO, UNITED STATES POSTAL SERVICE

Good morning, Mr. Chairman, and members of the subcommittee. I am pleased to be with you today as we discuss the United States Postal Service, its achievements, its challenges, its opportunities, and our appropriations request for fiscal year 2007.

I know this subcommittee shares our mutual goal of protecting affordable, universal service for every American household and business for many, many years to come.

Since it was created by reform legislation in 1970, the Postal Service has demonstrated a remarkable ability to transform itself from a traditional government agency to a customer-focused, business-driven organization—one that has realized outstanding results. For the greater part of three decades, this success was supported by a business model that made it possible to balance the costs of an ever-expanding delivery network with revenue from continuing growth in mail volume, particularly high-contribution First-Class Mail.

Over the last decade, it has become clear that this model would be unsustainable for the long term. The explosive expansion of electronic communications and, to a lesser extent, intense competition for package and document delivery, has had profound effects on mail volume growth, upsetting the delicate balance that is at the heart of our 36-year-old business model.

Against this background, the Postal Service took decisive steps to stabilize finances, increase efficiency, improve performance, and pursue growth by making mail a better value than ever. Our 2002 Transformation Plan defined specific strategies to help us achieve these goals.

The results speak for themselves. We ended 2001 with outstanding debt of \$11.3 billion. By 2006, that debt was completely retired, reducing interest costs on borrowings from more than \$300 million per year to only \$2 million in 2005.

We committed to removing \$5 billion in costs from our system by the end of 2006. We achieved that goal 1 year ahead of time. Cumulatively, our Transformation Plan savings have reached \$17 billion.

By the end of 2005, we achieved a record sixth consecutive year of productivity gains, helping to offset a portion of inflationary cost growth over the same period. Since 2000, our annual productivity gains have, on average, been almost six times higher than those achieved annually from 1972 through 1999. This progress was not a given. It is the result of sound governance, focused management, engaged employees and the effective use of technology, both in operations and administrative activities.

Total revenue of \$70 billion in 2005 was up from \$66.7 billion in 2002. This is a positive reflection of our efforts to drive growth by adding value to the mail by adding products, services and features that meet the needs of our customers, and

by expanding access, making it easier than ever for all mailers to do business with the Postal Service. Significantly, our customers experienced a full 3½ years of rate stability during this period.

Our focus on the bottom line was matched by a focus on service. We closed fiscal year 2005 with 11 straight quarters of 95 percent or better on-time delivery of First-Class Mail with an overnight service commitment. Similarly, customer satisfaction continued to maintain record levels.

Through the dedication and performance of the 700,000 men and women of the Postal Service, we have sustained our historic mission to bind the Nation together and we remain a vital part of American commerce and American life.

And yet, the challenges we face have never been greater.

While we had record volume of 212 billion pieces in 2005, this was marked by a challenging trend in the mix of mail entering our system. For the first time in our history, Standard Mail, primarily catalogs and advertising mail, has exceeded First-Class Mail volume; it is now our largest volume category.

At the same time, First-Class Mail growth was essentially flat, with a 4 percent decline in single piece First-Class Mail offset by growth of just below 4 percent in workshare First-Class Mail.

Single piece First-Class Mail is most vulnerable to electronic diversion, and we expect its continued decline as businesses, organizations, governments, and consumers increasingly shift transactions from the mail to the Internet. Since 1998, the volume of single piece First-Class letters has declined by 20 percent—11 billion pieces—representing a revenue loss of \$3 billion. From a revenue perspective, it takes two to three pieces of Standard Mail to make the same contribution to system overhead as just one piece of First-Class Mail.

While 2005's total mail volume set a new record of 212 billion pieces, the shifting mix of the mail has affected revenues substantially. At 2005 postage rates, the lower volume and the specific mail mix of 2000 would have generated \$3.3 billion more in revenue.

We are also challenged by continued growth in our delivery network, which must expand to serve about 2 million additional homes and businesses every year. The costs of this expansion, coupled with the financial effects of the changes in the mail mix, have resulted in a continued decline in revenue per carrier delivery.

And we are faced with steady increases in costs over which we have little or no control. Every 1 cent increase in the cost of gasoline adds \$8 million to our costs. Last year alone, our transportation costs increased by \$468 million, due primarily to higher fuel costs.

Despite significant reductions to our workforce, the cost of health benefits for current employees has doubled since 2001, reaching \$5.1 billion in 2005. Over the same period, retiree health benefits have grown from \$858 million to \$1.5 billion. Overall, retirement and health benefits for active and retired Postal Service employees, most of which are statutorily mandated, accounted for \$14 billion last year, fully 20 percent of all Postal Service costs, and an increase of almost \$1 billion from 2004.

Looking ahead, we are concerned by a sluggish economy. For the fourth quarter of 2005, the Gross Domestic Product increased by only 1 percent. This was reflected in the Postal Service's first quarter results, with First-Class Mail volume down by 3.8 percent, compared to the same period last year, producing a \$415 million revenue decline. This was only partially offset by growth of 0.5 percent in Standard Mail volume, representing a revenue increase of just \$30 million. Clearly, this is a trend that is unsustainable in the long term.

It is our experience that mail use is an indicator of general economic activity. Quarter 1 results suggest that customers are changing their mailing behavior in response to the economy. We are monitoring this situation carefully and we will continue to do everything we can to increase efficiency to help offset any continued volume decline.

Our focused transformation efforts since 2002, coupled with the limited-term financial relief provided by the Postal Civil Service Retirement System Funding Reform Act of 2003, Public Law 108–18, have made it possible for us to absorb rising costs without the need to raise rates to meet increased operational costs since June, 2002.

The recent 5.4 percent across-the-board postage increase was implemented solely to meet the \$3.1 billion escrow payment required this year by Public Law 108–18. None of the revenue from the new rates is available to offset other costs as they continue to rise over the coming months and years. As a result, we are projecting a loss of up to \$2 billion this year.

Reluctantly, we have concluded that it will be necessary to ask the Governors of the Postal Service to file a rate case in the near future. While we have not determined when the filing will occur, we are working closely with the Governors as we

prepare for this action. This would represent the first adjustment in the price of postage since mid-2002 to address operational cost increases.

As I mentioned, the Postal Service and its customers have benefited from our strategy of pursuing increased productivity. In just the last year, this has resulted in the equivalent of more than \$700 million in cost savings. Looking forward, we must do everything possible to support continued productivity growth.

Building on the momentum of our original Transformation Plan, our Strategic Transformation Plan 2006–2010, is keeping us focused on our core business and the strategies we know produce results. We will promote growth by continuing to create more value for every customer. We will continue to reduce costs by improving efficiency in all of our operational and business processes. We will bring service performance to even higher levels. And we will achieve these results with an energized, customer-focused workforce.

Our transformation goals, and the methods we will use to achieve them, were developed to help us push the limits of business effectiveness and operational efficiency. They represent a sound approach to a dynamic business environment. They are effective. We believe they have the potential to be even more effective when applied to a business model that addresses the challenges of a new century.

I am also here today with more immediate needs—our appropriations request for fiscal year 2007. This request covers funding for revenue forgone and free and reduced rate mail. Our request differs from the amounts recommended by the administration's fiscal year 2007 budget in several ways.

Our first request is for \$29 million for revenue forgone reimbursements. The administration's budget does not include funding for the Federal Government's own debt to the Postal Service for services required by statute. In accordance with the Revenue Forgone Reform Act of 1993, the Postal Service is to receive \$29 million annually through 2035. This payment covers the cost of services we were required to provide in fiscal years 1991 through 1993, but for which there were insufficient amounts appropriated. It also covers payment for services provided from fiscal year 1994 through 1998.

For two decades after the creation of the Postal Service, Congress continued to fund reduced postage rates for certain categories of mail and mailers through the so-called "revenue forgone" appropriations. Congress required that the Postal Service provide reduced postage rates as well as free mail for purposes which Congress considers to be in the public interest. These favored types of mail included reduced-rate bulk standard mail advertising sent by qualified non-profit organizations, and in-county mailings of local newspapers. These appropriations were devoted entirely to the benefit of these historically-favored mailers, and did not financially benefit the Postal Service.

Under the provisions of the Revenue Forgone Reform Act of 1993, approximately half of the former taxpayer subsidy to non-profit mailers was transferred to regular-rate postal customers, and that portion of the "revenue forgone" subsidy was ended. In this same legislation, Congress authorized a series of 42 annual appropriations of \$29 million, without interest, as reimbursement for \$1.2 billion in costs incurred by the Postal Service (\$515 million in past under-funding of revenue forgone plus the cost of phasing reduced postage rates to higher levels over 5 years, under the Revenue Forgone Reform Act). The outstanding balance on this debt is approximately \$840 million. This year's appropriation would be the fourteenth in the series of 42 annual payments to reimburse the Postal Service the \$1.2 billion owed for these purposes. Failure to fund this authorized appropriation places the remaining debt of nearly \$840 million at risk of nonpayment.

As the Postal Service continues to responsibly address its long-term obligations, it is counter-productive to increase those costs through non-payment of a debt already deferred by interest-free installment payments spread over a period of 42 years.

The second part of our request is for \$123.7 million in payment for costs imposed on the Postal Service by statute. This \$123.7 million is for current year costs of \$80.127 million and a \$43.608 million reconciliation adjustment for prior years. This appropriation reimburses the Postal Service for the statutory obligations to provide free mail for the blind and others who cannot use or read conventionally printed materials, the mailing of absentee balloting materials that can be mailed free by members of the armed forces and other United States citizens residing outside of the United States, and balloting materials that can be mailed in bulk between State and local election officials.

This request differs from the administration's budget recommendation of \$79.915 million. The administration provides \$60.725 million for current year costs plus a \$19.190 million reconciliation adjustment. The administration's proposal not only provides an amount less than that requested, but also continues an "advance fund-

ing” process adopted in recent years of deferring actual payment of the recommended funding until the following fiscal year.

Although this approach provides limited funding for these services, these funds are only made available long after the service has been delivered. These actions place the postage ratepayer at a greater risk of absorbing a social service cost beyond the mission of the Postal Service. The Postal Service does not have the authority to control or limit these mailings to reduce the funding needed. And we have no way to mitigate the shortfall in funding. Providing less than the requested amount will continue to compound the financial burden caused by the current “advance” funding.

I should note that the Postal Service takes great pride in its success in funding postal operations solely through the sale of postal products and services. While we are authorized by statute to request a public service appropriation every year for costs incurred in providing effective and regular postal services nationwide, even in communities where Post Offices may not be deemed self-sustaining, we have operated without this appropriation since fiscal year 1982, saving the American taxpayers more than \$11 billion. Again, for fiscal year 2007, we are not requesting an appropriation for public service.

In closing, I would like to take this opportunity to acknowledge the hard work and dedication of the men and women of the Postal Service. They are at the heart of our success. They are valued and trusted members of every community they serve.

Thank you, Mr. Chairman and members of the subcommittee for the opportunity to discuss our fiscal year 2007 appropriations request. I would be pleased to respond to any questions at this time.

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#### PREPARED STATEMENT OF THE UNITED STATES TAX COURT

The United States Tax Court provides a national forum for the resolution of disputes between taxpayers and the Internal Revenue Service (IRS). As such, the U.S. Tax Court handles over 95 percent of Federal tax cases.

The Tax Court is uniquely able to deal with disputes arising under the Nation’s tax laws. As the largest Federal trial court, we receive and close approximately 23,000 cases each year. The Court maintains numerous courtroom facilities and conducts hundreds of weeks of trial sessions in 77 cities across the United States. The Court accomplishes this mammoth task with less than 300 employees, including the judges and their staffs.

#### TAX COURT CASES AND WORKLOAD

Significantly, the Tax Court has no control over the type or volume of cases that are docketed. Congress, through legislation; the Internal Revenue Service, through its audit and enforcement activity, and taxpayers by their choice of forum determines our caseload.

Deficiency cases comprise 90 percent of the current caseload. The remaining 10 percent of cases include: administrative costs, abatement, employment classification, lien/levy, Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership, declaratory judgment, and section 6015 (stand alone, innocent spouse) cases. The Court’s pending caseload increased by 4 percent in fiscal year 2005. The largest increase was in deficiency cases.

The Tax Court’s fiscal year 2007 budget request anticipates a moderate increase in cases of all types. The estimated caseload in fiscal year 2007 is in part, based on the increase in audit and enforcement activity projected by the IRS.

#### FISCAL YEAR 2007 BUDGET REQUEST

##### *Staffing Needs*

The Tax Court studied caseload data and projections of IRS audit and enforcement activity and determined that it could lower the number of funded vacancies from 40 to 15. Maintaining these positions provides the Court the flexibility to promptly address increases in caseload. The requested positions allow the Court to make contingency plans for changes in workload. With no control over the flow of cases into the Court, it is prudent to maintain the flexibility to respond to increases in workload.

The Court expects to have a stable staffing pattern in fiscal year 2007. However, the Court, as of June 1, 2006, will have only 17 of 19 of its presidentially appointed judges on board. Funding for two additional presidentially appointed judges and staff is included in the Court’s request.

### *Training*

As mentioned in the fiscal year 2007 budget request, the training program for Court employees is ongoing. The program, begun in 2005, focuses on improving employees' job-related skills and helping them become eligible for greater responsibility as part of the Court's succession plan.

The Tax Court has a large number of employees eligible to retire. A total of 43.2 percent of the Court's staff can retire over the next 5 years. Of the total eligible to retire, 19.7 percent are eligible now. The training program is a key part of the Court's succession plan. The Court is identifying and training employees, so they are ready to fill positions of increased responsibility or areas where the Court lacks sufficiently trained staff.

Training is provided consistent with guidelines for employee training contained in 5 C.F.R. Part 410. The Court maximizes its training dollars by providing on-site group training where possible.

### *Modular Furniture*

In 2005, the Court initiated a project to replace a large inventory of outmoded wooden desks purchased in 1985, with modular furniture. The modular or systems furniture more suitably accommodates today's office technology by providing built-in electrical outlets and wiring raceways for computer and printer equipment. It provides a further advantage over the traditional desk configuration by offering better space economy and the flexibility to reconfigure workspace to meet the requirements of workload and corresponding staffing changes. To date, using modular furniture has allowed the Court to more efficiently use the space in its headquarters.

The fiscal year 2007 budget request builds on this replacement project. Fiscal year 2007 is the final year for replacing old, traditional office furniture with new, efficient modular furniture. The Tax Court is establishing a cyclical replacement program to ensure cost-effective use and replacement of furniture in the future.

### *Field Courtroom Restoration*

In fiscal year 2006, the Court initiated a multi-year effort to survey, renovate and refurbish, as needed, its field courtroom inventory. The Court's national jurisdiction requires its judges to travel to over 70 cities providing litigants with a geographically convenient forum. The Court leases courtroom and chambers space in 35 of these cities. Many of these leased sites have not been refurbished or refurbished in 20 years. Several of these facilities are in dire need of new furniture to replace worn 25-year-old equipment. Several facilities are in need of new carpet and paint, and a handful will undergo minor remodeling to correct deficiencies.

We are also installing technology systems cabling in all of the leased field courtroom and chambers to facilitate networking capabilities with headquarters. Judges and Court personnel will have secure electronic access to the Court's network and their case files. All of the Court's case information is now electronically stored and must be accessible by the judges and staff when they are hearing cases across the country.

We expect to spend approximately \$1 million in our field courtroom renovation project in fiscal year 2006. This effort will address, at a minimum, the problems in one-third of the Court's leased space inventory. The fiscal year 2007 request contains funding to accomplish needed upgrades in another one-third of field courtrooms. We anticipate requesting funds for the final one-third of needed renovations for fiscal year 2008.

### *Technology Upgrades*

The Court's fiscal year 2007 budget request continues the cyclical replacement of technology begun in the fiscal year 2006 budget. In addition to replacing or upgrading technology at the Court, we have been engaged in a comprehensive review of our operating procedures in an effort to enhance our services to the tax bar and the taxpayers we serve. This comprehensive evaluation is intended to result in the application of technological tools, such as automated master calendaring, comprehensive document imaging and RFID (radio frequency identification) enabled records tracking, to improve the quality of service and the speed at which it is delivered. We expect to continue these improvements within the funding levels requested in the fiscal year 2007 budget.

The Tax Court implemented a new telephone system in February 2006. The Court is now using a voice-over-internet protocol for its phone service. This technology allows Court judges and employees who travel to retrieve voice mail wherever they are by phone or through a web portal. This technology provides faster, less expensive, and more efficient communication between Headquarters staff and traveling judges and employees. The Court also purchased and installed a server that runs

SQL software, allowing us to implement improvements in our accounting, purchasing, payroll and human resources systems. The Tax Court appreciates the subcommittee's support for these projects that will make the Tax Court more efficient in accomplishing its mission.

The Tax Court is launching an e-filing pilot project this year that will be ready for beta testing in fiscal year 2007. In connection with this, the Court is currently reprogramming its case management database and ancillary systems from a legacy language to a sequel medium to permit them to operate on a SQL server. As a result, the Court will be able to receive and process electronically delivered case documents. In advance of implementation, we will update our attorney admissions and enrollment database and will be training, late this fiscal year or early in fiscal year 2007, the enrollees in the selected e-filing pilot group on the e-filing program. In addition to facilitating access to case data, the Court expects electronic filing will save time for the parties and reduce their document processing expenses.

#### *Tax Court Independent Counsel Fund*

The Tax Court independent counsel fund is established by IRC section 7475. The Tax Court uses the fund to retain counsel to assist the Court in its attorney disciplinary process, for example, investigations of alleged misconduct.

The monies in the independent counsel fund are derived from fees charged to individuals who wish to practice before the Court. The current balance in the independent counsel fund is \$404,239.18.

The Tax Court Modernization Act, S. 661, would expand the Court's authority to use the fund to provide more services for *pro se* taxpayers.

#### *The Judges' Survivors Annuity Fund (JSAF)*

The Judges' Survivors Annuity Fund was statutorily created to provide survivor benefits for the spouses and eligible children of presidentially-appointed Tax Court Judges. The Judges' Survivors Annuity (trust) Fund is funded with approximately \$8.5 million. The majority of the funds are invested in Treasury securities with a portion held aside to pay current annuitants. In addition to income from interest payments, judges contribute 3.5 percent of their salary or retired pay to the fund. The JSAF is voluntary. Of the 32 judicial officers of the Tax Court, 21 participate in and contribute to the JSAF. Additional funds, subject to a maximum of 11 percent of the participating judges' salaries and based on an annual actuarial study, are paid into the fund from the Tax Court's annual appropriation to ensure that the JSAF is actuarially sound. The fiscal year 2006 liability for survivorship annuity payments is \$511,911.

For fiscal year 2007, the Tax Court is requesting budget authority of \$1 million in order to make payments to the annuitants of the JSAF.

#### OTHER MATTERS OF CONCERN TO THE TAX COURT

The following matters are of concern to the Tax Court. The Court is not asking the subcommittee for any funds in its fiscal year 2007 budget to address these concerns. These matters are being brought to the subcommittee's attention because of their possible impact on future budget requests by the Court.

#### *Security*

Unlike other Federal judicial officers, the U.S. Tax Court Judges are not protected by the United States Marshals Service (USMS). While Tax Court Judges do not hear criminal matters, they are involved with tax protesters and other individuals who wish to express their opposition to the United States Government. The Marshals Service is not always available to provide courtroom security for Tax Court Judges. They do not provide any security directly to the Tax Court in its Washington, DC Courthouse and offices. The Tax Court has a contractual agreement with the Marshals Service to provide special security officers for the Tax Court building in Washington, DC. The USMS has informed the Tax Court that the Court will have to bear more of the cost of providing courthouse security in Washington, DC, as well as in each of the cities in which we conduct trial sessions. The USMS also has informed the Court that they are not legally required to provide outside-of-the-court-house security to our Court.

The Tax Court believes that the security needs of its judicial officers require the same level of attention as provided for the safety and security of judicial officers in other Federal courts. The Tax Court will continue to work with the Marshals Service and Congress to ensure the security of its judges.

*Leased Space*

The Tax Court holds trial sessions in over 70 cities. The Court currently leases courtroom and chambers space in 35 cities. As noted in our fiscal year 2006 budget, the Court reviewed its space usage and was able to reduce some of its leased space. We continue to monitor our space needs and work with the General Services Administration (GSA) to obtain the space we need to serve the taxpayers.

In the cities in which the Court does not lease space, it must try to borrow space in Federal courthouses and other Federal buildings. The Court finds it increasingly difficult to borrow suitable space in which to hold trial sessions. We are working with GSA to lease space in Seattle, Washington; Nashville, Tennessee; and Columbia, South Carolina, as we have been unable to borrow space from other courts in these cities. The Court continues to work with other Federal courts to obtain space when needed in order to conduct sessions throughout the country. Because the Tax Court must provide a convenient Nation-wide litigation forum, it cannot reduce its space budget at this time.

The Tax Court remits its annual rental payments to GSA. The rental payments made to GSA are approximately 20 percent of the Court's operating budget.

## CONCLUSION

The Court is carefully monitoring its use of resources. The Court also tries to use technology wherever possible to help reduce the cost of service delivery. Substantially all of the Court's budget is non-discretionary—spent for salaries, courtroom space rental, and travel and transportation. The Tax Court also pays for its retired judges from its appropriation, a practice that does not exist in most Federal agencies.

We have one program—managing docketed cases and providing a trial forum for those cases that are not settled prior to trial. In a large agency, a rescission or budget cut might be absorbed by reducing or eliminating one of several programs. With only one program or mission and no discretion over the volume or type of cases the Tax Court receives, we cannot easily absorb reductions to our budget.

However, the Court's ongoing efforts to control costs, improve the Tax Court's infrastructure, and efficiently manage the Court's business resulted in a \$888,000 reduction to the overall budget request for fiscal year 2007.

The Court is committed to being an effective steward of its resources while meeting its responsibilities to carry out its mission. The Tax Court's fiscal year 2007 request was designed to address the Court's needs and those of the government and taxpayers who appear before the Court. Thank you for your consideration of our fiscal year 2007 request.

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PREPARED STATEMENT OF THE HONORABLE HAL STRATTON, CHAIRMAN, U.S.  
CONSUMER PRODUCT SAFETY COMMISSION

I appreciate this opportunity to present to the subcommittee the appropriation request for the U.S. Consumer Product Safety Commission (CPSC) for fiscal year 2007. CPSC is an independent, bipartisan agency charged with protecting children and families from unreasonable risks of serious injury or death from more than 15,000 categories of consumer products under the agency's jurisdiction. Since its inception, CPSC has delivered critical safety benefits to America's families and has made significant contributions to the 30 percent decline in the rates of injuries and deaths related to hazardous consumer products.

While we are proud of these achievements, there still remains an average of over 25,000 deaths and 33 million injuries every year from consumer product incidents. These injuries and deaths and property damage cost the Nation more than \$700 billion annually. Because new products, new trends and new technologies are continuously being introduced into the marketplace, and subsequently into the American home, improving consumer product safety is never a completed task but always an ongoing process of research, standards development, enforcement and public education.

The CPSC appropriation request for fiscal year 2007 is \$62,370,000. This is the same funding level as the agency's final 2006 appropriation. To manage this funding projection for 2007, staff levels at the agency are again being reduced through natural attrition and incentives, such as "early outs" and "buy outs." Such actions will allow the agency to meet the increased costs of salaries and increased costs related to infrastructure that supports the agency's mission.

CPSC is a staff intensive organization with 80 percent of its funding going to staff salaries. Primarily as a result of the proposed 2.2 percent Federal pay increase for 2007 and other compensation costs, we estimate that the cost of staff will increase

in the new fiscal year by \$2 million. To achieve the necessary savings to pay this increase, CPSC's staffing level for fiscal year 2007 is targeted to be 420 FTEs, a decrease of 20 FTEs from the current fiscal year and a decrease of 51 FTEs from fiscal year 2005. This represents a decrease in our FTE ceiling during these 2 fiscal years of over 10 percent.

We estimate that non-salary costs such as service contracts, IT equipment and software maintenance will also increase. For example, over the past few years we have been required to implement several new operating systems, purchase IT infrastructure improvements, and provide increased building and information technology security enhancements. These system startups and enhancements all have recurring annual maintenance charges and cost increases.

Additionally, we foresee an increase in the cost of operation of our most important data source, the National Electronic Injury Surveillance System (NEISS), an internationally-recognized hospital emergency room injury reporting system which provides national estimates for injuries related to consumer products. CPSC staff annually reviews about 360,000 product-related injuries reported by NEISS.

Because quality data is central to the execution of CPSC's mission and lays the groundwork for the agency's standards setting and related hazard reduction activities, continuously maintaining and improving the overall quality of NEISS and other CPSC data is critical. Data collection is the foundation of the agency's early warning system that identifies hazardous products, injury patterns, and causes of deaths and injuries. Early identification of product hazards by our Office of Hazard Identification and Reduction allows CPSC to take prompt action to prevent and reduce injuries and deaths. This information is the underpinning of the agency's decision-making process as it relates to voluntary standards development, compliance, consumer education, product labeling, and rulemaking initiatives.

One example of a CPSC rulemaking that relied on the quality of our data is the new open-flame flammability standard for mattresses that was promulgated earlier this year. This is one of the most important safety standards ever adopted by the agency; it is estimated that when fully effective, the new standard will save over 250 lives per year. As with all Federal standards, its success and effectiveness rely on the accuracy, precision and soundness of the data that was used to develop it.

CPSC's mandatory safety standards are enforced by our Office of Compliance. In fact, whenever potential product hazards are identified, the Compliance staff conducts investigations to determine whether corrective action is required. In addition to monitoring compliance with safety standards by conducting field inspections of manufacturing facilities and distribution centers and making purchases at retail establishments or via the internet, CPSC Compliance staff also conducts surveillance and sampling of imported products at the Nation's ports of entry.

In 2005, CPSC staff conducted over 250 seizures and detentions involving almost 4 million units of imported products at the ports because of possible safety hazards. Examples of these products included over 240,000 units of hazardous toys and other children's products and over 1.3 million non-complying fireworks devices.

Our governing statutes also permit the Commission to assess civil penalties. Due to aggressive enforcement of our safety laws, 2005 set a new record with civil penalty assessments of \$8.8 million including the largest civil penalty ever issued by the agency against a company that failed to report some 12 million products that posed a danger to young children. (All of these amounts are paid to the U.S. Treasury and none are retained by CPSC.) In addition, staff assisted in securing criminal convictions for violations of the Federal Hazardous Substances Act.

In 2005, CPSC announced 398 cooperative recalls, also an all-time record for the agency, involving a wide range of products that included defective bicycles, cribs, all-terrain vehicles, gas grills and pacifiers. Over 100 of these recalls were for toys and other children's products involving nearly 16 million production units.

A key element of any recall is the targeted public notice that goes out to alert owners of the product to the hazard and to the remedies that are available to them. This effort is led by CPSC's Office of Information and Public Affairs which uses numerous outlets to publicize the recall.

In 2005 Public Affairs staff informed the public of hazardous products through 383 press releases and recall alerts, 1.2 million distributed publications (in English and in Spanish), numerous appearances on network television, and through CPSC's consumer hotline and website that had an increase in consumer "hits" from 200,000 in 1997 to 13.7 million in 2005. Staff also placed a number of video news releases that reached an audience of over 85 million viewers and conducted national public awareness campaigns throughout the year on critical issues such as swimming pool safety.

As noted earlier, one of the major challenges facing the agency is the surge in imported consumer products. In addition to our activities at the ports-of-entry, the

Office of International Programs and Intergovernmental Affairs has been expanded to focus on this challenge. Through this office CPSC has established working relationships with our counterparts in other countries through the execution of formal memoranda of understanding with 11 foreign governments including major trading partners such as China, Mexico, Canada, and the European Union.

As I stated last year, China is the No. 1 toy-producing country and the United States is the No. 1 toy-consuming country in the world. It is critical that we work to make certain these imported products are safe for American families before they are ever put on a ship bound for an American port.

CPSC is a small agency with a big mission. By any measure, each year CPSC saves the Nation many times the agency's annual budget. Through our standards work, compliance efforts, industry and consumer partnerships, and education programs, the agency contributes to substantial reductions in deaths and injuries from a wide variety of hazards. Notable CPSC "success stories" include significant death and injury reduction over the years from residential fires, electrocutions, carbon monoxide poisonings, and child poisonings. In fact, consumer product-related deaths in these hazard areas decreased by almost 500 deaths per year by the end of the period covered by our first Strategic Plan.

We have worked diligently to generate savings and implement efficiencies to offset the cost increases that we confront. We have achieved substantial cost savings in the past with such efforts as replacing regional offices with field telecommuting.

In 2005, we began the process of reducing our FTE ceiling from 471 to 440. We achieved those staff reductions, primarily, by focusing on administrative efficiencies. With expected 2006 attrition, by offering "early outs" and "buy outs", and by careful attention to filling only critical vacancies, the agency plans to achieve the necessary 420 FTE staff level by the start of 2007. Our goal is to carefully adjust our activities to this reduced resource level in such a manner that the remaining programs continue to adequately protect American families.

I appreciate the committee's continued interest in our work, and I want to assure the senators that we at the CPSC remain committed to our mission to reduce product hazards and to assure the safety of the consumer products that are used in our homes, backyards and playgrounds across the Nation.

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PREPARED STATEMENT OF PATRICIA BLACK, DEPUTY INSPECTOR GENERAL, OFFICE OF INSPECTOR GENERAL, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. Chairman and members of the subcommittee, I am pleased to present the fiscal year 2007 budget request totaling \$26.3 million, or \$4.4 million less than fiscal year 2006 (including a 1 percent rescission) for the Office of Inspector General (OIG) at the Federal Deposit Insurance Corporation (FDIC). This budget has been possible because of the improved health of the banking industry since the early 1990's, the continued staff downsizing at the FDIC and within the OIG, and our internal efforts to improve our performance and productivity even with reduced budgets.

As you know, the FDIC was established by the Congress in 1933, 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. While the basic insurance coverage of individual deposits remains at \$100,000, as of April 1, 2006 the FDIC raised the deposit insurance coverage on certain retirement accounts to \$250,000 from \$100,000. As of December 31, 2005, the FDIC insured \$3.893 trillion in deposits for 8,845 institutions, of which the FDIC supervised 5,245. The FDIC also promotes the safety and soundness of these institutions by identifying, monitoring, and addressing risks to which they are exposed.

The Corporation reports that financial institutions have recently had record earnings. The rate of bank and thrift failures has remained at a relatively low level over the past 10 years, and the Corporation has substantially reduced its estimates of future losses from failures. In fact, 2005 was the first year in the FDIC's history where no institution has failed, nor has 2006 seen any failures to date. Assets held in receiverships following bank failures are at comparatively low levels, and significant progress has been made in closing older receiverships. These are important indicators of a healthy banking system, and the Corporation can take pride in its positive contributions in these areas.

The FDIC OIG is an independent and objective unit established under the Inspector General Act of 1978, as amended (IG Act). 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.

As the Deputy Inspector General, I have led the office since January 2005 (when Gaston L. Gianni, Jr. retired). I will continue to dedicate myself to carrying out the mission of the OIG until an Inspector General is confirmed. In this capacity, I will support the Congress, the FDIC Chairman, and other corporate management in meeting current and future challenges facing the FDIC and the banking industry.

I am proud of the work the OIG accomplished this past fiscal year. This statement discusses the fiscal year 2005 accomplishments, our assistance to FDIC management, internal management and operational initiatives to improve the OIG, and our new "2006 Business Plan". I am also providing additional details about our fiscal year 2007 budget and how it will be spent.

#### A REVIEW OF THE FDIC OIG'S FISCAL YEAR 2005 ACCOMPLISHMENTS

As in past years, during fiscal year 2005, our work resulted in a number of major achievements, as follows:

- \$42.4 million in actual and potential monetary benefits;
- 76 non-monetary recommendations to FDIC management;
- 42 referrals to the Department of Justice;
- 36 indictments/informations;
- 27 convictions; and
- 3 employee/disciplinary actions.

More specifically, our accomplishments included 38 completed investigations that led to the above indictments and convictions as well as fines, court-ordered restitution, and recoveries that constitute slightly over \$29.5 million in actual and potential monetary benefits from our work. Also, we issued a total of 40 audit and evaluation reports, which included about \$3.3 million in questioned costs and \$9.5 million in recommendations that funds be put to better use. The audit reports contained 76 non-monetary recommendations to improve FDIC policies, operations, and controls that ultimately are designed to improve FDIC's ability to effectively and efficiently accomplish its mission. A number of these recommendations addressed important cross-cutting corporate issues, e.g., the corporate planning process, the use of consultants, and human capital.

Further, the OIG accomplished many of its organizational goals during the fiscal year as outlined in our annual performance plan. Our 2005 Performance Report shows that we met or substantially met 31 of our 37 goals, or 84 percent. This compares to 76 percent met or substantially met in 2004. 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.

Examples of the OIG's audit, investigation, and evaluation work that contributed to these accomplishments follow:

#### *Bank Fraud in Connection with BestBank Failure*

After a 3-week trial in the U.S. District Court, District of Colorado, a jury found the owners of Century Financial Services, Inc. and its successor Century Financial Group, Inc. (Century), guilty on charges of conspiracy, bank fraud, wire fraud, and operating a continuing financial crimes enterprise that contributed to the 1998 failure of BestBank in Boulder, Colorado.

By way of background, the owners owned and operated Century, a company that marketed and sold travel club memberships to subprime borrowers. Subprime credit card borrowers are high-risk borrowers with poor credit histories. The subprime borrower would finance a membership by charging it to a new BestBank unsecured VISA card. In 1998, the largest asset of the bank was the portfolio of subprime credit card accounts containing more than 500,000 credit card accounts with a reported value of more than \$200 million.

From 1996 through July 1998, the defendants, through Century, applied \$20 credits to the accounts of numerous cardholders who did not pay their credit card bill and whose accounts otherwise would have grown increasingly delinquent. These payments made the portfolio appear to be performing better than it was. During this same period of time, BestBank continued to fund the growing credit card portfolio with insured deposits. In July 1998, the Colorado State Banking Commissioner and the FDIC determined that the value of the subprime credit card portfolio, the primary asset of BestBank, was overstated because delinquent loans were fraudulently made to appear current. BestBank was found to be severely undercapitalized, with losses exceeding \$200 million, resulting in one of the largest adverse impacts to the Bank Insurance Fund in the last 10 years.

While Century earned in excess of \$460 million in gross receipts, the owners each derived more than \$11 million from the offenses. Each of them faces a possible mandatory minimum sentence of 10 years to life in Federal prison and fines of up to twice the amount gained from committing the offenses. Sentencing has not yet been scheduled by the Court.

Also charged in the same indictment for offenses relating to the failure of BestBank are the dissolved bank's Chief Executive Officer and Chairman of the Board, the Chief Financial Officer, and the President. The jury trial against the remaining three defendants is scheduled to begin in July 2006.

We investigated the case jointly with the FBI and the IRS Criminal Investigative Division. The U.S. Attorney's Office for the District of Colorado and the U.S. Department of Justice are prosecuting the case.

*Investigation Into Misapplication of Bank Funds at Connecticut Bank of Commerce*

The former chairman of the board of directors of Connecticut Bank of Commerce was sentenced in January 2005, to 51 months' incarceration and 36 months' supervised release after pleading guilty to one count of misapplication of bank funds. No criminal restitution was ordered by the court because the parties agreed that the former chairman's payment of \$8.5 million to the FDIC, as part of his settlement of the agency's administrative charges, satisfied all losses directly related to his criminal conduct.

We conducted this investigation jointly with the FBI. The U.S. Attorney's Office for the District of Connecticut prosecuted the case.

*FDIC's Supervision of an Institution's Compliance With the Bank Secrecy Act (BSA)*

We conducted this audit in response to a congressional request for our independent assessment of the circumstances related to an institution's BSA violations. We reported that responsibilities to ensure compliance with BSA were not adequately fulfilled by either institution management or the FDIC. In addition, FDIC examinations lacked sufficient follow-up on corrective measures to address BSA violations. Further, the FDIC needed to more thoroughly consider the impact of BSA compliance violations when qualifying potential acquirers of a failed institution. As a result of our recommendations and its own initiatives, the FDIC has made significant improvements in, and is devoting substantially more resources to, its supervision of institution BSA compliance programs.

*FDIC's Investment Policies*

We issued a report on the results of an audit conducted by PricewaterhouseCoopers, LLP to determine whether the FDIC's investment strategy and portfolio management procedures provided the highest possible investment returns for the FDIC. This audit concluded that the FDIC's Division of Finance performed well in managing the FDIC's investment portfolio in the context of the applicable legal and regulatory framework, stated investment strategy, interest rate environment, and assessment of certain insured institutions undergoing financial stress.

The audit identified opportunities for the FDIC to improve the return on its investments through two broad courses of action. First, in certain market environments, the FDIC should decrease holdings in overnight certificates and increase holdings in longer-maturity securities. Second, the FDIC should explore the possibility of changes in its investment approach, such as expanding the universe of allowable investments. We recommended that the Corporation perform an internal review of its investment policies, adopt certain performance measures and goals, and obtain periodic independent reviews of the investment program. All recommendations in the report were resolved.

Our semiannual reports to the Congress provide many other examples of OIG work that has contributed to fiscal year 2005 accomplishments. These reports can be found on our Web page at <http://fdicig.gov> or obtained by contacting our office.

ASSISTANCE TO FDIC MANAGEMENT

In addition to 2005 audits, investigations, and evaluations, the OIG made contributions to the FDIC in several other ways. We strive to work in partnership with Corporation management to share our expertise and perspective in certain areas where management is seeking to make improvements. Among these contributions were the following activities:

- Reviewed 35 proposed corporate policies and offered comments and suggestions when appropriate.
- Provided advisory comments on the FDIC's 2005 Annual Performance Plan and 2005 Annual Report.

- Participated in division-level conferences and meetings to communicate our audit 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. We also participated in an advisory capacity on the Information Technology Subcommittee of the Audit Committee.

#### OIG MANAGEMENT AND OPERATIONAL INITIATIVES

An important part of our stewardship over the funding we receive includes our continuous efforts to improve OIG performance and plans. We provide objective, fact-based information and analysis to the Congress, the FDIC Chairman, other FDIC officials, and the Department of Justice. Our key efforts typically involve our audits, evaluations, or criminal investigations conducted pursuant to the IG Act and in accordance with applicable professional standards. We also make contributions to the FDIC in other ways, such as reviewing and commenting on proposed corporate policies and draft legislation and regulations; participating in joint projects with management; providing technical assistance and advice on various issues such as information technology, strategic planning, risk management, and human capital; and participating in internal FDIC conferences and seminars.

The OIG has continued to downsize with the Corporation through reorganization, closing two field audit offices, and offering buyouts and retirement incentives to impacted employees under an FDIC-wide program. The OIG will continue to carry out several key initiatives to implement our human capital strategic plan and ensure that the OIG is a results-oriented high-performance organization. Many of the planned initiatives relate to staff development and include: the establishment of a mentoring program; providing training and development related to the OIG core competencies and business knowledge needs; and developing a strategy to improve the supervisor-staff feedback process.

Other internal initiatives included our hosting an interagency symposium on the Federal Information Security Management Act (FISMA) of 2002. Representatives from more than 18 Federal agencies attended the symposium to share information, ideas, and best practices related to the implementation of FISMA. The OIG also hosted an "Emerging Issues" conference with participants from other OIGs of financial regulatory agencies, GAO, regulatory agency officials, and congressional staff. The conference brought together distinguished speakers who shared their perspectives on the banking and financial services community with Inspector General staff in the interest of enhancing the value that OIGs can add to their agencies by successfully addressing risk areas. We also sponsored the annual conference of the Federal Audit Executive Council, a working group comprised of the heads of Federal audit organizations. This forum helps ensure that Federal audit organizations keep current with auditing standards, practices, priorities, and issues of concern.

#### BUSINESS PLAN

The OIG developed a new business plan that explains what we are about, what we want to accomplish, and how we will get there. It also provides a means to assess our performance. Our "2006 Business Plan" represents the results of concerted efforts over time, especially during the past year, to improve our planning process and demonstrate the value added by our office to sound FDIC governance and to executive and legislative branch decision-makers.

The "2006 Business Plan" combines the OIG Strategic Plan and Performance Plans. This plan contains six strategic goals to help accomplish our mission. In carrying out the key efforts of our plan, we will strive 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.

The complete "2006 Business Plan" is available at [www.fdicig.gov](http://www.fdicig.gov). We have begun the process for developing performance goals and key efforts for fiscal year 2007, which will continue building on this strategic framework. Our six 2006 strategic goals and selected key efforts follow:

*Strategic Goal 1.—Assist the FDIC to Ensure the Nation's Banks Operate Safely and Soundly*

Bank supervision is a cornerstone of the FDIC's efforts to ensure stability and public confidence in the Nation's financial system. The OIG's role under this strategic goal is targeting audits and evaluations that review the effectiveness of various FDIC programs aimed at providing continued stability to the Nation's banks. The OIG also conducts investigations of fraud at FDIC-supervised institutions,

fraud by bank officers, directors, or other insiders; obstruction of bank examinations; fraud leading to the failure of an institution; fraud impacting multiple institutions; and fraud involving monetary losses that could significantly impact the institution. Below are selected key efforts representing ongoing work or work envisioned in support of this goal.

- Conduct material loss reviews of failed banks, as needed;
- Review bank examination procedures for addressing bank sensitivity to interest rate risks;
- Investigate criminal obstruction of bank examinations;
- Review bank examination procedures for addressing electronic banking risks;
- Review whether bank examinations adequately consider the reliability of property appraisals;
- Investigate financial institution fraud;
- Review the FDIC’s use of the Financial Crimes Enforcement Network (FinCEN); and,
- Review the use of Bank Secrecy Act examinations for foreign transactions.

*Strategic Goal 2.—Help the FDIC Maintain the Viability of the Deposit Insurance Funds*

FDIC deposit insurance remains a central component of the Federal Government’s assurance to the public that it can be confident in the stability of the Nation’s banks and savings associations. Since its establishment in 1933, the FDIC has insured deposits up to the legally authorized threshold, which historically was at \$100,000. For almost two decades following bank crises in the late 1980’s and early 1990’s, the FDIC has managed two deposit insurance funds—one for banks with about \$35 billion, and one for savings and loans with about \$13 billion. These funds, which are primarily an accumulation of premiums that insured depository institutions have paid the FDIC and interested earned, have been used to pay FDIC operating expenses and insured depositors, as necessary. On February 1, 2006, the Congress enacted deposit reform legislation that will create a deposit insurance system that is more focused on risk and better able to adapt to rapidly changing industry. The new deposit insurance reform legislation:

- Merges the two deposit insurance funds into a single Deposit Insurance Fund.
- Maintains deposit insurance coverage for individual accounts at \$100,000, but provides for indexing for inflation every 5 years beginning in 2010.
- Increases deposit insurance coverage for retirement accounts to \$250,000 and provides for indexing for inflation every 5 years beginning in 2010.
- Replaces the current Designated Reserve Ratio of 1.25 percent of estimated insured deposits by permitting the reserve ratio to move within a range of 1.15 percent to 1.50 percent of estimated insured deposits.
- Requires the FDIC to provide cash rebates in amount equaling 50 percent of the amount in excess of the amount required to maintain the reserve ratio at 1.35 percent. Requires the FDIC to provide cash rebates in amount equaling the total amount in excess of the amount required to maintain the reserve ratio at 1.50 percent.
- Provides financial institutions with a one-time transitional premium assessment credit based on the assessment base of the institution on 12/31/96 as compared to the combined aggregate assessment base of all eligible depository institutions.

The Corporation has begun the process for implementing the provisions of the new legislation. To date, the FDIC has merged the two deposit insurance funds into a single Deposit Insurance Fund and raised the deposit insurance coverage on certain retirement accounts to \$250,000 from \$100,000. As insurer, the FDIC must evaluate and effectively manage how changes in the economy, the financial markets, and the banking system affect the adequacy and the viability of the deposit insurance funds. The OIG has a responsibility to evaluate the FDIC’s programs and operations to ensure that the agency has adequate information to gauge the risks inherent as financial institutions consolidate, enter into new business areas, and become more global. In support of this goal, we have planned the following key efforts.

- Review the FDIC’s approach to risks posed by large or multiple bank failures;
- Review the FDIC’s risk-based premium program;
- Review the insurance application process for industrial loan companies (ILCs); and,
- Review FDIC methods for maintaining adequate insurance fund reserves.

