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Key Questions for Timothy Geithner, Nominee for Treasury Secretary

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The United States Senate will soon consider the nomination of Timothy Geithner to be Treasury secretary of the United States. If confirmed by the Senate, Geithner will be at the center of efforts to settle the storm in national and global financial markets. In this he will be continuing his work of past months from his current position as the president of the New York Federal Reserve Bank.

The Treasury secretary is traditionally the top economic advisor to the President on domestic economic policy. As such, Geithner will play critical roles in designing policies to help restore economic growth and create the 3.5 million jobs President Barack Obama has promised.[1] He will also assume a central role in the coming debate on financial markets reform and in the development of the tax policy and in the administration of the tax law through the Internal Revenue Service.

The Treasury Department is tasked with managing the nation's publicly held debt, currently totaling over $6.7 trillion, a figure that is expected to increase rapidly, raising serious questions about the market's ability to absorb the additional government debt. In addition, the Treasury secretary is traditionally the Administration's chief spokesman and policymaker on matters of international economic relations and exchange rate policy.

The Geithner nomination is shadowed by a dark cloud regarding his past taxes. According to reports, Geithner failed to pay $34,000 in Social Security and Medicare payroll taxes dating from early in the decade and then paid the taxes plus interest when it became apparent that he was under consideration to be nominated. As the Treasury secretary nominee charged with overseeing the Internal Revenue Service collecting federal taxes, Geithner's unhappy brush with the tax system may give him greater sensitivity to what some taxpayers endure. The question Senators need to ask in this regard and for which clear and direct answers should be forthcoming before he is confirmed is whether Geithner made a common taxpayer's mistake or knowingly and persistently failed to pay the taxes over an extended period.

If honest mistakes were made, then this is a minor issue. As the evidence comes out and Geithner responds, if it appears Geithner intentionally cheated on his taxes, then Senators should not support his nomination and it should be withdrawn.

Aside from his personal tax issues, Geithner should address in his remarks and questioning a broad array of missions critical to the future prosperity of the nation. The following are a few of the many questions Geithner should address in his confirmation process and in the months to come.

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Question 1: Deficit Spending to Stimulate the Economy

How is it that increased deficits are to stimulate the economy if Treasury borrowing to finance the deficits first reduces the amount of capital available to the private sector?

Answer: With the economy expected to remain very weak throughout 2009, the nation needs an effective stimulus program. Yet the legislation advancing in Congress, consistent with Obama's stated views, emphasizes increased government deficits and debt from increased government spending and tax cuts with minimal effects on incentives. The theory behind this approach is that the economy will recover if total demand in the economy increases.

Government spending must be financed even in a recession, and that means withdrawing funds from the private sector, reducing the funds that would otherwise by spent by consumers and investors or increasing the trade deficit if the funds are borrowed from abroad. Thus, this deficit spending policy cannot increase total demand but rather shifts the composition of demand, leaving the economy no stronger and the national debt higher.[2]

Question 2: Expiration of Tax Cuts

Would delaying for some years the expiration of existing tax law, including the 15 percent dividends and capital gains tax rates, be an effective means of eliminating a debilitating threat to the recovery?

Answer: Raising taxes today or threatening to raise taxes in the near future are prescriptions for continued economic malaise. Yet taxpayers are faced with the largest tax hike in history beginning in 2011 as many important elements of current tax law are slated to expire, such as the increased per-child tax credit, the reduction in the marriage penalty, lower income tax rates, the 15 percent capital gains tax rate, the 15 percent dividend tax rate, and the elimination of the death tax. This threatened tax hike should be eliminated by making each of these provisions permanent, but short of this clear policy the Congress should delay the tax hike at least until 2013. Doing so would eliminate a serious threat to the economy, and cutting marginal tax rates on individuals and businesses further would then provide strong, positive, effective stimulus to the economy.[3]

Question 3: The Negative Effects of Debt

What assurances can you give that the unprecedented amounts of debt expected to be issued by the Treasury over the next two years will not cause interest rates to soar and the nation's debt rating to plummet?

Answer: The United States has about $6.7 trillion of outstanding public debt. The projected budget deficits in 2009 and 2010 combined are expected to approach about $2 trillion. In addition, the Treasury will need to issue $350 billion in additional debt to finance its activities following the release of the second tranche of the Troubled Asset Relief Program, and it will need to issue another nearly trillion dollars to finance the expected stimulus. In total, the national debt is expected to increase by half in just the next two years. At the same time, nations around the world are preparing their own expanded deficit stimulus programs, putting further pressure on global capital markets.

