Budgeting for National Priorities

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1775 Massachusetts Avenue, NW Washington, DC 20036-2103
Tel: 202-797-6000 Fax: 202-797-6004
www.brookings.edu

Restraining Federal Domestic Spending

James C. Capretta

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PAPER SUMMARY

Spending restraint has never been more important as a policy objective. Several critical national priorities (the Global War on Terror, emergency preparedness) must be addressed simultaneously and will require substantial resources, even as the country is on the brink of unprecedented and expensive population aging. Curbing the near-term federal budget deficit is an imperative. This paper recommends appropriations cuts to and reforms of a number of government programs (including Amtrak, economic development programs, education funding, and Medicaid administrative funding), along with the adoption of certain new policies that would help reduce government spending. Taken together, these proposals save $275 billion over the five years from 2008 to 2012—more than half the savings needed to balance the budget at the end of this period.

James C. Capretta is a Fellow at the Ethics and Public Policy Center.

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Other papers in this series:

Taming the Deficit, William Frenzel, Charles Stenholm, William Hoagland, and Isabel Sawhill

Pruning the Defense Budget, Jeffrey M. Tebbs

Reducing the Deficit Through Better Tax Policy, Diane Lim Rogers

Cost-Effective Investments in Children, Julia B. Isaacs

Introduction

Advocating federal spending restraint is a popular position to take—*in the abstract.* Political leaders and candidates find it appealing to assert their intent to impose greater fiscal discipline, as voters have a general sense that governments at all levels waste resources and require vigilant oversight.

In recent months, it has even become popular to target specific spending provisions. News media coverage of excessive, and perhaps abusive, appropriations earmarking has given opponents of so-called pork-barrel spending a new opening to target projects that were included in the budget without the normal agency review and public scrutiny.

And yet it remains true that cutting spending—that is, non-trivial cuts that change the size and scope of federal activity—is more popular in concept than in reality. And the reason is quite straightforward: Many federal programs provide benefits to a narrow constituency, who fiercely defend these benefits in the political process. Meanwhile, the cost of maintaining these programs is spread across millions of taxpayers. In other words, the benefits are concentrated, and the costs are diffuse.

The task of spending restraint is made more difficult still by the high-minded public policy goals of most federal programs: improving national and homeland security, offering better education for children, enhancing job prospects, and providing a compassionate safety net, among others. It is a rare federal effort that does not resonate with most voters as a worthwhile endeavor. And so politicians advocating spending cuts can be portrayed by their political opponents as against something not unlike the infamous "motherhood and apple pie."

Further complicating matters is the lack of financial incentives for economizing in the federal budget process. Direct political power over concrete budget decisions is spread among a large number of players in the executive and legislative branches, and each of the major players has a much stronger interest in maintaining their portion of the budget pie than in economizing. Any savings lawmakers achieve in their slice of the budget is simply lost to them, with no financial gain to the programs they are accountable for running and no clear reward politically because few taxpayers or voters will ever notice that the savings occurred. In this environment, it is a rare occurrence when a political leader or a program manager—those closest to the programs and with the most direct knowledge of where savings could be achieved—voluntarily shrinks the size of the budget they oversee.

While difficult, spending restraint has perhaps never been more important as an economic policy objective. Today, the federal government must address several critical national priorities simultaneously—fighting and winning the Global War on Terror, improving homeland security systems and emergency preparedness for all manner of disasters, and rebuilding in the Gulf states after Hurricanes Katrina and Rita. Each of these efforts requires substantial resources, even as the country is on the brink of unprecedented and expensive population aging.

Further, many policymakers and economists believe another major priority must be to hold individual and corporate income tax rates as low as possible to foster an environment conducive to strong economic growth. Recent research suggests that Europe's high tax rates have reduced the labor supply substantially. According to economists Steven J. Davis and Magnus Henrekson, a 12.8 percentage point increase in the tax rate reduces work effort by, on average, 122 hours per year per worker.[1]

Excessive deficit spending is unquestionably risky for our economy. Borrowing to pay for federal spending adds the burden of interest to the costs paid by taxpayers and exposes our economy to the risks associated with dependence on foreign lending. If China or other large purchasers of U.S. Treasury securities change their view of the value of these investments, it could precipitate rapid interest rate increases, followed by a recession and significant economic dislocation.

Wasteful spending and excessive borrowing are essentially a tax on our future. Federal borrowing pushes the cost of consumption today onto future taxpayers—today's children—who are not empowered at the ballot box to protect themselves from these costs. And families who could be investing more of their resources in the future workforce—their children—are burdened instead with unnecessarily high taxes and debt service costs driven by a lack of spending discipline. America's future depends in the end on the strength of American families and the children they are raising. Policymakers have an obligation to protect these families from unnecessary economic burdens that hinder their primary mission.

It is important for U.S. political leaders to remember these national priorities when making budget decisions because every dollar of wasteful federal spending will, in some sense, come at the expense of a better, more important, and sometimes urgent, use of those resources.

The Long-Run Outlook

This paper is directed at cutting the near-term federal budget deficit by restraining federal domestic spending. But it should be noted that the near-term federal budget deficit is arguably not the most urgent fiscal issue that the country faces. It is critically important—even urgent as the baby boom generation reaches retirement age—for policymakers to tackle long-term entitlement reform.

Without reform, the Congressional Budget Office (CBO) projects that entitlement spending for Social Security, Medicare, and Medicaid—fueled by population aging and rapid health care cost growth—will increase from 8.4 percent of gross domestic product (GDP) in 2005 to 18.0 percent of GDP in 2030 and 28.5 percent of GDP in 2050, if health spending continues to increase at the historical rate.[2]

Entitlement reform will be an immensely difficult undertaking for political leaders. It is likely to require several important policy changes, all of which will entail economic sacrifices by voters: longer working lives and later eligibility ages for full entitlement benefits, higher premiums based on ability to pay, and more consumer responsibility for expensive health insurance coverage.