*Strategic Goal 3.—Assist the FDIC to Protect Consumer Rights and Ensure Community Reinvestment*

The FDIC oversees statutory and regulatory requirements aimed at protecting consumers from unfair and unscrupulous banking practices. The FDIC has recognized the importance of its role in this regard by establishing its own strategic goal to ensure that consumers' rights are protected and supervised institutions invest in their communities. The FDIC's bank examiners conduct examinations in FDIC-supervised banks on a scheduled basis to determine the institutions' compliance with laws and regulations governing consumer protection, unfair lending, and community investment. When problem institutions are identified, primarily through the examination process, the FDIC attempts using reason and moral suasion to bring about corrective actions; however, the Corporation possesses broad enforcement powers to correct situations that threaten an institution's compliance with applicable laws. The OIG's role under this strategic goal is targeting audits and evaluations that review the effectiveness of various FDIC programs aimed at protecting consumers, fair lending, and community investment. Additionally, the OIG's investigative authorities are used to identify, target, disrupt, and dismantle criminal organizations and individual operations engaged in fraud schemes that target our financial institutions. Our planned 2006 work towards this goal includes the following key efforts:

- Investigate misrepresentations of deposit insurance coverage;
- Work with Congress and FDIC management to strengthen enforcement against misrepresentations of deposit insurance;
- Investigate "phishing," "pharming," and other identity theft schemes;
- Review multiple FDIC efforts to ensure financial data privacy;
- Evaluate the FDIC's approach to examining fair lending and community reinvestment;
- Review risks posed to institutions and the FDIC by predatory lending;
- Assess how the FDIC makes use of data required by the Home Mortgage Disclosure Act; and,
- Review how the FDIC addresses deficiencies reported in compliance examinations.

*Strategic Goal 4.—Help Ensure That the FDIC is Ready to Resolve Failed Banks and Effectively Manages Receiverships*

When a bank that offers Federal deposit insurance fails, the FDIC fulfills its role as insurer by either facilitating the transfer of the institution's insured deposits to an assuming institution or by paying insured depositors directly. Although there have been far fewer failures in recent years than occurred during the years of crisis in the banking industry, the FDIC's responsibility for resolving troubled institutions remains a challenge. The FDIC reports that failures in today's economy would differ in nature, size, and cost from the record failures of the 1980's and early 1990's. Nonetheless, the FDIC could potentially have to handle a failing institution with a significantly larger number of insured deposits than it has had to deal with in the past or have to handle multiple failures caused by a single catastrophic event.

The OIG's role under this strategic goal is targeting audits and evaluations that assess the effectiveness of the FDIC's various programs designed to ensure that the FDIC is ready to and does respond promptly, efficiently, and effectively to financial institution closings. Additionally, the OIG investigative authorities are used to pursue instances where fraud is committed to avoid paying the FDIC civil settlements, court-ordered restitution, and other payments as the institution receiver. Our office is focusing on the following key efforts.

- Assess the FDIC's planning for large or multiple bank failures;
- Review the recovery of unclaimed deposits in failed banks;
- Review the development framework for a new technology-driven asset servicing project; and,
- Identify and investigate instances of assets fraudulently concealed from the FDIC.

*Strategic Goal 5.—Promote Sound Governance and Effective Stewardship of Financial, Human, Information Technology, and Procurement Resources*

The FDIC must effectively manage and utilize a number of critical strategic resources in order to carry out its mission successfully, particularly its financial, human, information technology (IT), and procurement resources. Financial resources are but one aspect of the FDIC's critical assets. The Corporation's human capital is also vital to its success. The FDIC appreciates the importance of its people, with four of its six values, integrity, competence, team work, and fairness specifically referencing the workforce.

Information technology drives and supports the manner in which the public and private sector conduct their work. At the FDIC, the Corporation seeks to leverage IT to support its business goals in insurance, supervision, consumer protection, and receivership management, and to improve the operational efficiency of its business processes. Along with the positive benefits that IT offers comes a certain degree of risk. In that regard, information security has been a long-standing and widely acknowledged concern among Federal agencies. A key effort for all agencies must be the establishment of effective information security programs.

The OIG's role in this strategic goal is to perform audits, evaluations, and investigations that identify opportunities for more economical, efficient, and effective corporate expenditures of funds; recommend actions for more effective governance and risk management practices; foster corporate human capital strategies that benefit employees, strengthen employees' knowledge, skills, and abilities; ensure employee and contract integrity; inspire employees to perform to their maximum capacity; help the Corporation to leverage the value of technology in accomplishing the corporate mission; promote the security of both IT and human resources; and ensure that procurement practices are fair, efficient, effective, and economical. The key efforts below are some of the ongoing work or work to be undertaken in support of this goal.

- Evaluate selected FDIC efforts to operate efficiently, effectively, and economically;
- Review the FDIC's personnel discrimination complaint tracking system;
- Investigate FDIC employee or contractor misconduct, as needed;
- Review succession planning initiatives;
- Review safeguards over sensitive employee information;
- Review the FDIC's information security, privacy, and data protection programs; and,
- Review selected procurement practices.

*Strategic Goal 6.—Continuously Enhance the OIG's Business and Management Processes*

The OIG's final strategic goal has an internal focus on continuous improvement. Our aim under this goal is to:

- Enhance our own business and management practices;
- Enhance strategic and annual planning and performance measurement;
- Strengthen human capital management;
- Ensure the continued quality and efficiency of audits and investigations; and,
- Foster good relationships with clients, stakeholders, and OIG staff.

THE OIG'S FISCAL YEAR 2007 BUDGET REQUEST

The proposed fiscal year 2007 OIG budget includes funding in the amount of \$26,256,000, or \$4,434,000 less than fiscal year 2006 (after a 1 percent rescission). This budget will support an authorized staffing level of 130—a 19 percent reduction from the 160 staff authorized in fiscal year 2006. The FDIC has continued a downsizing effort over several years in response to changes in the banking industry, information technology, and fewer bank failures. Consequently, we have conducted a thorough review of our workload and determined that we can reduce the number of audits to be performed and some other aspects of our workload because of certain decreased elements of risk, fewer assets under FDIC receivership management, and fewer bank failures experienced and anticipated. However, the OIG's investigative workload is increasing, with a substantial caseload of financial institution fraud because Federal Bureau of Investigation resources have been redirected to the war on terrorism.

The FDIC OIG has been operating under an appropriated budget since fiscal year 1998 in accordance with Section 1105(a) of Title 31, United States Code, which provides for "a separate appropriation account for appropriations for each Office of Inspector General of an establishment defined under Section 11(2) of the Inspector General Act of 1978." The FDIC OIG is the only appropriated entity in the FDIC, and this funding approach is part of the statutory protection of the OIG's independence. As in past years, the funds for the OIG budget would be derived from deposit insurance funds and the FSLIC Resolution Fund. The insurance funds are funded by assessments on deposits held by insured banks and thrifts and from the interest on the required investment of fund reserves held in government securities. These funds are the ones used to pay for other FDIC operating expenses.

## BUDGET BY STRATEGIC GOALS

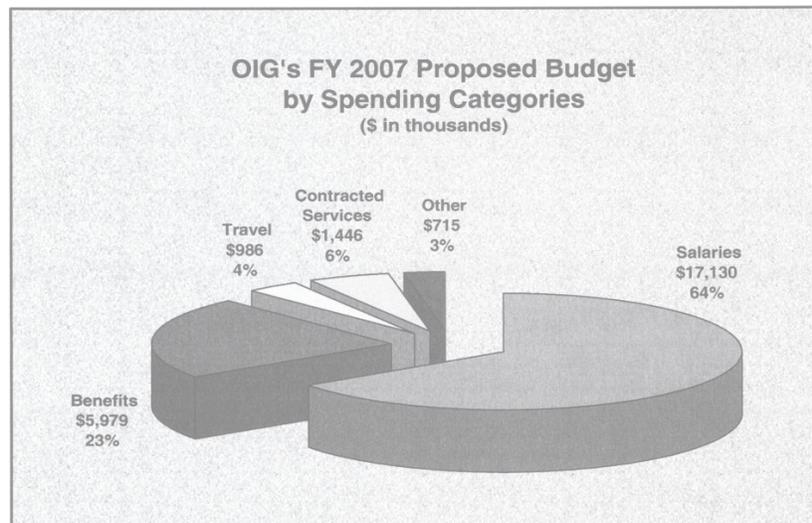
For fiscal year 2007, the OIG developed the budget based on the six strategic goals that I discussed earlier. The six strategic goals, along with their associated portion of budget dollars follow:



- Strategic Goal 1.*—Assist the FDIC to Ensure the Nation’s Banks Operate Safely and Soundly;
- Strategic Goal 2.*—Help the FDIC Maintain the Viability of Deposit Insurance Funds;
- Strategic Goal 3.*—Assist the FDIC to Protect Consumer Rights and Ensure Community Reinvestment;
- Strategic Goal 4.*—Help Ensure the FDIC is Ready to Resolve Failed Banks and Effectively Manages Receiverships;
- Strategic Goal 5.*—Promote Sound Governance and Effective Stewardship of Financial, Human, Information Technology, and Procurement Resources; and,
- Strategic Goal 6.*—Continuously Enhance the OIG’s Business and Management Processes.

## FISCAL YEAR 2007 BUDGET BY MAJOR SPENDING CATEGORIES

The following chart shows the distribution of the OIG’s budget by major spending categories. Mostly, the OIG budget is comprised of salaries and benefits for its employees and the necessary funding for travel and training expenses. Our fiscal year 2007 budget also includes funds to replace our staff’s laptop computers, which will be over 3 years old and due for replacement, in accordance with the Corporation’s computer replacement schedule.



#### CONCLUDING REMARKS

Mr. Chairman and members of the subcommittee, I appreciate the support and resources we have received through the collaboration of the President, the Congress, and the FDIC. As a result, the OIG has continued to make a real difference in FDIC operations in terms of financial benefits and improvements, and by strengthening our own operations and efficiency. I look forward to continue working with this subcommittee and working with the new Inspector General when appointed. I believe our fiscal year 2007 budget strikes an appropriate balance between the mandate of the Inspector General Act, other legislative requirements, our judgments of OIG workload needs, the changing conditions in the banking industry, and the FDIC's downsizing. 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.

#### PREPARED STATEMENT OF AUSTIN SMYTHE, OFFICE OF MANAGEMENT AND BUDGET

Mr. Chairman, Senator Murray, members of the subcommittee, I am pleased to present the President's fiscal year 2007 budget request for the Office of Management and Budget (OMB).

#### PROGRESS ON SPENDING RESTRAINT

Before reviewing OMB's fiscal year 2007 budget, I would like to take a moment to review the substantial accomplishments in spending restraint we were able to achieve together over the past year. In line with the President's budget request, the Congress sent the President appropriations bills that held the growth of total discretionary spending below the rate of inflation and cut non-security spending. In addition, Congress adopted 89 of the President's proposed 154 cuts and terminations, saving \$6.5 billion in the process. And Congress achieved nearly \$40 billion in mandatory savings over 5 years, the first time in 8 years reconciliation has been used to slow the growth in spending.

President Bush's 2007 budget builds on last year's progress by focusing on national priorities and tightening our belt elsewhere. It gives our troops and those who defend our security what they need to fight and win the Global War on Terror. And it supports the President's pro-growth economic agenda.

In order to stay on track to meet the President's goal of cutting the deficit in half by 2009, we must continue to do two things: keep the economy growing and restrain spending.

First, the 2007 budget will support continued economic growth by proposing to make permanent the tax relief signed into law by the President in 2001 and 2003.

Some have argued that we should let the tax relief expire. A tax increase is the wrong prescription, not only for the Nation's economic health, but for the government's fiscal health as well.

We are not an under-taxed society. By rejecting tax increases on families and small businesses, this budget will help keep the economy on a continuing course of job creation and strengthen the foundations for long-term growth.

The second critical component of deficit reduction is a vigorous policy of spending restraint. Similar to last year, the budget holds overall discretionary spending growth below the rate of inflation. It again proposes a cut in non-security discretionary spending. It calls for major reductions in or total eliminations of 141 Federal programs, saving nearly \$15 billion. And it continues our efforts to slow the growth in spending on mandatory programs, by proposing \$65 billion in savings over 5 years.

The Appropriations Committees and the Congress have achieved considerable progress in restraining discretionary spending. We need to continue this progress on the mandatory side of the budget. The efforts begin to restrain the growth in mandatory spending are vital—not just for our near-term deficit reduction efforts—but especially for the long-term. Toward the end of the next decade, deficits stemming largely from entitlement programs such as Social Security and Medicare will begin to rise indefinitely. At that point, no plausible amount of discretionary spending cuts or tax increases will restore our long-term fiscal health.

The President has shown a willingness to take on these future unfunded obligations and to propose long-term reforms. This year's budget proposes \$36 billion in savings from Medicare, and includes proposals that pave the way for additional reforms in the future. As with Social Security and Medicaid, we do not need to cut Medicare, but we do need to slow its growth—and the President's budget begins to do just that.

#### DELIVERING RESULTS

To ensure the Federal Government spends taxpayer dollars more effectively, the administration continues to implement the President's Management Agenda (PMA). The PMA helps individual agencies and programs focus on and produce results. It promotes this goal through several key components: strategic management of human capital; competitive sourcing; improved financial performance and reporting standards; electronic government (e-gov) initiatives; and integration of budget policy with performance measures.

OMB has successfully designed and implemented the Program Assessment Rating Tool, or PART, to help agencies measure the success of their programs, focus efforts to improve program performance, and set budgetary policy accordingly. To support these efforts, OMB has introduced a new website called ExpectMore.gov. ExpectMore.gov allows taxpayers to review the OMB assessments of nearly 800 Federal programs. You can search the programs by rating, topic, or by a simple keyword search. I urge you and your staffs to use this new resource in evaluating whether programs are achieving the results you, the Congress, intend.

In addition to the PART, I want to highlight our competitive sourcing and electronic government initiatives about which some members of Congress have raised concerns.

The Competitive Sourcing initiative finds the lowest cost, highest quality sources to perform the government's commercial activities. This initiative is expected to generate savings to the taxpayers of more than \$800 million a year.

The Expanded Electronic Government initiative is identifying and eliminating duplicative information technology systems in agencies. The result is improved service delivery to citizens, businesses and Federal employees at a lower cost. Overall, these E-Government initiatives are delivering to Congress and the American people more than \$380 million a year in cost savings and millions more in cost avoidance.

Both of these initiatives have been the subject of statutory restrictions that inhibit their progress. OMB's Deputy Director for Management Clay Johnson is the lead for the administration on these issues and we want to work with you to make these initiatives a success. In this time of fiscal restraint, our mutual goal should be to maximize rather than limit the savings resulting from these common sense programs.

#### OMB'S BUDGET

Consistent with the President's overall fiscal year 2007 Budget, the Office of Management and Budget has submitted a disciplined request for our agency. OMB's budget requests \$68.8 million—a 0.6 percent reduction from the fiscal year 2006 enacted level when measured on an apples-to-apples basis.

To achieve this spending restraint, OMB is pursuing cost savings wherever possible. OMB has been operating under very tight budgets. 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 490 positions in 2005.

In last year's appropriations bill, Congress provided a net increase of \$750,000 to our request, boosting our budgeted staff levels to 500 positions. Following the guidance provided by the committee, we have increased staff levels in the resource management offices (RMOs) of OMB. To meet increased pay and other costs and achieve the 0.6 percent reduction proposed in OMB's budget for fiscal year 2007, OMB would reduce staff levels by 11 positions compared to the enacted fiscal year 2006 level.

We believe OMB can continue to deliver high-quality performance and fulfill our many important core responsibilities with these lower 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 subjects. We work to ensure that all the administration's proposals in these areas are consistent with relevant statutes and Presidential objectives. In meeting these responsibilities, OMB is prepared to work within the constraints of a tight budgetary environment.

I look forward to working with the Congress to develop a final budget that is consistent with our goals of spending discipline while focusing on national priorities.

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PREPARED STATEMENT OF W. DOUGLAS BUTTREY, CHAIRMAN, SURFACE  
TRANSPORTATION BOARD

Mr. Chairman, and members of the subcommittee, thank you for the opportunity to submit for the record this testimony on the fiscal year 2007 budget request of the Surface Transportation Board (Board).

BACKGROUND ON THE BOARD

The Board is a three-member, bipartisan, decisionally independent adjudicatory body organizationally housed within the Department of Transportation (DOT) with jurisdiction over certain surface transportation economic regulatory matters.

The Board provides an efficient and effective forum for the resolution of disputes relating to surface transportation regulation. The Board has jurisdiction over railroad rate and service issues and rail restructuring transactions (mergers, line sales, line construction, and line abandonments); certain trucking company, moving van, and non-contiguous ocean shipping company matters; certain matters relating to the structure, finances and operations of intercity passenger bus companies; and certain pipeline matters not regulated by the Federal Energy Regulatory Commission.

The Board's Section of Environmental Analysis performs environmental reviews of construction, abandonment, and merger matters that come before the Board for review and approval, as required by the National Environmental Policy Act. These reviews have become more complex and require significant resources.

THE BOARD'S FISCAL YEAR 2007 BUDGET REQUEST

The budget request submitted by the Board for fiscal year 2007 totals \$25,618,000. This budget level mirrors the Board's fiscal year 2006 budgetary authority enacted by Congress, adjusted for a decrease in funding associated with the one-time build-out cost in fiscal year 2006 for the Board's new office space and offset by the fiscal year 2007 pay raise as well as the amount required to physically move to the new space. The Board also seeks resources and authority to operate at 150 FTEs, the current staffing level authorized by Congress.

The Board is requesting \$375,000 for moving services to complete the agency's relocation by the General Services Administration (GSA) from its current physical site. The Board has been at its current site for the duration of its 10-year lease, which expires early in 2007. The Board cannot remain in its current building and must find new space because the building owners intend to vacate the building to provide for extensive renovation and modernization. GSA had the replacement lease prospectus approved by Congress during 2004. GSA advertised the lease solicitation during the summer of 2005 and will award the lease by the summer of 2006. GSA will begin the design and interior construction in 2006 with an anticipated move-in date of January 2007. Funds included in the fiscal year 2006 appropriations bill

will provide GSA with the resources to schedule the network and telecommunication connections and interfaces and perform the required structural changes to the leased space to support the Board's mission. The Board is requesting funds in fiscal year 2007 for the physical relocation of its furniture, equipment and files to the new space, as well as an amount to pay for the new level of rent.

The Board would use the remaining additional funds requested to cover salary and employee benefit costs associated with the fiscal year 2006 and fiscal year 2007 pay increase and increases associated with employee health benefit and retirement costs. Unlike many agencies, there is little room in the Board's budget to absorb a pay increase without additional resources, because fixed costs, including salary and rent, comprise about 95 percent of the agency's expenses. Absorbing even a small amount of the pay increase would impair the Board's ability to perform its statutory mission.

The requested authorization for 150 FTEs will enable the Board to hire staff to replace retirement eligible staff prior to their anticipated retirement date. Currently, 47 employees, or 34 percent of the Board staff, are retirement eligible. Several retirements can be expected in the near future. Having the flexibility to hire qualified people when they are available is particularly important for an agency that must hire professionals with technical expertise when they are available in the labor market.

Consistent with appropriation acts for past fiscal years, the Board requests a provision allowing user fee collections to be credited to the appropriation as offsetting collections and used for necessary and authorized expenses to the extent that they are collected. The overall budget request reflects the workload that is expected and the statutory and regulatory deadlines associated with the resolution of the cases filed.

#### OVERALL GOALS OF THE BOARD

The Board seeks to resolve matters brought before it fairly and expeditiously. Through use of its regulatory exemption authority, streamlining of its decisional process and the regulations, and consistent application of legal and equitable principles, the Board seeks to facilitate commerce by providing an effective forum for efficient dispute resolution and facilitation of appropriate business transactions. The Board continues to strive to develop, through rulemakings and case disposition, new and better ways to analyze unique and complex problems, to reach fully justified decisions more quickly, and to reduce the costs associated with regulatory oversight. The Board will continue to:

- strive for a more streamlined process for the expeditious handling of rail rate reasonableness and other complaint cases in an effort to provide additional regulatory predictability to shippers and carriers;
- diligently process cases before the Board and ensure that appropriate market-based transactions in the public interest are facilitated;
- adhere to all statutory deadlines for the resolution of matters pending before the Board;
- encourage new opportunities for the various sectors of the transportation community to work cooperatively with the Board and with one another to find creative solutions to persistent industry and/or regulatory problems involving carriers, shippers, employees, and local communities;
- work to ensure the provision of rail service that is responsive to the needs of customers; and
- ensure that the Board's processes are open and transparent to the public.

#### NATIONAL RAILROAD PASSENGER CORPORATION (AMTRAK) DIRECTED SERVICE PROVISION

The fiscal year 2006 Transportation Appropriations Act directed the Secretary of Transportation to reserve \$60 million of Amtrak's fiscal year 2006 appropriation to fund directed service, that is to direct another carrier or carriers to carry out the functions currently performed by Amtrak that are necessary to continue commuter and freight rail operations, in the event Amtrak ceased to operate during the fiscal year. The fiscal year 2007 President's budget request also proposes to provide the Board with \$60 million to support commuter and freight rail service should Amtrak cease operations. These funds would allow the Board to direct service of commuter and freight rail operations that fail as a result of a cessation of service by Amtrak.

The Board has statutory authority under section 11123 of title 49 to direct service, or in other words, order another railroad to step into the shoes of a rail carrier that has stopped operating (usually because of bankruptcy) and serve its customers. This authority was broadened by Congress in 2005 to include authority for the Board to direct the continuation of commuter and freight rail services that fail as a result

of a cessation of service by Amtrak. The Board participates in a joint working group to coordinate issues relating to Amtrak directed service with the U.S. Department of Transportation's Federal Railroad Administration (FRA). That group has met with all major stakeholders—including Amtrak, the affected commuter and freight railroads, and representatives of labor—to identify issues. It has compiled all of the services Amtrak provides to commuter and freight railroads, and has examined legal issues that might arise. However, these planning efforts would need to be significantly supplemented were the need to implement directed service imminent. While matters brought before the Board are often lengthy, in directed service proceedings section 11123 does alter some administrative procedures to allow the Board to act cooperatively and quickly.

#### FISCAL YEAR 2006 AND 2007 ACTIVITIES OF THE BOARD

The Board's workload involving rail rates and services is expected to remain stable through fiscal year 2007. The Board will continue to look for ways to streamline and improve its regulatory process and to promote private sector resolution of problems. In this regard, the Board is open to proposals filed by parties and independently will look for ways to shorten and streamline its procedures and processes.

The Board has instituted a rulemaking proceeding to address major issues regarding the proper application of the stand-alone cost (SAC) test in rail rate cases and the proper calculation of the floor for any rail rate relief. The Board's general standard for judging reasonableness of rail freight rates are set forth in the Coal Rate Guidelines, which adopted a set of pricing principles known as constrained market pricing (CMP). Most captive rail shippers seek relief under CMP's SAC test. Under the SAC constraint, the rate at issue cannot be higher than the railroad would need to charge to serve the complaining shipper while fully covering all its costs, including a reasonable return on investment. Because the issues being addressed in the rulemaking have been raised or are implicated in the pending rail cases, the Board is holding the pending rail rate cases in abeyance while it examines these important issues.

The Board will continue to handle rail cases involving questions of whether certain State or local regulation of certain rail-related facilities is preempted by Federal law. These issues have generated considerable interest in recent years, as the Board and the courts have explored the extent of Federal preemption on a case-by-case basis.

Board staff expeditiously handles on an informal basis rail consumer inquiries and complaints concerning matters related to rates and other charges, car supply and other service issues, claims for damages, and service-related problems, employee concerns, and community issues. The Board's Rail Consumer Assistance Program is an informal mechanism for resolving disputes between freight railroads, and between those railroads and their customers. This program has a special toll-free telephone number and a website connection to assist rail customers and others with concerns involving railroads. It resolved 121 rail consumer issues during 2005.

The Board has participated in forums between railroads and their customers to facilitate better communications regarding service issues and plans to resolve them. The Board continues to encourage parties in cases before it to reach private sector solutions to their disputes outside of the Board's formal processes.

The Board's responsibility with respect to rail carrier consolidations includes a broad range of control transactions among larger railroads and smaller railroads. In addition, the Board continues to resolve issues related to past Class I rail mergers. We are not aware that any major rail mergers are contemplated in the immediate future, so the workload in this category is expected to remain constant through fiscal year 2007. Of course, it is impossible to predict with certainty that no major merger will be proposed during fiscal year 2007. If a major merger is proposed, that would significantly increase the workload beyond the expected level.

The Board projects that its line construction docket will remain constant through fiscal year 2007. The Board has an unprecedented number of railroad line construction proposals currently under review. These 14 proposals vary in size and scope, ranging from less than 1 mile to 280 miles of new rail line. The associated environmental review work is significant. The Board granted final approval in its decision in STB Finance Docket No. 33407, "Dakota, Minnesota & Eastern Railroad Corporation Construction into the Powder River Basin", for a railroad to construct a 280-mile rail line into the Powder River Basin subject to extensive environmental mitigation conditions. This case represented a major multi-year effort on the part of the Board to address the complexities of a major rail construction case. Demands on the Board to conduct environmental reviews for such transactions continue to grow, and these activities require significant resources to complete.

Other line transaction activity is expected to remain constant through fiscal year 2007 as more carriers continue to sell unprofitable or marginally profitable lines as an alternative to service abandonment. The Board continues to see a number of line acquisitions by both small carriers and noncarriers as the larger rail carriers continue to restructure their rail systems.

Regarding non-rail matters, the Board has pending before it one pipeline rate dispute and one water carrier dispute, in addition to one water carrier dispute that has been decided by the Board and is now under court review. The Board's pipeline work is expected to remain constant as the pending case moves forward. The Board's intercity bus merger and pooling workload are projected to remain constant through fiscal year 2007; as is the Board's noncontiguous domestic water trade rate case activity. The Board expects to devote the same level of staffing resources to work on cases involving motor carrier ratemaking antitrust immunity through fiscal year 2007.

#### SUMMARY

The Board's budget request would ensure the resources needed for the Board to continue to implement its responsibilities expeditiously and effectively as Congress intends. I appreciate the opportunity to submit this statement for the record and would be happy to respond to any questions that the committee may have about the Board's fiscal year 2007 budget request.

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#### PREPARED STATEMENT OF THE FEDERAL ELECTION COMMISSION

Mr. Chairman, Ranking Member Murray, and members of the committee, it is my privilege to present the Federal Election Commission's (FEC's) fiscal year 2007 appropriation request. To begin, on behalf of the agency, I thank you for last year's appropriation. Your bipartisan support of the FEC budget has enabled us to continue to implement the Bipartisan Campaign Reform Act of 2002 (BCRA), which amended the Federal Election Campaign Act of 1971. We have used those funds to continue a process of constantly seeking to improve the FEC's operation in all three of its core missions: disclosure, enforcing compliance with the law, and operation of the presidential matching funds system. Despite some financial belt-tightening in fiscal year 2006, we can see a measurable improvement in the FEC's ability to meet its core functions.

Our fiscal year 2007 appropriation request is for \$57,138,000, an increase of \$2,985,000 or 5.51 percent over our enacted fiscal year 2006 appropriation. This increase will permit the agency to continue its current functions while meeting statutorily mandated salary and benefit increases. This year, the FEC is seeking only a modest increase over its fiscal year 2006 budget of \$54,153,000 (\$54,700,000, less the fiscal year 2006 across-the-board rescission). The fiscal year 2007 request represents a continuation of fiscal year 2006 funding levels, adjusted for inflation and salary and benefit increases. As such, it represents essentially a Current Services request for fiscal year 2007, with no additional funds or staff for new programs or initiatives. I am pleased to report this request conforms to the President's fiscal year 2007 budget request for the FEC. We have provided detailed support for this request in our fiscal year 2007 budget justification.

I would also like to note that our fiscal year 2007 request sets the agency's authorized personnel level at 375 FTE, a decrease of 16 FTE from our previous authorized level of 391. Although the agency is authorized for 391 FTE in fiscal year 2006, we found it necessary to reduce staffing in order to handle the increased cost of operations and to fund some non-recurring expenses in fiscal year 2006. As spelled out in our fiscal year 2006 Management Plan, the FEC's projected FTE utilization for fiscal year 2006 will be approximately 380 FTE. In fiscal year 2007, we estimate that an FTE level of 375 will enable us to maintain operations at the current service level and absorb the full cost of the fiscal year 2007 COLA.

Generally, the Commission submits a package of legislative recommendations to the President and the Congress in March. However, this year the district court's decision in *Shays v. FEC* required the Commission to rewrite some portion of nine of its previous rules in a condensed timeframe. Therefore, the annual review of legislative recommendations will be submitted at a later date. In the meantime, there is one legislative change that the Commission unanimously decided to include in its fiscal year 2007 budget request to Congress.

We are seeking statutory authority to charge and use registration fees for FEC-hosted conferences. The Commission has always relied on effective outreach and our informational programs to reduce violations due to lack of understanding of the law. These programs, such as the 800 informational line, the campaign finance work-

shops and seminars, and the campaign guides and brochures, have all received high marks from the election community, the media, and the public. Unfortunately, due to budget constraints we found it necessary to cancel our campaign finance workshops and seminars for 2006. In order to preserve these conferences in the future, we are seeking legislative authority to charge and use registration fees to help offset the costs of these conferences. If legislative authority is not granted, the Commission will require additional appropriated funds in order to host future conferences.

Over the past few years, the FEC has achieved several major successes, while also seeing a steady improvement in its operations. These significant achievements include meeting statutory and court deadlines for implementing BCRA, successfully defending legal challenges to the constitutionality of BCRA, and settling the largest enforcement case in the history of the agency. In addition, the agency has expanded and invigorated its compliance program and improved the timeliness of reporting. These successes are the result of FEC efforts and support from our Congressional oversight committees.

I now will provide a brief overview of the FEC's three core program areas and relate those areas to the agency's fiscal year 2007 budget request.

#### DISCLOSURE PROGRAM

The FEC's disclosure program reviews, compiles, and places candidate and political committee campaign finance reports and information on the public record, primarily through the FEC's extensive electronic databases. The disclosure program is also responsible for educating the public and practitioners about the Federal campaign finance laws and their application. Over one-third of the agency's staff (143.4 FTE), are involved in our Disclosure program. This includes staff from the Public Records Office, Information Technology Division, Reports Analysis Division, Press Office, Information Office, and attorneys from the Office of General Counsel (OGC) who formulate proposed regulations and draft responses to advisory opinion requests.

A key objective of the Disclosure program is to improve the web accessibility of FEC information. Via the FEC's website at [www.fec.gov](http://www.fec.gov), the public can conduct detailed searches of candidate and political committee reports, closed FEC enforcement matters, and the agency's advisory opinions. The website also provides access to the most up-to-date campaign guides and brochures, past and current regulations, litigation materials, and agenda documents. Beginning this year, the FEC has made audio file podcasts of meetings available for download within 48 hours of meetings.

The Disclosure program provides education outreach to the public and regulated community through campaign finance conferences and seminars, through a toll-free help line, and through the FEC's public records room. Our campaign finance conferences are crucial to the overall success of our Disclosure program, and it is imperative that we receive the statutory authority explained above in order to host these conferences without taking funds away from other core programs.

Improvements in productivity, aided by information technology (IT) enhancements, have enabled the FEC to keep pace with the large increases in Federal campaign finance activity during recent election cycles. Campaign financing has skyrocketed since 1976, when the FEC regulated the \$310 million in disbursements by Federal candidates and committees in the first publicly-funded Presidential election. For the 2004 Presidential and Congressional elections, the FEC regulated the disbursement of approximately \$4.8 billion—an increase of more than 1,500 percent in just eight Presidential election cycles. With your help, we are building an impressive system capable of handling our IT needs well into the future. This system offers the capability of instantly updating our campaign finance database and expanding the types of information collected. As you are aware, however, this system is expensive. Our fiscal year 2007 budget request for IT funding is \$6.5 million. This is the minimum amount required for IT projects. It keeps the "lights on" and supports the basic IT mission only. It forgoes some upgrades and desirable improvements. In future fiscal years we will require additional resources to complete necessary IT infrastructure upgrades and to make needed improvements in our disclosure and review functions. We do, however, plan to apply any savings realized through the course of the fiscal year to our IT programs.

With the passage of legislation mandating electronic filing of campaign finance reports, we are seeing benefits of improved timeliness. Since the institution of electronic filing, the median time to process detailed information from all documents received has improved from 11 (2000 cycle) to 6 (2002 cycle) to 2 days (2004 cycle) from receipt of the disclosure reports by the Commission. Due to both the enhanced use of technology and management initiatives, the FEC is processing and reviewing

disclosure reports more rapidly than ever, despite the huge increase in the amount of campaign finance funds and information to be processed and disclosed. This provides voters with more accurate and timely disclosure information prior to an election, enabling them to make an informed decision when it comes to the sources and uses of campaign funds by the candidate.

#### COMPLIANCE PROGRAM

Obtaining voluntary compliance with Federal campaign finance laws is the foundation of the FEC's mission and central to its strategic and performance plans. An effective and comprehensive enforcement program is, however, an essential complement to any voluntary compliance effort.

Nearly one-half of Commission resources in the proposed fiscal year 2007 budget are dedicated to ensuring compliance with the law. In fiscal year 2007, we anticipate assigning over 175 FTE to compliance, including enforcement, supervisory, and support staff from OGC, Information Technology Division, Reports Analysis, and the Audit Division. In recent years, the administrative fine program and alternative dispute resolution program have been added to the Commission's compliance program.

Together with the standard enforcement program, these three compliance programs allow the FEC to handle significantly more cases than it did several years ago. These programs have allowed the FEC to activate more cases, close more cases with substantive action, resolve cases that would otherwise have been dismissed, and generally enforce the law in a more thorough and efficient manner, while preserving the Commission's legal resources for more complex enforcement matters.

The standard enforcement program, which is the responsibility of the Office of General Counsel, deals with the most complex cases and the most significant violations of the law. The General Counsel has undertaken a number of management and organizational initiatives in the last 5 years to increase the efficiency of processing matters under review (MURs), and those efforts have resulted in a more current caseload and significantly higher civil penalties. Despite a caseload that now involves the most factually and legally complex cases, MURs have been closed on average 35 percent faster in fiscal year 2005 than in fiscal year 2003, and a greater percentage of the assigned (or active) caseload now involves allegations arising from the most recent election cycle (i.e., 2003–2004). The administrative fine and alternative dispute resolution programs have helped to speed the resolution of less serious violations of the law.

Overall, the compliance program has become more effective, as well as more efficient. In 1991, prior to the introduction of the administrative fine and alternative dispute resolution programs, the FEC assessed civil penalties totaling \$534,000. By fiscal year 2004, approximately 4 years after the implementation of the administrative fine and alternative dispute resolution programs, that figure had grown to \$3.46 million. Thus far in fiscal year 2006, the FEC has assessed civil penalties and fines totaling \$5.302 million, including a single \$3.8 million civil penalty, the largest in the history of the agency. Fiscal year 2006 marks the seventh consecutive year with more than \$1 million in civil penalties.

The alternative dispute resolution (ADR) program affords both the FEC and the respondents the opportunity to resolve cases more rapidly with a focus on ensuring future compliance with the law. Since the inception of the program on October 1, 2000, through September 30, 2005, the ADR Office concluded agreements with respondents and formally closed 214 cases, 150 with substantive action (70 percent). These 214 cases were generally closed within 6 months of referral to the ADR program. The ADR Office has negotiated approximately \$310,000 in civil penalties since fiscal year 2001. In fiscal year 2005 alone, civil penalties negotiated through ADR totaled \$154,500. The administrative fine program has closed 1,223 cases since fiscal year 2000 and assessed civil penalties totaling \$2,309,454 in cases of late and non-filed reports. In fiscal year 2005, cases were closed on average 201 days from when the reports were due to be filed at the FEC.

Finally, in the audit track of the compliance program, we are pleased to report that the agency has sufficient resources to enable it to initiate 40 to 45 audits "for cause" for the 2006 election cycle. Further details on the compliance program are contained in the fiscal year 2007 Budget Justification.

#### PUBLIC FUNDING PROGRAM

The Commission also administers the Presidential public funding program. During fiscal year 2007, approximately 55 FTE from the Audit Division, Office of General Counsel, and Information Technology Division will be directly involved in this program. Their responsibilities will include completing the audits of the remaining two candidates who received matching funds for the 2004 election, and the two gen-

eral election candidate committees, for a total of four Presidential audits continuing from the 2004 cycle. In addition, they will be preparing for the 2008 Presidential election cycle by replacing the sampling software used to process matching funds requests and updating the Commission's "Guideline for Presentation in Good Order". The Guideline sets forth the uniform format required for the presentation of matching funds requests and specifies the quality of content standard that must be met.

On a related matter, we believe it is appropriate to bring to your attention the potential shortfall in the Presidential Public Funding Program. There was a brief shortfall in the February primary matching payments for the 2004 Presidential election, which was restored the following month with the February deposits to the Fund. This was the only shortfall for the 2004 cycle. We did not experience a major shortfall for the 2004 Presidential election because several major candidates decided not to take Federal matching funds for the 2004 primaries. This may change, however, in future elections. The Treasury Department maintains the matching fund account, which is comprised of money derived from a taxpayer check-off system. Shortfalls in 1996, 2000, and 2004 occurred for several reasons. First, the Treasury Department does not consider expected election-year check-off proceeds to be available when calculating payout resources on January 1 of the election year. Second, while payouts under the program have been adjusted upward, due to inflation, the \$3 check-off amount has not been increased since 1993. Third, the number of taxpayers participating in the check-off has been declining. Fourth, the "front-loading" of primaries and caucuses, which puts a premium on early fundraising, has resulted in a high demand for matching payments early in the election year. Finally, the eligibility requirements for matching funds have not been adjusted since 1974, and many candidates can qualify for public funding as a result. Absent legislative action, the shortfall problem will recur in future elections.

The foregoing summarizes the FEC's fiscal year 2007 budget request. For a more detailed review of this request, I would urge members of the committee to consult our budget justification, which includes charts delineating how our budget request would be allocated and how it compares to previous years. It also demonstrates how the FEC has developed and used strategic and performance planning.

Again, I thank you, Mr. Chairman and the committee, for your continued support and the opportunity to present our fiscal year 2007 budget request.

PREPARED STATEMENT OF TERRENCE L. BRACY, CHAIR, MORRIS K. UDALL  
FOUNDATION

Mr. Chairman, members of the subcommittee, thank you for the opportunity to present testimony regarding the fiscal year 2007 budget of the Morris K. Udall Foundation. We have previously submitted our Congressional Justification and met with the subcommittee's staff to answer their questions regarding our programs and budget.

The Foundation has two major program areas, supported by two distinct appropriations funds: First, the U.S. Institute for Environmental Conflict Resolution (the U.S. Institute), supported by a combination of annual appropriations and fees charged for services; and second, the Education Programs, supported by the annual interest from a Trust Fund (invested solely in Treasury obligations).

The President's budget requests \$700,000 for the Institute in fiscal year 2007. The Institute anticipates generating an estimated \$3.1 million in gross revenues in fiscal year 2007, of which an estimated \$2.4 million will fund extramural mediation services and \$700,000 will be applied to intramural costs. The Institute will continue to work toward maximizing its revenues from collection of fees for its services. An additional \$750,000 will be applied from the remainder of the Institute's original appropriation for capitalization expenses.

The President's budget requests no new appropriation for the Trust Fund. The Foundation education programs are expected to have a total budget of \$1.6 million in fiscal year 2007, which includes \$1.5 million in interest and \$100,000 in carryover from fiscal year 2006. This funding is expected to allow the Foundation to maintain current Education Programs in fiscal year 2007, including 80 scholarships of \$5,000 each and a grant of \$296,000 to the Udall Center for Studies in Public Policy, as required by the Foundation's enabling legislation.

The Foundation's budget details are thoroughly discussed in our Congressional Justification. In this testimony, I would like to focus on some of the programmatic highlights at the Udall Foundation over the last year.

The U.S. Institute for Environmental Conflict Resolution continues to be recognized as a significant resource for assistance in resolving and preventing environmental conflicts involving Federal agencies. In November 2005, the Office of Man-

agement and Budget and Council on Environmental Quality jointly issued a memorandum directing all Federal agencies to increase the effective use of environmental conflict resolution and build institutional capacity for collaborative problem solving. The policy memorandum encouraged agencies to draw on the services of the U.S. Institute to assist in resolving disputes, as appropriate, and to help review strategies for increasing the use of environmental conflict resolution by those agencies. The U.S. Institute is coordinating an interagency forum of senior agency staff that will oversee implementation of the policy memo.

In addition, the U.S. Institute has continued to provide conflict resolution and training services around the country. A substantial amount of work has been with the Federal Highway Administration—for example, the Institute has provided conflict resolution services in connection with a FHWA project in Oregon (the West Eugene Parkway), and it also has conducted workshops to strengthen FHWA efforts to work with State, local and tribal governments. One workshop focused on Federal and State consultation with American Indian Tribes, as required by the National Historic Preservation Act, bringing together the Tennessee Division of FHWA, the Tennessee Department of Transportation, and 11 federally recognized Tribes. Additional customized workshops are expected to strengthen Federal and State agencies' efforts to successfully meet agency coordination and cooperation mandates of the Transportation Equity Act for the 21st Century (TEA-21), Section 1309: "Environmental Streamlining" and Executive Order 13274: "Environmental Stewardship and Transportation Infrastructure Project Reviews".

The Institute recently completed one of the few successful mediations on timber issues in the United States, helping the parties to resolve a lawsuit challenging a timber sale in Oregon. The settlement provided for the Bureau of Land Management to continue with logging on 75 percent of the original 152 acres planned for sale and canceled logging on the rest, preserving old growth habitat. One innovation of the settlement was an agreement that community representatives can ride along with contract administrators during logging activities and visit post-harvested sites. The agreement is also important as a possible prototype for other settlements—at present, about 80 percent of proposed Forest Service timber sales are involved in litigation nationwide.

Another area of increasing activity for the Institute has been in customized training for Federal agency personnel in the use of collaborative processes to resolve conflicts. For example, Institute staff designed and led training in multi-party negotiation and conflict management for the U.S. Air Force. This training was first delivered in April at the Air War College in Alabama. The Air Force plans to use alternative dispute resolution more systematically in environmental and land-use disputes, with the goal of reducing dispute resolution cycle times and avoiding unnecessary dispute resolution costs. The Air Force already has reported saving time and much of the cost of litigating contract disputes through use of ADR, while achieving results at least equal to those expected from litigation.<sup>1</sup>

The Education Programs of the Udall Foundation are also thriving. The Foundation continues to draw the highest quality applicants for its scholarships, fellowships, and internships. A total of 836 college scholarships have been awarded through fiscal year 2006 to students from all 50 States and 259 colleges. The Native American Congressional Internship Program has placed 126 interns from 87 tribes in Congressional offices, the Executive Office of the President, and high-placed offices at the Departments of Interior, Education and Defense. Beginning in August 2006, the Foundation is planning a year-long "Celebration of Public Service" to mark the 10th anniversary of its Education Programs. As part of this effort, current and former scholars, fellows and interns will initiate and implement public service projects all around the country.

Native Nations Institute, a joint project of the Udall Foundation and the University of Arizona, has conducted executive education sessions for more than 1,700 councilors, presidents and senior managers from more than 340 Indian nations over the last 5 years and has reached many more through conference presentations. In partnership with the Harvard Project on American Indian Economic Development, NNI has developed the leading research on tribal economic development, leadership and self-determination. NNI has maintained program levels in fiscal year 2006 due to a transfer from the fiscal year 2006 Udall Foundation Trust Fund appropriation

<sup>1</sup>Report to the Secretary of the Air Force on the Air Force Alternative Disputes Resolution Program, January 2005. The Air Force ADR Program said data through fiscal year 2004 showed ADR resolves disputes in less than half the time, on average, compared with litigation through trial, and avoided much of the cost of full litigation, including the government's liability for interest on contractor claims. Early resolution through ADR also meant less disruption to Air Force programs and to the Air Force's working relationships with contractors, the report said.

(as authorized by Congress in Public Law 109–115); in fiscal year 2007, NNI will receive no additional funding from the Foundation but will utilize \$176,000 in carry-over from fiscal year 2006 and an estimated \$62,000 in fees to continue the Native American internships and the executive education program. NNI will continue to seek other funding, including grants from public and private organizations.