Under the circumstances, most serious questions arise as to whether debt markets can absorb this volume of government debt issuance, whether the Treasury will have to pay exceptionally high rates of interest to sell the debt, and whether in doing so the Treasury will be degrading the status of United States government debt as the safest of all financial instruments.[4]

1. J. D. Foster, "Cut Tax Rates and Create 2.5—No, 3.5 Million New Jobs," Heritage Foundation *WebMemo* No. 2218, January 13, 2009, at *http://www.heritage.org/Research/Economy/wm2218.cfm*.
2. Brian Riedl, "Why Government Spending Does Not Stimulate Economic Growth," Heritage Foundation *Backgrounder* No. 2208, November 12, 2008, at *http://www.heritage.org/Research/Budget/bg2208.cfm*.
3. J. D. Foster and William W. Beach, "Economic Recovery: How Best to End the Recession," Heritage Foundation *WebMemo* No. 2191, January 7, 2009, at *http://www.heritage.org/Research/Economy/wm2191.cfm*.
4. William W. Beach, "Fiscal Challenges for Government at All Levels: How Economic Stimulus Drives Up Deficit and Debt," Heritage Foundation *WebMemo* No. 2227, January 16, 2009, at *http://www.heritage.org/Research/Economy/wm2227.cfm*.

Question 4: Entitlement Reform

Do you believe that substantial reforms to Social Security and Medicare to reduce these programs' nearly $100 trillion in unfunded obligations would improve the willingness of markets to absorb the enormous amounts of additional debt the federal government is expected to sell in the next few years?[5]

Answer: Social Security and Medicare are core programs of the federal government that are vital to America's seniors. However, in their current forms they are wildly unsustainable, a matter on which there is broad consensus. There is also broad consensus that these programs cannot be made sustainable either through modest improvements in economic performance or by raising taxes.[6] The central issue is that the federal government has made promises of benefits to tomorrow's seniors that it cannot hope to keep. President Obama has clearly indicated his understanding of these basic facts and has signaled his desire to address these problems head on. The task will be difficult, but it is absolutely essential to America's fiscal future.

While the underlying policy issue is long term, the consequences of serious, credible reform may be immediate. The federal government appears about to increase the debt sold to the public by half over the next two years, selling as much as $3.5 trillion in additional debt. This raises a serious question as to the ability and willingness of markets to absorb this amount of debt. One factor that may improve the markets' reception of this debt would be for the federal government to reduce significantly the fiscal threat posed by these entitlement programs. Demonstrating a serious concern for fiscal responsibility by reducing long-term threats may go a long way toward assuaging debt markets awash in new Treasury bonds.

Question 5: Foreign Investment in the U.S.

There has been growing concern with the level of foreign investment in the United States and the process the U.S. implements to screen for the national security implications of foreign investment. *In your opinion, does foreign investment pose a threat to U.S. economic and national security? If so, do you believe that America should impose stronger restrictions against foreign investment?*

Answer: Even with the current financial crisis and economic downturn, the U.S. remains a major destination for foreign investment. The United States generally welcomes foreign investors, providing equitable and nondiscriminatory access to investment opportunities because the benefits of foreign investment extend into the American economy as a whole. Increased investment and competition generate higher productivity and more efficient resource use. Ultimately, this culminates in greater economic growth, job creation, and higher living standards. In addition, foreign investment introduces new technologies and skills to America's economy, helping to promote U.S. competitiveness abroad.

While the bulk of foreign investment in America generates no threat to national security, some investments raise legitimate national security issues for which the U.S. government has established and recently re-examined appropriate vetting procedures. In this re-examination it was affirmed that any excessive rules restricting, delaying, or politicizing foreign investment would result in the loss of foreign investment as greater uncertainty and delays in investment transactions add to the cost of foreign firms' doing business in the U.S. America would pay for higher investment barriers with lower growth, fewer jobs, and a reduced role in an increasingly competitive global economy.

Moreover, there may be secondary consequences of enacting new foreign investment barriers. America could face less market access and opportunity abroad as countries enact retaliatory policies that result in ever higher barriers to global investment.

5. J. D. Foster, "Medicare's Financial Woes, Bigger Than Official Estimates," Heritage Foundation *Backgrounder* No. 2174, September 2, 2008, at *http://www.heritage.org/Research/Budget/bg2174.cfm*; The Heritage Foundation, "The Budget and Entitlements: Time to Take Action," at *http://www.heritage.org/research/Budget/upload/FWUT-handOut.pdf*.