I am pleased to report to the subcommittee that the Foundation received an unqualified “clean” audit opinion again for fiscal year 2005, and no material inadequacies were identified by the independent auditor, Clifton, Gunderson, LLP. As in prior years, I want to assure the chairman and members of the subcommittee that the Foundation has taken extraordinary steps to keep down administrative expenses and get the most value out of its limited funds.

Thank you for the opportunity to provide testimony. We look forward to working with you and your staff on fiscal year 2007 appropriations.

PREPARED STATEMENT OF KENNETH D. WADE, CHIEF EXECUTIVE OFFICER,  
NEIGHBORHOOD REINVESTMENT CORPORATION DBA NEIGHBORWORKS AMERICA

Neighborhood Reinvestment Corporation, now doing business as NeighborWorks America, is pleased to submit this testimony for the record, on behalf of the NeighborWorks system. This system includes NeighborWorks America and 240 nonprofit, community-based organizations that comprise the NeighborWorks network. In fiscal year 2005, we served over 4,000 communities and generated over \$2.4 billion in direct investment.

OVERVIEW OF THE NEIGHBORWORKS SYSTEM

To help more Americans seize opportunities to build wealth, strengthen their communities and realize the dream of home ownership, we work on three basic fronts:

- NeighborWorks America headquarters and training agency;
- Our national NeighborWorks network of nonprofit community development organizations; and
- Financial backing through Neighborhood Housing Services of America.

For nearly 30 years, the NeighborWorks System has proven to be an increasingly effective and efficient vehicle for generating significant private-sector resources for community revitalization and affordable housing. The NeighborWorks System relies on public-private partnerships, the leveraging of Federal funding, and flexible revolving loan funds to achieve results. Innovations that are generated in response to community needs are a hallmark of the NeighborWorks System. We were borne out of a real and present community need for more private sector investment in decaying urban areas in the 1970’s and continue to nimbly address real and present community needs today.

*NeighborWorks America*

NeighborWorks America evolved from a 1972 effort by the Federal Home Loan Bank Board to increase thrift-industry lending in declining neighborhoods. Recognizing the model’s effectiveness in community development and turning around urban blight, Congress chartered NeighborWorks America as a public nonprofit organization in the Housing and Community Development Amendments of 1978 (Public Law 95–557).

Today NeighborWorks America:

- As the Nation’s largest certifier of high-quality home ownership education counselors, creates a national force of home ownership and financial literacy education counselors that have educated and empowered 500,000 Americans nationwide.
- Fuels local innovation with a powerful battery of community development training, research, managerial advice, turnaround specialists and an aggressive brokering of business and government partnerships.
- Maintains high performance standards for its NeighborWorks member organizations through rigorous and thorough audits to ensure accountability and results.
- Empowers underserved populations and regions of the Nation. When comparing total lending activity, the NeighborWorks network serves four times as many minorities as conventional lenders and twice as many as served by government agencies (as a percentage of the total clients served).
- Ensures continued responsiveness to local needs through sound dependable capital loan funds that have invested \$2.5 billion in communities in the last 5 years alone.
- Challenges predatory lending with the twin tools of education and customized, responsible lending.

*The NeighborWorks Network*

In the early 1970's, NeighborWorks America founded the NeighborWorks network, a group of community-based nonprofits that has evolved from a few organizations to more than 240 members active in more than 4,000 communities across the country. NeighborWorks organizations operate in our Nation's largest cities, suburban neighborhoods and rural areas across all 50 States, Puerto Rico and the District of Columbia. No matter what their location, NeighborWorks organizations are responsive and effective, because they function as partnerships of local residents, lenders and other business leaders, and representatives from local government. NeighborWorks network results include:

- forging private-sector partnerships that revitalize blighted communities to create an infusion of job retention and economic development strategies to local economies;
- providing full-service affordable rental housing that provides citizens with much more than a roof over their heads;
- creating home ownership incentives that help individuals realize the American dream and build wealth for their families and communities;
- educating communities about strategies that improve safety and attract wealth-building opportunities.

*Neighborhood Housing Services of America (NHTSA)*

Flexible financing enables NeighborWorks organizations to be nimble, competitive and effective. Neighborhood Housing Services of America works in partnership with NeighborWorks America to meet special secondary market needs of NeighborWorks organizations and their clients. The primary mission of NHTSA is to operate a specialized secondary market created to replenish the revolving loan funds and capital pools of local NeighborWorks organizations. As such, it has become an important tool for challenging predatory lenders.

## PROJECTED OUTCOMES FOR FISCAL YEAR 2007

This is a time of unprecedented challenges and opportunities in housing and community development. NeighborWorks America is in a prime position to deliver results.

An appropriation of \$120 million will allow the NeighborWorks system to:

- Award 8,300 training certificates in community development and housing; home ownership and community lending; home ownership education and counseling; construction, production, real estate and housing management; nonprofit management and leadership; and economic development, revitalization and community building to practitioners throughout the country.
- Generate \$20 in other investment for every \$1 appropriated to NeighborWorks America, for a total reinvestment of over \$2.4 billion in American communities.
- Provide affordable housing and counseling to more than 180,000 individuals or families living in 4,000 communities by 240 organizations that comprise the NeighborWorks network.
- Increase financial fitness education in underserved markets to build better money management skills that position families to build assets and achieve financial independence.
- Secure and expend \$85 million in social investments in support of affordable housing loans.

For fiscal year 2006, NeighborWorks America received an appropriation of \$118 (minus an across-the-board rescission). The proposed increase for fiscal year 2007 of \$2 million will further NeighborWorks America's work to create and sustain minority home ownership through grants to NeighborWorks organizations, as well as continue to allow NeighborWorks America to attract and retain qualified and competent staff in community development.

## PRIORITIES FOR FISCAL YEAR 2007

In developing the Corporation's fiscal year 2007 budget, NeighborWorks America is setting more aggressive expectations for the NeighborWorks system. NeighborWorks America has always worked to be good stewards of the funds that Congress has entrusted to us, and the Corporation continues to diligently work to maximize our efficiency and effectiveness. In order to meet these expectations, NeighborWorks America and the NeighborWorks system will:

- Leverage strategic partners and resources to stay on the forward edge of housing and community development needs;
- Monitor the efficiency and results of the NeighborWorks network through financial and performance reviews;

- Fuel network innovation that can be applied across the Nation; and,
- Build skills and performance in the housing and community development field.

*Leverage Strategic Partners and Resources*

Historically, the success of the NeighborWorks System has far exceeded its visibility. In fiscal year 2007, NeighborWorks America will continue its efforts to enhance the visibility of NeighborWorks by launching a public awareness and branding campaign: “NeighborWorks America—Transforming Lives and Strengthening Communities.” The campaign will unite the corporation with the national network it supports—240 NeighborWorks organizations across 50 States. Neighborhood Reinvestment is adopting the name “NeighborWorks America” as its public trade name. A resolution of the Board of Directors directing the Corporation to launch this public awareness and branding campaign passed unanimously on September 20, 2004.

More awareness of NeighborWorks America will help us serve more communities, creating a force of empowered consumers and engaged communities. NeighborWorks America will promote several tools to empower neighbors to maximize their financial position, to become informed homebuyers and savvy homeowners whose home values grow and provide equity. As NeighborWorks America, united with our national network under one name and a singleness of purpose, we will become a more visible and powerful national force for change.

*Increase the Efficiency and Results of the NeighborWorks Network*

Our scale and history allows NeighborWorks America and its affiliated NeighborWorks network to be responsive and innovative, successfully navigating the rocky terrain of the current housing and community development landscape. To keep pace with the breakneck and challenging changes in the current environment, we will:

*Demand Accountability and Results*

NeighborWorks America is committed to promoting and maintaining a network of productive, well-managed, nonprofit housing and community-development corporations that deliver high quality services responsive to local needs and have a measurable impact on the communities they serve.

*Conduct Rigorous and Thorough Audits and Reviews of NeighborWorks System*

As part of its responsibility to be a strong steward of Federal funding and protect the investment of other partners and the reputation of the NeighborWorks network as a whole, NeighborWorks America uses a rigorous and thorough audit and review of all NeighborWorks programs and organizations. Those who don’t measure up are given a defined time period to turnaround or leave the network. We demand high-performance and results.

Through a system of continuous monitoring, we assess the risks faced by each NeighborWorks organization with a thorough collection and analysis of programmatic and financial data.

*Measure the Success of the Community Development Field*

As stewards of taxpayer money and advocates for our most needy neighbors, we must make sure our investments are working in ways that truly make a difference. It’s not good enough to talk about simple counts of housing units produced or dollars leveraged. We must be willing to hold ourselves accountable for results. If banks and actuaries can refine their investment and insurance packages with increasing accuracy and sophistication, we also must find new ways to measure the impact of our work. This year NeighborWorks America will begin using the Success Measures Data System as one important tool to help answer the question: “Are we making a difference?” This state-of-the-art program can measure dividends such as changes in safety, property values, levels of civic engagement and the quality and performance of schools and healthcare, helping us to work smarter in serving the real and present needs in our communities.

The development of this index has been encouraged by OMB through its Program Assessment Rating Tool (PART) process. Federal Reserve Chairman Alan Greenspan cited Success Measures as a model tool for providing “objective and quantifiable standards to assess community development programs.”

*Improve Efficiency and Coverage of Underserved Areas*

The efficacy of the NeighborWorks system is measured in productivity, more efficient use of resources and more responsive service delivery. In many underserved areas, the most effective growth strategy is to expand the reach and/or programmatic services of an existing network member or to facilitate a merger of two

organizations to create one powerful organization with greater impact and efficiency.

We receive far more applicants to become NeighborWorks members than we charter. Through a careful affiliation process, NeighborWorks America ensures that before any organization is chartered as a NeighborWorks entity, it is sound and productive; led by a board of directors reflective of the community it serves; and committed to a mission with goals, values, programs and accomplishments compatible with the focus and priorities of the NeighborWorks network.

#### *Invest in What Works*

Responsible, responsive real-estate development and lending requires dependable equity capital grants. NeighborWorks America provides our network with this critical gap funding and equity, allowing NeighborWorks organizations to make loans for home purchase, property rehabilitation and small business loans.

NeighborWorks America also provides grants to NeighborWorks organizations to address a range of community needs, such as financial fitness education, home ownership counseling and education, development of affordable rental property, loans for improving safety, and much more.

#### *Fuel an Engine of Innovation*

The structure of the NeighborWorks network facilitates collaborative learning to harness all the practical knowledge picked up on the ground and in our research. Initiatives that allow NeighborWorks organizations to learn directly from each other include: the NeighborWorks Campaign for Home Ownership, the NeighborWorks Multifamily Initiative, the NeighborWorks Rural Initiative, and the NeighborWorks Insurance Initiative and its National Insurance Task Force.

To help organizations stay on the forward edge of business practices and community development, we deploy several strategies:

#### *Topflight Expertise and Coaching*

NeighborWorks America deploys a team of experts to provide NeighborWorks organizations with the expertise and coaching needed to continue to serve resident needs.

This on-call team provides help in six areas:

- Organizational development;
- Resource development and marketing;
- Community revitalization and business planning;
- Management systems (including technology and financial management);
- Single-family housing and lending; and
- Real-estate development and management.

#### *Championing Home Ownership Opportunities*

NeighborWorks America has worked for the past 20 years on expanding home ownership opportunities. Over the past 5 years, while access to credit has become easier, access to appropriately-priced mortgages continues to adversely and inordinately affect minority, female-headed households and immigrant families. The NeighborWorks network's financial literacy and homebuyer education efforts work to increase access to the best-priced mortgage for each consumer. The NeighborWorks System provides home ownership opportunities in a number of important and highly effective ways.

- 67 percent of those assisted by the NeighborWorks Campaign for Home Ownership are low- or very low-income households. Only 25 percent of the clients of conventional mortgage lenders have low or very low incomes.
- 51 percent of the households assisted by the NeighborWorks Campaign for Home Ownership are ethnic minorities, compared to only 25 percent of the clients served by conventional mortgage lenders are minorities.
- 46 percent of the buyers assisted by the NeighborWorks Campaign for Home Ownership are female, compared to only 21 percent of the clients of conventional mortgage lenders.

#### *The NeighborWorks Campaign for Home Ownership*

The NeighborWorks Campaign for Home Ownership is a joint effort of government, banks, the insurance industry, secondary markets, the real-estate community and others, coordinated by NeighborWorks America in conjunction with more than 158 community-based NeighborWorks organizations. Since 1993, the combined efforts of the Campaign have created more than 90,300 new homeowners (the majority of whom are low- and moderate-income minority families) and provided counseling to more than 538,300 individuals. As a result, \$9.05 billion has been invested in many of America's distressed communities. The campaign provides resources and

education for homeowners and empowers those for whom the American dream is thought out of reach.

#### *HomeOwnership Centers*

To date, NeighborWorks America has supported the development of nearly 100 NeighborWorks HomeOwnership Centers throughout the Nation. These Centers are one-stop shops for a broad range of home ownership services available to low- and moderate-income families including unbiased advice, counseling, training, referrals to partners such as lenders, real-estate agents, inspectors, contractors, and special financial assistance to income-qualified buyers. The Centers can also help existing homeowners with housing rehabilitation advice and assistance along with maintenance training. Financial counseling to avoid credit problems, loan delinquencies and foreclosures is also available.

NeighborWorks America expects to add at least 10 percent more HomeOwnership Centers in fiscal year 2007. On average, after becoming fully operational, each HomeOwnership Center will produce over 100 new homeowners per year and counsel over 375 families per year.

#### *Minority Home Ownership Strategies*

Between 2003 and 2007 the Campaign for Home Ownership set a goal to reach 30,000 minority homeowners. This goal also helps support the White House's Minority Home Ownership Initiative. Through 2005, the Corporation has developed and implemented a series of strategies to meet this goal. Among the strategies are development of an online searchable database called "Winning Strategies" that documents innovative strategies successfully used to promote minority home ownership in local communities; promoting expansion of financial education with new partners such as churches, schools and employers; working through NeighborWorks Center for Home Ownership Education and Counseling (NCHOC) to initiate new partnerships to develop training and certification classes on home ownership education that will be offered regionally and nationally; hosting national symposia on minority home ownership issues, education and counseling, and promoting stronger partnerships between nonprofits and real-estate agents, credit unions and employers.

#### *NeighborWorks Home Ownership Activities for Fiscal Year 2007*

In fiscal year 2007, the NeighborWorks System will continue to focus attention on helping qualified lower-income families and individuals purchase, maintain and stay in their homes for the long term. Our plans include:

- Delivering new training classes on "Reaching Underserved Homebuyers" that will continue to be offered regularly at the NeighborWorks Training Institutes;
- Designing a new "minority marketing toolbox" in 2005 that will include templates, tools and marketing materials to help local NeighborWorks organizations implement enhanced marketing efforts to attract more minority customers as potential homebuyers;
- Promoting expansion of financial education and home ownership-education programs with new partners such as churches, schools and employers.

#### *Financial Literacy and Education to Help Avoid Predatory Lending*

Predatory lending tactics are at an all-time high, particularly those preying on minority families, immigrants, and financially less-sophisticated borrowers. Too often bad actors encourage homeowners to pursue inappropriate debt consolidation, refinancing schemes, home improvement, or home equity loans that threaten the assets that the NeighborWorks System has worked so hard to help them acquire. NeighborWorks America just added a new course to its training curriculum to help combat predatory lending. The class filled up immediately and given this ballooning need, we are working to accommodate more.

Other strategies we use to combat predatory lending include:

- A Financial Fitness Program that prepares families to build sound finances and be aware of predatory tactics. The Corporation developed standards, adapted and created training materials, trained trainers to initiate this comprehensive program, and supports its growth;
- The addition of 10 Financial Fitness sites in fiscal year 2007 to expand the reach of financial education efforts across the network;
- A new consumer training curriculum for "Refinancing Your Home" that can be offered to assist existing homeowners in making smarter choices when considering the multitude of options in refinancing their home;
- A new consumer training curriculum on "Buying a Manufactured Home" to help consumers who are considering buying manufactured homes; and
- A study on the cost/benefit of providing pre-purchase counseling to consumers.

*Support the Center for Foreclosure Solutions*

We need to prevent foreclosures earlier—before a family even thinks of buying a home. NeighborWorks America’s approach is to provide education and counseling at every stage—pre- and post-ownership. We want to empower individuals, their families, their communities and their economies to be on a path of continued wealth creation. Informed consumers can leverage better service, lower costs and a more transparent, accountable lending and real estate industry.

Over the past 10 years, there have been dramatic increases in high-risk lending, growing job instability and excess consumer debt obligations that are all trademarks of susceptibility to foreclosures. NeighborWorks America has established the Center for Foreclosure Solutions (CFS) to research and test home ownership preservation efforts.

Our NeighborWorks affiliate—Chicago Neighborhood Housing Services—is blazing trails for other organizations across the Nation. Chicago NHS teamed up with city officials and 20+ lenders to reduce geographically concentrated foreclosures that leave neighborhood blocks riddled with vacant homes. The Home Ownership Preservation Initiative (HOPI) provides counseling to financially strapped owners and assistance in working with lenders to discuss refinancing, lowering interest rates and modifying payment plans. Over the past 2 years, the HOPI campaign prevented 940 foreclosures through innovative outreach and counseling efforts.

In fiscal year 2007, NeighborWorks America will expand the work of HOPI to establish a national model to address concerns about growing foreclosure problems. Other national and local partners are critical to successfully addressing these problems.

The goals of the Center for Foreclosure Solutions include market penetration in 15 markets with a phase roll-out approach focusing on key foreclosure hotspots, telephone counseling 24 hours, 7 days a week through a national, third-party intermediary, and implementation of a national and local targeted media and public relations campaign to reach delinquent and at-risk homeowners.

*Rural America*

The NeighborWorks network has become increasingly active in rural communities around the country. Today, 77 out of 240 chartered NeighborWorks organizations—about 30 percent of the network—serves rural populations, across 39 States and Puerto Rico. As a result of a series of growth and programmatic innovations, the number of rural Americans assisted by the network is expected to increase to 50 percent in the next few years. The needs of rural homeowners and renters differ in many aspects from those in urban or suburban areas. In many States, rural areas have the highest rate of substandard housing, the highest poverty rate, and median incomes often 35 percent or less than the median incomes of urban residents. Unfortunately, rural areas traditionally have lacked the financial resources for home financing.

In fiscal year 2007, NeighborWorks America will seek new affiliations with community-based organizations serving rural communities and will boost the capacity of existing NeighborWorks organizations to significantly increase their rural service areas to include high-priority under-served populations.

Hurricane Katrina has demonstrated the importance of coordinating relief efforts. In addition to new and expanded NeighborWorks charters, the Corporation will partner with at least three regional capital intermediaries based in perennially under-served rural regions. The NeighborWorks System will provide access to customized training event, including place-based Training Institutes in areas such as the Gulf and Appalachia; equity capital to leverage targeted investment in housing and community economic development, and at least partial liquidity for those investments through the Corporation’s national partnerships.

During fiscal year 2007, the Corporation will also launch at least six pilot sites for community economic development projects in rural markets. The pilot project will be designed to strengthen communities through job creation, retention and enhancement strategies.

This aggressive growth strategy is designed to increase NeighborWorks America’s overall production in rural communities from \$500 million in direct investments and 16,000 individuals served in fiscal year 2005 to \$750 million in direct investments and 24,000 rural Americans served by the end of fiscal year 2007.

*Areas Affected by Natural Disasters*

The NeighborWorks System (NeighborWorks America, related Capital Corporations such as Neighborhood Housing Services of America and affiliated local NeighborWorks organizations) along with the Corporation’s national partners are well-positioned to play a significant role in rebuilding the areas of the Gulf Coast

region affected by Hurricane Katrina. This nationwide network has access to skilled housing and community development experts who will apply their expertise to the affected are in a number of ways:

- Contractors and construction managers who can do a triage of work on existing properties to determine which properties can be rehabilitated and which should be demolished;
- Real estate developers who know how to take an idea and turn it into a reasonably-priced quality constructed house or subdivision;
- Mortgage lenders who can originate and underwrite loans;
- Counselors on credit and housing issues, who can assist residents through complex processes involved with property rehabilitation and/or mortgage financing;
- Contractors who are knowledgeable of various Federal, State and local programs and funding sources that may be available;
- Organizers who can help provide hope to the affected families and communities, and mobilize volunteers in the rebuilding efforts; and,
- Resource development professional who have a proven track record in soliciting private-sector contributions in support of rebuilding efforts.

#### *Affordable Rental Opportunities*

The desire to own a home is strong across all socioeconomic groups, but not everyone is adequately prepared, and the strongest communities offer multiple housing options. Therefore it remains important to have viable rental housing—especially units that allow a safe, stable environment—with rents affordable enough for occupants to accumulate savings. Tomorrow's first-time buyers are renters today.

A major focus of NeighborWorks Multifamily Initiative, which provides affordable rental housing, has been on strengthening aging property portfolios that may be suffering a weakness in cash flow. Our expert coaches and analysts suggest operational improvements, and explore creative ways to restructure financing, with an eye to improving cash flow across the entire portfolio.

NeighborWorks America also promotes more opportunities to increase the supply of affordable rental homes. In 2004, the Corporation was able to use the special set-aside of \$5 million for multifamily housing to promote mixed income rental homes that truly serve their communities by providing more than just sound housing.

NeighborWorks organizations in our Learning Center Consortium provide after-school care, job training, health care, parenting classes and much more. NeighborWorks America has commissioned a study to measure the impact on the difference made on the kids and their families in the form of dropout rates, GPA, attendance rate, and job retention.

#### *Build Skills and Performance in the Housing and Community Development Field*

##### *NeighborWorks Center for Home Ownership Education and Counseling*

NeighborWorks is the Nation's largest certifier of high-quality home ownership educators and counselors, working to empower consumers to make the biggest investment of their lives a successful one. Although the value of home ownership education and counseling to homebuyers is supported by research and is increasingly recognized as a powerful tool to promote neighborhood revitalization, the quality is uneven and the coverage insufficient. There are few national certification standards, limited continuing-education requirements for trainers and counselors, gaps in coverage across the Nation, and a lack of quality control for home ownership education and counseling—ranging from intensive, multi-day curriculum and standards to “sham” counseling programs that lure potential buyers into predatory loan deals. There is also a dearth of well-trained educators and counselors to meet the growing national need.

To address these concerns, NeighborWorks America, through the nationally recognized NeighborWorks Training Institute, has launched the NeighborWorks Center for Home Ownership Education and Counseling (NCHEC) to create a national force of high-quality home ownership and financial education counselors. To date these counselors have helped more than 500,000 Americans gain critical financial literacy skills and make the most of home ownership.

NCHEC aims to increase the number of home ownership educators and counselors trained and certified through the NeighborWorks Training Institute from 700 to more than 2,000 per year—indirectly ensuring the education and counseling of several million individuals and families by 2007. NCHEC has already provided over 3,800 training certificates a year in more than 20 courses in home ownership, education, counseling and lending.

In the fall of 2004, the Department of Housing and Urban Development awarded NeighborWorks America \$7.75 million over 2 years to train and certify HUD-approved housing counselors around the country through NCHEC. In addition to ex-

panded home ownership and community-lending training offered at the NeighborWorks Training Institutes, NCHCEC has partnered with other intermediaries, State-wide counseling collaboratives, and NeighborWorks organizations to offer trainings in local settings around the country.

*NeighborWorks Training Institutes*

For more than 15 years, NeighborWorks America has been providing outstanding community development training in the country through its NeighborWorks Training Institutes, which are held four to five times a year in different cities throughout the United States. In recent years, NeighborWorks America has begun taking its NeighborWorks Training Institute courses to local markets in the form of "place-based trainings" conducted in collaboration with local and regional partners. NeighborWorks America has also offers an Advanced Practitioner Program (APP) for seasoned community development practitioners and board members.

CONCLUSION

Let me close by thanking the subcommittee for the opportunity to brief you on our work, and the results generated by NeighborWorks America's congressional appropriation. The NeighborWorks System and NeighborWorks America's congressional appropriation represents a precious asset for 240 community development organizations and more than 4,000 communities across America. With our leveraging of dollars, NeighborWorks has been efficient and effective in ensuring the maximum impact of our Federal appropriation. Congress has allowed NeighborWorks America to be flexible and responsive to local needs; as a result, families and communities are stronger and more self-reliant.

NeighborWorks America is committed to continuing to build healthy, strong and safe communities all across America. Your continued support is vital to us in accomplishing this goal.

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PREPARED STATEMENT OF THE HONORABLE STEVEN R. BLUST, CHAIRMAN, FEDERAL MARITIME COMMISSION

Mr. Chairman and members of the subcommittee, thank you for this opportunity to present the President's fiscal year 2007 budget for the Federal Maritime Commission.

The President's budget for the Commission provides for \$21,474,000 for fiscal year 2007. This represents an increase of 5.8 percent, or \$1,180,000, over our fiscal year 2006 appropriation. This budget provides for 132 work-years of employment.

Our fiscal year 2007 budget request contains \$15,691,000 for salaries and benefits to support the Commission's programs. This is an increase of \$1,178,000 over our fiscal year 2006 appropriation. This includes all salaries, including those for employees hired in fiscal year 2006, promotions, within-grade increases, and an anticipated cost of living adjustment. The funding includes annualization of the fiscal year 2006 cost of living adjustment increase, and an anticipated 2.2 percent fiscal year 2007 cost of living adjustment. Further, it includes funds to hire two critical staff: a Commissioner's Counsel and an attorney for our Office of Consumer Affairs and Dispute Resolution Services.

Official travel has been straight-lined at our fiscal year 2006 level of \$237,000. Travel remains an essential aspect of our effort to provide better service to the ocean transportation industry and to accomplish our oversight duties more effectively. We are committed to working within our straight-lined travel funding to ensure that our expanded outreach and compliance programs are fully supported, in addition to providing appropriate travel funds to support all other program efforts.

Administrative expenses have increased \$2,000 net over fiscal year 2006, to \$5,546,000. The Commission is planning for a small increase in rent to accommodate rental rate increases in our field offices, as well as an increase to fund Homeland Security charges. Other administrative expenses will be incurred in fiscal year 2007 to support increases in our customary business expenses, such as maintaining government and commercial contracts, and for items such as telephones, postage, and supplies. These increases are partially offset by a reduction of \$157,000 for furniture and equipment.

Just as in previous years, the Commission's budget contains primarily non-discretionary spending. These items represent the basic expenses any organization faces in order to conduct its day-to-day operations, and are crucial to allow us to meet the responsibilities Congress has entrusted to the agency. This budget request therefore represents a modest increase over the current year appropriation, primarily to address anticipated cost increases over current year expenses.

As you know, Mr. Chairman, the Commission is responsible for the regulation of oceanborne transportation in the foreign commerce of the United States. Since 1916, the Commission and its predecessor agencies have effectively administered Congress' directives for the ocean transportation industry, and its long-standing expertise and experience have been recognized by Congress, as well as by the industry the Commission oversees, courts, and other nations. Working with the industry, we have developed a regulatory system that allows for necessary oversight with minimal disruption to the efficient flow of U.S. imports and exports. I would like to highlight for you some of the significant activities in which the Commission is involved.

Last year, I advised you of the Commission's rulemaking proceeding to allow non-vessel-operating common carriers ("NVOCCs") to enter into confidential service arrangements with their shipper-customers. As you will recall, NVOCCs otherwise in compliance with the licensing, financial responsibility, and tariff publication requirements of the Shipping Act are now permitted to enter into confidential NVOCC Service Arrangements, or NSAs, with their shipper customers in lieu of publishing their rates in a publicly-available tariff, provided that the NSA is filed confidentially with the Commission and the essential terms are published in the NVOCC's tariff. This new regulation is consistent with those regulations governing service contracts between ocean common carriers and their shipper customers, and we anticipate that it will result in greater competition in the shipping industry.

Originally the exemption rule did not allow NVOCCs or shippers associations with NVOCC members to participate in NSAs as shippers. We were concerned about the potential antitrust implications of such arrangements. Some of those concerns were ameliorated after issuance of a judicial decision last fall, and the Commission determined that it could remove these limitations. Two or more NVOCCs are still prohibited from jointly offering a single NSA, as we believe this might run counter to recent judicial interpretations which construe the antitrust provisions of the Shipping Act in a manner we believe to be much broader than what was envisioned by Congress, this Commission, and indeed even the industry. I indicated last year that we would continue to work with the industry to address this issue. In fulfillment of this obligation, the Commission requested the comments of industry participants on potential ways to authorize joint NSAs by multiple NVOCCs. The Commission received numerous comments in late 2005, and is presently evaluating them.

As of mid-April 2006, 300 original NSAs had been filed—by 57 NVOCC filers—out of 355 NVOCCs who are registered to be able to offer NSAs. That means that only slightly more than 10 percent of all NVOCCs have registered to offer NSAs, and fewer than 2 percent have taken advantage of the new contracting option. It will take some time for new business processes, skills and recognition of benefit to converge into a new market; however, I forecast a substantial growth in the use of NSAs in the future as the industry becomes more familiar with these agreements.

As part of the Commission's enforcement and ocean transportation intermediary oversight functions, as well as the ombudsman services provided by the Office of Consumer Affairs and Dispute Resolution Services, the Commission recently commenced a formal investigation against nine household goods moving companies operating in violation of the Shipping Act. The Commission's preliminary investigation indicated that these companies were unlawfully doing business as unlicensed NVOCCs without proof of financial responsibility or published tariffs, and were engaging in conduct that created risks of significant financial harm to the public. On January 17, 2006, the U.S. District Court for the Southern District of Florida granted the Commission's motion for a preliminary injunction against four of the companies and three of the individuals named as respondents in the proceeding. The injunction, which prohibits these respondents from operating in violation of the Shipping Act, will remain in effect pending the completion of the Commission's investigation.

The Court injunction and the Commission's formal investigation are based on more than 250 consumer complaints. Some examples of those complaints include failure to deliver cargo and refusal to return the pre-paid ocean freight; loss of the shipper's cargo; charging the shipper for marine insurance never obtained; withholding cargo until the shipper pays a higher rate than the one originally quoted; misleading the shipper as to the cargo's whereabouts; and finally, making the release of cargo dependent upon the shipper paying a second carrier or warehouse for transportation and warehousing already pre-paid to respondents. As most of the injuries of which we are aware involve shippers' personal household possessions, the Commission considers it especially important that every effort be made to prevent the respondents from injuring anyone else. At the moment, the proceeding is before the Commission's administrative law judge and we will seek additional injunctions as warranted.

Last year, I advised you about the agency's public outreach initiative involving a series of informational seminars hosted by the Commission's Area Representatives and other Commission personnel at various locations around the country. These seminars continue to be successful in creating a forum for enhanced dialogue between the industry and the Commission. As you may recall, we also started a program where we have invited representatives from various segments of the industry to brief our staff on current issues and concerns affecting the ocean transportation industry. Thus far, we have met with representatives from the ocean transportation intermediary, passenger vessel and vessel operator communities, as well as shippers, marine terminal operators, and port authorities. We are in the process of planning more informational briefings for 2007 with other segments of the maritime industry, including Federal agencies. One Federal agency, the Maritime Administration, briefed Commission staff last March, and the U.S. Customs and Border Protection is scheduled to brief our agency in June about the Automated Commercial Environment trade processing system. I am confident that these briefings will provide the Commission and its staff with a greater awareness and understanding of the most current issues facing the maritime community.

The Commission continues to address restrictive or unfair foreign shipping practices under section 19 of the Merchant Marine Act, 1920 ("Section 19"); the Foreign Shipping Practices Act of 1988 ("FSPA"); and the Controlled Carrier Act of 1978. Section 19 empowers the Commission to make rules and regulations to address conditions unfavorable to shipping in our foreign trades; FSPA allows the Commission to address adverse conditions affecting U.S. carriers in our foreign trades that do not exist for foreign carriers in the United States. Under the Controlled Carrier Act, the Commission can review the rates of government-controlled carriers to ensure that they are not below a level that is just and reasonable.

In my statement last year, I advised you of several pending proceedings related to shipping conditions in China. In particular, the Commission was investigating whether Chinese laws and regulations might discriminate against and disadvantage U.S. vessel operators and NVOCCs with regard to a variety of maritime-related services. As you know, in December of 2003, the United States, through the Secretary of Transportation, and his Chinese counterpart, the Minister of Communications, signed a bilateral maritime agreement which appeared to address many of the concerns raised by the Commission, including issues affecting vessel operators, NVOCCs, and other industry interests. That agreement became effective with the exchange of diplomatic notes in April of 2004.

Subsequently, the Commission requested comment from the industry on whether the commitments made in the bilateral agreement, which would have relieved the impediments to U.S. companies identified by the FMC, were being honored.

The issues we raised were adequately addressed, and the Commission terminated the formal proceeding investigating these Chinese practices on April 21, 2005. Informally, we continue to receive positive feedback from the U.S. industry in this regard. Another U.S.-flag carrier has entered the U.S.-China trade and has opened offices in two cities in China. Matson Navigation's first vessel in the Ningbo-Shanghai-Long Beach express service called in Ningbo on February 21, 2006. As always, we will continue to monitor practices around the world to determine whether formal action is warranted.

Lastly, the Commission recognizes that its oversight of ocean common carriers, ocean transportation intermediaries, including ocean freight forwarders and NVOCCs, and marine terminal operators, is an important element in the effort to protect our Nation's seaports. We are continuing our efforts to combat unlawful participation in the U.S. ocean transportation system by ensuring that all entities engaged in the U.S. foreign commerce are in compliance with the requirements of the statutes we administer. The Commission has met with the Office of Naval Intelligence, the Department of Homeland Security and the Department of Transportation to discuss information sharing and other possible FMC contributions to maintaining a safe and efficient maritime transportation system. The Commission's regulation of operators of U.S. marine terminals ensures that they follow just and reasonable practices, and that they do not unreasonably prefer or prejudice any person or unreasonably discriminate against carriers using their facilities. While our oversight is limited to the regulation of such commercial practices, we make every effort to work closely with other agencies to share information in this area. Moreover, the Commission is a member of the Committee on the Marine Transportation System, the inter-agency group created by this administration to carry out a joint strategic plan that ensures that the U.S. marine transportation system achieves the expansion goals necessary to support the level of traffic anticipated in the 21st Century in a secure, environmentally sound and coordinated manner for all stakeholders. We also continue to exchange information with the U.S. Customs Service through a

Memorandum of Understanding. As the Commission continues to refine its role in the safeguarding of our national security, we stand ready to provide our technical expertise and assistance to all groups that are on the front lines of securing our ports and vessels.

Mr. Chairman, I hope that my comments have served to give you a clear indication of the important work to be accomplished by the Federal Maritime Commission. I respectfully request favorable consideration of the President's budget for the Commission so that we may continue to perform our vital statutory functions in fiscal year 2007.

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PREPARED STATEMENT OF MARK V. ROSENKER, ACTING CHAIRMAN, NATIONAL  
TRANSPORTATION SAFETY BOARD

Chairman Bond, Ranking Member Murray, and members of the Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies, the National Transportation Safety Board appreciates the opportunity to present testimony on its appropriations request for fiscal year 2007.

The National Transportation Safety Board is an agency with the critical mission of ensuring the safety of the traveling public through transportation accident investigation and special study of transportation safety concerns. The Safety Board investigates aviation, pipeline, rail, hazardous material, marine, and highway accidents. The Board also conducts highly technical laboratory examinations and analyses of voice and data recorders and physical evidence recovered in accident investigations. The Board determines the probable cause of the transportation accidents and makes safety recommendations to prevent similar accidents from happening again. We address these recommendations to the agencies, organizations, and companies that are best able to make improvements. The Board's investigators serve as U.S. accredited representatives as specified in international treaties for aviation accidents outside U.S. borders involving U.S.-registered aircraft or involving aircraft or major components of U.S. manufacture. Beyond our national and international accident investigation work, the Board works closely with State governments to transform our safety recommendations into laws that save lives.

I assure you that we work hard to manage well the people and resources of the Safety Board to perform our critical mission. During last year's appropriations cycle, the committee expressed concerns about the distribution and management of agency resources. Over the last year we have made considerable progress to improve the mission focus of the Safety Board.

Recent leadership changes at the Safety Board have been significant. In March 2005, Joe Osterman began serving as the Board's Managing Director, its highest-ranking career leader. Mr. Osterman is effectively leading a highly talented management team. Over the past year, the Board has changed personnel in 14 of the top 24 leadership positions. Highly qualified and experienced professionals, from both inside and outside the Board, fill these important positions. Some noteworthy new members of the team are Dr. Jack Spencer, the Director of our Office of Marine Safety, and Colonel Gary Halbert, our General Counsel. Dr. Spencer, an MIT-educated naval architect, comes to us from the private sector, and Mr. Halbert—an accomplished attorney and aviator—recently retired from the U.S. Air Force. Both have hit the ground running and are making important contributions to the Board. Also, we are currently recruiting for a Chief Information Officer who will join the agency's management team with the responsibility of managing the agency's information infrastructure. We are improving our performance management system throughout the agency; and, most importantly, we are refocusing our efforts on leadership, internal communication among staff and the Board members, external communications with our committees and the public, and dedication to the Board's mission.

The Safety Board has reinvigorated its focus on the timely completion of investigations and the production of accident reports. We have increased production of reports, with safety recommendations by 50 percent, without compromising the quality that is the hallmark of Safety Board investigations and reports. Since this time last year, the Board has considered and adopted 21 investigation or safety reports in public meetings and conducted two public hearings. Moreover, our leadership team is on track to improve this record even further. A dozen of next year's Board products have been scheduled, and three public hearings and one safety forum have been proposed for the Board's consideration. We are focused on the mission. Furthermore, our leadership team is improving the management of the agency. In each of the last 3 fiscal years, timely and accurate NTSB financial statements have received clean audit opinions from the Department of Transportation Inspector

General. The Board now has a strategic plan, and we are working closely with the Government Accountability Office to examine our management practices to determine where we can make additional improvements.

The Safety Board also has heard clearly the concerns regarding the NTSB Academy. The building is the site of our training center, but it also houses the Board's Mid-Atlantic Aviation Safety Regional Office, the reconstruction of the TWA flight 800 wreckage (an important training tool) and a laboratory. Finally, it serves as the continuity-of-operations site for the Board as well as for other government agencies. In the fiscal year 2006 appropriations for the Board, this committee acknowledged the Academy's benefit in sharing accident investigation best practices with the broader transportation community; however, the committee also believed that the functions of the Academy should be secondary to the Board's core mission of accident investigation. The committee directed the Board to reduce the investigator workforce hours at the Academy so that critical investigative responsibilities would not suffer because accident investigators were diverted to Academy teaching assignments. The committee encouraged the Board to more boldly and directly cover the cost of the Academy using authority to impose and collect fees for the Academy's services. (Consistent with the committee's direction, we have redirected our approach.) The Board now looks at the Academy as an integral adjunct to the core investigative mission, concentrating on the Academy's unique ability to develop and sustain innovative and state-of-the-art training courses that support, not supplant, accident investigation and safety activities.

I would like to provide a brief overview of some of the major accidents, reports, and activities of the Safety Board in each mode of transportation, and also touch on the important work of other major offices during this past year.

*Marine Safety.*—The Safety Board initiated five marine accident investigations in fiscal year 2005 including the sinking of the uninspected passenger vessel *Sydney Mae II* in Oregon in September 2005. Board investigators led the investigation of a fire on board the passenger vessel *Lady Baltimore* in Baltimore, Maryland, and also a fire on the small passenger vessel *Express Shuttle II* in Port Richey, Florida, in October 2004. The Board also investigated accidents involving two foreign ships: the *Norwegian Dawn*, a Bahamian flag passenger vessel en route to New York that suffered heavy weather damage, and the Malaysian flag bulk carrier *Selendang Ayu* that went aground in the Aleutians.

The Board completed four marine investigations in fiscal year 2005. These included the collision of the U.S. Navy submarine *USS Greenville* and the Japanese vessel *Ehime Maru* off the coast of Hawaii, the passenger vessel *Taki Tooo*, the Staten Island Ferry *Andrew J. Barberi*, and the Alaskan Marine Highway System ferry *Leconte*.

*Aviation Safety.*—The Safety Board initiated five major domestic aviation accident investigations in fiscal year 2005, including the crash of a Northwest AirlinK regional jet that killed both crewmembers during a repositioning flight in Jefferson City, Missouri. Just 5 days later, the Board launched a second go-team to Missouri to investigate an accident involving an American Connection commuter flight that crashed on approach to Kirksville causing 13 fatalities. A go-team also was launched to Houston, Texas, in November to investigate an accident involving a Gulfstream jet that was en route to pick up former President Bush for a foreign speaking engagement. Two other accidents involving corporate jets occurred in February: one was taking off from Teterboro, New Jersey; the other was carrying Circuit City executives to Pueblo, Colorado.

The Board launched investigators to assist on 17 foreign accidents in fiscal year 2005, including the crash of a military Boeing 737 charter in Kabul, Afghanistan. August was an extremely busy month for foreign investigations—the Board launched investigators to a Sikorsky S-76 helicopter accident in Tallin, Estonia, and launched investigators to assist in airline accident investigations in Canada, Greece, Venezuela, and Peru.

The Board completed four major investigations in fiscal year 2005: American Airlines flight 587 in-flight separation of the vertical stabilizer in Belle Harbor, New York; Air Sunshine in-flight engine failure near Treasure Cay, Bahamas; Federal Express hard landing and gear collapse in Memphis, Tennessee; and Executive Airlines crash during landing near San Juan, Puerto Rico. During this time, the Board also issued two important aviation safety studies: "General Aviation Activity Reporting Requirements" and "General Aviation Weather Accidents".

Regional investigators initiated 1,862 general aviation accident investigations in fiscal year 2005, and initiated 132 investigations involving commercial (not GA accidents) operations. Regional investigators completed 2,132 investigations during this period. The Board also published annual reviews of aircraft accident data for air carrier and general aviation operations.

*Railroad, Pipeline, and Hazardous Materials.*—In fiscal year 2005, the Safety Board launched teams to investigate 13 railroad accidents and 2 pipeline and hazardous material accidents. These included a launch to Graniteville, South Carolina, in which a freight train dived at full speed onto an industrial siding where it subsequently crashed into a standing train, releasing chlorine gas that killed nine people and resulted in the evacuation of more than 5,400 people. The Board completed eight railroad and three pipeline and hazardous materials accident investigation reports and one pipeline safety study in fiscal year 2005. The accidents included a tank car explosion in Freeport, Texas, that occurred during chemical off-loading operations and the derailment of an Amtrak train in Flora, Mississippi.

*Highway Safety.*—The Safety Board launched investigators on 6 major highway investigations and 31 other investigations during fiscal year 2005. Those included a 14-fatality motorcoach rollover accident in Turrell, Arkansas; a motorcoach that struck an overpass in Alexandria, Virginia, while the driver was talking on a cell phone; two accidents causing 5 fatalities in which gasoline tankers overturned (one near the Pentagon in Arlington, Virginia, and the other in Davie, Florida); a school bus collision with a trash truck in Arlington, Virginia, in which 2 children were killed; and the tragic motorcoach fire in Wilmer, Texas, that killed 23 elderly passengers during the Hurricane Rita evacuation.

Five major reports were completed in fiscal year 2005, including reports on two accidents 7 months apart at a Border Patrol security checkpoint in North Hudson, New York, killing 4 and injuring 54; an accident involving a motorcoach that struck the rear of a parked tractor-trailer near Tallulah, Louisiana, killing 8; and another accident in which a motorcoach crossed a highway median in a rainstorm striking an SUV and killing 7 in Hewitt, Texas. In addition, the office of Highway Safety also completed a special investigation report for the Board on “Medical Oversight of Non-Commercial Drivers” that highlighted the dangers of seizures and other medical issues uncovered during the investigations of four accidents that resulted in 8 fatalities and 27 injuries. The Board also completed a report on the effectiveness of driver’s education programs that involved a public hearing on an accident in Belgrade, Montana, that killed a driver’s education instructor and three students.

*Safety Recommendations.*—The most important result of an accident investigation are the safety recommendations that help prevent future accidents. Our recommendation acceptance rate was over 82 percent in 2005. We currently have 850 open safety recommendations of which 62 percent are to operating administrations of the Department of Transportation and the U.S. Coast Guard in the Department of Homeland Security.

In fiscal year 2005, the Safety Board issued 84 safety recommendations and closed 142, 111 of which were closed with an acceptable response. In aviation, 29 were successfully closed, as were 37 in highway, 8 in pipeline and hazardous materials, 10 in marine, and 27 in rail. The Board also updated its Most Wanted List of critical safety recommendations targeted to Federal regulators and States that, if implemented, will make the most dramatic impact on safety. The Most Wanted List contains 56 recommendations directed to Federal recipients, and 9 directed to the States. Additionally, the Safety Board conducted more than 20 meetings and legislative briefings in 10 States to promote Safety Board recommendations.

Some examples of successfully implemented recommendations include tougher surveillance of rapidly growing air carriers, revised lubrication intervals and pilot checklist procedures for horizontal stabilizer trim systems on DC-9 and MD-80/90 and B-717 aircraft, new regulations upgrading safety requirements for 9- to 15-passenger vans, a requirement that steel pipe used in construction pipelines must have adequate toughness to prevent brittle fracture, and improved crew resource management training for railroad employees.

*NTSB Academy (Training Center).*—Fiscal year 2005 marked the first full year of operational experience on site for the Academy. During the year, the Academy expanded course offerings and received accreditation from the International Association for Continuing Education Training, allowing continuing education credits to be given to students who meet the required criteria. Also, as a result of the direction provided in the Board’s appropriations, the philosophical approach for the Academy has changed significantly and investigative resources are used for Academy programs have been sharply curtailed. The focus of the NTSB Academy is to support the accident investigation mission of the Safety Board and promote transportation safety in the following ways:

- Improving the quality of NTSB accident investigations through technical training and instruction;
- Improving the effectiveness of NTSB staff through skill development instruction;

- Improving the efficiency and effectiveness of NTSB accident investigations by communicating lessons learned, sharing accident investigation techniques, and fostering the exchange of new ideas and experience among organizations that participate in NTSB investigations as parties and the broader transportation safety community;
- Providing a forum for instruction, outreach, and advocacy on issues relevant to the transportation safety community;
- Providing a facility for advanced laboratory and research activity; and
- Utilizing its high-quality training resources to facilitate transportation disaster response programs, collaborative instruction with partner agencies, and other compatible activities.

*Summary.*—Included in the President's fiscal year 2007 budget for the National Transportation Safety Board is a provision that would rescind the \$1.998 million balance in the Board's no-year emergency fund and make that sum available in the Board's fiscal year 2007 1-year appropriation account. In addition, the President's budget proposal would make up to \$5 million of the 1-year appropriation available until expended, thus allowing the Board to set aside up to \$5 million of the appropriation for extraordinary expenses, such as those that normally would be covered by the emergency fund.

Should the Congress approve this provision, the Safety Board would anticipate initially reserving some portion of its appropriations to ensure that a minimum amount would be available for carry over for emergency expenses. Any additional amounts that are available at year-end would also be carried over for this purpose. Because establishing an adequate pool of money for emergency expenses would likely take several years to accomplish, this provision would necessarily need to be included in the Board's appropriation language for subsequent fiscal years as well.

As the Acting Chairman of the National Transportation Safety Board, I am very proud of the men and women with whom I work. Other countries have adopted our model, and many countries ask for the Safety Board's assistance. The employees at the Board are considered to be the best in the business, and prove it every day. What surprises many people is the size of the agency. Currently the Board has only 399 employees. Of this number, 283 employees are investigators or are mission-critical to an accident investigation. Seventy percent of our budget is used for employee compensation and benefits, 15 percent for fixed expenses (such as office space, telephones, etc.) and 15 percent for everything else including travel to accident sites, accident investigation services, and lab equipment replacement and upgrades. I appreciate very much that the Appropriations Committee has had to make difficult choices in the last several years. This year's appropriation, which was held to last year's funding level, was further reduced by a 1 percent across-the-board rescission. In addition, the cost of the annual pay increase had to be absorbed in the reduced appropriation. As a result, we reduced our FTE level by 15 and have not been able to replace some key staff.

The Safety Board faces significant challenges. Although the Board has executed a human capital forecast this year to realign our existing resources to continue to meet critical mission needs, the Board will find increasing challenges in some critical areas. Advances in transportation technologies, increases in our necessary involvement in foreign aviation accident investigations, and the sheer complexity of many recent accident investigations will stretch thin our employee resources. The Board has been very careful with its appropriated funds, but we will have difficulty sustaining the high standards we demand of ourselves without sufficient funding. In fiscal year 2005, we have made demonstrable improvements in the management, financial fitness, and mission focus of the NTSB. I would like to request that the subcommittee consider the Board's critical mission and our future needs for additional professionals to continue the fine work of the Safety Board. In 2004, there were more than 44,000 fatalities in transportation accidents, and we know that Congress shares our belief that more can be done to prevent these fatalities. I would like to thank the subcommittee for your continued support of the Safety Board.

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PREPARED STATEMENT OF HONORABLE PATRICK E. MCFARLAND, INSPECTOR  
GENERAL, OFFICE OF PERSONNEL MANAGEMENT

Mr. Chairman and members of the subcommittee, thank you for providing me with this opportunity to discuss the President's fiscal year 2007 request for appropriations for the Office of the Inspector General. The total request for the Office of the Inspector General is \$17,764,000 which is \$452,000 below the amount enacted in fiscal year 2006. Of this amount, \$1,598,000 is from the salaries and expenses/

general fund and \$16,166,000 is from the trust funds. These resources are requested to perform our core functions which include:

- Conduct audits of agency programs and operations, primarily carriers participating in the Federal Employees Health Benefits Program (FEHBP), associated information systems, and internal agency operations and financial systems;
- Provide investigative oversight of the OPM-administered employee benefit programs; and
- Issue administrative sanctions, including debarments, suspensions, and civil monetary penalties, to health care providers who pose a financial risk to the FEHBP itself or a health care risk to persons who receive health insurance coverage through the FEHBP.

The Office of the Inspector General recognizes that oversight of the retirement and health and life insurance trust funds administered by OPM is, and will remain, its most significant challenge. These trust funds are among the largest held by the United States Government. Their assets totaled \$715.8 billion in fiscal year 2005, their receipts were \$85.1 billion, and their annual outlays were \$94.4 billion. The amounts of their balances are material to the integrity of the government's financial position. I continue to allocate the vast majority of the Office of the Inspector General's efforts and resources to trust fund oversight, and we remain fully committed to trust fund activities.

OPM makes outlays from the retirement trust funds in the form of payments to millions of annuity recipients. The health insurance trust fund provides payments to approximately 270 health insurance plans nationwide. In turn, the health insurance carriers pay millions of claims for services filed by their enrollees and health care providers. We have shown through our investigations and audits that such health insurance payments may be at risk through improper, inaccurate or fraudulent claims.

We are obligated to Federal employees and annuitants to protect the integrity of their earned benefits. Our audit and criminal investigative work reduces losses due to fraud and improper payments and recovers misspent funds whenever possible. We have a special obligation to the Federal agencies and the American taxpayers who provide the majority of the funding.

The Office of the Inspector General has achieved an impressive record of cost effectiveness. Audits and criminal investigations of the OPM administered trust fund programs have resulted in significant financial recoveries to the trust fund and commitments by program management to recover additional amounts. Since fiscal year 1992, these recoveries and commitments total approximately \$1.2 billion which is approximately \$10 of positive financial impact for each direct program dollar spent. During fiscal year 2005, the positive financial impact exceeded \$121.7 million, and current estimates for fiscal year 2006 and fiscal year 2007 are \$130 million and \$115 million respectively. In addition, we believe that audits and criminal investigations provide a significant deterrent against future instances of fraud, waste, and abuse.

With the additional resources received over the past few years, the Office of the Inspector General has established 21 investigative field offices. We have determined that the most effective deployment of investigative staff is to locate them in areas of the country where FEHBP and retirement benefits are more concentrated. Experience has shown that criminal investigators located in these areas often work in cooperation with other law enforcement entities similarly located resulting in additional criminal leads and better protection of OPM programs. In many instances, criminal investigators located outside of Washington, DC work exclusively on cases referred to them by local authorities. During fiscal year 2005, investigative work resulted in 38 arrests, 43 indictments, and 20 convictions and we are projecting similar outcomes in fiscal years 2006 and 2007.

During fiscal year 2007, we will continue to conduct audits of pharmacy benefit managers (PBMs). The premiums paid for prescription drug coverage have risen exponentially over the last 10 years and allegations against PBMs have also increased. It is estimated that approximately \$6 billion was paid during 2004 in prescription drug premiums to experience-rated carriers by the Office of Personnel Management and Federal employees. This represents approximately 26 percent of experience-rated carrier premiums paid for health benefits coverage for Federal employees and annuitants.

Also during fiscal year 2007, we will further our development of a data warehouse of health benefits claims. A data warehouse offers the best opportunity for detecting erroneous health benefit payment transactions by medical providers, insurance carriers and subscribers by accumulating all benefit claims for all fee-for-service insurance carriers in a single data repository. This effort will enhance our current claims reviews by enabling the auditors to target certain types of potential claim payment

errors on a program-wide rather than on a plan-by-plan basis. This will provide a significant improvement in our audit efficiency and effectiveness by offering us the opportunity to address significant issues one time only, instead of multiple times per year and to recover overcharges to the program when appropriate.

The data warehouse also provides information enabling our criminal investigative staff to react quickly to criminal investigative leads. For example, the OIG investigators are able to determine the potential program risks associated with an identified provider or subscriber fraud allegation, and take appropriate action in a matter of hours instead of the days or weeks currently required.

Our administrative sanctions program has continued to improve its effectiveness in protecting FEHBP and its enrollees against untrustworthy health care providers. This program enforces the FEHBP sanctions statute, which authorizes suspension or debarment of providers on the basis of 18 different categories of violations. The most frequently-encountered violations represent criminal convictions or loss of professional licensure. The highest priority sanctions cases involve providers who are the subject of investigation by our Office of Investigations. We have also developed a state-of-the-art capability to obtain sanctions-related information online and integrate it into our decision-making processes. With the nature and extent of electronically accessible information constantly growing, we are now able to identify violations involving providers nationwide who are directly associated with FEHBP as members of preferred provider organization networks and or who have actually submitted claims to FEHBP carriers. We select cases for action on the basis of the seriousness of the provider's violations and the risks that the provider poses to the FEHBP and its subscribers. We currently have over 29,350 active debarments and suspensions in effect.

Thank you for this opportunity to present my resource request for fiscal year 2007.

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PREPARED STATEMENT OF THE HONORABLE LINDA M. SPRINGER, DIRECTOR, OFFICE OF PERSONNEL MANAGEMENT

Mr. Chairman and members of the subcommittee, I appreciate the opportunity to submit for the record a statement addressing the appropriations request for the Office of Personnel Management (OPM) for fiscal year 2007.

As you know, OPM provides a variety of products and services to the nearly 1.8 million employees in the Federal Government. Some of our products and services include managing health insurance for approximately 8 million current and former Federal employees and their families, administering retirement services for over 2 million retirees from all branches of government, completing 90 percent of background investigations, and administering career development programs. As the OPM Director, I am committed to successfully delivering on our responsibilities on a timely basis. In short, I believe the American citizens and the Federal civilian workforce expect us to get things done, and our fiscal year 2007 budget request will allow us to do just that.

OPM'S NEW STRATEGIC AND OPERATIONAL PLAN

Mr. Chairman, operational planning and budgeting go hand in hand, and the OPM process is no exception. For an organization to fulfill its mission, it is first necessary to have a clear understanding of that mission, with supporting strategic objectives and operational goals. These goals must be accompanied by strong oversight and accountability in order to reach optimal performance.

With these principles in mind, we recently reassessed the agency's goals and priorities, with an eye toward creating a more transparent and accountable OPM. This planning process was guided by an advisory group consisting of executives and senior General Schedule employees with OPM knowledge and expertise. During these meetings, the advisory group reviewed draft strategic objectives and goals, identified important program needs and milestones, and played a critical role in the development of the resultant plan.

During the planning process, I also reached out to other resources for input, including members of Congress, the Chief Human Capital Officers Council Executive Committee, union leadership, and the Office of Management and Budget.

The result is OPM's new Strategic and Operational Plan, which begins with a concise mission statement—to ensure the Federal Government has an effective civilian workforce. While this plan complies with the Government Performance and Results Act of 1993, it differs markedly from previous OPM plans and other Federal agency plans as well. This is intentional. Its goals are straightforward and readily identifiable, with each being action-oriented and beginning with a verb. Each goal also has

a date by which it will be accomplished. The plan's 170 goals are included in the OPM Senior Executives' performance agreements. This means that, under the new SES performance-based pay system, executive compensation is directly linked to successful execution of the plan's goals. The bottom line is this—program performance will remain subject to high level management attention to ensure achievement.

The new plan was developed concurrently with our 2007 budget request. The budget priorities you have seen in the Congressional Budget Justification can be traced back to program priorities in our new plan. This means that accomplishing the goals of the plan is realistic as long as the funding request is sustained.

We are requesting \$36.6 billion to carry out our mission in fiscal year 2007. Of this total, \$36.4 billion is requested for mandatory programs and \$255.7 million for discretionary activities. The discretionary request reflects \$238 million for Salaries and Expenses—including transfers from the Trust Fund Accounts of \$126.9 million—and \$17.7 million for the Office of the Inspector General. The total discretionary request reflects a net increase of \$17.2 million compared to the fiscal year 2006 enacted level.

Highlights of the request are discussed below.

#### RETIREMENT CLAIMS PROCESSING AND BENEFITS PROGRAMS

OPM's request includes funding to improve the services it delivers to Federal employees, annuitants, and their families through the retirement and insurance programs. Most notably, we will reduce the time needed to process claims for benefits submitted by retiring Federal employees to an average of 30 days. This represents a significant improvement over the timeliness reported for fiscal year 2005—80 days for employees retiring under the Civil Service Retirement System (CSRS), and 93 days for those under the Federal Employees' Retirement System (FERS).

The budget requests an additional \$26.7 million in No-Year Trust funds for the Retirement Systems Modernization (RSM) Project. These funds will allow OPM to continue the conversion of millions of paper retirement records to electronic data and contract for the information technology needed for the system. RSM is the core strategy to meet OPM's long-term customer service, business, and financial management goals for the retirement program. As RSM is implemented, OPM will authorize new retirement benefits within 5 or fewer days (for 17 percent of all claims in fiscal year 2008 and 49 percent in fiscal year 2009). RSM will also improve the accuracy of retirement claims from 90 percent (CSRS) and 93 percent (FERS) to between 95 percent and 97 percent, respectively.

RSM implementation is scheduled for 18 to 36 months from contract award. During this period, OPM will need experienced Legal Administrative Specialists (claims processors) to provide subject matter expertise and advice as the effort progresses. The fiscal year 2007 budget provides the flexibility to support RSM implementation while maintaining timeliness and accuracy in processing retirement claims.

For the Federal Employees Health Benefits Program (FEHBP), OPM will continue to negotiate and contract with private insurance companies that offer a broad range of health insurance benefits, including high-deductible health plans with Health Savings Accounts and consumer-driven health plan options. Customers can make informed health insurance decisions by several means: OPM-sponsored health plan brochures and Web site postings, health plan customer satisfaction survey results, Web-based comparison/decision tools, and the Health Plan Employer and Data Information Set. OPM will continue to carry out tough negotiations with health carriers to contain premium hikes and maintain benefit levels, and continue to provide, improve, and expand tools so customers can make informed health insurance decisions. In addition, OPM will continue to maintain the competitiveness of the insurance programs by implementing the new dental/vision benefits required by Public Law 108-496.

#### HUMAN RESOURCES MANAGEMENT (HRM) REFORM

In fiscal year 2007, OPM will pursue policy initiatives that continue to reform human resources management in Federal agencies. We will work with the Departments of Homeland Security (DHS) and Defense (DOD) to ensure the reforms underway link pay to performance. At the same time, OPM will work with other agencies engaged in Alternative Personnel Systems to assess the lessons learned from various modernization efforts. OPM is uniquely positioned to apply lessons learned from modernization efforts undertaken at DHS and DOD to the rest of the Federal workforce.

Mr. Chairman, in the last half-century, the Federal workforce has changed significantly, and the old personnel system has not kept pace. According to the 2004 Federal Human Capital Survey (FHCS), for example, only 27 percent of Federal employ-

ees believe steps are being taken to deal with poor performers, and only 29 percent believe differences in performance are recognized in a meaningful way. Little of an employee's current compensation is based on performance or mission accomplishment. The fiscal year 2007 request will allow OPM to deliver this needed human resources modernization.

The fiscal year 2007 budget will also allow OPM to maintain the competitiveness of Federal employee benefits by promoting affordable options within the Federal Employees Health Benefits Program, such as health savings plans, explore ways to refine market adjustments to Federal pay, and provide Federal employees with opportunities, benefits, and service delivery that compare favorably with other employers. For instance, OPM will continue to develop new workforce recruitment strategies and tools, and further improve the hiring process.

OPM will assess the results of its strategic human resources policy activities by analyzing data collected from the FHCS and Federal Benefits Survey to be issued in 2006 and by continuing to track and report the extent to which agencies use innovations such as hiring flexibilities, teleworking, and student loan repayments. The results of these surveys will provide broad Government-wide indicators on the status of Federal human capital, which will benefit lawmakers, managers, and employees—and enable OPM to assess its performance in terms of delivering new human resources policies and issuing ongoing policy guidance as needed.

#### IMPLEMENTING HUMAN CAPITAL STANDARDS FOR SUCCESS

OPM will use requested funds to engage Federal agencies in implementing Human Capital Standards for Success, and other best practices in human capital management, in keeping with the Merit System Principles, veterans' preference, and other standards. OPM's success will be measured by the number of agencies that meet the Human Capital Standards for Success. At the beginning of fiscal year 2006, 11 of the 26 agencies reporting under the President's Management Agenda Scorecard met these standards, up from 8 in 2005, and zero in 2003. An additional 14 agencies have made significant progress toward achieving these standards. As a result, more than 99 percent of the Federal civilian workforce is employed by agencies that have made significant progress toward meeting these standards.

OPM expects continued improvement in 2006 and 2007 as it strengthens these standards and engages more agencies to fully adopt them. Also, OPM expects Federal agencies to make hiring decisions more quickly and implement improved and documented succession plans. In addition, OPM anticipates Federal employees to be better trained for their jobs and to be held accountable for their performance as agencies implement improved performance management systems.

Through the Compliance Program, OPM will continue audit, review, and oversight activities to ensure agencies comply with Merit System Principles and veterans' preference, and to ensure whistleblower protection and other rights and privileges are honored and protected. OPM will strengthen this program by implementing a human capital accountability system that holds agencies accountable for adhering to these principles, laws, and rules, as well as the human capital best practices referenced above.

#### HUMAN RESOURCES LINE OF BUSINESS

In 2007, OPM will continue to be a leader in the President's Management Initiative for Expanding Electronic Government and has included \$8,349,000 in its request for this purpose. The requested resources will support the Human Resources Line of Business (HR LOB) and Enterprise Human Resources Integration (EHRI). HR LOB will continue to identify and document common functional, technical, and data requirements consistent with Federal human resources policies. It will work toward the establishment of Federal and private sector Shared Service Centers to meet these requirements. During 2007, the EHRI project will continue to modernize how the Federal Government maintains, stores, protects, and transmits human resources transactions and resulting information.

#### SECURITY-RELATED ACTIVITIES

The fiscal year 2007 request includes funding for a number of important security-related activities. OPM will implement Homeland Security Presidential Directive 12 (HSPD-12), Policy for a Common Identification Standard for Federal Employees and Contractors, which was signed by the President on August 27, 2004. This mandates the circulation of a Federal standard for a secure and reliable form of identification for Federal employees and contractors. HSPD-12 requirements will enhance OPM's strategic goal of improving security and emergency actions throughout the agency. Our request also contains funds for security upgrades at OPM field offices across

the country. These funds will be used to address critical vulnerabilities and correct the most serious problems identified during field evaluations. Failure to correct these deficiencies compromises the security of our employees.

#### OFFICE OF THE INSPECTOR GENERAL

OPM's discretionary request includes a total of \$17.8 million for the Office of the Inspector General (OIG) to carry out its audit, investigative, and oversight responsibilities. This amount reflects a net decrease of \$452,000 (2.2 percent) in general funds from the 2006 appropriated resources. The trust funds annual level is unchanged from 2006 and will enable the OIG to continue its investigative oversight of the Federal Employees Health Benefits Program and the Civil Service Retirement System/Federal Employees' Retirement System programs, to audit FEHBP plans and carrier information systems, and to continue its prescription drug audit plan, established in 2005.

#### REVOLVING FUND

OPM also provides a variety of ongoing services that are financed by other agencies through our revolving fund. These services include providing one-stop access to high-quality e-Training products and services; offering professional development and continuous learning for Federal managers and executives; providing employment information and assessment services; automating other agencies' staffing systems; providing examining services when requested by an agency; providing technical assistance and consulting services on all facets of HRM; testing potential military personnel for the Department of Defense where it is cost-effective for OPM to do so; managing the selection, coordination, and development of Presidential Management Fellows; and conducting investigations for all employees to determine whether they are suitable for employment, as well as more in-depth investigations for employees whose positions require a security clearances. For those ongoing revolving fund responsibilities, the fiscal year 2007 budget includes an estimated \$1 billion in obligations and 2,786 FTE to be financed through payments for OPM's services by other agencies.

#### MANDATORY PAYMENT ACCOUNTS

Since OPM serves as the "employing agency" for Federal annuitants, the OPM budget request also includes, as always, mandatory appropriations to fund the government contributions to the health benefits and life insurance programs for those individuals.

A "such sums as may be necessary" appropriation is requested for each of these accounts because of the mandatory nature of those payments. For the approximately 1.9 million annuitants participating in the Federal Employees Health Benefits Program, we estimate that about \$8.8 billion will be needed to pay the government's share of the cost of coverage. That represents an increase of \$560 million over fiscal year 2006. We estimate that, for the 500,000 annuitants under age 65 who elect post-employment life insurance coverage, an appropriation of \$39 million will be required.

Also, as mandated by the financing system established in 1969 by Public Law 91-93, liabilities resulting from changes (principally pay raises) since that year that affect retirement benefits must be amortized over a 30-year period. For that purpose, we are requesting a "such sums as may be necessary" payment to the Civil Service Retirement and Disability Fund in the amount of \$27.5 billion dollars. This represents an increase of \$350 million to cover the service cost of the Civil Service Retirement System, which is not funded by and for active employees.

#### PAY RAISE

Finally, the President's budget proposes an overall average civilian Federal pay increase of 2.2 percent—the same overall average increase as proposed for the military. This amount is equal to the full increase in the Employment Cost Index for the 12-month period ending in September 2005. It is designed to preserve the relative position of the Federal Government in the overall labor market.

The budget includes a legislative proposal that would provide the President with the flexibility to allocate a portion of the 2.2 percent pay increase to special rate increases for specific groups of employees (by occupation, location, or grade level) for which recruitment or retention efforts are or may become significantly handicapped.

This proposal is designed to send a signal that the Federal pay adjustment process should be "smarter"—i.e., more strategic and market-sensitive. This new flexibility cannot be exercised without congressional approval of the proposed legislation.

It would be used only if the government has sufficient data to support the need for such pay increases in response to demonstrated recruitment/retention problems and OPM determines its readiness to implement.

Thank you again for the opportunity to provide for the record a discussion of OPM's budget request. I would be pleased to provide any additional information the subcommittee may need.

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PREPARED STATEMENT OF THE U.S. MERIT SYSTEMS PROTECTION BOARD

Chairman Bond, Ranking Member Murray and members of the subcommittee, thank you for the opportunity to submit this statement for the record on the fiscal year 2007 appropriations request for the U.S. Merit Systems Protection Board (MSPB or "the Board").

An independent quasi-judicial agency, MSPB employs 227 employees in its Washington, DC headquarters, 6 regional and 2 field offices. The Board has two statutory missions. The first mission is to adjudicate employee appeals of personnel actions such as removals, suspensions, furloughs, and demotions; employee complaints filed under the Whistleblower Protection Act, the Uniformed Services Employment and Reemployment Rights Act, and the Veterans Employment Opportunities Act; Special Counsel complaints of prohibited personnel practices and Hatch Act violations; and appeals of administrative decisions affecting an individual's rights or benefits under the Civil Service Retirement System or the Federal Employees' Retirement System. The Board's second statutory mission is to conduct studies of the Federal civil service and other Federal merit systems in the Executive Branch.

OVERVIEW OF THE REQUEST

The Merit Systems Protection Board is a small agency that uses approximately 79 percent of its appropriation for personnel costs and approximately 20 percent of its appropriation for fixed expenses, such as space rent and utilities. We are requesting \$36,531,000 in appropriated funds and a reimbursement limitation of \$2,579,000 from the Civil Service Retirement and Disability Trust Fund to support the operations of the agency. This request represents a \$1,287,000 increase over the fiscal year 2006 funding level, taking into account the government-wide rescission. This increase covers the built-in cost increases for pay raises and space rent as well as the costs of relocating the San Francisco Regional Office because the current space is not compliant with current earthquake standards.

FISCAL YEAR 2005 ACCOMPLISHMENTS WITH FISCAL YEAR 2007 OUTLOOK (BY BUDGET ACTIVITY)

*Adjudication*

In fiscal year 2005, the Board did an outstanding job, at both the regional and headquarters levels, in adjudicating cases in a timely manner. During fiscal year 2005, the administrative judges in the regional and field offices issued approximately 6,800 initial decisions, with an average case processing time of 92 days.

At the headquarters level, the Board members issued approximately 1,600 decisions, most of which were on petitions for review of decisions issued by the administrative judges. The Board has reduced its inventory of outstanding cases by 48 percent. The average case processing time for adjudicating petitions for review of initial decisions was 265 days in fiscal year 2005. All this was accomplished with no loss of quality, despite the growing complexity of the law and the changing makeup of the Board. The Court of Appeals for the Federal Circuit left unchanged 94 percent of the Board decisions that were appealed to the Court.

The Board expanded its Mediation Appeals Program (MAP) to include all regional and field offices and completed mediation training for new mediators. Of the 105 cases that were processed through MAP, 83 mediations were completed. Settlements were reached in 40 of the 83 cases mediated for a success rate of 48 percent.

Both the Department of Homeland Security (DHS) and the Department of Defense (DOD) have issued final regulations to implement their new personnel systems. While Congress granted both agencies the option of establishing an alternative process to adjudicate their employee appeals, both decided to continue to have the Merit Systems Protection Board adjudicate these appeals. All aspects of the Board's operations will be affected by these new procedures. The regulations of both departments have been challenged in the courts. We expect to see a resolution to the court actions soon.

It should be noted that, while the new DHS and DOD systems require the Board to revise its procedural regulations, the Board will still be adjudicating appeals from

DHS and DOD employees under several laws (e.g., the Whistleblower Protection Act, Uniformed Services Employment and Reemployment Rights Act and Veterans Employment Opportunities Act) under procedures that are applicable to all other agencies subject to the Board's jurisdiction.

As the agency begins adjudicating appeals under the new DOD and DHS regulations with the faster processing times, it is important that the agency have the staffing and administrative resources to process appeals involving all other agencies in a timely manner.

Approximately 198 FTE, or about 84 percent of the approximately 236 FTE, have been allocated to the Board's adjudication function for fiscal year 2007.

#### *Merit Systems Studies and Oversight*

The Board issues 6 study reports and 4 newsletters annually. Our studies and reports are based on objective, independent research using established scientific methods. To ensure the value of our products and the effective use of government resources, we work closely with research groups from the Government Accountability Office, the Office of Personnel Management, and the National Academy of Public Administration to share research agendas and expand the peer reviews of our work. Reports of the Board's studies are directed to the President and the Congress and are distributed to a national audience of human resource practitioners and professional organizations.

Recent study reports include: "Contracting Officer Representatives: Managing the Government's Technical Experts to Achieve Positive Contract Outcomes (2006)"; "Designing an Effective Pay for Performance Compensation System (2006)"; "Reference Checking in Federal Hiring: Making the Call (2005)"; "Building a High-Quality Workforce: The Federal Career Intern Program (2005)"; and "Probationary Period: A Critical Assessment Opportunity (2005)".

In addition to these reports, the Board completed its latest Merit Principles Survey (MPS) in 2005. MSPB has conducted the MPS every 3–5 years for the past two decades. Each administration of the MPS assesses the degree to which Federal agencies adhere to the merit principles, tracks the incidence of prohibited personnel practices in Federal agencies, and gathers information to support other OPE research studies. The MPS 2005 was the first MPS administered via the World Wide Web. Nearly 37,000 full-time civilian Federal employees completed the MPS during the summer and fall of 2005. The Board's Office of Policy and Evaluation is currently analyzing the data from this survey and preparing a report for release by the end of fiscal year 2006.

The new DHS and DOD personnel systems will affect about half of the Federal civil service employees, resulting in the biggest change since the Civil Service Reform Act was passed in 1978. To facilitate the accomplishment of MSPB's statutory mission of studying the health of the civil service system, the Board will be gathering baseline data about how the personnel systems in these agencies are currently working. This data will then be compared with similar data after the new systems have been operational for approximately 2 years.

This function will use approximately 12 FTE, or about 4 percent of the approximately 236 FTE, the Board is projected to use in fiscal year 2007.

#### *Management Support*

The management support function, which will use approximately 26 FTE, or 11 percent of the 236 estimate in fiscal year 2007, provides the information resources management, human resources management, budget, finance, procurement, equal employment opportunity, travel, space, and property management services for the agency.

In the area of information technology, the Board upgraded its wide area network (WAN) infrastructure to improve response time and to support the increasing traffic of electronic documents between the headquarters and regional offices. In fiscal year 2006, we started piloting wireless broadband technologies that enable high-speed access for MSPB staff from any major metropolitan area.

The Board's Office of Information Resource Management (IRM) began an impact analysis study on the transition to IPv6, as directed by OMB (See OMB Memorandum No. M-05-22). This OMB memorandum requires the agency's network backbone to be capable of passing IPv6 traffic by June 30, 2008. This IPv6 project will require careful planning, staff training, hardware upgrade, and possible system changes and budget implications over the next several years in order for us to prepare for a smooth transition to meet all of OMB's requirements.

IRM has also increased its computer security in accordance with the Federal Information Security Management Act. In fiscal year 2002 and fiscal year 2003, IRM developed security plans, analyzed risks, prepared contingency plans, upgraded

servers and system software, installed additional monitoring and access controls, and tested recovery plans. In fiscal year 2004 and 2005, IRM made further enhancements to IT security, following the recommendations of the independent auditors and improvements identified from risk assessments and penetration tests. These enhancements included updating of policies, clarification of the role of program offices in IT security, implementation of a centralized anti-virus server and spam filtering software, improvements in internal network security, annual security awareness training, and additional testing of contingency plans. IRM will continue to make further enhancements to IT security and comply with FISMA guidelines.

The Board has implemented several technology initiatives such as e-Appeal that will expedite case processing and adjudication. Through e-Appeal, individuals may file appeals online. Another innovation provides all Board members with electronic access to complete case files. As a result, Board members can analyze case records and issue decisions while on official travel.

As previously stated, the Board is requesting funds to cover the costs of relocating the San Francisco Regional Office because the current space is not compliant with current earthquake standards.

CONCLUSION

I am honored to serve as Chairman of the Merit Systems Protection Board. My staff and I are mindful of the need for all Federal agencies to exercise fiscal restraint in this tight budgetary environment. We have been, and will continue to serve as, careful stewards of the public resources that have been entrusted to us for the purpose of carrying out our statutory missions. The Board and its staff continue to work diligently to maintain the reputation for efficiency, effectiveness, and fairness it has earned over its long history. We appreciate the support we have received from our appropriations committees and welcome the opportunity to continue our partnership in service to the American public.

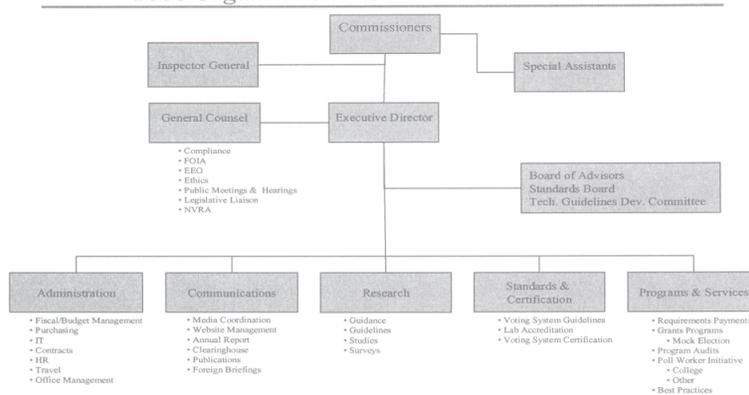
PREPARED STATEMENT OF THE U.S. ELECTION ASSISTANCE COMMISSION

INTRODUCTION

Thank you Mr. Chairman and members of the subcommittee for the opportunity to submit testimony regarding the work of the U.S. Election Assistance Commission (EAC) and its budgetary needs to continue assisting the States in implementing the Help America Vote Act of 2002 (HAVA) and the National Voter Registration Act of 1993 (NVRA) in fiscal year 2007 .

EAC is a bipartisan commission consisting of four members: Paul DeGregorio, chairman; Ray Martinez III, vice chairman; Donetta Davidson; and Gracia Hillman. In addition to the four commissioners, EAC employs 19 full-time staff persons.

**U.S. Election Assistance Commission**  
*2006 Organizational Chart*



HAVA instructs the EAC to develop and update national voluntary voting system guidelines and manage the Federal Government's first voting system certification



or lever voting systems, implementing provisional voting, purchasing equipment and software to build State-wide voter registration databases, as well as various activities aimed at improving the administration of Federal elections. To help clarify the appropriate uses of HAVA funds, EAC and GSA applied OMB Circulars A-87, A-102, and A-133. In addition, EAC provided guidance and information on the appropriate use of HAVA funds in response to questions from the States. Even with these resources, EAC must answer questions daily from the 50 States, four territories and the District of Columbia about allowable expenses under HAVA.

EAC requires that States, territories and the District of Columbia report their uses of HAVA funds. In the second quarter of each year, States report on their use of both Title I and Title II funds. The Title II report includes: (a) a list of expenditures for each category of activities described in Title III; (b) the number and types of voting equipment obtained with the funds; and (c) an analysis and description of the activities funded to meet HAVA requirements and how such activities conform to the State plan. Title I reports require States to (1) disclose, in separate reports for section 101 and 102 funds, the financial activity for the previous calendar year on a Standard Form 269; and (2) provide the same detail on the expenditures that is required for the reports on Title II requirements payments. EAC conducts a detailed review of each report to validate that the expenditure of funds met the requirements of HAVA and was in accordance with plans filed by the State or territory. The States' Title I and Title II reports are available to the public upon request.

#### *Auditing*

Section 902 of HAVA gives EAC and other HAVA granting agencies the authority to conduct regular audits of HAVA funds. EAC's audit activity will be conducted through EAC's Office of the Inspector General (OIG), which currently consist of two types of reviews to determine if the States are exercising sufficient controls and using the funds distributed under HAVA for appropriate purposes. One is an assessment of procedures each State uses to administer and monitor HAVA funds, as well as a review of certain critical elements such as whether the State has maintained sufficient matching funds. On a concurrent track, OIG will commission audits of several States each year to more fully review the State's internal controls, processes, procedures, and transactions to ensure compliance with Government Auditing Standards.

In addition to EAC's regular audits, HAVA also provides for two other means of extraordinary audit authority—(a) funds are subject at least once during the term of the program to an audit by the Comptroller General; and (b) section 902(b)(6) of HAVA allows EAC to conduct a "special audit" or "special examination" of the funds that are subject to regular audit under Section 902(b)(1). This special audit authority covers every HAVA program, including funds distributed under Title I, Title II, and programs administered by the Department of Health and Human Services. If EAC determines that a special audit is warranted, by vote of the Commission, EAC will refer the matter to the OIG for review.

The OIG currently employs 1 full-time staff person. Two additional persons have been provided to EAC by the Department of Interior via a Memorandum of Understanding (MOU). These persons are responsible for conducting the majority of the State assessments discussed above, monitoring outside contracts for audits, reviewing EAC's internal operations, and coordinating investigations of complaints, as necessary.

#### *Financial and Human Resources Needs for Management of HAVA Funds in Fiscal Year 2007*

In fiscal year 2006, EAC has budgeted \$2.5 million for these activities. Of that, \$1.65 million is allocated to the OIG for auditing the use of HAVA funds and assessing State controls. At this level of funding, EAC anticipates that it will be able to fund the MOU for the two persons provided by the Department of Interior, conduct assessments of four or five States, and begin four or five full audits of States. The remaining \$550,000 is budgeted for management activities such as reviewing reports submitted by the States, answering questions related to the proper use of HAVA funds, and reviewing States' indirect cost proposals. Three full time equivalents (FTE) and two staff persons via MOU with the Department of Interior currently serve these functions.

In fiscal year 2007, EAC anticipates allocating the same amount of funding and personnel to this function, including pay and non-pay adjustments (\$2.6 million). At this rate, EAC will be able to continue assessing and auditing States at the rate projected for fiscal year 2006. Availability of personnel will depend on the willingness of the Department of Interior or other agencies to continue providing assistance through an MOU. It is essential that EAC maintain the current level of staff sup-

port (5 persons), either through FTE or MOU in order to assure that the use of HAVA funds is monitored appropriately.

#### AIDING IN THE IMPROVEMENT OF VOTING SYSTEMS

One of the most enduring effects of HAVA will be the change in voting systems used throughout the country. All major HAVA funding programs can be used by States to replace outdated voting equipment. HAVA also provides for the development and maintenance of testable standards against which voting systems can be evaluated. It also provides for Federal certification according to these standards. EAC is responsible for and committed to improving voting systems through these vital programs.

##### *Voluntary Voting System Guidelines*

One of EAC's most important mandates is the testing, certification, decertification and recertification of voting system hardware and software. Fundamental to implementing this key function is the development of updated voting system guidelines, which prescribe the technical requirements for voting system performance and identify testing protocols to determine how well systems meet these requirements. EAC along with its Federal advisory committee, the Technical Guidelines Development Committee (TGDC), and the National Institute of Standards and Technology (NIST), work together to research and develop voluntary testing standards.

On December 13, 2005, EAC adopted the first iteration of the Voluntary Voting System Standards (VVSG). This document was an initial update to the 2002 Voting System Standards focusing primarily on improving the standards for accessibility, usability and security. These testing guidelines also incorporated standards for reviewing voting systems equipped with voter verifiable paper audit trails (VVPAT) in recognition of the many States that now require this technology. VVSG also establishes the testing methods for assessing whether a voting system meets the guidelines.

Significant work remains to be done to fully develop a comprehensive set of standards and testing methods for assessing voting systems and to ensure that they keep pace with technological advances. In fiscal year 2007, EAC along with TGDC and NIST, will revise sections of the VVSG dealing with software, functional requirements, independent verification, and security and will develop a comprehensive set of test suites or methods that can be used by testing laboratories to review any piece of voting equipment on the market.

##### *Accreditation of Voting System Testing Laboratories*

HAVA Section 231 requires EAC and NIST to develop a national program for accrediting voting system testing laboratories. The National Voluntary Laboratory Accreditation Program (NVLAP) of NIST will provide for the initial screening and evaluation of testing laboratories and will perform periodic re-evaluation to verify that the labs continue to meet the accreditation criteria. When NIST has determined that a lab is competent to test systems, the NIST director will recommend to EAC that a lab be accredited. EAC will then make the determination to accredit the lab. EAC will issue an accreditation certificate to the approved labs, maintain a register of accredited labs and post this information on its website.

In July 2005, NVLAP advertised for the first class of testing laboratories to be reviewed under the NVLAP program and accredited by EAC. Five laboratories have applied for the accreditation program. Pre-assessments of these laboratories began in April 2006 and formal review will proceed thereafter. NVLAP anticipates that those laboratories will be reviewed and those that are eligible to be recommended for accreditation will be delivered to EAC in fall 2006.

Because testing of voting systems cannot be delayed, there must be some interim review and accreditation of laboratories. In late 2005, EAC invited laboratories that were accredited through the National Association of State Election Directors (NASED) program as Independent Testing Authorities (ITAs) to apply for interim accreditation. All three ITAs have applied for interim accreditation. Interim accreditation reviews by EAC contractors will begin in the Spring 2006. ITAs will be accredited on an interim basis until the first class of laboratories is accredited through the NVLAP process. After that time, all testing labs must be accredited through the NVLAP evaluation process.

##### *Voting System Certification*

In 2006, EAC is assuming the duty of certifying voting systems according to national testing standards. Previously, NASED qualified voting systems to both the 1990 and 2002 Voting System Standards. EAC's certification process will constitute the Federal Government's first efforts to standardize the voting system industry.

EAC's program will encompass an expanded review of voting systems. It will utilize testing laboratories and EAC technical reviewers. The program will also include assessments of quality control, field monitoring, vendor registrations, and enhanced public access to certification information.

Historically, voting system qualification has been a labor intensive process. In 6 months, NASED received 38 separate voting system test reports for review and qualification. All requests must be received, processed and monitored while the testing laboratory is assessing compliance. Once a test report is produced, technical reviewers must analyze the reports prior to recommending systems for certification. Based upon the NASED data, this process will take anywhere from 4 to 120 hours per report. In addition, EAC's enhanced testing and certification program will require reviewers to evaluate voting system technical data packages prior to testing, which will take an additional 4 to 20 hours per voting system.

#### *Financial and Human Resources Needs for Fiscal Year 2007*

In fiscal year 2006, EAC has budgeted \$3.95 million for its work to aid in improving voting systems used throughout the country. Of that amount, \$2.772 million is transferred to NIST for its research for and support of the TGDC. The remaining \$1.178 million is dedicated to the development, implementation, and operation of a voting system certification program and laboratory accreditation program. EAC currently employs one FTE to support all of these functions. In addition, EAC anticipates hiring several contractors to serve as technical reviewers in the voting system certification program and one contractor to assist with the development of the VVSG and administration of the voting system certification and laboratory accreditation programs.

In fiscal year 2007, EAC has requested \$6.421 million, which represents an increase of \$2.471 in this program. Of that amount, \$4.95 million, which includes an increase of \$2.178 million, will go to NIST to complete work on the VVSG prior to the 2008 presidential election. The needed work includes updating and revising the testing standards and the development of testing protocols to assess whether a voting system meets the standards. The remaining \$1.471 million will be applied to administering the voting system certification, voluntary voting system guidelines, and laboratory accreditation programs. This includes an increase of \$293,000 to hire two additional FTE to manage the day-to-day operations of the voting system certification and laboratory accreditation programs, including work to assess vendor facilities and processes to assure that quality control provides equipment that is consistent with the caliber of the samples that are certified under the EAC program.

#### NATIONAL CLEARINGHOUSE OF ELECTION INFORMATION

HAVA establishes EAC as a national clearinghouse of election information, which means EAC studies and makes research available on a range of issues including best practices in election administration, hours and places for voting, and election data. EAC has conducted extensive research on a variety of topics related to election administration, has begun an ongoing process of collecting election related data, and has compiled election-related resources such as statutes and regulations. This information is presented to the election community and to the public through the EAC's website as well as through formal reports on studies and data collections. Through this clearinghouse, EAC positions itself as a primary source of information about Federal elections.

#### *Research and Study*

HAVA requires EAC to conduct a number of studies and provides considerable discretion to research other election administration issues to assist States in their efforts to improve election reform. EAC uses its Federal advisory committees to assist in prioritizing research topics that are important to and that will assist election officials. In 2006, EAC will produce guidance, best practices and reports on recruiting, training and retaining poll workers; usability of ballots and information provided to voters; procedures for counting and recounting ballots; provisional voting; voter identification; voter fraud and intimidation; as well as launching a legal resources database that will provide election officials and the public with access to election laws and regulations from each of the 50 States. In addition, EAC will also issue election management guidelines as a companion to the VVSG.

In fiscal year 2007, EAC will focus on completing the research required by HAVA on the use of social security numbers in voter registration, standards for internet voting, and the possibility of postage-free absentee voting. EAC will also collect and analyze data from the 2006 Federal elections including voter turnout, absentee voting, voter registration and military and overseas citizen voting. The 2006 Election

Day Survey will provide comprehensive data indicating the progress States have made in implementing HAVA.

*EAC's Website as a Clearinghouse*

Using EAC's website as its main means of transmitting information to the public is a useful, accessible and cost-effective tool. As its studies, guidance and best practices are completed, EAC will have an increasing amount of information to store and display through its website. EAC will also use the website to provide information about the voting system standards and certification program. EAC currently has a memorandum of understanding with the General Services Administration for its information technology (IT) support including servers to maintain EAC data. In addition, EAC contracts for the hosting and maintenance of its website. To accommodate the expanding clearinghouse, EAC will need to expand its IT capabilities by either enhancing its contracts for web services and IT support or by considering bringing those services in-house.