6. Stuart Butler *et al.*, "Taking Back Our Fiscal Future," Heritage Foundation *White Paper*, March 31, 2008, at *http://www.heritage.org/Research/Budget/wp0408.cfm.*

Since the U.S. is the world's biggest investor, foreign retaliation in reaction to new U.S. investment restrictions would be costly for many Americans.[7]

Instead of erecting new barriers to foreign investment, America needs to ensure the mechanisms already in place to protect legitimate U.S. national security interests from unsafe investment work appropriately. Recently implemented reforms to improve the transparency and effectiveness of the Committee on Foreign Investments in the United States—the body charged with ensuring that foreign investment does not compromise national security—represent a solid improvement in America's investment regime that best strikes a balance between America's national and economic security concerns.[8]

Question 6: China as U.S. Creditor

Are you concerned about China's $1 trillion holdings of U.S. government bonds? If not, is there a level of Chinese holdings that would concern you? If so, what policy response do you believe is appropriate?

Answer: Our nation's biggest international trade and investment relationship is with China, and China is now the top purchaser of American government bonds, having amassed a financial mountain of Treasury bonds. China's bond purchases are an outgrowth of the Sino-American trade relationship, China's currency controls, and the depth and attractiveness of our bond market.

Given the weak state of the U.S. economy, the apparent similar condition of the Chinese economy, and expectations that the U.S. government will be issuing trillions of dollars in additional debt in the next couple of years, a reasonable concern is whether the Chinese will be willing to continue to hold their existing Treasury bonds, let alone buy significant additional amounts. However, fears that China will significantly alter its foreign investment flows may be misplaced, at least for the present. Due to its exchange rate system imposed by the Chinese government, China continually purchases large sums of dollars to preserve the U.S. dollar/Chinese RenMinBi exchange rates, dollars which then need to be reinvested in dollar-denominated assets. To date, China has shown little inclination to relax its exchange rate controls and to move toward market-determined exchange rates.[9]

Question 7: Income Tax Reform

Where do you stand on reforming the federal income tax to enhance economic performance and economic growth?

Answer: The federal income tax code places an enormous constraint on America's international competitiveness, productivity growth, wage growth, and jobs. The U.S. corporate tax rate is almost the highest in the industrialized world. The income tax contains well-established biases against the basic forces of economic growth such as work effort, saving, investment, risk taking, and entrepreneurship. The tax system is so poorly designed that dissatisfaction with the system is widespread, bipartisan, and persistent.

The Treasury secretary is the Administration's point person on tax policy, both with respect to the formulation of new policy and with respect to the administration of the overall tax system through the Internal Revenue Service. The recession and the ongoing trade deficit underscore the need to pursue a wide range of policies that will strengthen the economy fundamentally and for the long term. Correcting the flaws of the federal income tax should rank toward the top of that list.

7. Daniella Markheim, "The Need for CFIUS Reform to Address Homeland Security Concerns," Heritage *Lecture* No. 944, June 13, 2006, at *http://www.heritage.org/Research/NationalSecurity/hl944.cfm*.

8. Daniella Markheim, "New CFIUS Regulations Support U.S. National and Economic Security Concerns," Heritage Foundation *WebMemo* No. 2176, December 18, 2008, at *http://www.heritage.org/Research/tradeandeconomicfreedom/wm2176.cfm*

9. Derek Scissors, "Chinese Investment (Mostly) Welcome," Heritage Foundation *WebMemo* No. 2081, September 26, 2008, at *http://www.heritage.org/Research/AsiaandthePacific/wm2081.cfm*; Scissors, "The Coming U.S.–China Trade Conflict," Heritage Foundation *WebMemo* No. 2172, December 12, 2008, at *http://www.heritage.org/Research/AsiaandthePacific/wm2172.cfm*.

Question 8: Analysis of Tax Proposals

Do you support the continued development of the Treasury Department's capabilities to assess the economic consequences of new tax policy proposals?

Answer: The Treasury Department, paralleling efforts at the Congressional Budget Office and the Joint Committee on Taxation, has taken great strides in recent years developing the ability to assess the broad economic consequences of major tax policy changes. While still in its infancy, this analysis may someday shed important light on the economic efficacy of different policies as policymakers seek a tax code that raises the requisite amounts of revenue while doing the least amount of damage to economic prospects.

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