*Financial and Human Resources Needs for Fiscal Year 2007*

In fiscal year 2006, EAC budgeted \$2.5 million for its research and study. In fiscal year 2007, EAC anticipates spending \$2.13 million on required research projects, data collection and analysis, development of best practices documents, and expansion and maintenance of its technical resources to host a clearinghouse on its website.

GUIDANCE AND INFORMATION TO THE STATES

HAVA established EAC to provide guidance and assistance to the States on implementation of the law and transferred to EAC the responsibility of implementing the National Voter Registration Act (NVRA). EAC has provided valuable guidance to the States on what HAVA means, implementing the law, and appropriate use of HAVA funds. In fiscal year 2007, EAC will continue that work by developing election management guidance, expanding on its voter registration data base guidance, and by updating and revising the NVRA regulations and national voter registration form. The election management guidance is a comprehensive companion document to the VVSG that will assist States in managing an election from receipt of voting equipment to the reporting of results to the canvass or recount that follows. EAC's continued work on voter registration databases will focus on studying the appropriate use of security measures, verification of voter information using appropriate matching protocols, and sharing information with other State agencies and, ultimately, with other States. EAC will address issues involving voter registration using the Federal form by updating the NVRA regulations and the Federal registration form.

*Financial and Human Resources Needs for Fiscal Year 2007*

EAC has budgeted \$750,000 in fiscal year 2006 for these activities. In fiscal year 2007, EAC anticipates spending \$1.2 million on providing guidance and assistance to the States.

ADMINISTRATION

The administration objective represents the efforts of EAC, internally or through contracts and MOUs, to support the mission and work of this agency and meet the HAVA-imposed mandates. These costs include rent, equipment, supplies, human resources functions, finance and budget, computers, telephones, publication, and printing. This objective includes maintaining the leadership and support staff for the agency. Charges for salaries and benefits for the Commissioners and non-programmatic support staff are included in this category. In addition, the administrative objective includes supporting the efforts of EAC's two Federal advisory committees, the Board of Advisors and Standards Board. Between these two boards there are 147 members who meet at least once in each fiscal year to fulfill their responsibilities under HAVA. The leadership of these Boards meets more frequently, approximately once each quarter.

*Financial and Human Resources Needs for Fiscal Year 2007*

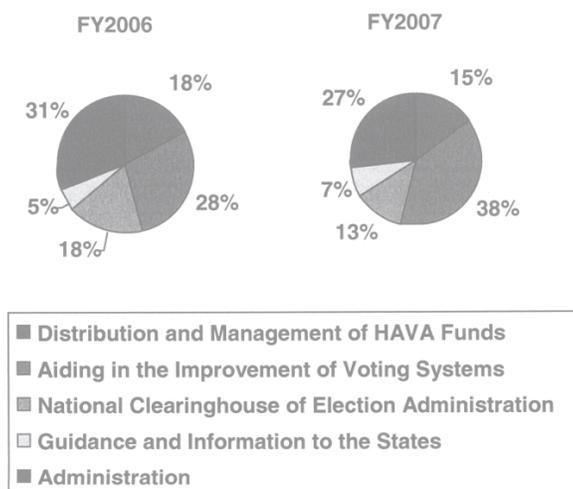
In fiscal year 2006, EAC has budgeted \$4.4 million for these activities. In fiscal year 2007, EAC anticipates spending a similar amount, including pay and non-pay adjustments (\$4.55 million).

CONCLUSION

In the first 2 years of EAC's existence, the main focus was expeditiously completing the distribution of more than \$3 billion in HAVA funds to the States to pur-

chase voting equipment and implement other election administration improvements. During this time, EAC also adopted the 2005 Voluntary Voting System Guidelines within the HAVA-prescribed 9-month timeframe. The completion of these activities generates a new set of related priorities: (1) monitoring and auditing the use of HAVA funds; (2) making sure the VVSG keep pace with technology by updating them periodically, especially in the areas of security and usability; and (3) establishing the Federal Government's first voting system certification program.

Consequently, EAC will direct more funding in fiscal year 2007 to its audit program, the VVSG and the certification program.



EAC will also continue to conduct research about election administration issues and make that information available to election officials to assist them in making policy decisions at the local level. EAC will assure that all HAVA funds are used properly to effectuate the required election reforms.

The EAC appreciates the opportunity to provide this testimony regarding our needs for fiscal year 2007. If you have any questions regarding these activities and allocations of funding, we will be happy to address them.

PREPARED STATEMENT OF WILLIAM A. CHATFIELD, DIRECTOR, SELECTIVE SERVICE SYSTEM

Chairman Bond and members of this subcommittee, it is an honor for me as Selective Service Director to present once again the President's fiscal year 2007 Appropriations request of \$24,255,000 for the agency. This Congress and successive administrations under both parties have acknowledged the wisdom of maintaining Selective Service as a hedge against unforeseen threats and a relatively low-cost insurance policy against underestimating any threat our Armed Forces might face in a still-dangerous world.

This agency is as determined as ever to carry out the mission Congress has given us, no matter how austere the budget climate shaped by the requirements of homeland security and other priorities listed in the President's January 31, 2006, State of the Union Address. To achieve this balancing act of advancing the mission while accepting budgetary realities will require creativity and discipline. I welcome the challenge, and appreciate the opportunity to share my vision for Selective Service with you today.

Personnel reductions at Selective Service have come from planned attrition and will not involve a reduction-in-force. Meanwhile, the agency will continue to employ more state-of-the-art information technologies and public outreach to accomplish its statutory mission of raising nationwide registration compliance by eligible young men while preserving maximum customer service. Satisfying our goals will assure a Selective Service that is beyond reproach while meeting the needs of its primary customer, the Department of Defense.

## WHAT WE DO TODAY

Selective Service is in business to perform two unique functions. Should the Congress and the President authorize a return to a military draft, the agency can conduct a draft that is efficient, fair, and accepted by the public. It is also ready to administer a program of alternative community service for men who are classified as conscientiously opposed to military service.

Additionally, each and every day Selective Service continues its close partnership with the Department of Defense by providing direct support to Armed Forces recruiting and accessions processing. Specifically, Selective Service provides names of registrants to the Secretary of Defense for recruiting purposes, in accordance with a provision in the Military Selective Service Act. Approximately every 1 to 2 weeks, information about Armed Forces opportunities for Regulars, National Guard, and Reserves and a business reply card are enclosed with our registration acknowledgment that the Selective Service sends to each new registrant. For calendar year 2005, these contacts totaled over 2.2 million young men. Consequently, the Defense Department benefits by "piggy-backing" on our routine mailings which generate actual recruiting leads. And it reimburses us for the additional costs in accordance with the Economy Act.

Beyond its compliance with the Military Selective Service Act and providing these tangible services, the agency also promotes an intangible national benefit. For present and future generations of America's young men, Selective Service is a very critical link between society-at-large and today's volunteer military. It is a reminder that, as Americans, every young man is personally responsible to "provide for the common defence" in the time-honored tradition of preceding generations.

## AREAS OF EMPHASIS

To foster a greater public reception of the agency's new approach to its traditional missions, I have approved an augmenting approach to harness the power, passion, and patriotism of air shows to our core mission of raising registration compliance by young men.

My vision for Selective Service is to present the agency in huge, open community venues across the Nation, highlighting authentic American heroes, and promoting public service and patriotic themes appealing to multiple generations. Air shows are the second most attended spectator events in America, and attract a high concentration of registration-age men. I am convinced that funding and implementing this approach will result in a substantial increase in registration compliance, the surest path to assuring Americans that any future draft will be fair and equitable. We are conducting this pilot effort by absorbing the less than \$300,000 expense out of our fiscal year 2006 budget. No new money is involved.

The value of this effort presented itself after several months of assessing the agency's capabilities, priorities, and missions. These events will complement other agency activities directed at conforming to the President's Management Agenda.

I would point to three endeavors that I believe satisfy administration and Congressional charges to Federal agencies to evolve into performance-based organizations.

*Organizational Adjustments.*—The agency continues the process of internal review and analysis it undertook in fiscal year 2004. As part of this comprehensive "bottom-up review," Selective Service is restructuring. This will empower the agency to satisfy its missions more efficiently and to bring Selective Service to full mobilization more effectively in the event of a return to conscription. Additionally, full-time civilian staffing has been reduced, and all full-time military officers eliminated. Also, the number of part-time military officers has decreased. I am convinced benefits accrued from strategic management of human capital, competitive sourcing, improved financial performance, expanded e-Government, and better integration between budget and performance will substantially increase agency efficiency in its core and support processes. Be assured that each of my changes and staffing decisions is being driven by practical, cost-conscious considerations grounded in greater customer service.

*Registration Compliance.*—Here the air shows will play an important role in 2006 and possibly beyond. Although Selective Service has reversed the decline in registration compliance from a high of 98 percent in 1991 to a low of 87.7 percent in 2000, anything less than 100 percent compliance constitutes a challenge. Only when all eligible young men are equally vulnerable will any future draft be considered completely fair and equitable. The public would believe, rightly so, that not everyone who should be in the manpower pool is accounted for; and therefore those who are registered have an increased chance of being called for involuntary service.

Our final accounting for calendar year 2005 indicates about 93 percent of eligible men (ages 18 to 25) are registered. Keeping this rate high is very important because I believe a compliance rate of less than a healthy 90-plus percent would contribute to a lack of public confidence in our ability to administer a fair and equitable draft. The compliance rate of for “on-time” registration of men turning 18 continues at 76 percent.

Naturally, our priority is to maintain an increasing registration compliance rate. We appreciate the subcommittee’s support in ensuring that our work over the past decade continues, and our successes satisfy our congressional mandate to raise and maintain favorable registration compliance. Since public trust in Selective Service is at stake, I will use every resource to continue proven positive trends in compliance. In addition to our outreach air shows effort, Selective Service intends in pursuit of that goal to:

- (a) Continue to develop and distribute public service broadcast messages to low compliance markets, together with printed materials. To support this effort, we have distributed new radio public service announcements in English and Spanish. These high-quality products have been praised by listeners around the country. In calendar year 2005 and so far this year, the agency has secured commercial airings representing 82,036 worth of free airings, a commercial airtime value of more than \$5.1 million. These airings are in markets with no or optional driver’s license supporting legislation and cost Selective Service only the expense of development, replication and distribution. Public service broadcast messaging by Selective Service is a very efficient method of raising public awareness of the legal registration obligation, especially among those who most need access to governmental benefits linked to registration such as minorities. Support of the President’s budget request guarantees that this effective and efficient outreach effort continues and America’s youth are reminded of their civil responsibility.
- (b) Carry on routine updating of the interactive Selective Service pages on the World Wide Web ([www.sss.gov](http://www.sss.gov)) where online registration, database verification, the ability to file changes of information, and to review a wealth of other agency information are available to anyone with access to the Internet. For fiscal year 2005, 81.2 percent of registrations reached Selective Service through electronic means, an increase of more than 2 percent over 2004. Electronic registrations are more cost-effective than processing paper registrations and provide better customer service. We are also placing links to our site with other Federal, State and local agencies, schools, and assorted organizations to enhance public education and facilitate customer responsiveness.
- (c) Profit from an increasing number of States which link obtaining a driver’s license or State I.D. card to the Selective Service registration requirement. These State and territorial laws currently provide Selective Service with an average of nearly 71,000 registrations per month. As of this month, 34 States, three territories, and the District of Columbia have laws enacted. These jurisdictions represent 63 percent of the national 18-year-old male registrant population. We continue to work closely with additional States where such legislation is pending to provide technical expertise. Data electronic exchanges are the most cost-effective, timely, user-friendly, and technology-simple registrations available. Selective Service is committed to aid the remaining 16 States in implementing this easy method to protect their young men’s eligibility for State and Federal benefits and programs. This program has been a valuable tool to reach not only all eligible registrants, but also has enabled a more customer-friendly system.

*Information Technology (IT).*—The agency has applied new initiatives to the traditional way it does business. Support of the President’s request will allow Selective Service to continue to modernize its core and support processes. We are pleased with the returns generated by these IT investments. The agency has turned to information technology because it is a force multiplier to offset reduced staffing and constrained dollars. It permits this small agency to examine how it does business, how it might improve its IT architecture, both hardware and software, and to have the support structure necessary to advance its operations. I am committed to investing in IT because I know that it enhances customer service, increases productivity, compensates for limited human and fiscal resources, and establishes the technological framework to administer well a fair and equitable draft. The agency has no choice but to keep pace with IT applications in the Federal Government and society-at-large.

## FOCUSED YET FLEXIBLE

While there has been much dialogue among the public, private groups, the media, and academia concerning a future draft, volunteerism, homeland security, and national service, the Selective Service System remains focused on its missions. It manages its volunteer board members, is prepared to administer programs of alternative community-based service for men classified as conscientious objectors, and updates its conscription plans and registration procedures. All these efforts are aimed at being ready to conduct a fair and equitable classification procedure to determine who should serve when not all can serve during an emergency. To ensure fairness and equity, each Selective Service board is a gathering of civic-minded men and women reflecting the racial, cultural and ethnic diversity of the young men in the communities it serves. Through these volunteers, a unique bond has been formed at the grass roots with young American men, society-at-large, and the U.S. Armed Forces. Through the Selective Service structure, every American community plays a positive role in providing for the common defense. In short, this agency has extensive practical experience in identifying, contacting and classifying people to participate in a national security or a community service program. Selective Service can lend its expertise and ample experience to any appropriate task directed.

## CLOSING

Mr. Chairman, Selective Service stands prepared to perform its time-tested responsibilities, when directed. The fiscal year 2007 appropriation request of \$24,255,000 will be invested prudently in one of the Nation's important security assets in an increasingly dangerous and ambiguous world. The president's request is adequate to provide a compact, cost-efficient civilian structure capable of expansion in a crisis; to provide manpower to the U.S. Armed Forces as required; and to do it fairly, equitably, and within the necessary timeframes. Additionally, this funding will allow outreach to minority and out-of-the-mainstream youth, better privacy protections in our contacts with the public, and improvements in our registration compliance rates. All these outcomes will advance the guidance of the Congress, satisfy our statutory mandate, and maintain the high registration compliance rates so painstakingly raised over the last decade. Selective Service is staying the course, ever watchful for opportunities to improve. It remains an active partner in the national preparedness community.

Thank you, Mr. Chairman. I would be pleased to answer your questions.

## NONDEPARTMENTAL WITNESSES

[CLERK'S NOTE.—The following testimonies were received by the Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies for inclusion in the record. The submitted materials relate to the fiscal year 2007 budget request.

The subcommittee requested that public witnesses provide written testimony because, given the Senate schedule and the number of subcommittee hearings with Department witnesses, there was not enough time to schedule hearings for nondepartmental witnesses.]

### PREPARED STATEMENT OF INDEPENDENT SECTOR

Independent Sector appreciates the opportunity to comment on fiscal year 2007 Federal appropriations for Internal Revenue Service activities.

Independent Sector is a nonprofit, nonpartisan membership organization committed to strengthening, empowering, and partnering with nonprofit and philanthropic organizations in their work on behalf of the public good. Our coalition of more than 500 nonprofit organizations, foundations, and corporate philanthropy programs collectively represents tens of thousands of charitable groups as well as millions of donors and volunteers serving a wide range of causes in regions across the country. We have worked since our inception to assist our member organizations to meet the highest standards of ethical practice, accountability, and effectiveness.

We write today in support of increased funding of the Internal Revenue Service's enforcement budget and urge you to appropriate, at a minimum, the level requested by the President.

Increased resources for IRS tax law enforcement would:

- Continue Congress' recent efforts to restore the IRS enforcement program;
- Help protect the integrity and credibility of the charitable sector by providing resources to audit organizations' annual returns and deter and penalize wrongdoers; and
- Foster greater compliance by funding additional education of charitable organizations about existing tax law.

### CONTINUE RESTORATION OF THE IRS ENFORCEMENT PROGRAM

During the late 1990's resources for IRS tax law enforcement activities declined dramatically. According to testimony by IRS Commissioner Mark Everson before this committee in April 2004, between 1997 and 2001 the total number of revenue agents, revenue officers, and criminal investigators each declined by over 25 percent.<sup>1</sup> During the same period the number of IRS examinations of tax-exempt annual returns dropped by 22 percent, while the number of returns filed increased by 19 percent.<sup>2</sup> Explaining the consequences of these circumstances in a March 2005 letter to Senate Finance Committee Chairman Charles Grassley, Commissioner Everson wrote that, "This decline, combined with the significant growth of the tax-exempt sector . . . created opportunities for noncompliance."<sup>3</sup>

We applaud the recent increased investments Congress has made toward restoring IRS enforcement activities. In addition to conducting audits of individuals, cor-

<sup>1</sup> Commissioner of Internal Revenue Mark W. Everson, Written Statement, Senate Committee on Appropriations, Subcommittee on Transportation, Treasury and General Government, Hearing on Internal Revenue Fiscal Year 2005 Budget Request, at 2 (April 7, 2004).

<sup>2</sup> Government Accountability Office, "Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities" (GAO-02-526) at 21-22 (April 2002).

<sup>3</sup> Commissioner of Internal Revenue Mark W. Everson letter to Chairman Charles E. Grassley, Senate Committee on Finance, p. 3, available at <http://www.senate.gov/~finance/hearings/other/Letter%20from%20Everson.pdf> (March 30, 2005).

porations, and tax-exempt organizations and collecting due revenue, this funding has permitted the IRS to undertake critical investigations into areas of concern in the tax-exempt sector, including abuses by credit counseling agencies and nonprofit compensation practices, and provide valuable guidance educating tax-exempt organizations about their obligations under current law.

We believe, however, that still more needs to be done. The Government Accountability Office noted in a statement for the record before this committee in April 2006 that “. . . tax law enforcement continues to be included on our list of high-risk Federal programs. This is due, in part, to the persistence of a large tax gap.”<sup>4</sup> Commissioner Everson noted in his March 2005 letter to Chairman Grassley that the IRS continues to “struggl[e] with yearly increases in the number of applications for tax exemption.”<sup>5</sup>

The administration has emphasized the need for continued oversight resources, requesting in the President’s fiscal year 2007 Federal budget an increase of \$137 million over fiscal year 2006 to sustain fiscal year 2006 enforcement initiatives. The IRS Oversight Board has recommended an even greater funding increase—\$368 million over fiscal year 2006—as part of a broader effort to address the tax gap. The recently approved Senate fiscal year 2007 Budget Resolution proposes an increase of \$500 million.

ADDITIONAL IRS ENFORCEMENT FUNDING WILL HELP PRESERVE THE PUBLIC’S TRUST IN THE CHARITABLE SECTOR AND FOSTER GREATER COMPLIANCE BY CHARITABLE ORGANIZATIONS

Our country’s expansive network of charitable organizations provides vital services in such fields as health, education, social assistance, community development, and the arts. Charities depend upon the generosity of Americans—their gifts of time and money—to achieve these missions. These gifts are fueled by the confidence that they are used for the purposes for which they were intended. Indeed, this public trust is essential to maintaining a viable and vibrant nonprofit sector, and preservation of that trust depends upon a combination of vigorous self-regulation by the sector and effective enforcement of the law.

In recent years, media stories have revealed increased instances of abuse by taxpayers using charitable organizations for personal gain and individuals claiming excessive contributions. Although few in number, these occurrences threaten to cripple the charitable sector by eroding the public’s confidence. IRS Commissioner Mark Everson encapsulated this threat in testimony before this committee 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.”<sup>6</sup>

At the encouragement of the chairman and ranking member of the Senate Finance Committee, owing in large measure to these reports, leading members of the charitable community convened the Panel on the Nonprofit Sector in October 2004 to consider and recommend actions to improve the transparency and accountability of charitable organizations. Over the next 9 months, over 5,000 individuals participated in the Panel’s efforts, making comments on the best methods for providing legitimate oversight of the sector while protecting the independence crucial to its ability to remain innovative and effective.

The Panel submitted its “Final Report to Congress and the Nonprofit Sector”<sup>7</sup> in June 2005 recommending more than 120 actions to be taken by charitable organizations, Congress, and the IRS. A key recommendation 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 charitable sector requires vigorous enforcement of the law. Education of charitable organizations about changes in Federal and State laws and reporting requirements is also critical to increasing compliance. During the past 20 years, however, funding for IRS oversight of exempt

<sup>4</sup> Government Accountability Office, “Internal Revenue Service: Assessment of the Interim Results of the 2006 Filing Season and Fiscal Year 2007 Budget Request” (GAO-06-499T), at 1 (April 27, 2006).

<sup>5</sup> Commissioner of Internal Revenue Mark W. Everson letter to Chairman Charles E. Grassley, *supra* at p. 3.

<sup>6</sup> Commissioner of Internal Revenue Mark W. Everson, Written Statement, Senate Committee on Appropriations, Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies, Hearing on Internal Revenue Fiscal Year 2006 Budget Request, at 8 (April 7, 2005).

<sup>7</sup> 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](http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf) (June 2005).

organizations has remained essentially constant while the sector has nearly doubled in size and become even more complex. While recognizing the fiscal challenges facing Congress, the Panel emphasized “that, without adequate resources for oversight and enforcement, those who willfully violate the law will continue to do so with impunity.”<sup>8</sup>

In addition to continuing recent efforts to restore the overall IRS enforcement program, increased resources for IRS oversight would help protect the integrity and credibility of our Nation’s charitable sector by providing resources to audit organizations’ annual returns and deter and penalize wrongdoers. Moreover, it would foster greater compliance over the long term by making possible increased education of charitable organizations about existing tax law.

#### CONCLUSION

Following a significant decline in resources, the Internal Revenue Service has made great strides toward restoring its tax law enforcement program. This achievement is due in large measure to recent actions by Congress to appropriate increased funding to IRS oversight. We applaud and appreciate this effort.

However, we echo recommendations by 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. We urge you to support the enforcement capacity of the IRS by increasing the agency’s fiscal year 2007 enforcement budget.

We thank you for consideration of these comments.

#### PREPARED STATEMENT OF EASTER SEALS

##### EASTER SEALS PROJECT ACTION (ACCESSIBLE COMMUNITY TRANSPORTATION IN OUR NATION)

Chairman Bond, Ranking Member Murray and members of the subcommittee, Easter Seals appreciates this opportunity to share the successes and needs of Easter Seals Project ACTION.

#### PROJECT ACTION OVERVIEW

The Transportation appropriations process initiated Project ACTION in 1988 by providing funding to the Federal Transit Administration to undertake this effort with Easter Seals. We are indeed grateful for that initiative and the ongoing strong support of this subcommittee in subsequent years.

Following its initial round of appropriations, Congress authorized assistance to Project ACTION in 1990 with the passage of ISTEA, continued the authorization in 1997 in TEA-21 and reauthorized the project in 2005 as part of SAFETEA-LU. The strong interest and support of all members of Congress has been greatly appreciated by Easter Seals as it has pursued project ACTION’s goals and objectives.

Since the project’s inception, Easter Seals has administered the project through a cooperative agreement with the Federal Transit Administration. Through steadfast appropriations support, Easter Seals Project ACTION has become the Nation’s leading resource on accessible public transportation for people with disabilities. The current project authorization level is \$3 million, and Easter Seals is pleased to request the appropriation of that sum for fiscal 2007.

The strength of Easter Seals Project ACTION is its continued effectiveness in meeting the congressional mandate to work with both the transit and disability communities to create solutions that improve access to transportation for people with disabilities of all ages and to assist transit providers in complying with transportation provisions in the Americans with Disabilities Act (ADA).

The activities of the project are guided by input from a national steering committee that includes representatives from transportation and disability organizations. Easter Seals Project ACTION has worked effectively with the Department of Transportation under four Presidents, and numerous Department of Transportation (DOT) Secretaries and Federal Transit Administration (FTA) Administrators. Today, Project ACTION is working closely with Secretary Mineta and the FTA. Secretary Mineta, who worked on the original authorization of Project ACTION, has worked closely with us since taking over DOT.

Easter Seals Project ACTION was also heavily featured in the President’s New Freedom Initiative Progress Report released in 2004. This demonstrates how closely

<sup>8</sup>*Id.* at 25.

the administration is working with Project ACTION to reach our shared goal of a safe, accessible, reliable, efficient and affordable transportation for and by citizens with disabilities at the local, State, regional and national levels throughout the United States.

#### SUPPORT FOR EASTER SEALS PROJECT ACTION

Easter Seals Project ACTION's successes are diverse and the value of the Project to both the transit and disability communities can be well documented. For instance, Barry Barker, Executive Director of the Transit Authority of River City (Louisville, KY) states that, "Easter Seals Project ACTION's support has enhanced our ability to maximize the quality of service we provide to all of our customers. The project helps us provide our customers with the mobility necessary to fully participate in the community."

Maureen McCloskey, National Advocacy Director of the Paralyzed Veterans of America states that, "The forum that Easter Seals Project ACTION has provided has created a dynamic dialogue between the disability and transit communities that has resulted in increased access to transportation for people with disabilities."

#### EASTER SEALS PROJECT ACTION WORKING AT THE COMMUNITY LEVEL

Among the programs pursued by the project in the recent period have been efforts aimed at increasing community capacity to meet the transportation needs of people with disabilities. For instance, in 2001, Easter Seals Project ACTION initiated the first Mobility Planning Services (MPS) Institute. The latest Institute will take place in April of this year and approximately 25 communities will take place in the 2-day event. The teams are representing localities across the country including Thomas Jefferson District, VA; Harford County, MD; Montgomery County, PA; Aiken County, SC; Santee Wateree Region, SC; Jacksonville, FL; Louisville, KY; Ann Arbor, MI; Genesee County, MI; Lake County, OH; Polk County, MN; Washburn County, WI; Capital Area Region, TX; Valencia County, NM; Spearfish, SD; Orange County, CA; Fairbanks County, AK; and Multnomah-Clackamas-Washington Counties, OR. This was the fourth group of communities to go through the MPS training. The first three groups of communities remain active and working with Project ACTION to continue their work at the community level. To participate in the Institute, each community had to identify a leadership team to attend the training. The leadership team had to consist of representatives from transit providers, disability service providers and disability advocacy organizations. This team approach will assure that all stakeholders are involved in implementing MPS. The greatest success so far of the MPS concept has been that it provides the disability community and the transportation industry an opportunity to develop tools for working together where in the past there had often been a lack of communication and in some cases even animosity. By implementing MPS, communities do a better job of meeting the transportation needs of people with disabilities and therefore better meet the transportation needs of all residents. Communities that participate in MPS receive ongoing in-depth technical assistance from Project ACTION staff ranging from access to Project ACTION materials to on-site training and facilitation by Project ACTION staff.

#### EASTER SEALS PROJECT ACTION WORKING AT THE STATE LEVEL

Project ACTION has partnered with the FTA on several initiatives designed to increase the capacity of States to support accessible transportation for people with disabilities.

A good example of this collaboration is the work that Project ACTION is doing with the FTA to support the success of the multi-Federal Department "United We Ride" initiative. Project ACTION helped facilitate a national meeting in March of 2003 of Governor-appointed representatives from State Departments of Labor, Transportation, Education and Health and Human Services. Forty-six States and territories participated in this forum that was one of five elements of an FTA effort to bring together Federal and State agencies to help identify, plan and alleviate barriers to human service transportation coordination. Project ACTION is assisting in the dissemination of the FTA developed Framework for Action planning process guide to help States and communities build and operate coordinated transportation systems and is providing technical assistance on its use throughout the country.

#### EASTER SEALS PROJECT ACTION WORKING AT THE NATIONAL LEVEL

Some of the materials that Easter Seals Project ACTION has developed over the years include:

- A toolkit for assessing bus stop accessibility;
- A guide for employment professionals working with people with disabilities on how to solve transportation issues that serve as a barrier to employment;
- A public transportation curriculum for children with disabilities in grade 8–12; and,
- A guide to transportation resources in rural communities for people with disabilities.

All resource materials available from Easter Seals Project ACTION activities are available free of charge through the Project ACTION clearinghouse on the Project ACTION website: [www.projectaction.org](http://www.projectaction.org).

As mentioned, Project ACTION staff also are involved in continuously providing technical assistance to transit providers, nonprofit human service organizations, people with disabilities, and the general public. The forms of technical assistance provided are provided based on the determination of what would be the most helpful in the situation being addressed. Assistance from Project ACTION ranges from the delivery of basic information in the form of brochures from our national clearinghouse to telephone, e-mail, participation in the training program and on single or ongoing on-site work.

#### CONTINUING NEED FOR EASTER SEALS PROJECT ACTION

Access to transportation is a vital issue for people with disabilities. For many people with disabilities, a lack of accessible, affordable public transportation is the primary barrier to employment, education and participation in community life. In his New Freedom Initiative, President Bush recognized the importance of accessible transportation for people with disabilities, and has proposed an increase in Federal support for promoting innovative and alternative transportation solutions for people with disabilities. As these proposals are implemented, it will become increasingly important that the resources and skills, relationships and knowledge that Easter Seals Project ACTION has fostered remain strong. Should the appropriations process support this New Freedom Initiative, Project ACTION is committed to working with DOT on implementation.

There is a growing need for outreach by Project ACTION to specific populations. While Project ACTION has historically worked with rural communities to help address their transportation issues, the lack of access for rural residents with disabilities is still unacceptable. Easter Seals national headquarters and Project ACTION are working together to coordinate efforts to better serve rural residents with disabilities in a variety of service areas including transportation. Further, as the population ages, there is also a need to develop and provide additional specific resources and assistance to transit providers and older passengers. Since most people will experience some level of disability as they age and require accessible transportation, Project ACTION's resources will again be invaluable as transit providers struggle to meet the needs of this new wave of riders.

#### FISCAL YEAR 2007 REQUEST

In order to continue the outstanding work of Easter Seals Project ACTION, Easter Seals national headquarters respectfully requests that \$3 million be allocated in fiscal 2007 to the Department of Transportation for project activities.

Mr. Chairman, thank you for the opportunity to present this testimony to the subcommittee. Your efforts have improved the accessibility of transportation for persons with disabilities and the ability of the transportation community to provide good service to all Americans. Easter Seals Project ACTION looks forward to continuing to work with you toward the pursuit of these objectives.

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#### PREPARED STATEMENT OF THE SKOKOMISH TRIBE

My name is Gordon James. I am Chairman of the Skokomish Tribe of Washington State. The Skokomish Indian Reservation is a rural community located at the base of the Olympic Peninsula with a population of over 1,000 people. The Skokomish Tribe appreciates the work of the subcommittee and asks that you provide \$2.1 million from the Department of Transportation, Federal Lands Highway Fund for the Skokomish Tribe Highway 101 Improvements and Parkway Access Infrastructure Project. The Tribe requests this funding for construction and improvements on Highway 101 and the access road leading to the site of the Tribe's planned community housing development.

## BACKGROUND AND NEED

The need for housing in the Skokomish community is great. We currently have 91 families with no available housing. Of the existing housing stock, nearly half is within the 100-year floodplain. Flooding has already caused damage to 40 percent of the Reservation's septic systems, resulting in serious community health concerns and environmental damage, such as dissolved oxygen in the Hood Canal. Because it is in the floodplain, Federal funds are not available to rehabilitate this housing.

To meet this need, the Tribe has been working for the past 9 years to plan and develop a safe, practical and culturally relevant housing development for tribal members. The Tribe recently purchased 160 acres and will soon begin construction on the Skokomish Community Housing Development. The development will eventually contain 138 homes and will be constructed in three phases. Phase 1, which will entail construction of 30 homes and the necessary infrastructure to support them, will be constructed over the next 2 years. (Please see Attachment 3: Estimate for Skokomish Master Plan for a detailed budget for the housing development.)

The funding requested for fiscal year 2007 will support the road improvements necessary to complete Phase 1. Highway 101 passes near the development site, but the access road leading to the site is a small logging road used for access to an adjacent State park. In order to use it as a residential area, the access road must be drastically improved. In addition, because the access road leaves the highway at a corner, substantial infrastructure improvement will be needed to improve the line of sight and make the road safe for frequent use. This includes, for example, constructing a retaining wall, widening the highway and adding a left turn lane. In addition to its use as an access road for the Tribe's housing development, this road will also offer improved access to the State park.

## STATUS OF PROJECT

Over the past year and a half, the Tribe has acquired land and developed a master plan for construction of a tribal housing development. On April 1, 2006, construction will begin on the infrastructure for Phase 1 of the development (the first 30 homes), including the water and wastewater facilities. The Washington Department of Transportation has issued a permit so that construction can begin even without an asphalt road. However, improvement to U.S. Highway 101 and the access road will be critical to both the construction process and the eventual use of the development. We anticipate that Phase 1 will be completed within 2 years. Once Phase 1 is completed, tribal members can begin moving into the first 30 homes. Phases 2 and 3 will involve subsequent expansion of the development. Funding from the fiscal year 2007 HUD budget will enable the Tribe to complete the road improvements necessary for Phase 1. Funds for the housing have been secured from other sources.

The total project cost is \$2.1 million for road improvements (highway improvement and parkway access). These improvements will be undertaken during Phase 1 of the project, which we estimate will be completed in approximately 2 years. Of this, at least \$1.1 million will be expended during fiscal year 2007. This amount includes the items listed in Part A of Attachment 2: Parkway, Highway 101 to West Side of Phase 1 & 2 (parkway access). It also includes the cost of Construction Surveying and Engineering & Administration listed in Part B: Highway 101 Improvements (costs necessary to begin surveying for Highway 101 improvements). For additional information please see Attachment 2: Estimate for Highway 101 Improvements and Parkway Access.

## STATE, LOCAL AND FEDERAL SUPPORT

The Tribe has broad Federal and State support for its housing development project. For Phase 1, the Tribe has secured a Community Development Block Grant from HUD for water and wastewater and is pursuing a grant/loan from the USDA for additional infrastructure costs. Infrastructure funding will also come from HUD's Indian Community Development Block Grant program and from the Indian Health Service. Washington's Community Trade and Economic Development Council will contribute money from its revolving fund for housing.

In addition to these financial commitments, the project is supported by the Washington Department of Transportation, the Public Utility Department and various financing institutions, and all these Federal and State entities participate in regular planning meetings with the Tribe.

For the reasons described above, the Skokomish Tribe supports full funding of the Federal Lands Highway Fund and requests a special appropriation of \$2.1 million to support this project. We appreciate the opportunity to present testimony on these

important infrastructure needs. If we can provide any additional information, please contact the Tribe or our Counsel.

*Attachments.*—(1) Letter from Chairman James; (2) Estimate for Highway 101 Improvements and Parkway Access; (3) Estimate for Skokomish Master Plan; and (4) Phase 1 Design diagram. This diagram shows a proposed dual access road that would serve both the housing development and the adjacent State park. We are working closely with the State to ensure that both sites are served by the improved access road.



## Skokomish Indian Tribe

Tribal Center (360) 426-4232

N. 80 Tribal Center Road

FAX (360) 877-5943

Skokomish Nation, WA 98584

February 24, 2006

Dear Ms. Pavel,

I am writing on behalf of the Skokomish Indian Tribe to request a *special appropriation for two critical roads* that will have a direct and immediate impact on the Tribe's new housing development project. The Skokomish Tribe is asking for a **\$2.3 million dollar** earmark that will be used for the realignment of U.S highway 101 and the access road up to the housing development. The monies for U.S. 101 will be used to create a left hand turn lane, drastically improve the line of sight and create a safe entrance onto the access road leading to the development. The access road to the site is an old logging road with a relatively steep grade that will need substantial earthwork and improvements to meet the necessary fire department codes and regulations.

For nine years the Tribe has been trying to locate suitable land in order to develop new housing, community facilities, and green spaces for our Tribal members. Over the past year and a half, the Skokomish Tribe has worked tirelessly at acquiring land, developing a master plan, and collaborating with federal, state, and local organizations to realize a safe, practical and culturally relevant housing development. Due to the tremendous need for our Skokomish housing project we have gained valuable support from a wide variety of housing professionals and more importantly created a momentum and enthusiasm among Tribal members.

The need for a new housing development for the Skokomish Indian Tribe cannot be overstated. Currently forty percent (40%) of the Tribe's core housing falls within the 100 year flood plain. Due to the excessive flooding and high water tables, individual septic systems have been drastically compromised causing severe community health issues, structural damage to existing housing and environmental degradation to the Skokomish River and the Hood Canal.

There are presently 91 families on the Skokomish housing wait list with no available housing and virtually no land for further development. Compounding the problem is the fact that 40% of the Tribe's core housing is within the 100-year flood plain which eliminates the use of any federal funds and/or grant opportunities for home rehabilitation. This creates a situation where families already in homes take on their extended relatives, currently on the housing wait list, exacerbating overcrowded conditions and creating extreme ware on the current housing stock.

As stated earlier, the Tribe has made significant progress toward realizing the first phase (30 homes) of a three phase housing development. One hundred and sixty acres of land have already been

purchased, the Skokomish Tribal Council has approved the overall master plan for 138 homes, a water tank and well house are due to begin construction in conjunction with the wastewater system the beginning of April, 2006. In addition, the Skokomish Tribe is holding "technical team" meetings every other month to update the *critical path* making sure that tasks, and the people responsible for the tasks, are understood and acted on. Included in our technical team meetings are USDA, HUD, Washington State Dept. of Transportation, Public Utility Dept., financing institutions, Indian Health Services, Tribal Council members and of course Skokomish community members.

A critical path has been established for Roads & Infrastructure, Housing, and Finance, each with an assigned sub-committee to meet on a monthly basis. Sub-committees are responsible for follow through and reporting at the overall planning meetings. The collaboration on the Skokomish housing development has been fully supported and encouraged by all the federal, state, and local agencies and quite frankly has been a complete success.

As we progress, it is clear that the Tribe will need substantial assistance in order to develop safe and reliable roads leading to and from the new housing development. I am encouraged by the progress that the Tribe has made and the potential impact the Skokomish housing project could have for an entire people.

We hope that you can see the critical need of what we are trying to accomplish and would be extremely grateful if you would consider our request to earmark \$2.3 million dollars needed to complete the roads. A safe, new, and much needed housing development will bring hope and security to the future of the Skokomish people.

Sincerely,

/s/

Gordon James  
Tribal Chairman  
Skokomish Indian Tribe

3/1/2006

Cascade Design Professionals, Inc.

PROJECT: SKOKOMISH Neighborhood & Housing Development  
Hwy 101 Improvements & Parkway Access**PART A PARKWAY, HWY 101 TO WEST SIDE OF PHASE 1 & 2**

NO.	ITEM	UNIT	UNIT PRICE	AMOUNT	TOTAL PRICE
A1.	Mobilization	L.S.	\$10,000.00	All Req'd	\$10,000.00
A2.	Traffic Control	L.S.	\$2,500.00	All Req'd	\$2,500.00
A3.	Erosion Control	L.S.	\$10,000.00	All Req'd	\$10,000.00
A4.	Clearing and Grubbing	Acre	\$6,000.00	6.2	\$37,200.00
A5.	Topsoil, Remove & Stockpile	C.Y.	\$12.00	5037	\$60,444.00
A6.	Unclassified Excavation	C.Y.	\$15.00	7763	\$116,445.00
A7.	Crushed Aggregate Base Course	Ton	\$25.00	7193	\$179,825.00
A8.	Asphaltic Concrete	Ton	\$80.00	2620	\$209,600.00
A9.	Stormwater Detention Ponds	S.F.	\$10.00	8160	\$81,600.00
A10.	12" ADS N-12 Storm Drainage Pipe	L.F.	\$40.00	666	\$26,640.00
A11.	Street Trees	Each	\$150.00	62	\$9,300.00
A12.	Joint Utility Trench and Conduits	L.F.	\$15.00	3400	\$51,000.00
A13.	Electrical Transformer (by Mason County PUD)	L.S.	\$15,000.00	1	\$15,000.00
A14.	Electrical Utility Vault	Each	\$5,000.00	4	\$20,000.00
A15.	Street Lights	Each	\$1,500.00	22	\$33,000.00
A16.	Permanent Signing	L.S.	\$5,000.00	1	\$5,000.00
<b>Subtotal-Part A:</b>					<b>\$867,554.00</b>

<b>PART B HWY 101 IMPROVEMENTS</b>						
NO.	ITEM	UNIT	UNIT PRICE	AMOUNT	TOTAL PRICE	
B1.	Mobilization	L.S.	\$15,000.00	All Req'd	\$15,000.00	
B2.	Traffic Control	L.S.	\$35,000.00	All Req'd	\$35,000.00	
B3.	Erosion Control	L.S.	\$5,000.00	All Req'd	\$5,000.00	
B4.	SPCC Plan	L.S.	\$2,000.00	1	\$2,000.00	
B5.	Clearing and Grubbing	Acre	\$6,000.00	6.2	\$37,200.00	
B6.	Remove Existing Asphalt	S.Y.	\$7.50	7560	\$56,700.00	
B7.	Unclassified Excavation	C.Y.	\$15.00	500	\$7,500.00	
B8.	Borrow	C.Y.	\$12.00	1934	\$23,208.00	
B9.	Crushed Aggregate Base Course	Ton	\$25.00	3780	\$94,500.00	
B10.	Asphaltic Concrete	Ton	\$80.00	1622	\$129,760.00	
B11.	Pavement Marking	L.S.	\$5,000.00	All Req'd	\$5,000.00	
B12.	Remove Existing Culvert	L.S.	\$5,000.00	1	\$5,000.00	
B13.	36" ADS N-12 Storm Drainage Pipe	L.F.	\$100.00	64	\$6,400.00	
B14.	Trimming and Cleanup	L.S.	\$2,000.00	1	\$2,000.00	
B15.	Permanent Signing	L.S.	\$3,000.00	1	\$3,000.00	
					<b>Subtotal-Part B:</b>	<b>\$427,268.00</b>
					<b>PART A + PART B:</b>	<b>\$1,284,822.00</b>
GENERAL CONDITIONS AT 10% OF CONSTRUCTION:						\$129,482
TOTAL ESTIMATED COST OF PARKWAY & HWY 101:						\$1,424,304
CONTINGENCY AT 30% OF PROGRAM COST:						\$427,291
CONSTRUCTION SURVEYING:						\$30,000
ENGINEERING & ADMINISTRATION @ 13% OF CONST.						\$185,160
<b>TOTAL ESTIMATED COST:</b>						<b>\$2,066,755</b>

Estimate for Skokomish Master Plan-Phase 1					
Item	Description	Unit	Quantity	Unit Cost	Total Cost**
<b>SITE/CIVIL</b>					
1	Clearing and Grubbing (5% of Grading and Site Impr Cost)	LS	1		\$33,000
2	Parkway (not incl. Section through Potlatch SP)	LF	1522	77	\$117,000
	Intersection Improvements	LS	1	150000	\$150,000
3	Subdivision Streets + lighting	LF	1905	30	\$57,000
4	Paving				
	Parkway	LF	1522	51	\$78,000
	Subdivision Streets + lighting	LF	1905	47	\$90,000
5	Subdivision Grading	CY	3000	15	\$45,000
6	Landscaping				
	Trail	LF	565	10	\$6,000
	Community Area	SF	0	1	\$0
	Elder Housing	SF	0	1	\$0
	Central Open Space	SF	43560	1.5	\$65,000
	Shelter with grills & electrical hookups (30' x 40')	SF	1200	35	\$42,000
	Outdoor basketball court	LS	1	15000	\$15,000
<b>SITE/CIVIL SUBTOTAL</b>					<b>\$698,000</b>
<b>WATER</b>					
1	Well Development - Test well	LS	1	35000	\$35,000
	Second community well	LS	1	35000	\$35,000
	10-hp Pump Assembly (60 gpm)	EA	2	15000	\$30,000
	Control Building w/appurtenances	LS	1	170000	\$170,000
2	Storage Tank	LS	1	250000	\$250,000
3	Distribution				
	Service Lines	EA	30	3000	\$90,000
	8" PVC, C900	LF	4000	35	\$140,000
	Appurtenances (50% of distribution piping cost)	LS	1		\$70,000
<b>WATER SUBTOTAL</b>					<b>\$820,000</b>
<b>SEWER</b>					
1	WWTP	gpd	17300	20	\$346,000
2	Conveyance				
	12"	LF	1040	26	\$27,000
	8" PVC, 3034	LF	1660	20	\$33,000
3	Disposal System	SF	30000	3	\$90,000
<b>SEWER SUBTOTAL</b>					<b>\$496,000</b>
<b>OTHER UTILITIES</b>					
1	Electrical Power	LS	1		\$198,000
2	Telecommunications	LS	1		\$99,000
<b>OTHER UTILITIES SUBTOTAL</b>					<b>\$297,000</b>
<b>INFRASTRUCTURE SUBTOTAL</b>					<b>\$2,311,000</b>
General Conditions at 5% of Construction					\$116,000
<b>TOTAL ESTIMATED COST OF INFRASTRUCTURE CONSTRUCTION</b>					<b>\$2,427,000</b>
Contingency @ 25% of Program Cost					\$607,000
Surveying (Topo and Boundary)					\$50,000
Engineering & Administration at 13% of Construction					\$316,000
<b>TOTAL ESTIMATED INFRASTRUCTURE COST</b>					<b>\$3,400,000</b>
<b>HOUSING</b>					
Single Family Homes (w/o garage & pole storage)					
1	1300 SQ. FT. Single Family (11)	SF	14300	88	\$1,258,000
2	1500 SQ. FT. Single Family (11)	SF	16500	83	\$1,370,000
3	1750 SQ. FT. Single Family (7)	SF	12250	81	\$992,000
<b>HOUSING SUBTOTAL</b>					<b>\$3,620,000</b>
General Conditions at 5% of Construction					\$181,000
<b>TOTAL ESTIMATED COST OF HOUSING</b>					<b>\$3,801,000</b>
Contingency @ 20% of Program Cost					\$760,000
Arch/Engr Design & Administration at 7% of Construction					\$263,000
<b>TOTAL ESTIMATED HOUSING COST</b>					<b>\$4,814,000</b>
<b>TOTAL PROGRAM COST</b>					<b>\$8,214,000</b>

\*\*Total cost rounded to the nearest thousand.

Cascade Design Professionals, Inc.

Estimate for Skokomish Master Plan-Phase 2						
Item	Description	Unit	Quantity	Unit Cost	Total Cost**	
<b>SITE/CIVIL</b>						
1	Clearing and Grubbing (5% of Grading and Site Impr Cost)	LS	1		\$13,000	
2	Parkway (not incl. Section through Potlatch SP)	LF	0	77	\$0	
	Intersection Improvements	LS	0		\$0	
3	Subdivision Streets + Lighting	LF	1700	30	\$51,000	
4	Paving					
	Parkway	LF	0	51	\$0	
	Subdivision Streets + Lighting	LF	1700	47	\$80,000	
5	Subdivision Grading	CY	1800	15	\$27,000	
6	Landscaping					
	Trail	LF	1410	10	\$14,000	
	Community Area	SF	13200	1	\$13,000	
	Elder Housing	SF	34675	1	\$35,000	
	Central Open Space	SF	24053	1.5	\$36,000	
	Shelter with grills & electrical hookups	SF	0	35	\$0	
	Outdoor basketball court	LS	0	15000	\$0	
<b>SITE/CIVIL SUBTOTAL</b>					<b>\$269,000</b>	
<b>WATER</b>						
1	Well Development	LS	0	35000	\$0	
	Second community well	LS	0	35000	\$0	
	10-hp Pump Assembly (60 gpm)	EA	0	15000	\$0	
	Control Building w/appurtenances	LS	0	170000	\$0	
2	Storage Tank	LS	0	250000	\$0	
3	Distribution					
	Service Lines	EA	0	3000	\$0	
	8" PVC, C900	LF	1700	35	\$60,000	
	Appurtenances (50% of distribution piping cost)	LS	1		\$30,000	
<b>WATER SUBTOTAL</b>					<b>\$90,000</b>	
<b>SEWER</b>						
1	WWTP	gpd	0	10	\$0	
2	Conveyance					
	12"	LF	0	26	\$0	
	8" PVC, 3034	LF	1700	20	\$34,000	
3	Disposal System	SF	0	3	\$0	
<b>SEWER SUBTOTAL</b>					<b>\$34,000</b>	
<b>OTHER UTILITIES</b>						
1	Electrical Power	LS	1		\$38,000	
2	Telecommunications	LS	1		\$19,000	
<b>OTHER UTILITIES SUBTOTAL</b>					<b>\$57,000</b>	
<b>INFRASTRUCTURE SUBTOTAL</b>					<b>\$450,000</b>	
General Conditions at 5% of Construction					\$23,000	
<b>TOTAL ESTIMATED COST OF INFRASTRUCTURE CONSTRUCTION</b>					<b>\$473,000</b>	
Contingency @ 15% of Program Cost					\$71,000	
Surveying (Topo and Boundary)					\$50,000	
Engineering & Administration at 13% of Construction					\$61,000	
<b>TOTAL ESTIMATED INFRASTRUCTURE COST</b>					<b>\$655,000</b>	
<b>HOUSING</b>						
Single Family Homes (w/o garage & pole storage)						
1	1300 SQ. FT. Single Family (7)	SF	9100	88	\$801,000	
2	1500 SQ. FT. Single Family (7)	SF	10500	83	\$872,000	
3	1750 SQ. FT. Single Family (5)	SF	8750	81	\$709,000	
<b>HOUSING SUBTOTAL</b>					<b>\$2,382,000</b>	
General Conditions at 5% of Construction					\$119,000	
<b>TOTAL ESTIMATED COST OF HOUSING</b>					<b>\$2,501,000</b>	
Contingency @ 12% of Program Cost					\$300,000	
Arch/Engr Design & Administration at 7% of Construction					\$167,000	
<b>TOTAL ESTIMATED HOUSING COST</b>					<b>\$2,968,000</b>	
<b>TOTAL PROGRAM COST</b>					<b>\$3,623,000</b>	

\*\*Total cost rounded to the nearest thousand.

Estimate for Skokomish Master Plan-Phase 3					
Item	Description	Unit	Quantity	Unit Cost	Total Cost**
<b>SITE/CIVIL</b>					
1	Clearing and Grubbing (5% of Grading and Site Impr Cost)	LS	1		\$61,000
2	Parkway (not incl. Section through Potlatch SP)	LF	1012	77	\$78,000
	Intersection Improvements	LS	0		\$0
3	Subdivision Streets + lighting	LF	4875	30	\$146,000
4	Paving				
	Parkway	LF	1012	51	\$52,000
	Subdivision Streets + lighting	LF	4875	47	\$229,000
5	Subdivision Grading	CY	5500	15	\$83,000
6	Landscaping				
	Trail	LF	865	10	\$9,000
	Community Area	SF	154237	1	\$154,000
	Elder Housing	SF	92064	1	\$92,000
	Central Open Space	SF	193735	1.5	\$291,000
	Shelter w/ grills and electrical hookups (40' x 60')	SF	2400	35	\$84,000
	Outdoor basketball court	LS	0	15000	\$0
<b>SITE/CIVIL SUBTOTAL</b>					<b>\$1,279,000</b>
<b>WATER</b>					
1	Well Development	LS	0	35000	\$0
	Second community well	LS	0	35000	\$0
	10-hp Pump Assembly (60 gpm)	EA	0	15000	\$0
	Control Building w/appurtenances	LS	0	170000	\$0
2	Storage Tank	LS	0	250000	\$0
3	Distribution				
	Service Lines	EA	0	3000	\$0
	8" PVC, C900	LF	4875	35	\$171,000
	Appurtenances (50% of distribution piping cost)	LS	1		\$86,000
<b>WATER SUBTOTAL</b>					<b>\$257,000</b>
<b>SEWER</b>					
1	WWTP	gpd	32000	20	\$640,000
2	Conveyance				
	12"	LF	1012	26	\$26,000
	8" PVC, 3034	LF	4875	20	\$98,000
3	Disposal System	SF	53000	3	\$159,000
<b>SEWER SUBTOTAL</b>					<b>\$923,000</b>
<b>OTHER UTILITIES</b>					
1	Electrical Power	LS	1		\$240,000
2	Telecommunications	LS	1		\$120,000
<b>OTHER UTILITIES SUBTOTAL</b>					<b>\$360,000</b>
<b>INFRASTRUCTURE SUBTOTAL</b>					<b>\$2,819,000</b>
General Conditions at 5% of Construction					\$141,000
<b>TOTAL ESTIMATED COST OF INFRASTRUCTURE CONSTRUCTION</b>					<b>\$2,960,000</b>
Contingency @ 15% of Program Cost					\$444,000
Surveying (Topo and Boundary)					\$100,000
Engineering & Administration at 13% of Construction					\$385,000
<b>TOTAL ESTIMATED INFRASTRUCTURE COST</b>					<b>\$3,889,000</b>
<b>HOUSING</b>					
Single Family Homes (w/o garage & pole storage)					
1	1300 SQ. FT. Single Family (34)	SF	44200	88	\$3,890,000
2	1500 SQ. FT. Single Family (34)	SF	51000	83	\$4,233,000
3	1750 SQ. FT. Single Family (23)	SF	40250	81	\$3,260,000
<b>HOUSING SUBTOTAL</b>					<b>\$11,383,000</b>
General Conditions at 5% of Construction					\$569,000
<b>TOTAL ESTIMATED COST OF HOUSING</b>					<b>\$11,952,000</b>
Contingency @ 12% of Program Cost					\$1,434,000
Arch/Engr Design & Administration at 7% of Construction					\$797,000
<b>TOTAL ESTIMATED HOUSING COST</b>					<b>\$14,183,000</b>
<b>TOTAL PROGRAM COST</b>					<b>\$18,072,000</b>

\*\*Total cost rounded to the nearest thousand.

Estimate for Skokomish Master Plan-Extension to HWY 101					
Item	Description	Unit	Quantity	Unit Cost	Total Cost**
<b>SITE/CIVIL</b>					
1	Clearing and Grubbing (5% of Grading and Site Impr Cost)	LS			\$27,000
2	Parkway	LF	1805	77	\$139,000
	Intersection Improvements	LS	1	300000	\$300,000
3	Subdivision Streets + Lighting	LF	0	30	\$0
4	Paving				
	Parkway	LF	1805	51	\$92,000
	Subdivision Streets + Lighting	LF	0	47	\$0
5	Subdivision Grading	CY	0	15	\$0
6	Landscaping				
	Trail	LF	0	10	\$0
	Community Area	SF	0	1	\$0
	Elder Housing	SF	0	1	\$0
	Central Open Space	SF	0	1.5	\$0
	Shelter w/grills & electrical hookups	SF	0	35	\$0
	Outdoor basketball court	LS	0	15000	\$0
<b>SITE/CIVIL SUBTOTAL</b>					<b>\$558,000</b>
<b>WATER</b>					
1	Well Development	LS	0	35000	\$0
	Second community well	LS	0	35000	\$0
	10-hp Pump Assembly (60 gpm)	EA	0	15000	\$0
	Control Building w/appurtenances	LS	0	170000	\$0
2	Storage Tank	LS	0	250000	\$0
3	Distribution				
	Service Lines	EA	0	3000	\$0
	8" PVC, C900	LF	0	35	\$0
	Appurtenances (50% of distribution piping cost)	LS	0		\$0
<b>WATER SUBTOTAL</b>					<b>\$0</b>
<b>SEWER</b>					
1	WWTP	gpd	0	10	\$0
2	Conveyance				
	12"	LF	0	26	\$0
	8" PVC, 3034	LF	0	20	\$0
3	Disposal System	SF	0	3	\$0
<b>SEWER SUBTOTAL</b>					<b>\$0</b>
<b>OTHER UTILITIES</b>					
1	Electrical Power	LS	0		\$0
2	Telecommunications	LS	0		\$0
<b>OTHER UTILITIES SUBTOTAL</b>					<b>\$0</b>
<b>INFRASTRUCTURE SUBTOTAL</b>					<b>\$558,000</b>
General Conditions at 5% of Construction					\$28,000
<b>TOTAL ESTIMATED COST OF INFRASTRUCTURE CONSTRUCTION</b>					<b>\$586,000</b>
Contingency @ 15% of Program Cost					\$88,000
Surveying (Topo and Boundary)					\$50,000
Engineering & Administration at 13% of Construction					\$76,000
<b>TOTAL ESTIMATED INFRASTRUCTURE COST</b>					<b>\$800,000</b>
<b>HOUSING</b>					
Single Family Homes (w/o garage & pole storage)					
1	1300 SQ. FT. Single Family (0)	SF	0	88	\$0
2	1500 SQ. FT. Single Family (0)	SF	0	83	\$0
3	1750 SQ. FT. Single Family (0)	SF	0	81	\$0
<b>HOUSING SUBTOTAL</b>					<b>\$0</b>
General Conditions at 5% of Construction					\$0
<b>TOTAL ESTIMATED COST OF HOUSING</b>					<b>\$0</b>
Contingency @ 12% of Program Cost					\$0
Arch/Engr Design & Administration at 7% of Construction					\$0
<b>TOTAL ESTIMATED HOUSING COST</b>					<b>\$0</b>
<b>TOTAL PROGRAM COST</b>					<b>\$800,000</b>

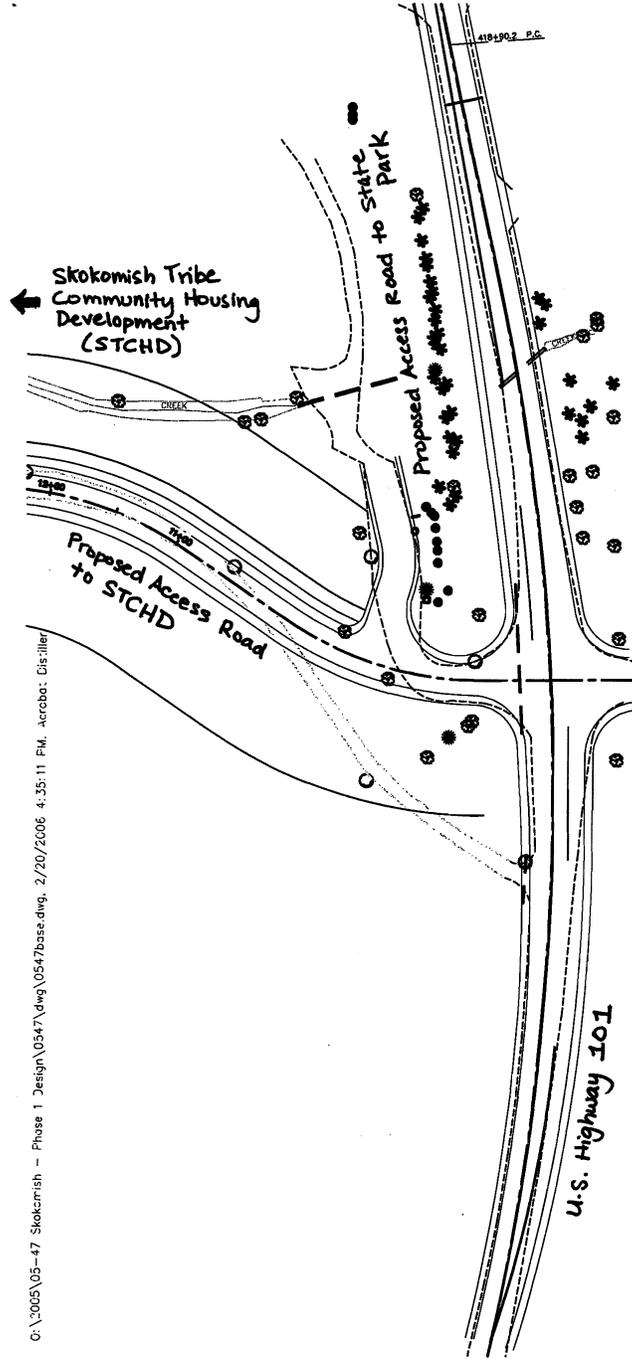
\*\*Total cost rounded to the nearest thousand.

Cost Estimate for Skokomish Master Plan-Total					
Item	Description	Unit	Quantity	Unit Cost	Total Cost**
<b>SITE/CIVIL</b>					
1	Clearing and Grubbing (5% of Grading and Site Impr Cost)	LS			\$133,000
2	Parkway	LF	4339	77	\$334,000
	Intersection Improvements	LS			\$450,000
3	Subdivision Streets + Lighting	LF	8480	30	\$254,000
4	Paving				
	Parkway	LF	4339	51	\$221,000
	Subdivision Streets + Lighting	LF	8480	47	\$399,000
5	Subdivision Grading	CY	10300	15	\$155,000
6	Landscaping/Site Improvements				
	Trail	LF	2840	10	\$28,000
	Community Area	SF	167437	1	\$167,000
	Elder Housing	SF	126739	1	\$127,000
	Central Open Space	SF	261348	1.5	\$392,000
	Shelter w/grills & electrical hookups	SF	3600	35	\$126,000
	Outdoor Basketball Court	LS	1	15000	\$15,000
<b>SITE/CIVIL SUBTOTAL</b>					<b>\$2,801,000</b>
<b>WATER</b>					
1	Well Development - Test Well	LS	1	35000	\$35,000
	Second Community Well	LS	1	35000	\$35,000
	10-hp Pump Assembly (60 gpm)	EA	2	15000	\$30,000
	Control Building w/appurtenances	LS	1	170000	\$170,000
2	Storage Tank	LS	1	250000	\$250,000
3	Distribution				
	Service Lines	EA	30	3000	\$90,000
	8" PVC, C900	LF	10575	35	\$370,000
	Appurtenances (50% of distribution piping cost)	LS	3		\$185,000
<b>WATER SUBTOTAL</b>					<b>\$1,165,000</b>
<b>SEWER</b>					
1	WWTP	gpd	49300	20	\$986,000
2	Conveyance				
	12"	LF	2052	26	\$53,000
	8" PVC, 3034	LF	8235	20	\$165,000
3	Disposal System	SF	83000	3	\$249,000
<b>SEWER SUBTOTAL</b>					<b>\$1,463,000</b>
<b>OTHER UTILITIES</b>					
1	Electrical Power	LS	1		\$529,000
2	Telecommunications	LS	1		\$264,000
<b>OTHER UTILITIES SUBTOTAL</b>					<b>\$793,000</b>
<b>INFRASTRUCTURE SUBTOTAL</b>					<b>\$6,212,000</b>
General Conditions at 5% of Construction					\$311,000
<b>TOTAL ESTIMATED COST OF INFRASTRUCTURE CONSTRUCTION</b>					<b>\$6,523,000</b>
Contingency @ 25% of Program Cost					\$1,631,000
Surveying (Topo and Boundary)					\$250,000
Engineering & Administration at 13% of Construction					\$848,000
<b>TOTAL ESTIMATED INFRASTRUCTURE COST</b>					<b>\$9,252,000</b>
<b>HOUSING</b>					
Single Family Homes (w/o garage & pole storage)					
1	1300 SQ. FT. Single Family (41)	SF	67600	88	\$5,949,000
2	1500 SQ. FT. Single Family (41)	SF	78000	83	\$6,474,000
3	1750 SQ. FT. Single Family (21)	SF	61250	81	\$4,961,000
<b>HOUSING SUBTOTAL</b>					<b>\$17,384,000</b>
General Conditions at 5% of Construction					\$869,000
<b>TOTAL ESTIMATED COST OF HOUSING</b>					<b>\$18,253,000</b>
Contingency @ 20% of Program Cost					\$3,651,000
Arch/Engr Design & Administration at 7% of Construction					\$1,217,000
<b>TOTAL ESTIMATED HOUSING COST</b>					<b>\$23,121,000</b>
<b>TOTAL PROGRAM COST</b>					<b>\$32,373,000</b>

\*\*Total cost rounded to the nearest thousand.

<b>Cost Estimate for Skokomish Master Plan-Total</b>						
<b>Item</b>	<b>Description</b>	<b>Phase 1</b>	<b>Phase 2</b>	<b>Phase 3</b>	<b>Access</b>	<b>Total Cost*</b>
<b>INFRASTRUCTURE</b>						
	Site Civil	\$ 698,000	\$ 269,000	\$ 1,279,000	\$ 558,000	\$ 2,804,000
	Water Supply, Storage and Distribution	\$ 820,000	\$ 90,000	\$ 257,000	\$ -	\$ 1,167,000
	Wastewater Collection and Treatment	\$ 496,000	\$ 34,000	\$ 923,000	\$ -	\$ 1,453,000
	Other Utilities	\$ 297,000	\$ 57,000	\$ 360,000	\$ -	\$ 714,000
	<b>INFRASTRUCTURE SUBTOTAL</b>	<b>\$ 2,311,000</b>	<b>\$ 450,000</b>	<b>\$ 2,819,000</b>	<b>\$ 558,000</b>	<b>\$ 6,138,000</b>
	General Conditions at 5% of Construction	\$ 116,000	\$ 23,000	\$ 141,000	\$ 28,000	\$ 307,000
	<b>TOTAL EST. COST OF INFRASTRUCTURE CONSTRUCTION</b>	<b>\$ 2,427,000</b>	<b>\$ 473,000</b>	<b>\$ 2,960,000</b>	<b>\$ 586,000</b>	<b>\$ 6,445,000</b>
	Contingency @ 25% of Program Cost	\$ 607,000	\$ 118,000	\$ 740,000	\$ 147,000	\$ 1,611,000
	Surveying (Topo and Boundary)	\$ 50,000	\$ 50,000	\$ 100,000	\$ 50,000	\$ 250,000
	Engineering & Administration at 13% of Construction	\$ 316,000	\$ 61,000	\$ 385,000	\$ 76,000	\$ 838,000
	<b>TOTAL ESTIMATED INFRASTRUCTURE COST</b>	<b>\$ 3,400,000</b>	<b>\$ 702,000</b>	<b>\$ 4,185,000</b>	<b>\$ 859,000</b>	<b>\$ 9,144,000</b>
<b>HOUSING</b>						
	Single Family Homes (w/o garage & pole storage)					
1	1300 SQ. FT. Single Family (41)	\$ 1,258,000	\$ 801,000	\$ 3,890,000		\$ 5,949,000
2	1500 SQ. FT. Single Family (41)	\$ 1,370,000	\$ 872,000	\$ 4,233,000		\$ 6,475,000
3	1750 SQ. FT. Single Family (21)	\$ 992,000	\$ 709,000	\$ 3,260,000		\$ 4,961,000
	<b>HOUSING SUBTOTAL</b>	<b>\$ 3,620,000</b>	<b>\$ 2,382,000</b>	<b>\$ 11,383,000</b>		<b>\$ 17,385,000</b>
	General Conditions at 5% of Construction	\$ 181,000	\$ 119,000	\$ 569,000		\$ 869,000
	<b>TOTAL ESTIMATED COST OF HOUSING</b>	<b>\$ 3,801,000</b>	<b>\$ 2,501,000</b>	<b>\$ 11,952,000</b>		<b>\$ 18,254,000</b>
	Contingency @ 20% of Program Cost	\$ 760,000	\$ 500,000	\$ 2,390,000		\$ 3,651,000
	Arch/Engr Design & Administration at 7% of Construction	\$ 253,000	\$ 167,000	\$ 797,000		\$ 1,217,000
	<b>TOTAL ESTIMATED HOUSING COST</b>	<b>\$ 4,814,000</b>	<b>\$ 3,168,000</b>	<b>\$ 15,139,000</b>		<b>\$ 23,122,000</b>
	<b>TOTAL PROGRAM COST</b>	<b>\$ 8,214,000</b>	<b>\$ 3,870,000</b>	<b>\$ 19,324,000</b>	<b>\$ 859,000</b>	<b>\$ 32,266,000</b>

\*Costs are in 2005 dollars & are rounded to the nearest thousand



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## PREPARED STATEMENT OF THE CALIFORNIA INDUSTRY AND GOVERNMENT CENTRAL CALIFORNIA OZONE STUDY (CCOS) COALITION

Mr. Chairman and members of the subcommittee, on behalf of the California Industry and Government Central California Ozone Study (CCOS) Coalition, we are pleased to submit this statement for the record in support of our fiscal year 2007 funding request of \$500,000 from the Department of Transportation for CCOS. These funds are necessary for the State of California to address the very significant challenges it faces to comply with new national ambient air quality standards for ozone and fine particulate matter. The study design incorporates recent technical recommendations from the National Academy of Sciences (NAS) on how to most effectively comply with Federal Clean Air Act requirements.

First, we want to thank you for your past assistance in obtaining Federal funding for the Central California Ozone Study (CCOS) and California Regional PM<sub>10</sub>/PM<sub>2.5</sub> Air Quality Study (CRPAQS). Your support of these studies has been instrumental in improving the scientific understanding of the nature and cause of ozone and particulate matter air pollution in Central California and the Nation. Information gained from these two studies is forming the basis for the 8-hour ozone, PM<sub>2.5</sub>, and regional haze State Implementation Plans (SIPs) that are due in 2007 (ozone) and 2008 (particulate matter/haze). As with California's previous SIPs, the 2007–2008 SIPs will need to be updated and refined due to the scientific complexity of our air pollution problem. Our request this year would fund the completion of CCOS to address important questions that won't be answered with results from previously funded research projects.

To date, our understanding of air pollution and the technical basis for SIPs has largely been founded on pollutant-specific studies, like CCOS. These studies are conducted over a single season or single year and have relied on modeling and analysis of selected days with high concentrations. Future SIPs will be more complex than they were in the past. The National Academy of Sciences (NAS) is now recommending a weight-of-evidence approach that will involve utilizing more broad-based, integrated methods, such as data analysis in combination with seasonal and annual photochemical modeling, to assess compliance with Federal Clean Air Act requirements. This will involve the analysis of a larger number of days and possibly an entire season. In addition, because ozone and particulate matter are formed from some of the same emissions precursors, there is a need to address both pollutants in combination, which CCOS will do.

Consistent with the new NAS recommendations, the CCOS study includes corroborative analyses with the extensive data provided by past studies, advances the state-of-science in air quality modeling, and addresses the integration of ozone and particulate pollution studies. In addition, the study will incorporate further refinements to emission inventories, address the development of observation-based analyses with sound theoretical bases, and includes the following four general components: Performing SIP modeling analyses, 2005–2011; Conducting weight-of-evidence data analyses, 2006–2008; Making emission inventory improvements, 2006–2010; Performing seasonal and annual modeling, 2008–2011.

CCOS is directed by Policy and Technical Committees consisting of representatives from Federal, State, and local governments, as well as private industry. These committees, which managed the San Joaquin Valley Ozone Study and are currently managing the California Regional Particulate Air Quality Study, are landmark examples of collaborative environmental management. The proven methods and established teamwork provide a solid foundation for CCOS.

For fiscal year 2007, our Coalition is seeking funding of \$500,000 from the DOT through Highway Research funds. DOT is a key stakeholder in air quality issues because Federal law requires that transportation plans be in conformity with SIPs. Billions of dollars in Federal transportation funds are at risk if conformity is not demonstrated for new transportation plans. As a result, transportation and air agencies must be collaborative partners on SIPs and transportation plans, which are linked because motor vehicle emissions are a dominant element of SIPs in California and nationwide. Determining the emission and air quality impacts of motor vehicles is a major part of the CCOS effort.

Heavy-duty trucks are known to have very different driving patterns than light duty cars and, despite smaller numbers, are responsible for a disproportionate amount of emissions (e.g. approximately 50 percent of California's mobile source NOx emissions). The continued growth of heavy-duty truck travel, including increases in inter-State and international goods movement, makes this element of the SIP transportation emission estimate critical. Thus, to support the region's new SIPs and to address the new NAS recommendations, improvement of the temporal and spatial distribution of heavy-duty truck emissions is needed. We propose fund-

ing of this activity at a level of \$500,000. The funding will go to collect data that can be used to more accurately characterize heavy-duty truck emissions, including those resulting from NAFTA.

Thank you very much for your consideration of our request.

#### COOPERATIVE PARTNERSHIP

##### *Private Sector*

Western States Petroleum Association; Pacific Gas and Electric Company; Electric Power Research Institute; Nisei Farmers League and Agriculture; Independent Oil Producers' Agency; California Cotton Ginners and Growers Associations.

##### *Local Government*

San Joaquin Valley Unified Air Pollution Control District (On Behalf of Local Cities and Counties); Bay Area Air Quality Management District; Sacramento Metro Air Quality Management District; San Luis Obispo County Air Pollution Control District; Mendocino County Air Pollution Control District.

##### *State Government*

California Air Resources Board; California Energy Commission.

##### *Federal Government*

Environmental Protection Agency; Department of Agriculture; Department of Commerce; National Oceanic and Atmospheric Administration; Department of Transportation; Department of Interior; Department of Energy (Invited Partner).

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#### PREPARED STATEMENT OF THE COALITION OF NORTHEASTERN GOVERNORS

As the subcommittee begins the fiscal year 2007 transportation appropriations process, the Coalition of Northeastern Governors (CONEG) is pleased to share with the subcommittee testimony on transportation and community development programs in the fiscal year 2007 Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies Appropriations bill. The CONEG Governors commend the subcommittee for its past support of funding for the Nation's highway, transit, and rail systems. We understand that the complex, interlocking issues that the subcommittee faces in crafting this appropriations measure are compounded by the overall budget challenges—challenges that are intensified by the deficit and defense and security needs. We urge the subcommittee to continue the important Federal partnership role that is vital to strengthening the Nation's multimodal transportation system. This system is a critical underpinning to the productivity of the Nation's economy and the security and well-being of its communities.

#### TRANSPORTATION

The subcommittee's challenge in the transportation arena is compounded by the uncertainty surrounding the future of contributions to the Highway Trust Fund and its ability to sustain the structure created by the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU) (Public Law 109-59). The CONEG Governors strongly support the National Surface Transportation Policy and Revenue Study Commission created by SAFETEA-LU (Section 1909) and are concerned that it produce a credible report. We encourage the subcommittee to review the funding levels provided to the Commission and urge your active involvement.

The Governors urge the subcommittee to fund the combined highway, public transit and safety programs at levels consistent with the authorized levels in SAFETEA-LU. This Federal funding is essential to continue the progress in recent years to improve the condition and safety of the Nation's highways, bridges and transit systems. Continued and substantial Federal investment in these infrastructure improvements—in both urban and rural areas—is necessary if the Nation's surface transportation system is to safely and efficiently move people and support the substantial growth in freight movement that is projected in the coming decade.

—We are pleased that the President requested a Federal aid highway obligation limit of \$39.1 billion for fiscal year 2007, a level equal to the authorized contract authority plus \$842 million from the Revenue Aligned Budget Authority (RABA).

—The Governors strongly urge the subcommittee to fund public transit at the fiscal year 2007 authorized funding level of \$8.97 billion. The proposed \$100 million shortfall in the newly-created Small Starts program is of concern. This program is attractive since it provides the flexibility to fund small but vital transit

projects, such as bus rapid transit, that might not be efficient or cost-effective if subject to the lengthy approval process needed for larger endeavors. Although the administration questions the funding level needed as the Small Starts program gets underway in fiscal year 2007, this does not justify a reduction in the overall funding level for the Capital Investment Grants program—a program which is highly competitive and oversubscribed. Furthermore, a failure to fully fund transit would undermine the important and historic 80/20 funding split between highways and transit.

—The Governors also urge the subcommittee to provide sufficient funding for the Coordinated Border Infrastructure Program. A strong program—one that invests in transportation projects addressing both security and transportation needs—can contribute to safer, more efficient and secure flows of people and goods across international borders and through gateways.

The CONEG Governors also request that the fiscal year 2007 appropriations include \$1.598 billion in Federal funding for intercity passenger rail, with specific funding levels provided for operations, capital and debt service. This funding level requested by the Amtrak Board can ensure the stability of the current national system as capital investment and operations reform are undertaken through concerted and hopefully coordinated activities of Amtrak, the U.S. Congress, the U.S. Department of Transportation (USDOT), and the States. The administration's request of \$900 million for Amtrak, particularly its exclusion of funds required for debt service, could undermine the reforms and critical capital investments currently underway.

—Capital investment in infrastructure and equipment is the key to improved reliability, increased ridership, and greater operational efficiency. It is essential that the Federal Government continue to be a consistent partner in funding the capital needs of the Nation's intercity passenger rail system. Across the Nation, States already partner with Amtrak by investing in tracks, stations and equipment. Between 2002–2006, the Northeast States have spent or committed approximately \$1.7 billion for infrastructure improvements that benefit intercity passenger rail. Amtrak is embarked upon a long-deferred capital program to bring the federally-owned Northeast Corridor (NEC) to a state of good repair. In fiscal year 2006, Northeast Corridor States and commuter agencies and other third parties will provide almost half of Amtrak's NEC infrastructure budget. We are particularly concerned that the subcommittee ensures that Amtrak can continue to fund the critically needed bridge repair projects and life-safety work in the New York and Baltimore tunnels.

—Intercity passenger rail is a complex and interconnected system. Therefore, operations reform, such as that being developed for Amtrak's long distance service, is an incremental process that must be carefully designed and implemented to minimize unintended consequences for ridership and revenues. Since actual savings may not be realized for a number of years, we urge the subcommittee to continue providing Federal operating funds to Amtrak as part of its regular quarterly grant, not as the discretionary Efficiency Incentive grant. The quarterly operations and capital grant process is already subject to USDOT oversight and approval.

—Amtrak has incurred substantial debt in past years to maintain operations of the national system, acquire and improve equipment for the entire system, and invest in infrastructure. As in fiscal year 2006, we believe that the fiscal year 2007 appropriations should specifically include adequate Federal funds for debt service so that this expense, incurred on behalf of the entire national system, should not be paid at the expense of essential capital investment.

The CONEG Governors recognize that the Appropriations Committee has assumed a primary role in instituting reforms of Amtrak's internal management, and more recently, reform of system management. We previously shared with the subcommittee and the administration our concerns with a number of specific and immediate reform provisions imposed by the fiscal year 2006 transportation appropriations bill (Public Law 109–115). We appreciate the subcommittee's recognition of the importance of consulting with States in a number of these proposed system reforms. However, we continue to believe that reform of intercity passenger rail must occur in an orderly, timely process that reflects collaboration with the States—not through an annual appropriations process.

—We are deeply concerned with the NEC commuter access fee provision that, for the first time, injects the USDOT into the public-private contractual arrangements that govern passenger rail cost-sharing on the Northeast Corridor. Rail service on the NEC is governed by hundreds of carefully negotiated legal, financial and operating agreements that involve substantial State financial investments and numerous in-kind exchanges. The Northeast Governors met with Secretary Mineta and Deputy Secretary Cino, and chief executive officials from

the State transportation agencies and commuter authorities are engaged in ongoing discussions about this access fee. As previously noted, Northeast Corridor commuter agencies already fully pay for the additional operations expenses incurred by Amtrak due to commuter rail service, and they participate in numerous joint-benefit capital projects on this vital national transportation corridor. Therefore, we urge the subcommittee to allow the issue of cost-sharing to continue as part of negotiated agreements between the commuter agencies and Amtrak—and to allow any future changes to be undertaken as part of these negotiations or parallel authorization legislation.

—As the subcommittee also reviews the fiscal year 2006 appropriation bill's reform provision dealing with restrictions on ticket pricing and food and beverage service, we urge careful consideration to ensure that any legislative requirements do not negatively impact the ability of State-supported intercity services to offer innovative food and beverage service and market-based fares to grow intercity ridership, improve overall financial performance, and meet State transportation goals.

A number of other national rail programs are important components of the evolving Federal-State-private sector partnerships to enhance passenger and freight rail across the country. SAFETEA-LU creates a new Rail Relocation Program and enhances the Swift High Speed Rail Development Program. We encourage the subcommittee to provide funding for both these programs. We are concerned with the President's budget proposal to eliminate the Railroad Rehabilitation and Improvement Financing (RRIF) loan program, the principal Federal program for addressing shortfalls in rail infrastructure investment. This proposal is at odds with the tenfold increase in the RRIF program authorized by SAFETEA-LU. The RRIF program provides an important financial tool, particularly for the many regional and short line railroads that serve communities across the Northeast and the Nation, as they seek to upgrade infrastructure and equipment to meet the demands of changing and competitive markets.

The CONEG Governors also support a modest increase in funding for the Surface Transportation Board (STB) to \$25.6 million. This funding level will allow the STB, which provides essential oversight services for the Nation and the Northeast, to maintain current service levels while also addressing its increased building and security costs.

#### COMMUNITY DEVELOPMENT

The CONEG Governors urge the subcommittee to maintain the fiscal year 2006 funding level for the Community Development Block Grant (CDBG) program in fiscal year 2007. Federal funding for CDBG is an efficient Federal investment since it leverages significant private and public funds. Each \$1 of Federal CDBG funding is matched by \$3 in private funds. The CDBG enables States to provide funding for infrastructure improvement, housing programs, and projects that attract businesses to urban and rural areas. It helps create new jobs and spurs economic development, growth and recovery in the Nation's low income and rural communities.

The CONEG Governors thank the entire subcommittee for the opportunity to share these priorities and appreciate your consideration of these requests.

#### PREPARED STATEMENT OF THE NATIONAL TREASURY EMPLOYEES UNION

##### FISCAL YEAR 2007 IRS BUDGET

NTEU represents 150,000 Federal employees in 30 Federal agencies and departments, including the men and women who work at the Internal Revenue Service. I appreciate the opportunity to provide the subcommittee with comments on the IRS budget for fiscal year 2007.

There are several items in the administration's IRS budget that NTEU believes would be detrimental to the IRS's mission. The two most egregious items include the administration's plans to contract out tax collection to private collection agencies starting this summer, and an inadequate budget request that will prevent the IRS from continuing to improve its customer service record while bolstering enforcement.

##### BUDGET

The IRS budget forms the foundation for what the IRS can provide to taxpayers in terms of customer service and how the agency can address the ever-increasing tax gap through enforcement. Without an adequate budget the IRS cannot expect continued IRS customer service performance ratings and to shrink the tax gap. I commend the administration for acknowledging in its fiscal year 2006 Budget in

Brief (page 12) that the “IRS yields more than four dollars in direct revenue from its enforcement efforts for every dollar invested in its total budget.” However, I must criticize the administration for failing to request a budget for fiscal year 2007 that is commensurate with the needs of the agency to meet its customer service, as well as enforcement challenges.

NTEU supports the IRS Oversight Board’s overall IRS budget recommendation which calls for an increase of \$732 million over the enacted fiscal year 2006 IRS budget. The Board’s budget represents a 6.9 percent increase over the fiscal year 2006 budget and includes increases in enforcement and taxpayer service programs, in contrast to the President’s budget request which calls for a cut of 2,500 full-time equivalent (FTEs) employees and relies on unrealistic assumptions such as an increase of \$135 million in user fees. NTEU specifically supports the increased enforcement budget proposed in S. Con. Res. 83, the fiscal year 2007 Budget Resolution, as passed by the Senate. The Senate Budget Resolution quadruples the President’s enforcement request from a \$137 million increase over fiscal year 2006 to an additional \$500 million increase for IRS enforcement in fiscal year 2007.

NTEU believes that if the IRS is going to continue to ask for improved performance from its employees then it must request a realistic budget that is commensurate with the agency’s goals. The President’s budget request falls short and I would urge the subcommittee for an appropriation that is commensurate with the IRS’s goals of bolstering enforcement and improving customer service.

#### SPAN OF CONTROL

I realize that Congress does not operate in a vacuum and it must consider all Federal Government budget needs. In its fiscal year 2006 IRS Budget/Special Report, the IRS Oversight Board stated that it “agrees that investing in enforcement does pay for itself many times over, not only in increased revenues but by reinforcing the belief that all taxpayers are paying their fair share.” Although it’s widely recognized that additional funding for enforcement may provide a great return on the investment, the administration seems reluctant to request an adequate budget for the IRS enforcement budget. Thus, the agency must look toward other cost-cutting measures within its budget framework.

NTEU recommends the IRS look at the management-to-bargaining-unit employee ratio to find much needed resources for additional collection work. Although the number of frontline employees who do the work at the IRS has decreased by 5.1 percent since 2000, the number of managers who supervise these employees has increased by 1 percent over this same period. If the IRS decreased the number of managers and management officials at the same rate as it has decreased its rank and file employees, the agency could put the savings toward bolstering collections work, and avoid cuts to customer service.

#### CUSTOMER SERVICE

Congress must continue to reject IRS’s plan to implement draconian cuts to customer service. I was pleased that the subcommittee decided to halt IRS’s plans to move forward with cuts to customer service at the end of last year with language in H.R. 3058 (Section 205), the Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act, 2006. H.R. 3058, Section 205, uses broad language that prohibits any of the appropriated funds to “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 . . .”. The IRS decided to move forward with cuts to the toll-free service by reducing hours of service and closing call sites, despite the language this subcommittee imposed in H.R. 3058. In response, the subcommittee followed up with additional language to clarify its intent in H.R. 2863, Section 5021 (the fiscal year 2006 Defense Appropriations bill) further explaining that “reduced taxpayer services” in the Transportation-Treasury Appropriations bill included—but was not limited to—any reductions in telephone service.

Despite these two explicit directives from Congress not to make any taxpayer customer service cuts, the IRS closed the Chicago and Houston telephone call sites. Furthermore, the IRS continues to consider cutting Taxpayer Assistance Centers (TACs) as a cost-saving measure, as confirmed in a recent TIGTA report (Reference Number: 2006-40-061). The report also indicates that management does not have reliable data on the TACs to make decisions about TAC operations. TIGTA also points out that 47 of the 400 TACs nationwide—nearly 12 percent—are “critically understaffed—meaning that they would be in danger of closing were it not for the dedicated IRS employees who are filling in from nearby TACs and through the use

of seasonal employees. In its first report responding to the congressional mandate in Section 205 of H.R. 3058, TIGTA sharply criticizes the business model the IRS used to justify the TAC closings last year (see TIGTA Reference Number: 2006-40-067). Clearly, the IRS lacks the management information necessary to provide adequate oversight of its TAC operations—much less make a decision to close any of them.

I urge the subcommittee to continue to oppose the IRS's plan to drastically cut customer service until the IRS has the data to justify its customer service cuts and can explain the effects of such cuts on taxpayers.

#### PRIVATE TAX COLLECTION

NTEU strongly opposes the administration's plan to privatize IRS debt collection, as authorized by Congress in 2004 in H.R. 4520, the American Jobs Creation Act of 2004. Under the statute, the IRS is permitted to hire private sector debt collectors and pay them a bounty of up to 25 percent of the money they collect. NTEU opposes this short-sighted proposal, anticipates its complete failure as witnessed in a similar 1996 pilot program and will continue to work towards its repeal.

The IRS has said that it has learned from the 1996 project and is better equipped to address the problems raised. However, a revealing report by the Treasury Inspector General for Tax Administration (TIGTA Audit No. 2003-20-010) provides evidence to the contrary. It shows how IRS contractors, revamping IRS computers, put taxpayers' data at risk.

The objective of the TIGTA audit was "to determine whether the Internal Revenue Service (IRS) has adequately protected Federal Government equipment and data from misuse by contractors." The review found: "The involvement of non-IRS employees in critical IRS functions increases the risk of misuse or unauthorized disclosure of taxpayer data, and could lead to loss of equipment or sensitive taxpayer data through theft or sabotage." The TIGTA audit found that the "lack of oversight of contractors resulted in serious security vulnerabilities." The report, found that, "contractors blatantly circumvented IRS policies and procedures even when security personnel identified inappropriate practices."

A more recent report by the General Accounting Office (GAO-06-328) highlights the continuing failure of the IRS to ensure the internal security of sensitive taxpayer data. GAO reported the IRS has corrected only 41 of the 81 information security weaknesses it previously discovered at two of the agency's critical data processing sites; moreover, GAO said it has identified "new information security weaknesses that threaten the confidentiality, integrity and availability of IRS financial information systems and the information they process." These include, for example, the agency's failure to implement effective "electronic access controls related to network management, user accounts and passwords; user rights and file permissions; and logging and monitoring of other information security controls to physically secure computer resources, and to prevent the exploitation of vulnerabilities." Its report added: "Collectively, these weaknesses increase the risk that sensitive financial and taxpayer data will be inadequately protected against disclosure, modification, or loss, possibly without detection, and place IRS operations at risk of disruption."

The GAO report presents yet another warning signal about the dangers of the IRS effort to move ahead with plans to hire private sector debt collectors to pursue tax debts. Rather than seek to move personal and sensitive taxpayer information into private hands the IRS needs to devote time, attention and resources to ensuring it can protect these vital data when the information is in its own hands. I don't think anyone can realistically be satisfied right now that the agency has accomplished that.

Clearly, the IRS does not have sufficient oversight of the current contractors or technology it employs. Combine this fact with a 25 percent bounty incentive paid to the contractors and you have a recipe for disaster, resulting in overly aggressive and abusive tactics on the part of the private debt collectors.

While the IRS is currently liable for damages caused by an IRS employee's misuse of sensitive taxpayer information, taxpayers would not have proper redress with the Federal Government for misuse of their confidential information by contractors. Instead, taxpayers would be left to seek damages against the private collection agency while the reputation of the IRS and the Federal Government is tarnished.

Furthermore, the debt collectors won't be given the same training that is given to IRS collections employees. Even the National Taxpayer Advocate in her 2005 Annual Report to Congress recognizes the problems with implementation of the private debt collection initiative:

"However, the current plan shortchanges taxpayers by exempting private collectors from the type of training required of IRS employees in similar

functions . . . Yet, the private collectors will not receive even a small fractions of the training that is given to the IRS employees in similarly situated positions. Moreover, the private collectors themselves will administer the PDC training.” (Volume 1, page 78).

Not only will the private debt collectors not be given the same training as IRS employees, but the contractors will be administering the training. IRS collection professionals have a wealth of tax knowledge that they have at their disposal in every case where they deal directly with the taxpayer. The private debt collectors on the other hand, will only be given a fraction of the training and not have that same level of expertise as the IRS employee.

One of the most often-heard arguments in favor of the use of private collection agencies is that if they are paid out of the proceeds of what they collect, IRS’s enforcement capabilities increase without having to increase appropriations. Numerous congressional supporters said they would prefer to have tax collection done by Federal employees, but would go along with the use of private collection agencies solely because it avoids the difficult issue of getting Congress to approve additional appropriations for the IRS.

The statute that gives the IRS the authority to use PCAs allows 25 percent of collected revenue to be returned to the collection companies as payment and 25 percent to be retained by the IRS for enforcement efforts, thereby circumventing the appropriations process altogether. There is nothing magical about revenues collected by private collection companies. If those revenues could be dedicated directly to contract payments and IRS enforcement efforts, there is no reason some small portion of other revenues collected by IRS employees couldn’t be dedicated to IRS enforcement efforts. This would allow for increased enforcement by IRS employees, which most people indicate is the preferable route and eliminate large payments (up to 25 percent of collections) to private collection companies, significantly increasing net revenue to the General Treasury. While legislation would be required to allow for this kind of dedication of revenue, I believe the precedent has now been set with the private collection agency funding provisions. Congress should consider supporting this approach as a common sense way to make real progress in closing the tax gap, lowering our deficits and making more funding available for our Nation’s critical needs.

It is a plain and simple fact: This plan to privatize tax collection at the IRS will hurt U.S. taxpayers, will hurt IRS workers and will erode the great gains the IRS has made with improved customer satisfaction ratings. I urge the subcommittee to scrutinize the IRS’s accountability of its contractors and hold the private collection agencies to the same standards as IRS employees.

#### PAY PARITY

The administration has asked Congress to provide only a 2.2 percent pay raise for Federal workers in fiscal year 2007. This would be the lowest raise since 1998, at a time when the cost of living rate is steeply increasing and health insurance premiums are going up dramatically. While in past proposals the Bush Administration did not honor the historic practice of parity between the civilian and military workforce, this year’s proposal provides an equally insufficient pay raise to both parts of government service.

Not only are Federal employees taking an effective pay cut once inflation and health care costs are considered but the pay gap between them and the private sector is widening. The Federal Employees Pay Comparability Act (FEPCA), enacted in 1990 to close the gap between Federal and private sector pay, has never been fully implemented. Today, Federal pay lags 13 percent behind the private sector. Bringing Federal worker pay into line with the private sector would be the most effective cure to the Federal Government’s hiring crisis.

Further reducing the potential fiscal year 2007 pay raise, the administration proposes to reduce pay in fiscal year 2007 by funding special rate pay out of this meager increase. While agencies should have the resources they need to provide special rate pay, it should not come by raiding the locality adjustments and annual pay increase for Federal workers.

NTEU urges the subcommittee to oppose the administration’s legislative proposal to fund special rate pay by diverting part of the locality and annual pay raise. I also seek your continued support for a fair and equitable pay raise for the Nation’s Federal civilian and military workforce for fiscal year 2007.

#### CONTRACTING OUT

Last year, the House and Senate Transportation-Treasury HUD subcommittees worked in a bipartisan, bicameral fashion to enact legislation in H.R. 3058, Section

852 that begins to level the playing field for Federal employees. NTEU supports the provisions and thanks the subcommittee for its work last year. The legislation allows Federal employees to offer their own realistic best bid with a most efficient organization (MEO) in job functions being performed by more than 10 Federal employees; requires a 10 percent or \$10 million cost savings of the contractor in order for the work to be contracted out; and allows executive agency heads to conduct public-private competitions to bring contracted work back in-house. NTEU would strongly recommend that the same provisions be included in the fiscal year 2007 Transportation-Treasury Appropriations bill and additional flaws in the process be examined.

For example, the process should prohibit the contractor from receiving a cost advantage in the competition by offering an inferior employer-sponsored health benefit than the Federal employees receive. Contractors have an incentive to cut benefits to their workers in order to reduce labor costs when offering their best bid. However, contracting out should not be a race to the bottom. If contractors want to offer inferior benefits to their workers, they should not be rewarded for this by being given an advantage in the competition for the work. Congress must also make sure that Federal employees are treated fairly throughout the competition process by allowing us the same legal standing before GAO for appeals purposes as has long been enjoyed by contractors.

This list is by no means exhaustive but it's a good starting point. If the administration is going to insist on using its flawed revised A-76 Circular, then Congress must insist on correcting those flaws in the competitive sourcing rules.

RIFS

I commend the subcommittee for acknowledging the IRS's haphazard approach to reorganizing the agency and directing "the IRS to consult with the Committee prior to elimination, consolidation, or reorganization of its workforce, and prohibits the IRS from proceeding with matters relating to such job movement prior to the Committee's action on the IRS budget." (Senate Rept. 109-109—Transportation, Treasury, the Judiciary, Housing and Urban Development and Related Agencies Appropriations Bill, 2006).

Despite the committee Report language, the IRS moved forward with its planned reductions in force (RIFs) in several different areas. Generally speaking, NTEU believes that the IRS would benefit both in terms of cost savings and human resource satisfaction by placing a greater emphasis on retraining current employees for other positions within the IRS. Unfortunately, this has not been the approach taken by the IRS with regards to RIFs at the agency. A more sensible downsizing model is needed if the IRS wishes to keep the talented workforce it currently has but also in order to attract new talent. A more comprehensive, thoughtful approach to RIFs will also ensure that the improved customer service gains made since 1998 are not lost.

CONCLUSION

It is indisputable 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. Without a doubt, the frontline employees are committed to working with management to increase efficiency and customer satisfaction. NTEU is committed to striking a balance between taxpayer satisfaction, business results and employee satisfaction. I invite Congress to join us in this endeavor.

PREPARED STATEMENT OF THE CITY OF SAN MARCOS, TEXAS

AIRPORT IMPROVEMENTS REQUEST—SAN MARCOS MUNICIPAL AIRPORT, SAN MARCOS, TEXAS

Mr. Chairman and members of the subcommittee, on behalf of the City of San Marcos, Texas, I am pleased to submit this statement in support of our requests for project funding for fiscal year 2007.

The City of San Marcos requests Federal funding for the San Marcos Municipal Airport to accomplish improvements that are in the public interest. The improvements are described in the three specific projects listed below:

	Amount
Northside T-Hangar Construction .....	\$3,500,000
New Terminal Building .....	4,500,000

	Amount
Fixed Base Operator (FBO) Facility .....	1,500,000
Total Request .....	9,500,000

The San Marcos Municipal Airport is a public general aviation airport owned and operated by the City of San Marcos, Texas. It is located just east of Interstate Highway 35 on Texas Highway 21 approximately 30 miles south of Austin and 45 miles north of San Antonio in one the fastest growing corridors in Texas.

The airport is part of a closed military base; the remainder of the former Air Force Base is occupied by the United States Department of Labor’s Gary Job Corps Center. When the base was closed and divided in 1966, the Job Corps retained the portion of the property with the buildings and other amenities while the City of San Marcos was given the aeronautical facilities consisting of runways, taxiways, and the parking apron.

This arrangement has resulted in a “bare bones” airfield that lacks the support structure to sustain an economically viable modern airport. We have adequate aeronautical facilities and real estate but little other facilities. In addition, current legislation provides for airport capital improvement funding assistance through the Federal Aviation Administration for aviation infrastructure, but not for the type of improvements that this airport needs.

The City of San Marcos requests help to transform the airport into a modern, self-sustaining enterprise. After analysis and master planning, we have determined that the three projects herein described will get us the “biggest bang for the buck.” These projects will meet our highest priorities and most immediate needs, and they will be a highly visible indicator that the San Marcos Municipal Airport is on the move. We are firmly convinced that these improvements will kick-start further development and attract private investment that will far surpass the amount that we are seeking in Federal support.

The following program descriptions outline our three requests:

NORTHSIDE T-HANGAR CONSTRUCTION—\$3,500,000

The layout of the former Gary Air Force Base is such that all the buildings and developed area of the base were to the south of the airfield. When the base was divided between the Gary Job Corps Center and the San Marcos Municipal Airport, the airport was given only a thin sliver of land on the south side to provide access and support the airfield. There is not enough room for all the support facilities such as hangars, maintenance shops, and terminal buildings that an active airport requires.

However, on the north side of the airfield is real estate that has never been developed. One prime piece of the northside area consists of approximately 40 acres of very desirable airport land that fronts on Texas Highway 21 and borders a newly refurbished main airport taxiway. Except for the absence of infrastructure, it is the “McDonald’s” location on the airport. The area requires an access road, drainage improvements, pavements, and utilities. It also needs a seed project to stimulate private investors to move into the area.

Our plan proposes to construct the infrastructure and to then build approximately 50 nested T-hangars in two or three city-owned buildings. Our planning estimate for the cost to implement this project is \$3,500,000. We are also convinced that once this northside development ball starts to roll, the future of the new San Marcos Municipal Airport will shift from the limited and constrained south side to the several hundred acres of undeveloped land available on the north side.

NEW TERMINAL BUILDING—\$4,500,000

The commercial, economic, and public service hub of a modern airport is the public terminal building. The terminal building provides public amenities such as a waiting room or lounge, airport administration offices and public meeting rooms, restrooms, flight planning facilities and communications links to obtain flight planning information, commercial lease space for such businesses as an airport restaurant, airport shops, and other aviation-related commercial activities.

These facilities are sorely lacking in our present airport configuration. It is opportune that the Federal Aviation Administration is programming a new air traffic control tower for our airport in fiscal year 2007. A new terminal building located adjacent to the control tower could be architecturally coordinated with the control tower for aesthetic advantage. The two facilities could achieve a significant efficiency in the coordinated construction of road access, utility services, parking facilities, drain-

age improvements, and landscaping. This same concept is being touted at several other airports similar to ours. (Dallas Executive Airport is a prime example.) The planned terminal building planning concept is for a building of approximately 10,000-square-foot first floor and total cost estimated at \$4,500,000.

FIXED BASE OPERATOR (FBO) FACILITY—\$1,500,000

For general aviation operations, airport activity centers on the FBO. This is where the transient and based pilots and aircraft operators go to buy fuel and obtain direct support for their flights. It is also a place where transient and based pilots can arrange to have their aircraft serviced, repaired, and hangared overnight or longer when required.

It is again opportune that the San Marcos Municipal Airport has an established FBO that is capable of accomplishing these vital services if a facility were available for them to lease. We propose that a modern, state-of-the-art FBO be constructed to meet the airport's present and future commercial requirements. The approximately 30,000 square foot structure would be mainly hangar space with an attached business, shop, and office area. Cost is estimated at \$1,500,000. Lease payments and other airport fees would offset this investment; and the investment is calculated to be a profitable enterprise for the airport in the long term.

The 1,356 acre San Marcos Municipal Airport is a potential economic dynamo for this region of Central Texas. The three airport improvement projects that we are proposing will result in an increase in activity and private investment. This is a good investment of public revenue that will result in more high-paying aviation jobs, an increased tax base, and more direct revenues in the form of airport fees and rents. Our airport will also better serve the aviation needs of the region and spur further growth, development, and prosperity for our citizens. These projects are grounded in sound public policy principles. They will result in excellent value for the American taxpayer and for the traveling public that will utilize the facilities.

The City of San Marcos sincerely appreciates your consideration of these requests for funding in the fiscal year 2007 cycle, and respectfully requests your support.

PREPARED STATEMENT OF THE ACCESS BOARD

The Access Board is requesting a total budget authority of \$5,956,000 for fiscal year 2007. The proposed budget is a 1.28 percent increase over the amount requested for fiscal year 2006. The Board is not planning new costly initiatives in fiscal year 2007. The Board will continue its primary programs and has followed the directives issued by the Office of Management and Budget for the preparation of the fiscal year 2007 budget.

INTRODUCTION

The Board was established by section 502 of the Rehabilitation Act and is the only Federal agency whose mission is accessibility for people with disabilities. The Board has three primary programs: guidelines and standards development; technical assistance, training, and research; and enforcement.

The Board is responsible for developing accessibility guidelines under the Americans with Disabilities Act, the Architectural Barriers Act, and the Telecommunications Act. The Board is also responsible for developing standards under section 508 of the Rehabilitation Act for accessible electronic and information technology used by Federal agencies. Additionally, the Board has responsibilities under the Help America Vote Act to serve on the Election Assistance Commission's Board of Advisors and Technical Guidelines Development Committee.

The Board provides technical assistance and training on each of its guidelines and standards, and on a variety of other accessibility issues. The Board also maintains a small research program that develops technical assistance materials and provides information needed for guidelines and standards development.

Finally, the Board enforces the Architectural Barriers Act, which requires federally financed facilities to be accessible.

The Board has adopted this mission statement to guide its programs: The Board is the catalyst for achieving an accessible America. The statement recognizes that achieving an accessible America requires bringing together the public and private sectors.

The Board has established long-range goals and annual objectives for its programs in accordance with the Government Performance and Results Act. The objectives are described in terms that permit future assessment regarding whether the objectives were achieved. To satisfy the requirements for an annual performance plan, this dis-

cussion and budget justification presents information under each of the Board's programs and reports on the results from fiscal year 2005 activities, reviews the planned fiscal year 2006 activities, and presents the fiscal year 2007 objectives.

The Board's long range goals are to promote accessibility by being a:

- Leader in developing and updating guidelines, standards, and codes for accessibility;
- Leader in information, education, and outreach on accessibility; and
- Leading partner with Federal agencies to make the Federal Government a model of compliance with accessibility standards.

The Board's strategies for achieving its long-range goals and annual objectives involve working with its stakeholders. The Board involves its stakeholders through advisory committees and review of draft guidelines and standards to establish consensus-based guidelines and standards that provide accessibility. The Board involves its stakeholders in developing and disseminating information, education, and outreach that will help covered entities understand and comply with the guidelines and standards. Where the Board has enforcement responsibilities over Federal agencies, the Board assists those agencies to achieve compliance with accessibility standards.

The Board's programs will result in accessible buildings and facilities, transportation vehicles, telecommunications equipment, and electronic and information technology across our country and, ultimately, the full economic and social integration of people with disabilities into our society. Achieving these results will depend not only on the Board's activities, but also on the level of commitment and action taken by other Federal agencies, State and local governments, and businesses that are required to comply with or enforce the various laws that guarantee the civil rights of people with disabilities.

#### GUIDELINES AND STANDARDS DEVELOPMENT

The Board's long-range goal is to be a leader in developing and updating guidelines, standards, and codes for accessibility. The Board will continue to develop and update accessibility guidelines and standards and to work cooperatively with organizations that develop codes and standards affecting accessibility through fiscal year 2007 and beyond.

In January 2006, the Board committed itself to three new rulemaking priorities. The three priorities include: (1) updating and revising the Section 508 standards for accessible electronic and information technology and the Telecommunications Act Accessibility Guidelines; (2) updating and revising the Americans with Disabilities Act (ADA) Accessibility Guidelines for Transportation Vehicles; and (3) rulemaking on a variety of communications access issues.

Updating and revising the Section 508 standards and the Telecommunications Act Accessibility Guidelines is the Board's top new rulemaking priority. The Board plays a central role in the implementation of Section 508 and keeping our standards current is a vital part of this role. The telecommunications provisions in the section 508 standards are based on and are consistent with the Board's Telecommunications Act Accessibility Guidelines. Therefore, updating and revising the Section 508 standards and the Telecommunications Act Accessibility Guidelines should be done in one rulemaking. The Board plans to charter a Federal advisory committee in fiscal year 2006 to begin this rulemaking. The committee will include representation from other Federal agencies, disability organizations, industry trade associations, and others. It will also include representation from other countries and international standards-setting organizations so the new standards are harmonized with efforts being taken around the globe.

Updating and revising the ADA Accessibility Guidelines for Transportation Vehicles is needed to address emerging technologies such as bus rapid transit and low floor vehicles. This rulemaking will be accomplished by holding a series of information meetings in fiscal year 2006 and 2007 to collect information before issuing a proposed rule.

Rulemaking on communications access issues will address features not already addressed, or not addressed fully, by the Board's guidelines such as interactive transaction machines, point of sale machines, drive-through machines, alerting devices for deaf and hard-of-hearing individuals including carbon monoxide detectors and sleeping room applications, and public address systems. This rulemaking will be accomplished by holding a series of information meetings in fiscal year 2006 and 2007 to collect information before issuing a proposed rule.

The status of current guidelines and standards efforts is presented below.

#### *Outdoor Developed Areas*

The Board's Outdoor Developed Areas Regulatory Negotiation Committee presented its report to the Board in September 1999. This committee developed new sections for parks, trails, camping and picnic areas, and beach access routes. In October 2001, the Board sponsored an information meeting on the final report of the Outdoor Developed Areas Regulatory Negotiation Committee. The meeting was held in Denver, CO during the annual meeting of the National Recreation and Park Association. The meeting was informal and provided an opportunity for a dialogue with Board members about the report.

In September 2003, the Board decided to develop a proposed rule on outdoor developed areas using only its rulemaking authority under the Architectural Barriers Act. Taking this approach will help move this rulemaking forward and allow the Federal Government to take the initiative of addressing accessibility in this area before applying requirements to State and local governments or private entities. Future rulemaking under the ADA will be enhanced by the experience of implementing accessibility guidelines at Federal facilities and the Federal Government will gain experience in implementing the guidelines. This experience should prove important before applying them to other entities. The Board expects to publish a proposed rule for public comment in fiscal year 2006.

#### *Passenger Vessels*

In September 1998, the Board convened a 21-member Passenger Vessel Access Advisory Committee to develop accessibility guidelines for cruise ships, ferries, excursion boats, and other vessels covered by the Americans with Disabilities Act. The Committee presented its report with recommendations to the Board in November 2000. The Board created an ad hoc committee of Board members to review the recommendations and begin developing a proposed rule on access to passenger vessels.

On November 26, 2004, the Board published for public comment an advance notice of proposed rulemaking (ANPRM) which addressed access to and in smaller passenger vessels and a notice of availability (NOA) releasing draft guidelines that addressed access to and in larger passenger vessels. The Board is coordinating this rulemaking with the Department of Transportation. The Department of Transportation issued an ANPRM on operational issues affecting passenger vessels on the same date as the Board. The Board held three public hearings in fiscal year 2005 to gather information and input on the ANPRM and the NOA. Over 150 vessel designers and operators, pier operators, persons with disabilities, and others attended the hearings. The Board plans to issue a second draft of the accessibility guidelines before issuing a notice of proposed rulemaking. The second draft is expected to be published in fiscal year 2006.

#### *Public Rights-of-Way*

In October 1999, the Board created a 32-member Public Rights-of-Way Access Advisory Committee to assist it in developing new guidelines for access to sidewalks, street crossings, and related pedestrian facilities. The Committee presented its report with recommendations to the Board in January 2001. The Committee will develop recommendations for a technical assistance manual for agencies and practitioners to support implementation of the future guidelines. In June 2002, the Board released draft guidelines on accessible public rights-of-way for public comment prior to issuing a notice of proposed rulemaking. Over 1,400 comments were received on the draft. The Board also held one public hearing during the comment period. The Board has revised the draft guidelines based on public comments and issued a notice of availability in November 2005 placing the revised draft guidelines in our rulemaking docket. The purpose of placing the draft guidelines in the docket is to facilitate gathering of additional information for the regulatory assessment and the preparation of technical assistance materials to accompany a future rule. The Board is not seeking comments on the draft guidelines. The Board will issue a notice of proposed rulemaking in fiscal year 2007 and will solicit comments at that time.

#### *Codes and Standards*

The Board works with model codes organizations and voluntary consensus standards groups that develop and periodically revise codes and standards affecting accessibility. We have voting membership in several codes and standards organizations, and monitor or are actively involved in the development or revision of dozens of other codes and standards affecting accessibility.

By working cooperatively with codes and standards-setting bodies, Federal and private codes and standards will be more similar, or harmonized, and the Board will be more alert to non-Federal influences affecting its constituencies. Harmonization between Federal and private requirements will make it more likely that buildings

and facilities will be accessible, thus reducing the necessity for complaints and litigation.

*Fiscal Year 2005 Results—Rulemaking*

In fiscal year 2005, the Board:

- Published a notice of availability of revised draft guidelines on access to public rights-of-way.

*Fiscal Year 2005 Results—Codes and Standards*

In fiscal year 2005, the Board:

- Actively participated in the development of the NSPI-9 Standard for Aquatic Recreation Facilities. This new standard addresses water parks and water attractions. The American National Standards Institute's (ANSI) Board of Standards Review approved NSPI-9 2004 "Aquatic Recreation Facilities" as an American National Standard.
- Provided comment on revisions to the Manual on Uniform Traffic Control Devices (MUTCD) which includes coverage of pedestrian signals, intersection design issues, pavement markings, signage, signalization, and other traffic control issues and actively participated on the Signals Committee Task Force to develop a draft standard for accessible pedestrian signals.

*Fiscal Year 2006 Planned Activities—Rulemaking*

In fiscal year 2006, The Board will issue two proposed guidelines:

- NPRM on outdoor developed areas.
- Second draft of guidelines for passenger vessels.

The Board will also charter a Federal advisory committee to begin the process of updating and revising the Section 508 standards and the Telecommunications Act Accessibility Guidelines.

*Fiscal Year 2006 Planned Activities—Codes and Standards*

The Board worked with the Election Assistance Commission (EAC) in the development of voluntary voting system guidelines under the Help America Vote Act. The guidelines were made available in January 2006. The voting system guidelines were developed with the assistance and input of a Technical Guidelines Development Committee and Board of Advisors. Two Access Board members serve on these groups. In fiscal year 2006, the Board will continue working with the EAC on the next version of the guidelines.

*Fiscal Year 2007 Objectives—Rulemaking*

In fiscal year 2007, the Board will issue one final rule and two proposed rules:

- Final rule on access to outdoor developed areas.
- NPRM on public rights-of-way accessibility.
- NPRM on access to passenger vessels.

*Fiscal Year 2007 Objectives—Codes and Standards*

In fiscal year 2007, the Board will continue efforts to harmonize its guidelines with model codes and standards, including the ICC/ANSI A117.1 Standard for Accessible and Usable Buildings and Facilities.

TECHNICAL ASSISTANCE, TRAINING, AND RESEARCH

The Board's long-range goal is to be a leader in information, education, and outreach on accessibility. The Board provides technical assistance to a wide variety of people regarding the accessibility guidelines and standards it issues. The Board's customers include architects, builders, designers, manufacturers, people with disabilities, State and local governments, and Federal agencies. The Board's technical assistance program has four components:

- Responding to customer inquiries. The Board responds to about 12,000 customer inquiries each year. We have four toll-free telephone lines for customers to call with questions. Customers also e-mail and fax us questions. Many literally are sitting at a drawing table with a design problem. They want accurate, reliable, and timely advice. Our customers value being able to discuss their questions directly with our accessibility specialists who developed the guidelines and standards.
- Developing and disseminating bulletins, manuals, and other publications. The Board maintains about 30 publications on accessibility issues. These range from short bulletins responding to frequently asked questions about specific issues such as accessible parking, to manuals on the Board's guidelines and standards. We send out about 15,000 publications each year in print and alternate formats.

- Providing training. The Board conducts about 90 training sessions each year. Training usually is provided at conferences and seminars sponsored by other organizations. Training sponsors generally reimburse us for travel expenses.
- Maintaining the Board's website. The Board's website ([www.access-board.gov](http://www.access-board.gov)) has become a very effective way to distribute information to the public. Customers can download many of our publications and view our accessibility guidelines and standards from our website. We received over 2.2 million user sessions on our website in fiscal year 2005.

The Board also has informal partnerships with other organizations such as the American Institute of Architects, the National Association of ADA Coordinators, and the Disability and Business Technical Assistance Centers (DBTAC) to disseminate information about the Board's programs. Many of the Board's guidelines and publications are available through these organizations' on-line networks. The Board also provides training for these organizations.

As the Board develops guidelines for new areas such as outdoor developed areas, passenger vessels, and public rights-of-ways, there will be increased demands for technical assistance from existing and new customer groups. There also will be opportunities to use existing partnerships and establish new partnerships with customer groups to disseminate information about the Board's guidelines and standards.

#### *Fiscal Year 2005 Results—Technical Assistance, Training, and Research*

Recently, the Board adopted a "focus issue" approach to public outreach and technical assistance that will allow the Board to reach a wider variety of audiences than it does now. The focused approach will supplement the Board's existing outreach programs. Focusing on an issue will allow the Board to make a large impact in a narrow segment of society in a way that its current approach does not allow. The Board selected access to courthouses as its first focus issue and in October 2004 created a 31-member Courthouse Access Advisory Committee to guide this work. The committee has met five times since its creation. It is scheduled to complete its work in November 2006. The committee will develop technical assistance materials related to the accessibility of courthouses, particularly courtrooms, including best practices, design solutions, and the promotion of accessible features.

The Board unveiled its newly redesigned website in June 2005 using the Board's new agency graphic identity. This new graphic identity provided the Board with a coordinated range of new templates for the layout of reports, bulletins, internet presence, and other print and electronic materials. The Board developed this new and more appropriate graphic expression, including both logo and text, for its family of print materials. The Board did this to reflect its professionalism and to communicate that the Board is the only Federal agency devoted to accessibility in the built environment and in communications and electronic technologies.

In fiscal year 2005, the Board responded to 12,271 customer inquiries; distributed 1,250 information packets; and conducted 108 training sessions, which were attended by 9,100 people. An information packet usually contains several publications. Since the Board does not collect data on publications disseminated through partner organizations, the actual number of publications disseminated to its customers is greater than the current data indicate.

The Board has used its website to provide copies of the Board's guidelines and answers to frequently asked questions about the guidelines so that more customers can get the information they need. The number of user sessions on the Board's website continues to grow. There were approximately 2.2 million user sessions in fiscal year 2005, nearly 600,000 more than the previous year. Due to the increasing use of the its website, the Board is focusing on web-based dissemination of information since this allows a variety of options for speedy distribution at a low cost to the Board. The Board also published and distributed six issues of *Access Currents*, a free newsletter issued every other month by mail and e-mail.

Technical assistance, research, and training projects funded in fiscal year 2005 include:

- Retail Checkout Counters and Point-of-Sales Machines.*—This project will develop a technical assistance bulletin demonstrating in well-illustrated and detailed case studies and best practices the application of accessibility requirements to the design, engineering, fabrication, and construction of check-out counters and transaction machines.
- Wheeled Mobility Research.*—This multi-year project will research and report on the space requirements, horizontal and vertical maneuvering parameters, reach ranges, and other key factors of occupied power wheelchairs and scooters in use in buildings, facilities, and transportation vehicles. The data collected is to be presented in a report that will facilitate comparison with provisions in current

accessibility guidelines, with key published studies of mobility aid space and maneuvering requirements, and will enable consideration of several increments of accommodation for both power wheelchairs and scooter types.

- Effects of Static Electricity in Play Areas.*—Static electricity in play areas is potentially harmful to children who have cochlear implants. This project will collect measures of the levels of static electricity being created in play areas where plastic play components are installed. The contractor will analyze the findings from several test areas and compare them to the charges that result from other sources and charges known to have effects on hearing technologies. A second phase of work will support additional site testing.
- Measures and Materials.*—This project will bring together representatives of design and construction industry organizations to work with the Board to incorporate information on tolerances relative to accessibility in industry specifications. A technical assistance publication will also be developed.
- Wayfinding at Intersections.*—This project funded a workshop that brought together highway engineers, orientation and mobility specialists, and people with disabilities in a 2-day workshop to consider possible changes to roadway design to facilitate wayfinding. Fiscal year 2005 funding supported continued discussion and development of standard intersection plans based upon workshop recommendations, with the objective of arriving at consensus schemes that can be implemented by industry.
- Passenger Vessels Regulatory Assessment.*—This project will develop an initial case study for use in the Passenger Vessels Regulatory Assessment.

*Fiscal Year 2006 Planned Activities—Technical Assistance, Training, and Research*

In November 2005, the Board set its research priorities for fiscal year 2006. The projects include the following:

- Communications in Transportation Facilities.*—This project will study and determine the need for changes in communications accessibility provisions in the Board's guidelines for transportation facilities and vehicles.
- Pedestrian Signals at Roundabouts.*—The draft public rights-of-way guidelines require pedestrian signals at multi-lane crossings of roundabouts. This study will identify candidate technologies in use elsewhere around the world.
- Wayfinding Research.*—The Department of Blind Rehabilitation at Western Michigan University is using seed funding from the National Eye Institute to assess the relative effectiveness of several physical wayfinding cues in the outdoor environment, including returned edges, tactile surfaces, guidestrips, and curb ramp orientation. Our funding will enable them to do more dispositive research with a larger group of subjects and test a wider range of cues.
- Standards for Assisted Transfer.*—This project will follow-up on an earlier one that collected and presented information on current practices in medical care and assisted living facilities by convening an expert group of stakeholders to recommend changes to the Board's guidelines.
- Slope and Surface Effects on Manual Wheelchair Users.*—This project will commission a comparative analysis relative to manual wheelchair use of the several standard protocols used to measure work, effort, energy expenditure, efficiency, difficulty, and rollability to develop a more accurate protocol.
- APS Troubleshooting.*—This project will commission a technical assistance bulletin regarding how to specify accessible pedestrian signals that are appropriate to specific intersection types and conditions.
- Sign Language Versions of Selected Board Material.*—People who are deaf would like to access materials in their native language, American Sign Language. This project will develop short video clips using American Sign Language to convey information about the Board and ways to file Architectural Barriers Act complaints and place the clips on the Board's web site.
- Indoor Environmental Quality Follow-up.*—This project will commission the National Institute of Building Sciences to pursue key recommendations of a previous Board sponsored study on improving the indoor environment for individuals with multiple chemical sensitivities and electromagnetic sensitivities.
- Study Lighting for Low Vision Users.*—This project will commission a research synthesis on existing lighting research and standards affecting people with low vision. This synthesis will be useful in providing technical assistance to improve access for people with low vision and could lead to eventual rulemaking.
- Regulatory Assessment for Passenger Vessel Rulemaking.*—This work is required by our rulemaking agenda.
- Regulatory Assessment for Public Rights-of-Way Rulemaking.*—This work is required by our rulemaking agenda. This year the Board will fund the incidental

expenses necessary to convene industry leadership to plan for data gathering and analysis.

Because of the Board's expertise in accessibility issues, many government agencies and private organizations ask for its assistance in ensuring access at their facilities. The Board provided technical assistance to the Department of Commerce on the proposed new Census Bureau building in Suitland, MD. Members of the Maryland Congressional delegation requested the Board's assistance to help make this building a model of accessibility. The Board also reviewed accessibility issues for the planned new Department of Transportation headquarters building.

*Fiscal Year 2007 Objectives—Technical Assistance, Training, and Research*

In fiscal year 2007 and beyond, the Board will develop training and technical assistance materials on its planned final rules on outdoor developed areas, passenger vessels, and public rights-of-ways. As the Board publishes final rules, it makes every effort to ensure that training and technical assistance materials will be available to organizations and individuals that must apply the new requirements.

ARCHITECTURAL BARRIERS ACT ENFORCEMENT

The Board enforces the Architectural Barriers Act (ABA), which requires that most buildings designed, constructed, altered, or leased by the Federal Government and certain other federally financed facilities be accessible to people with disabilities. Complaints received by the Board concern post offices, national parks, military facilities, veterans hospitals, courthouses, and a variety of other facilities. When the Board has jurisdiction and finds that the applicable accessibility standards were not followed, it requests a corrective action plan and monitors the case until the barrier is removed. Even when the Board does not have jurisdiction or no violation is found, it attempts to negotiate voluntary barrier removal.

The Board's long-range goal is to be a leading partner with Federal agencies to make the Federal Government a model of compliance with accessibility standards. The Board's experience with enforcement of the ABA is that most violations are not intentional. When violations are found, it is usually because the people responsible for designing buildings, reviewing plans, and on-site construction did not have a good understanding of the accessibility standards and how to apply them. People responsible for building planning and design at headquarters, regional and field offices, and local sites must have a working knowledge of the accessibility standards if compliance is to be achieved. As Federal agencies are reorganized and personnel assignments and responsibilities change, it is important that agencies have effective systems for training new people responsible for applying the accessibility standards and for monitoring compliance with the ABA. The Board has also worked with the Federal agencies responsible for issuing accessibility standards for facilities covered by the ABA to update their standards to be consistent with the Board's new ADA and ABA Accessibility Guidelines that were issued in July 2004. In November 2005, the General Services Administration updated its accessibility standards for the ABA. The new standards will apply to most Federal facilities that are constructed, altered, or leased after May 8, 2006. The United States Postal Services also updated its ABA standards for postal facilities in May 2005. The Board continues to work with the Department of Defense and the Department of Housing and Urban Development to update their ABA standards.

*Fiscal Year 2005 Results—ABA Enforcement*

In fiscal year 2005, the Board received 168 written complaints. These included complaints investigated under the Architectural Barriers Act, and also those concerning facilities not covered by that law but potentially covered by other laws, such as the Americans with Disabilities Act and the Rehabilitation Act. Of the 168 complaints, the Board opened 90 as new Architectural Barriers Act cases. Although the Board did not have authority under the Architectural Barriers Act in the other 78 complaints, the Board responded to the complainants, usually by referring them to the appropriate enforcement agency. In addition, the Board referred another 46 complainants to other agencies for action when our investigations revealed there was no violation of the Architectural Barriers Act or the Board did not have jurisdiction.

The Board responds quickly to all new complaints and contacts complainants frequently to update them on the status of their complaints. In fiscal year 2005, the Board sent initial letters to complainants acknowledging receipt of their complaint or began an investigation of the issues they raised within an average of 5 days. The Board's customers regularly say they are pleased to hear from a Federal agency so promptly. It is Board practice to keep complainants informed on a regular basis

throughout the course of our investigations. In fiscal year 2005, the Board contacted 159 complainants to provide updates on the status of their complaints.

*Fiscal Year 2006 Plans—ABA Enforcement*

In fiscal year 2006, the Board will continue to investigate complaints under the Architectural Barriers Act. The Board anticipates responding to complaints in an average of 5 or fewer business days and will continue to provide periodic updates to complainants on the status of their complaints. At the beginning of fiscal year 2006, the Board had 107 active cases. The Board expects to receive 180 new complaints in fiscal year 2006. Of this total, the Board estimates that 100 will be opened as new Architectural Barriers Act cases and 80 will be referred to other agencies for enforcement under other laws, such as the Americans with Disabilities Act and the Rehabilitation Act. This represents an increase over fiscal year 2005, which are anticipated in response to an outreach effort the Board just completed to provide informational packets on the Architectural Barriers Act to independent living centers and technical assistance centers throughout the country.

*Fiscal Year 2007 Objectives—ABA Enforcement*

In fiscal year 2007, the Board will continue to investigate complaints under the Architectural Barriers Act. The Board estimates that it will have 105 active cases at the beginning of fiscal year 2007 and will receive 180 new complaints. The Board expects to open 100 new Architectural Barriers Act cases and refer 80 complaints to other agencies for enforcement under other laws. The Board will continue to provide good customer service.

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PREPARED STATEMENT OF THE CAPITAL METROPOLITAN TRANSPORTATION AUTHORITY

Mr. Chairman and members of the subcommittee, on behalf of the Capital Metropolitan Transportation Authority in Austin, Texas, I am pleased to submit this statement for the record in support of our fiscal year 2007 funding requests from the Federal Transit Authority for Capital Metro—the transportation provider for Central Texas. I hope you will agree that the appropriating of funds for these Central Texas projects warrants serious consideration as Austin and the surrounding Texas communities plan for our region's growing transportation needs.

First, let me thank you for your past financial support for transportation projects in Central Texas. Your support has proven valuable to Capital Metro and to our Central Texas community as we face new challenges.

As you know, Interstate 35 runs from Canada to Mexico, and along the way it also runs through the City of Austin and Capital Metro's 600-square-mile service area. While traffic in this important corridor has always been a challenge, the North American Free Trade Agreement has resulted in increased traffic and congestion for our region. In fact, a 2002 study by the Texas Transportation Institute determined Austin, Texas to be the 16th most-congested city nationwide.

Also, Central Texas' air quality has reached near non-attainment levels. Together, our community has developed a Clean AirForce, of which Capital Metro is a partner, to implement cooperative strategies and programs for improving our air quality. Capital Metro has also unilaterally implemented several initiatives such as offering free rides on ozone action days for the last 14 years, converting its fleet to clean-burning Ultra Low Sulfur Diesel (ULSD), becoming the first transportation authority in Texas to introduce environmentally-friendly hybrid-electric buses, and creating a GREENRide program to carpool Central Texas workers in low emission hybrid gas/electric automobiles.

To address these transportation and air quality challenges as well as our region's growing population, in 2004 Capital Metro conducted an extensive community outreach program to develop the All Systems Go Long-Range Transit Plan. This 25-year transportation plan for Central Texas was created by Capital Metro, transportation planners, and local citizens. More than 8,000 citizens participated in the design of the program that will bring commuter rail and rapid bus technologies to Central Texas. The plan will also double Capital Metro's bus services over the next 25 years.

By a vote of over 62 percent, this long-range transportation plan was adopted by the Central Texas community in a public referendum on November 2, 2004. The plan received bipartisan support, along with endorsements from the business community, environmental organizations, neighborhood associations, and our community leaders.

An important component of the All Systems Go Long Range Transit Plan is the creation of an urban commuter rail line along a 32-mile-long freight rail line currently owned and operated by Capital Metro. The proposed starter route would pro-

vide urban commuter rail service extending from downtown Austin (near the Convention Center) through East and Northwest Austin and on to Leander.

To implement the community's All Systems Go Transit Plan, Capital Metro is seeking \$10 million for fiscal year 2007 for five projects of importance to our Central Texas community:

RAPID BUS PROJECT—\$2 MILLION

The All Systems Go Long-Range Transit Plan relies heavily on new rapid bus technologies. The plan creates several new rapid bus routes throughout the Central Texas region. The Rapid Bus Project is designed to provide faster, frequent and dependable service in main bus corridors with high ridership while avoiding large fixed costs and long lead times. Capital Metro is seeking \$2 million for the Rapid Bus Project.

ENHANCEMENT AND IMPROVEMENT OF BUSES AND BUS FACILITIES—\$5 MILLION

Capital Metro has embarked on a long-term plan to improve and expand bus service. In addition to improving bus routes, the agency is investing in critical park and ride facilities, transit centers and enhanced bus stop locations and amenities. As Capital Metro's service area and the population we serve continue to grow, we will continue to enhance our system and facilities while addressing traffic congestion and air quality concerns. In the next 3 years, Capital Metro has planned to invest \$82.5 million in capital projects to better serve our growing population. Capital Metro seeks \$5 million from the appropriations process for these improvements and expansions of our bus service and facilities.

Also, Capital Metro is seeking funds for three new strategically located park and ride facilities in our service area.

LEANDER PARK AND RIDE FACILITY—\$1 MILLION

The Leander Park and Ride will anchor Capital Metro's Urban Commuter Rail and express bus services serving Leander and rapidly growing areas of Western Williamson and Travis Counties. Connecting circulator service in Leander is also planned to expand and improve Capital Metro's service in Northwestern suburbs and throughout Central Texas. Capital Metro is seeking \$1 million for this project.

OAK HILL PARK AND RIDE FACILITY—\$1 MILLION

The Oak Hill Park and Ride facility will anchor Capital Metro's future rapid bus services to rapidly growing areas of Southwest Austin and Travis County. This facility and its routes will connect local service to several nearby neighborhoods to serve the growing number of suburban commuters in this portion of Capital Metro's service area. Capital Metro is seeking \$1 million for this project.

SOUTH IH-35 PARK AND RIDE FACILITY—\$1 MILLION

The South IH-35 facility will anchor Park and Ride and Rapid Bus services to Downtown Austin. It will also serve as a connecting point for local bus services in Far South Austin. These local services will expand as the area grows to improve Capital Metro's service in Southern suburbs and throughout Central Texas. Capital Metro is seeking \$1 million for this project.

I look forward to working with the committee in order to demonstrate the necessity of these projects. Your consideration and attention are greatly appreciated.

PREPARED STATEMENT OF THE GREATER ORLANDO AVIATION AUTHORITY

Chairman Bond and distinguished members of the Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies, the Greater Orlando Aviation Authority ("the Authority") greatly appreciates the opportunity to present written testimony in support of our funding request for important safety and capacity enhancements at Orlando International Airport.

The Authority respectfully requests your subcommittee's consideration and support of the following Federal initiative: Runway 36L Instrument Landing System Category II (ILS Cat II), with an Approach Lighting System with Sequenced Flashing Lights, associated Environmental Assessment and West Airfield modifications at Orlando International Airport (MCO).

The Authority respectfully requests the subcommittee to include the following line item in the fiscal year 2007 FAA F&E Budget:

“Acquisition and Installation of Runway 36L Instrument Landing System Category II (ILS CAT II) with an Approach Lighting System with Sequenced Flashing Lights (ALSF-2); and associated Environmental Assessment and West Airfield modifications at Orlando International Airport—\$4,140,000”.

Serving nearly 34 million passengers in 2005, Orlando International Airport is Florida’s busiest commercial service airport and is ranked as the 14th busiest airport nationwide. With its four parallel runway system, the airport averages nearly 1,000 daily aircraft operations (over 350,000 take-offs and landings annually). Runway 36L serves as the predominant arrival runway when aircraft are landing in a “north flow” approach at MCO. This runway end currently does not have precision instrument approach capability.

Installation of ILS/ALS equipment will increase capacity, reduce flight delays and provide enhanced safety and aircraft separation, by allowing FAA Orlando Air Traffic Control staff to optimize its preferred operational procedures of landing on outer runways and taking off on the interior runways.

In addition, Orlando International Airport is currently served by 56 different air carriers. The ILS CAT II system is the only established navigational system that is fully compatible with existing air carrier instrument flight capabilities.

#### JUSTIFICATION AND CLOSING

Orlando International Airport remains steadfast in its commitment to help our Nation in its mission to provide safe, efficient, and affordable air travel as an integral part of our Nation’s aviation system.

Orlando International Airport (OIA) is one of the Central Florida’s primary assets and has been previously designated as a U.S. Security Category X airport. In 2005, OIA served over 34 million passengers, surpassing Miami International Airport as the busiest commercial passenger airport in Florida. Additionally, OIA is the 14th busiest commercial service airport in the Nation and the 24th busiest in the world. In terms of origin and destination (O&D) passenger traffic at domestic airports, OIA ranked 4th behind Los Angeles International, Las Vegas’ McCarran International and traditional airline hub airports such as Chicago’s O’Hare International. O&D passengers represent approximately 95 percent of all passengers at OIA. This high level of O&D activity is expected to continue.

OIA has scheduled service to 84 non-stop domestic destinations and 19 non-stop international destinations, promoting increased airline service and competitive fares. The largest rental car market in the world is located at OIA. The airport shares a unique relationship with the regional economy. An Economic Impact Study completed in 2004 estimated that OIA generates a \$20.7 billion annual economic impact to the Central Florida Region and is responsible for 62,100 direct and indirect jobs.

The Authority expresses its gratitude for the opportunity to present this testimony to your subcommittee. We look forward to working with you and your staff in advancing these safety and capacity initiatives that will benefit the National Aviation System. If the subcommittee requires any additional information regarding the identified funding needs, please do not hesitate to contact the Greater Orlando Aviation Authority.

#### RUNWAY 36L INSTRUMENT LANDING SYSTEM CATEGORY II (ILS CAT II), APPROACH LIGHTING SYSTEM WITH SEQUENCED FLASHING LIGHTS AND ASSOCIATED ENVIRONMENTAL ASSESSMENT AND WEST AIRFIELD MODIFICATIONS AT ORLANDO INTERNATIONAL AIRPORT

“All of us who work for and with aviation safety professionals take pride in the results of our collective efforts, especially given the economic turbulence being experienced by U.S. carriers. But even as we recognize how safe it is to travel in commercial air transportation, we must look beyond to face the challenge of how to make the system safer. How can we continue to improve aviation safety as demand and complexity increase? We are facing record setting passenger numbers, new light jets, UAVs, . . . even space travel is not as far away as it once was. We cannot afford to rest on our laurels.”—Statement of Marion C. Blakely, FAA Administrator, before the Senate Commerce Committee, Subcommittee on Aviation on Safety Issues on Aviation Safety, November 17, 2005.

The Authority respectfully requests the subcommittee to include the following line item in the fiscal year 2007 FAA F&E Budget:

“Acquisition and Installation of Runway 36L Instrument Landing System Category II (ILS CAT II), with an Approach Lighting System with Sequenced Flashing

Lights (ALSF-2); and associated Environmental Assessment and West Airfield modifications at Orlando International Airport—\$4,140,000<sup>2</sup>.

This high priority airfield capacity enhancement project will include the following elements:

- Development of an Environmental Assessment (EA) to evaluate the planned ILS and ALS.
  - Procurement of ILS and ALS related equipment: glide slope, localizer, marker beacons (inner, middle, outer/DME), Runway Visual Range (RVR) and ALSF-2.
  - Design, construction, installation, and certification of ILS and ALS equipment.
- To support this airport capacity and safety related initiative, the following upgrades to existing facilities will be necessary:
- Runway/taxiway pavement markings and signage.
  - Electrical system and lighting.
- Installation of an ILS CAT II on Runway 36L will provide the following benefits:
- Increased capacity.
  - Reduced flight delays.
  - Enhanced safety and aircraft separation.
  - Allow FAA Orlando Air Traffic Control staff optimization of its preferred operational procedures by landing on outer runways and taking off on the interior runways.
  - Full compatibility with existing instrumentation utilized by all 56 air carriers currently serving Orlando International Airport.

PROJECT COST ESTIMATE—RUNWAY 36L ILS & ALS AND WEST AIRFIELD IMPROVEMENTS,  
ORLANDO INTERNATIONAL AIRPORT (MCO)

Item Description	Cost	Comments
ILS CAT II <sup>1 2</sup> .....	\$1,500,000	ILS eqpt. to be upgraded to CAT III as a future project. To serve R/W 36R ILS CAT II & future ILS CAT III. EA—Environmental Assessment.
ALSF-2 <sup>1 2</sup> .....	1,500,000	
ILS/ALS EA .....	35,000	
Subtotal .....	3,035,000	Allowance for electrical system, lighting, marking, signage improvements.
West Airfield Modifications .....	100,000	
Construction Total .....	3,135,000	
Professional Fees/Markups .....	1,008,216	
TOTAL .....	4,143,216	
TOTAL (ROUNDED) .....	4,140,000	

<sup>1</sup> Costs were provided by Dave Gigowski (FAA Southern Region) and are stated in 2006 dollars.  
<sup>2</sup> Includes costs for NAVAID design, equipment procurement, installation/construction and flight certification.

PREPARED STATEMENT OF THE NAVAJO NATION

NAVAJO DIVISION OF COMMUNITY DEVELOPMENT—INDIAN COMMUNITY DEVELOPMENT  
BLOCK GRANT

INTRODUCTION

The Navajo Nation reservation lies within the three States of Arizona, New Mexico and Utah and covers about 27,000 square miles—about the size of the State of West Virginia. According to the 2000 Census count the Navajo Nation has a population of 269,202 enrolled members and is considered the largest federally recognized Indian Tribe in North America. Most of its members still live in substandard housing, consisting of one room dwelling units with no running water or electricity and continue to suffer from high unemployment with about 43 percent of Navajos living below the poverty level with per capita income averaging about \$7,269 as compared to the national poverty level of 9.2 percent and \$21,587 for the national per capita income level. The Navajo people suffer chronic unemployment and must cope with a chronic massive need for housing and infrastructure. While unemployment in American averages 5 percent, the Navajo unemployment rate averages 38 percent to 56 percent, depending on the season.

The Navajo Nation's need for adequate housing is amply supported by other distressing statistics. For example, over 32 percent of Navajo homes do not have

plumbing or water, 60 percent do not have telephone services and 28 percent lack of adequate kitchen facilities. We have estimated the need for at least 30,000 new housing units and over 50,000 needing basic utility services.

#### NAVAJO NATION COMMUNITY DEVELOPMENT

The Navajo Nation Division of Community Development is responsible for providing housing and related assistance to low-income families who qualify under the following programs: (1) Weatherization Assistance Program; (2) Housing Services Program, and (3) Community Development Block Grant Program.

The Navajo Division of Community Development is established as part of the Executive Branch within the Navajo Nation government. It is the only Division responsible for providing community development throughout the Navajo Nation in terms of governmental buildings and home construction and related infrastructure. The Division of Community Development administers the Weatherization Assistance Program, the Housing Services Program, and the Community Development Block Grant Program, the Capital Improvement Office, Design and Engineering Services and Local Government Support Centers that provide assistance and services to communities throughout the Navajo Nation. The services provided by these programs are funded through the treasury of the Navajo Nation government and through external funds received from State and Federal grants and through appropriations administered through the Bureau of Indian Affairs.

The Navajo Nation relies on revenues generated from mineral leases that flow into its tribal treasury and is used to operate the Navajo government. In fiscal year 2007 the Navajo Nation will lose about \$21 million from its main employers who operate mineral leases that will expire or will cease to continue operations if negotiations fail with companies that do not upgrade their operation under the Clean Air Act and Court Decree filed by environmental groups. For this reason, the Navajo Nation looks to its trustee, the Federal Government to provide Federal appropriations to serve its vast population, many of whom live in rural and remote locations of the reservation and continue to have inadequate housing and no running water and electricity. This is all due to the vast Navajo land base that requires tens upon thousands of dollars to run power lines, sewer lines and other basic necessities through the rural communities and without Federal dollars to address basic services from the Federal Government and as part of its trust obligation to the Navajo Nation, the many Navajo members will continue to live below the poverty level well into the next decade and beyond.

#### COMMUNITY DEVELOPMENT BLOCK GRANT

The Navajo Nation hereby provides a position on the following proposed policy as it pertains to the Community Development Block Grant.

##### *The Navajo Nation Recommends More Tribal Consultation of Any Proposed Allocation That Impacts Tribal Governments*

At the present time there is basically no consultation between the Federal Government and the Navajo Nation.

The Navajo Nation strongly opposes President Bush's proposal to reform the CDBG formula by consolidating Native American Programs with other similar programs. Native Americans live in a very unique society and should not be grouped or compared with other distressed communities.

The President's fiscal year 2007 budget proposes to reform the ICDBG by consolidating and eliminating several economic development programs. The President's proposal will establish regional councils to focus more on programs that have regional impacts. The regional councils will not be familiar with Native American communities and have a different interpretation of rural communities. Indian country simply cannot sustain or support such a severe reduction in funding or changes in the ICDBG.

If other programs are consolidated into CDBG, the primary intentions of the ICDBG program will be lost. The focus will shift from infrastructure development such as water, electric, public facilities and economic development other types of development.

##### *The Navajo Nation Opposes the Transfer of ICDBG to the Department of Commerce*

The Navajo Nation strongly opposes the Bush Administration's proposal to transfer the Indian Community Development Block Grant program to the Department of Commerce. The Navajo Nation urges the Congress to keep the ICDBG program within the U.S. Department of Housing and Urban Development. Most of the work the Department of Commerce has done has been with municipalities and urban areas. If the ICDBG is transferred to Commerce, the rural areas and particularly

the Indian tribes will be neglected, because of the unfamiliarity of the Department of Commerce with rural development and Indian tribes.

If the ICDBG is transferred and consolidated with other programs with a common set of performance goals, it will probably be oriented towards established communities and not rural areas.

*The Navajo Nation Opposes Any Budget Cuts in the ICDBG and NAHASDA Programs*

The Navajo Nation opposes any proposed budget cuts in the ICDBG and NAHASDA. The Navajo Nation has been providing infrastructure of basic utilities to hundreds of Navajo families since 1976. The need for infrastructure and housing continues to escalate while the funding remains at the same level. The cost in materials, labor, inflation, and the increase in the Navajo population has all resulted in increase costs. A large number of the Navajo people need infrastructure development (electricity and water/wastewater facilities). The Navajo Nation continues to advocate for an increase in ICDBG funding to start addressing a large number of families.

Despite the proposed changes, reform, or decrease in funding, the ICDBG has made tremendous positive impacts to communities who have received ICDBG funding in the past. Within the past 5 years, the ICDBG has accomplished the following:

Year	Amount Funded	No. of Families Benefited
1999 .....	\$5,000,000	407
2000 .....	\$5,000,000	314
2001 .....	\$5,000,000	240
2002 .....	\$5,000,000	345
2003 .....	\$4,345,941	295
2004 .....	\$5,491,000	314

CONCLUSION

Therefore, the Navajo Nation urges the Congress to either increase the level of funding of ICDBG or maintain the current level of funding to provide the basic infrastructure for the increasing Navajo population. Lastly, Navajo urges Congress not to make any changes in organizational structure or formula structure of the CDBG until tribal consultation is made.

PREPARED STATEMENT OF THE AMERICAN PUBLIC TRANSPORTATION ASSOCIATION

APTA is a nonprofit international association of more than 1,600 public and private member organizations including transit systems and commuter rail operators; planning, design, construction and finance firms; product and service providers; academic institutions; transit associations and State departments of transportation. APTA members serve the public interest by providing safe, efficient and economical transit services and products. More than 90 percent of persons using public transportation in the United States and Canada are served by APTA members.

INTRODUCTION

Mr. Chairman and members of the committee, on behalf of the American Public Transportation Association (APTA), we thank you for this opportunity to submit written testimony on the need for and benefits of investment in Federal Transit Administration (FTA) programs for fiscal year 2007.

OVERVIEW

Mr. Chairman, the fiscal year 2007 Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies Appropriations bill is an opportunity to advance national goals and objectives through increased investment in our surface transportation infrastructure, particularly public transportation. For that reason, we strongly urge Congress to fund the Federal transit program at no less than the \$8.975 billion level authorized in the Safe, Accountable, Flexible, Efficient Transportation Equity Act—A Legacy for Users (SAFETEA—LU), which Congress approved by overwhelming margins just last summer.

Transit plays a number of important roles, including advancing energy independence. It reduces congestion and it provides mobility options. In fact, expanding pub-

lic transportation options is more important than ever, since transit is the single quickest way for individuals and families to beat the high cost of gasoline.

Americans took more than 9.7 billion transit trips in 2005, and transit ridership grew faster than highway travel (1.3 percent vs. 0.1 percent). Since 1995, the use of public transportation has increased by 25.1 percent—more than the growth of highway travel (22.5 percent) over that period. The growth of transit ridership during the past 10 years demonstrates that Americans want transportation choices and will leave their cars behind when convenient, quality public transit service is available. As gas prices continue to rise, the demand for public transportation will only continue to grow.

Additionally, it is important to recognize that public transportation benefits those who drive, as well as those who use transit. According to the 2005 Texas Transportation Institute's Annual Urban Mobility Report, transit is successfully reducing traffic delays and related congestion costs in America's 85 largest urban areas. Without transit, nationwide delays would have increased 27 percent, costing residents and businesses in those major urban areas an additional \$18.2 billion in lost time and fuel.

#### FISCAL YEAR 2007 GOALS

APTA recognizes the need to wisely invest limited Federal resources, and we believe that investment in public transportation is a wise use of limited resources. Our Nation has a tremendous need for new investment in transit and the rest of our surface transportation infrastructure. According to a recent study by the U.S. Chamber of Commerce's National Chamber Foundation, if the Federal share of transportation investment remains constant, in 2015 the Federal share of the average annual capital investment needed to maintain the Nation's existing highway and transit systems will be \$64 billion, and the Federal share to improve highway and transit systems will be \$89 billion.

APTA's funding request for FTA programs in fiscal year 2007 is based upon SAFETEA-LU, which was enacted last year. SAFETEA-LU authorizes and guarantees \$8.975 billion for Federal Transit Administration programs in fiscal year 2007. APTA urges Congress to fund the transit program at the authorized level so that communities across the Nation, utilizing State and local resources in tandem with Federal funds, can begin to address the overwhelming need both to preserve the existing transit infrastructure and to expand and improve that infrastructure in growing communities and those without good transit service.

SAFETEA-LU builds on the success of the two most recent surface transportation authorization laws—the 1991 Intermodal Surface Transportation Efficiency Act and the 1998 Transportation Equity Act for the 21st Century. Under SAFETEA-LU, the Federal transit program structure remains largely the same, retaining formula programs that target Federal investment to transit systems based on need and capital investment programs that address special needs and projects. The new law also provides for increased transit investment in rural communities, many of which have little or no transit service. It also establishes a number of new programs, including programs for new small fixed guideway projects, transit in our national parks, and another meant to help address the needs of people with disabilities beyond service required under the Americans with Disabilities Act.

#### PRESIDENT'S BUDGET PROPOSAL

The administration's fiscal year 2007 budget proposal recognizes the importance of public transportation investment. While we are pleased that the administration's proposal adheres to the authorized transit program in most respects, we want to identify two concerns APTA has with the President's fiscal year 2007 budget proposal.

First, the administration proposes to fund only \$100 million of the \$200 million authorized in fiscal year 2007 for the small starts program that is meant to assist the development and construction of smaller fixed guideway projects such as streetcars, trolleys, commuter rail, and bus rapid transit systems. This program is part of the program that provides funding to new fixed guideway projects—heavy and light rail, bus rapid transit, commuter rail, and trolleys—and the President's proposal would actually reduce total funding for this program below the fiscal year 2006 level.

Second, the President's budget proposal for the Federal Railroad Administration (FRA) proposes, consistent with last year's appropriations bill, that commuter railroad riders will assume a higher portion of maintenance and capital expenses on the Amtrak-owned portions of the Northeast Corridor. We are concerned that the imposition of these fees by the Federal Government will increase operating costs for

these commuter railroads and result in higher costs for commuter rail users and the State and local taxpayers who fund these systems, and therefore urge Congress not to include this fee in this year's appropriations bill.

#### NEW STARTS/SMALL STARTS

Mr. Chairman, APTA is disappointed that the administration has proposed to fund transit below the level so recently authorized and guaranteed by Congress. The administration requested \$100 million less than the amount authorized from the general fund for the new starts program, proposing only half of the funding authorized for the new small starts program, a program to fund less costly fixed guideway projects such as light rail, commuter rail, and bus rapid transit systems.

As this committee knows, there is overwhelming demand for new starts projects, and SAFETEA-LU authorized 387 projects. New fixed guideway projects are an important part of meeting transit needs, but these major capital projects take years to develop and require a predictable funding commitment. Once appropriated for a fiscal year, new starts program funding remains available for the 2 subsequent fiscal years. The effect of underfunding the small starts/new starts program will be felt disproportionately in future years by causing transit providers to fall further behind in the development of new, less expensive projects due to the cuts that would be implemented under the administration's proposal, robbing communities of the congestion relief and environmental benefits associated with the projects.

We want to make another point, Mr. Chairman. SAFETEA-LU restructured the general fund and Mass Transit Account (MTA) funding sources so that MTA outlays are now scored when they are actually spent rather than when they are appropriated. The good news is that MTA balances now are significantly higher than they would have been under the old scoring system. But this also means that the new starts program is now funded exclusively from the general fund. Mr. Chairman, it is important to emphasize that this was done to improve the overall financing of the Federal transit program, and was not meant to create funding uncertainty or program cuts, as the administration proposes.

Finally, and importantly, we note that 2005 ridership on light rail systems in the United States has grown at a faster rate than any other form of transit. Ridership on light rail grew by 6 percent in 2005. Some light rail systems showed double digit increases in ridership: Minneapolis (168.9 percent); Houston (38.0 percent); New Jersey (17.8 percent); Salt Lake City (13.3 percent); Sacramento (12.8 percent); and Los Angeles (10.5 percent). There is clearly overwhelming demand for these and other new starts projects. We look forward to working with this committee and ask for your support for fully funding new starts and all other elements of the fiscal year 2007 Federal transit program at the authorized level.

#### NORTHEAST CORRIDOR COMMUTER RAIL ISSUES

We are also concerned about another issue in the proposed fiscal year 2007 budget. The administration proposes that commuter railroads will assume a higher portion of capital and maintenance expenses on the Amtrak-owned portion of the Northeast Corridor. An amount of \$59 million in fees on commuter railroads is assumed in each of fiscal year 2006 and 2007 to support Amtrak spending.

The provision in the fiscal year 2006 Transportation Appropriations law that requires the Federal Railroad Administration to assess these fees has proven very difficult to implement. The administration began the process with a "top down" approach that did not take heed of the accompanying conference report which directed the Secretary to seek to achieve consensus among all stakeholders in the corridor. In fact, the FTA went so far as to place a notice in the Federal Register indicating its intent to make payment of these fees a condition for receipt of Federal transit grants to commuter railroads. More recently, the process has improved, but it still requires a series of very difficult calculations and has absorbed a considerable amount of time among top leaders of the FRA, State DOTs and commuter railroads.

The only silver lining for the 2006 process is that significant time has been invested by governors, State DOTs and commuter railroads in working with FRA on corridor issues. This time and effort should be devoted to developing a long-term plan for improving the corridor not to figuring out how to add to the substantial payments commuter railroads already make for corridor maintenance and capital improvements.

For fiscal year 2007, APTA urges Congress not to include language on commuter railroads similar to last year's appropriations law. Commuter railroads already pay a fair share of Northeast Corridor costs as established through carefully negotiated legal, financial and operating agreements involving substantial State investments.

## PUBLIC TRANSPORTATION AND ENERGY INDEPENDENCE

APTA is pleased that President Bush highlighted the need to focus on energy independence in his State of the Union address earlier this year. The President said that "keeping America competitive requires affordable energy . . . America is addicted to oil, which is often imported from unstable parts of the world." He further stated that "the best way to break this addiction is through technology."

We agree, Mr. President! We cannot think of a more important technology in that regard than fixed guideway transit, including heavy and light rail, commuter rail, and bus rapid transit. This technology is readily available and many communities already have systems which can be expanded with more investment.

We must remember also that at its current level of use, public transportation is already reducing Americans' energy bills:

—For every passenger mile traveled, public transportation is twice as fuel efficient as private automobiles.

—Public transportation saves more than 855 million gallons of gasoline a year, or 45 million barrels of oil. These savings equal about 1 month's oil imports from Saudi Arabia. In 2005, 9.7 billion trips were taken on public transportation.

Moreover, transit agencies are increasingly investing in alternative fuel buses to reduce dependence on oil. Almost 17 percent of fixed route buses now use alternative fuels and 20 percent of buses on order will use alternative fuels. Public transportation is clearly doing its part to promote energy independence through innovative technologies, and that is why we urge Congress to honor SAFETEA-LU and fully fund the transit program in fiscal year 2007.

## CONCLUSION

Public transportation plays a key role in meeting the goals of the administration and Congress in providing energy independence, congestion relief and transportation mobility options for Americans. APTA strongly believes that the Federal Government should invest no less than the level authorized and guaranteed by Congress for fiscal year 2007 in SAFETEA-LU if we are to advance these goals.

Mr. Chairman, on behalf of APTA's member organizations, I thank you for this opportunity to express our views.

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PREPARED STATEMENT OF THE NATIONAL ALTERNATIVE FUELS TRAINING  
CONSORTIUM, WEST VIRGINIA UNIVERSITY

Chairman Bond, Ranking Member Murray and members of the Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies Subcommittee on Appropriations, the National Alternative Fuels Training Consortium (NAFTC) respectfully supports the request of the National Association of State Fire Marshals (NASFM) fiscal year 2007 funding of \$950,000 to develop, offer and implement a comprehensive nationwide training program for all first responders to learn about the specifics of Alternative Fuel and Advanced Technology Vehicles. This program will provide first responders with the necessary training to safely respond to accidents involving these vehicles to minimize the potential for injury to themselves as well as the accident victims.

I am Al Ebron, Executive Director of the NAFTC, a consortium consisting currently of 27 educational institutions (listed in the attached table) dedicated to supporting the use of alternate fuel vehicles (AFVs)/advanced technology vehicles. First responders (including fire, police, EMT and other emergency personnel) need standardized training on the proper procedures to follow in accidents/incidents involving alternative fuel and advanced technology vehicles. These first responders require training to recognize the dangers inherent in advanced technology vehicles in order to ensure their safety, that of the persons involved in the accident, and bystanders. For example, the new hybrid technology vehicles contain battery packs which can discharge shocks in excess of 500 volts to the unwary. Fuel cell vehicles contain hot surfaces which can cause burns. Hydrogen-powered cars may be inherently dangerous from storage cylinders or fuel lines. All are safe with proper training.

I would like permission to enter into the record as part of my testimony a letter dated May 24, 2006, from Frank A. Burns, President of the NASFM, to the leadership of the Senate and House Appropriations Committees making them aware of this training needed for our first responders. This letter adds validity and urgency to our ability to jointly respond to this training need in order to save lives.

Many of these alternative fuel vehicles (AFVs) and advanced technology vehicles are in service today. These vehicles have all of the appearances of a conventional-

technology vehicle, but contain components which can be dangerous to personnel unfamiliar with advanced technology vehicles.

General Motors, Ford, Toyota, Honda and other automobile companies have sold hundred of thousands and have announced their intentions to build hundreds of thousands more of these advanced technology vehicles over the next 5 to 10 years. This large a fleet dramatically increases the potential for hazards faced by first responders at the scene of accidents involving these new vehicles. The U.S. Department of Energy's (DoE) Energy Information Administration estimates that in the near future, AFVs /advanced technology vehicles will comprise more than 20 percent of the light duty vehicles in the United States. This means that one in every five accidents could involve an AFV/advanced technology vehicle.

First responders (including other emergency personnel) should have standardized training on the proper procedures to follow in accidents/incidents involving alternative fuel and advanced technology vehicles. Such training can be accomplished through the development and dissemination of specialized courses that meet industry standards and the offering of such courses through a network of properly trained instructors. Currently available curricula are not structured to provide comprehensive training for working safely with damaged vehicles of these types. Resources to provide training for First Responders are limited. This program proposes to evaluate and review all known resources, combine the relevant resources into one training curriculum and associated training programs, and disseminate the materials across the United States. This type of integrated program is currently not available on a comprehensive basis. We propose to conduct 2 to 3 regional or nationwide events/meetings to disseminate the information and to conduct numerous local training classes.

West Virginia University and its National Alternative Fuels Training Consortium has the ability to conduct this project with the management of the National Association of State Fire Marshals and industry assistance. The NAFTC is a nationwide organization of post-secondary education institutions that develops advanced training curricula, conducts training classes taught by certified instructors, and promotes the use of alternative fuel and advanced technology vehicles. The NAFTC is prepared and ready to develop, offer and promote comprehensive training programs for first responders that cover the following alternative fuel or advanced technology vehicles:

- Hybrid Electric;
- Electric;
- Fuel Cell;
- Hydrogen ICE;
- Biodiesel;
- Ethanol/Methanol Flex-Fuel;
- Natural Gas (Compressed and Liquefied); and
- Propane.

NAFTC training is modular in concept to allow instructors to:

- Address all of the alternative fuels and advanced technologies in a course;
- Customize the course for a specific need;
- Training modules will include: Instructor Manuals, Participant Manuals/Textbooks, PowerPoint Presentations for Effective Lectures, and Scenario Training With Videos;
- Classes taught by certified NAFTC instructors and industry instructors to train students and future instructors; and
- Education and outreach materials.

Individuals completing these courses would learn how to: (1) determine the type of vehicle being approached; (2) avoid or circumvent on-board systems that could cause injury during victim extraction; (3) safely extract victims from vehicles; and (4) minimize damage to the environment, others, and themselves.

The National Alternative Fuels Training Consortium (NAFTC) is the only nationwide training organization dedicated to improving air quality and decreasing U.S. dependence on foreign oil by promoting, supporting, and expanding the use of alternative fuel and advanced technology vehicles. It is the premier organization to develop first responder training and provide train-the-trainer courses for first responder organizations.

The NAFTC currently:

- Offers over 20 courses and workshops nationwide on alternative fuels and advanced technology vehicles;
- Develops and delivers new courses and workshops yearly to meet demand and updated technology needs;
- Provides extensive technical assistance through timely and accurate technical data available on NAFTC web site;

- Produces two NAFTC Newsletters reporting on alternative fuel and advanced technology vehicles—the NAFTC eNews, a monthly web based newsletter and the NAFTC Clean Alternatives Report (CARReport), a printed bi-annual publication.

Since its inception in 1992, the NAFTC has created tremendous impact through:

- Delivery of over 700 courses and training to over 7,000 technicians, fleet managers, students, decision makers, and others on alternative fuel and advanced technology vehicles;
- Conducting over 775 workshops and education/awareness events with over 160,000 attendees;
- Enhanced liaisons with automobile manufacturers;
- Enhanced alliances with aftermarket retailers;
- Heightened awareness for millions about alternative fuels and advanced technology vehicles by conducting National AFV Day Odyssey. In 2004, this event consisted of 54 sites throughout the United States and two sites in Canada with nearly 25,000 direct attendees and over 24,000,000 people reached through media coverage.

The NAFTC has conducted training classes and workshops for government and private organizations such as the U.S. Department of Energy, U.S. DoE Clean Cities Coalitions, NASA, General Services Administration, U.S. Postal Service, U.S. Air Force, U.S. Navy, U.S. Federal Law Enforcement Training Center and Disney World.

Organizations in support of establishing a training program for first responders include the National Association of State Fire Marshals and the 27 members of the National Alternative Fuels Training Consortium (NAFTC), headquartered at West Virginia University. The NAFTC members are post-secondary academic institutions (with 10 to 25 new members to be added over the next year). Other supporters include numerous industry organizations in the AFV/Advanced Technology Vehicle and the Automotive Industry (including automobile manufacturers), Professional Associations, and Industry Trade Associations (including electric, biodiesel, natural gas, hydrogen and flex-fuel). The NAFTC will work cooperatively to promote and distribute the training through regional agencies (e.g., WVU Fire Extension Service and State Fire Academies), national agencies such as the National Association of State Fire Marshals, the National Fire Protection Association (NFPA), the National Fire Academy in Emmitsburg, Maryland, the Transportation Emergency Rescue Committee, International Association of Fire Chiefs and other first responder organizations.

I am pleased that the NAFTC has centers in the States of Chairman Bond and Ranking Member Murray as well as many other members of the committee. The NASFM has nationwide representation and leaders of their organization are in your States.

Thank you very much for your committee consideration of the joint NASFM-NAFTC proposal to bring our first responders up to speed on dealing with alternative fuel and advanced technology vehicles that are growing in popularity.

Today's worsening energy crisis and consumers flocking to alternative fueled vehicles are cause for concern among firefighters and other first responders. Firefighters and emergency personnel arriving on the scene of accidents and vehicle fires are sometimes searching for the answers to complex questions about alternative fueled vehicles. The answer to this dilemma is fiscal year 2007 funding of \$950,000 to launch a much-needed national program to provide alternative fuels safety training for emergency responders.

The need for this program was not so apparent just a few months ago. With energy prices at record levels, we have seen consumers, corporations, and government agencies move increasingly to alternative energy sources. Hundreds of companies have launched alternative energy products into the market place and are involved in extensive R&D in almost all States. These new technologies are vital to the future security and energy independence of our country, but a barrier threatens to halt progress. Firefighters simply are not prepared to protect the public or themselves in incidents involving these new technologies.

The United States has learned the hard way with pipelines, LNG and other energy infrastructure that local officials and the public take notice when emergency responders are apprehensive about new risks. Responders already have expressed concern about electrical hazards with hybrid autos, the proper firefighting foams to use on ethanol fires, and explosion risks with compressed gases. Fire departments have refused permits for some hydrogen demonstration projects.

Proper training and education of responders is the only practical solution. The National Association of State Fire Marshals (NASFM) consists of senior State-level public safety officials who either manage or play a key role in emergency responder

training at State, regional and local academies in their States. NASFM has the ability to reach responders quickly and efficiently.

With modest funding from U.S. Department of Transportation, NASFM has organized a national consortium of emergency responders, Federal and State agencies, universities, auto producers, energy companies and others who have been working on an alternative fuels safety training program for emergency responders.

Our plan is to complete work on a curriculum and materials, rapidly deploy the program to five existing academies which shall serve as regional centers, provide instructors and the program materials, and initiate train-the-trainer programs by the end of fiscal year 2007. The regional centers will require support to improve facilities and add training props, but these costs can be discussed at a later date. Without adequate resources, this program is unlikely to be ready much sooner than 2008 and would be slow to implement and inadequate in its content.

Elements of a strong and credible curriculum already exist. The National Alternative Fuels Training Consortium (NAFTC) at West Virginia University has much of what is needed, and other elements are available from industry, existing hazardous materials safety curricula and other sources. That process is underway with NAFTC working in collaboration with the University of Montana's College of Technology and the Missouri Transportation Institute, with input from the U.S. Departments of Energy and Transportation.

While the curriculum is developed, the NAFTC will adapt its material for the purpose of training first responders and add scenario and video training. NASFM and NAFTC are in the process of designating five State agencies to coordinate the regional training centers we will need to deliver the program. The leading candidates are the Missouri Division of Fire Safety; the Office of the State Fire Marshal, State of New Hampshire; the New Mexico State Fire Marshal; the Florida State Fire College; and the Office of the State Fire Marshal, State of Washington.

To move this program forward now, the NASFM, with support from the NAFTC is requesting a total of \$950,000 in fiscal year 2007 for the following tasks, consisting of these costs:

- \$600,000 to assemble and validate these components, produce and test a videotape and manual, and establish a website for on-line training.
- \$100,000 to enable us to make needs assessments of the existing fire academies to serve as regional alternative fuel safety training centers;
- \$100,000 to support two senior trainers to work with regional academy staff; and
- \$150,000 to produce and distribute sufficient copies of the videos and program materials to launch the program.

Safety is a shared responsibility. The public must be assured that their safety is in the forefront of a shift to alternative fuels. We have the people, the ideas and the responsibility to work with Congress and the administration to make the transition to alternative fuels.

The States and localities already invest much in our Nation's emergency responder training. In subsequent years, NASFM and NAFTC will seek support from industry partners. Many have been generous in helping State and local academies upgrade facilities for the pipeline safety programs that NASFM operate in cooperation with the U.S. Department of Transportation. But, it is doubtful that first responders can be adequately prepared for the influx of alternative fueled vehicles without fiscal year 2007 Federal dollars.

#### CURRENT NATIONAL TRAINING CENTERS

State	Educational Institution	City
Arizona	Gateway Community College	Phoenix
California	Rio Hondo College	Whittier
Connecticut	Gateway Community College	North Haven
Florida	Travis Career Center	Lakeland
Illinois	Morton College	Cicero
Indiana	Ivy Tech Community College of Indiana	Gary
Iowa	Des Moines Area Community College	Ankeny
Louisiana	Louisiana Technical College	Baton Rouge
Maryland	Com. Col. of Baltimore County (Catonsville)	Baltimore
Massachusetts	Wentworth Institute of Technology	Arlington
Michigan	Lansing Community College	Lansing
	Kalamazoo Valley Community College	Kalamazoo
Missouri	Ranken Technical College	St. Louis
Nebraska	Central Community College	Columbus

## CURRENT NATIONAL TRAINING CENTERS—Continued

State	Educational Institution	City
Nevada .....	Community College of Southern Nevada .....	North Las Vegas
New York .....	Onondaga Community College .....	Syracuse
North Carolina .....	Wake Technical College .....	Raleigh
Ohio .....	University of Northwestern Ohio .....	Lima
	Ohio Technical College .....	Cleveland
Oregon .....	Portland Community College .....	Portland
South Carolina .....	York Technical College .....	Rock Hill
Tennessee .....	Nashville Auto-Diesel College .....	Nashville
Texas .....	Tarrant County College .....	Ft. Worth
Washington .....	Shoreline Community College .....	Shoreline
West Virginia .....	West Virginia University .....	Morgantown

## TARGETED NATIONAL TRAINING CENTERS

State	Educational Institution <sup>1</sup>	City
Alaska .....	University of Alaska .....	Anchorage
Utah .....	Salt Lake Community College .....	Salt Lake City
Vermont .....	Vermont Technical College .....	Randolph Center
Virginia .....	Northern Virginia Community College .....	Alexandria

<sup>1</sup> Additional training centers will be recruited next in Alabama, California, Colorado, Idaho, New Mexico, New York, Oklahoma, and Pennsylvania.

## PREPARED STATEMENT OF THE NATIONAL ASSOCIATION OF RAILROAD PASSENGERS

The National Association of Railroad Passengers strongly supports Amtrak's fiscal year 2007 grant request of \$1.598 billion and the additional \$275 million in "strategic investment initiatives" Amtrak outlined. That \$275 million includes:

- \$100 million to be administered by the Secretary of Transportation, for a matching-funds program to support State efforts to improve and expand intercity passenger rail services. This would help address rail's longstanding competitive disadvantage with other modes of transportation, which enjoy Federal funding matches of 50 to 90 percent. We also support Amtrak's call for a Federal-State partnership including "reliable" Federal funding (80 percent Federal match).
- \$50 million (which also could be administered by the Secretary) for "joint investment [with States and railroads] targeted to network chokepoints and linked to threshold performance improvements in intercity passenger rail on-time performance."
- \$100 million to restructure some of Amtrak's debt, saving money both for Amtrak and the Federal Government. Amtrak says the restructuring "is intended to achieve savings of \$45 million, above the initial \$100 million cost, and a rate of return of 14.8 percent per year."
- \$25 million for Americans with Disabilities Act compliance (supplementing \$22 million for this purpose in the \$1.598 billion "base request").

This is the second straight year that Amtrak's board, composed entirely of Republicans appointed by President Bush, has supported a significant increase in Federal investment in Amtrak and passenger rail.

We of course agree with this from a May 28 New York Times editorial: "Amtrak does not need to make a profit, but it does need to work. The government directs billions of dollars to roads and bridges. Airports get plenty of help, but somehow very little trickles down to the rails. Amtrak, which at one point was to have received zero federal funds after 2002, has been offered \$900 million by the administration for next year. That amount is so low it should be an insult . . . If President Bush really wants transportation alternatives, it is time for a strategic look at how the railroads can serve as an even more important escape valve for the nation's overloaded transportation system."

Viewed in the context of national need and world energy concerns, as well as the last sentence in the above quotation, Amtrak's request, which totals \$1.873 billion, is conservative.

## WHY TRAINS ARE A GOOD INVESTMENT

*Citizens Want Them!*—Harris Interactive, Inc. provides the latest major poll indicating that Americans want more rail service and believe that this should be mainly a responsibility of the Federal Government. Significantly, the poll—released February 8—was taken December 8–14, 2005, before the latest run-up in gasoline prices.

Harris Interactive, Inc. asked, “In the future, as more people travel, which two of the following would you like to see have an increasing share of all passenger transportation?” Americans overwhelmingly chose commuter and long-range trains (44 percent and 35 percent, respectively) compared to long distance travel by car (10 percent) and bus (6 percent).

When Harris asked “. . . which of the following would you like to see have an increasing share of all goods and commodities movements in the United States?” the response was even more striking: fully 63 percent of respondents favored freight railroads, more than air freight (35 percent) and trucks (24 percent) combined. The survey then asked: “Who do you think should be mainly responsible for maintaining and improving the transportation system in the Nation as a whole?” More than two-thirds (68 percent) of adults said the Federal Government. (Full poll: [http://harrisinteractive.com/harris\\_poll/index.asp?PID=638](http://harrisinteractive.com/harris_poll/index.asp?PID=638))

*The Traveling Public Votes “Yes”*.—Amtrak ridership has risen in 8 of the last 9 years, with fiscal year 2005 ridership 29 percent above that for fiscal 1996.

I will not repeat the list of “justifications” for passenger rail I recited a year ago. However, when energy price increases are “above-the-fold” news, normal public support for passenger rail becomes even stronger, as does the public policy case for providing that service.

In his State of the Union Address, President Bush said, “America is addicted to oil, which is often imported from unstable parts of the world.” He was correct. Strengthening and expanding passenger rail will help reduce the vulnerability of our citizens and our economy to high energy prices. Strengthening public transportation in general as a response to high energy prices and concerns about long-term oil supplies is at once popular and sound policy.

The longer the Federal Government starves intercity passenger rail, the angrier the American people will be when they discover they do not have choices that help them adapt to higher energy costs while still preserving their freedom to travel and maintaining their quality of life.

We urge that all Amtrak routes be continued—and the New Orleans-Orlando segment restored—while Amtrak improves its cost-effectiveness in various ways, many of which are discussed below.

## AMTRAK EFFICIENCY CONCERNS

We share the concern of the subcommittee—and every responsible, interested party—that Amtrak use its revenues (both commercial and taxpayers) efficiently.

*Mechanical*.—Some of the biggest opportunities to improve Amtrak’s bottom line while maintaining and even expanding service involve updating Amtrak’s maintenance practices. The much-quoted GAO report on Amtrak management cites an important report by the Amtrak Inspector General. A key passage from the Amtrak IG’s report reads: “Both of our consultants independently commented that Amtrak’s maintenance operations are being performed similar to the way the other major railroads in North America did maintenance over 20 years ago. The other Class I railroads have since moved on to more sophisticated approaches to maintenance to improve reliability and reduce costs.”

Thus, Amtrak is updating and improving its practices, with an expectation that its Mechanical Department can boost output and quality while reducing costs.

*Dining Cars*.—Amtrak is well underway with projects that will significantly reduce the net cost of on-board food and beverage services. On long-distance trains, Amtrak is revising dining car processes and reducing on-board staff; reductions began before Christmas and are scheduled to be complete before the end of May.

Reducing food losses is a reasonable goal; eliminating them is not. Carriers worldwide consider on-board food and beverage service not as a profit center but as a necessary expense to attract and retain business. In a November 2005 speech, Jonathan Metcalf, Chief Operating Officer of Britain’s Great Northeastern Railway, said that food service on his trains “probably loses £2–£3 million a year, if we didn’t do food, we’d lose passengers . . . it’s a key reason why they travel with us . . . we probably would have lost £20–£30 million in ticket revenue (without food service).”

*Mail*.—Our Association repeatedly testified in support of David Gunn’s work to improve Amtrak. We believe Amtrak is much better off for his having served there. Nonetheless, we have urged Amtrak to look seriously at undoing one ill-advised step

that he took. He completely eliminated mail carriage even though every study of which we are aware indicated mail was profitable for Amtrak. Amtrak invested in the mail business and still owns relevant infrastructure and a sizable number of cars with good life expectancy. I have written to Amtrak urging a careful review of opportunities to restart mail carriage where this would be incrementally profitable.

*Fares and Technology.*—Amtrak is not buying market-share with low prices. Amtrak ridership has grown in spite of fare increases. Amtrak's yield (average fare per passenger-mile) has increased every year since at least fiscal year 1994 with the sole exception of fiscal year 2003. (A passenger-mile is one passenger traveling 1 mile.) Fiscal year 2005 yield was 65 percent above that in fiscal year 1994.

Through the first 7 months of fiscal year 2006 (October-April), the yield was 9.8 percent above the same period in fiscal year 2005. If anything, Amtrak arguably has been too aggressive in raising fares.

Amtrak does offer good deals on-line where this makes business sense—i.e., handling “distressed inventory” (that is, seats that otherwise would go empty and where eliminating their operation is impractical or would not achieve savings). This is also important for cultivating tomorrow's revenues, since some of the people who have time to search the internet for elusive good deals are young people who may become tomorrow's “full fare,” loyal customers. If Amtrak was not doing this sort of thing, others would criticize its fare-setting practices as out-of-date.

Creative use of the internet is not new at Amtrak. It offered full booking capability on-line starting in February, 1997, at about the same time as Continental Airlines and well before the other major airlines. Another indication of Amtrak's on-line sophistication is the interactive route map Amtrak recently introduced.

The DOT Inspector General, incidentally, criticized GAO's report for its glass-half-empty approach, that is, for not giving “equal time and space [to] what works’ at Amtrak, and what has been improved at Amtrak.”

*Fares and Public Policy.*—Sound public policy should encourage low fares. Lower fares mean higher ridership, and help America and its people deal more effectively with scarce oil. California's financial support for its three Amtrak corridors helps support lower fares than are found in many other parts of the Amtrak system. This should be encouraged!

#### STATUTORY DIRECTIVES (INCLUDING REPORT LANGUAGE)

We urge Congress to hold Amtrak accountable for the bottom line, but to be as restrained as possible with regard to specific directives as to how to get there.

The history of Amtrak is replete with examples of “good legislative intentions” which sometimes have resulted in higher costs rather than reform—including directives in the 1980's regarding food service.

The more the law contains specific directives about how to manage the company, the greater the danger that management focus would be distracted from doing what is best for the bottom line, and that responsibility for results would shift from management to the sources of the specific directives.

#### FUNDING LEVELS

The Bush Administration's request of \$900 million—30 percent below the current level of \$1.3 billion—would not keep the trains running. The administration characterizes its budget request as a “reward” for progress that Amtrak has made on reforms, but the numbers are clear.

—Debt service is estimated at \$295 million. Amtrak has taken on no new debt since June, 2002. From September, 2002, to December, 2005, total outstanding debt fell by \$300 million—from \$3.9 billion to \$3.6 billion.

—The operating grant requirement is estimated at \$498 million, which Amtrak's Board says “represents a significant stretch goal . . . \$42 million below the approved fiscal year 2006 budget [of \$540 million] and \$88 million below the DOT Inspector General's baseline operating budget.”

—Amtrak seeks \$730 million for capital (not counting \$177 million in non-Federal funding), and \$75 million for working capital.

If a \$900 million Federal grant did not cause an immediate shutdown, it certainly would begin a visible, downward spiral in service quality and reliability, due to elimination of rolling stock heavy overhauls and of work on infrastructure. Chances would grow that the failure of a moveable bridge would end Boston-New York service.

After debt service and operations (the first two bullets above), only \$107 million would remain for capital. This would be almost totally consumed by the \$90 million Amtrak seeks for “investment required to address legal and regulatory require-

ments, including NY tunnel life safety program, environmental remediation and pollution control, police and security, FRA-mandated rolling stock investment, and initial ADA station compliance work.”

#### LONG-DISTANCE TRAINS

Amtrak’s long-distance and shorter corridor services both are important, complementing each other and other U.S. transportation.

- Long-distance trains continue to show strength. In fiscal 2005, they carried an average 356 passengers per run, and the number on board at any one time (passenger-miles-per-train-mile) was 171. Sleeping car ridership was up 30,000 (or 6 percent) from fiscal 2004. Sleeping car passengers accounted for 15 percent of ridership but 39 percent of revenues on these trains.
  - A substantial number of coach passengers on long-distance trains travel very long distances—55 percent traveled at least 400 miles, 25 percent at least 800 miles. These fiscal year 2005 figures understate trip length since they are “unlinked trips,” that is, for example, a Washington-Milwaukee passenger must change trains in Chicago and thus is recognized as a Washington-Chicago passenger and a Chicago-Milwaukee passenger.
  - Therefore, elimination of dining cars would hurt coach ridership. Any analysis that assigns 100 percent of dining-car costs to sleeping car passengers is wrong. Amtrak reports that usage of dining cars by coach passengers has been increasing with the new “simplified dining service” Amtrak has introduced on most trains in the past several months.
  - Sleeping cars and food service are needed to attract discretionary travelers. If trains were operated only for those without any other option, “bottom fishing” would produce lower-volume, higher-unit costs and lower economic efficiency.
  - On a passenger-mile basis, corridor and long-distance trains require similar levels of operating support. [A passenger-mile is one passenger traveling 1 mile.] In fiscal year 2004, the “fare box loss” per passenger-mile actually was higher (“worse”) for short-distance trains (25 cents) than for long-distance trains (15 cents).
  - Long distance trains are the only intercity passenger trains in 25 States.
  - One cannot simply “buy everyone a plane ticket cheaper than running an Amtrak train” because hundreds of cities that Amtrak serves have no access to discount airline service. In addition, many Americans cannot or chose not to fly.
- Thank you for considering our views. We stand ready to help the subcommittee as we are able, including by providing such further information as you may request.



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