While important, all of these changes are likely to come with significant transition periods to garner support and to be fair to current beneficiaries. As a consequence, with the exception of a relatively modest adjustment in Social Security inflation indexing, structural entitlement reforms are not addressed in this paper.[3] It should be noted, however, that some steps can and should be taken within the major entitlement programs to reduce their near-term costs. These possible reforms are also beyond the scope of this paper, but could be an important element in a balanced budget exercise.

How Much Total Spending Restraint Is Needed?

Baseline projections of federal spending and revenues are inherently uncertain, as there are a large number of variables that can, and often do, move both spending and revenue off their expected path. These variables include the pace of economic growth, on-going engagement in the Global War on Terror, the possibility of a significant terrorist event or other disaster substantially disrupting international commerce, among many others. It is easy to get bogged down in a debate about assumptions instead of focusing on what policy steps are necessary to improve the fiscal outlook.

Nonetheless, before discussing specific proposals to cut the federal budget deficit, it is important to set the context for the proposals because, under virtually every credible scenario, policymakers are facing large federal budget deficits in the years ahead—deficits large enough to cause imbalances that unquestionably threaten sustained economic growth.

The 2006 federal budget deficit was $248 billion.[4] The 2006 deficit was $71 billion below the deficit recorded for 2005, due mainly to very strong growth in federal receipts.[5] CBO originally projected receipts would grow by about 7 percent in 2006, but the growth rate was actually 11.7 percent. CBO's August 2006 baseline makes modest corrections in the revenue estimates for future years, but revenue growth is projected to drop substantially, to just 4.7 percent in 2007, and to average 5.9 percent over the period 2006 to 2012. If revenue growth in 2007 and beyond trailed off more gradually than CBO projects, the deficit would likely be smaller at the end of the projection period. For instance, revenue growth averaging 7 percent over this period would increase revenues by more than $200 billion in 2012 compared to CBO's current baseline.

The August 2006 CBO baseline projections show the deficit declining to $54 billion by 2012. These estimates, however, assume expiration of the 2001 and 2003 tax bills, which substantially lowered rates on individual income as well as capital gains and dividends. President George W. Bush and many in Congress have made it clear that they intend to make these tax changes permanent, and, in any event, expiration of the current tax laws would mean very large increases in tax liabilities for nearly all American households between 2010 and 2011. Such abrupt tax hikes would be so large, in fact, that they are highly unlikely to occur. Therefore, it is more prudent to expect the Bush tax cuts to continue into the indefinite future.

Other analysts also assume that the additional revenue collected by the alternative minimum tax (AMT)—approximately $50 billion to $70 billion per year in revenue over the next ten years—should not be included in baseline revenue assumptions because of widespread criticism of the tax and enactment in recent years of a series of one-time AMT relief bills. The Bush administration, however, has made it clear that it does not intend to simply remove this revenue stream from government receipts, but would like to reform the entire income tax law in a revenue-neutral manner. Most Democrats in Congress are also strongly opposed to another sizeable tax reduction law. It seems sensible, therefore, to leave AMT revenue in the baseline, even if one assumes that this revenue will ultimately be collected in a manner which will be more widely supported politically.

CBO's baseline also assumes permanent continuation of the military operations in Iraq and Afghanistan, as funded in two 2006 supplemental appropriations bills. The projected baseline deficits can be adjusted to reflect a slow phase-down of military operations abroad and removal of certain one-time 2006 supplemental funding items from spending projected into the future.

With these adjustments, CBO's projected deficit in 2012 of $54 billion turns into a $127 billion deficit. Over period 2008 to 2012, the deficit would total $988 billion, and debt held by the public would reach nearly $6.5 trillion by the end of this period.

It is important to note that these projections are based on continued economic growth, which would stretch the current expansion to more than a decade. While the 1990s expansion was long, it lasted just about ten years.[6] It is reasonable to assume the U.S. economy could very well experience a recession within the projection period, which would substantially widen the deficit in the short-term.

With this baseline projection, it is possible to do a rough estimate of how much spending reduction would be necessary to achieve a balanced budget by 2012 (see table 1). Using a plausible path for spending cuts (growing somewhat with each year to reflect transition provisions), Congress and the president would need to cut approximately $400 billion over five years out of the current CBO baseline spending estimate to approximate a balanced budget in 2012. This cut would represent about 2.7 percent of total non-interest federal spending expected over this period. If enacted into law, it would represent one of the largest spending cuts ever adopted by Congress and signed by the president.

Table 1. Approximate Spending Reduction Path Required to Balance the Budget by 2012

(in billions of dollars)
Deficits and deficit increases shown as negative numbers

	2008	2012	Five-Year
CBO August 2006 baseline federal budget deficits	**-273**	**-54**	**-1185**
Enactment of 2006 tax law and permanent extension of Bush tax cuts	-3	-245	--
Phase-down of Iraq and Afghanistan operations and removal of one-time 2006 items	42	161	--
Adjusted federal budget deficits (with net interest effects)	**-233**	**-127**	**-988**
Spending reduction path	50	110	400
Federal budget deficit with spending reductions and net interest effects	**-181**	**1**	**-543**

Spending Reduction Proposals

In 2004 the Brookings Institution published *Restoring Fiscal Sanity: How to Balance the Budget* (RFS 2004).[7] Chapter 4 of that volume offered a series of illustrative reductions in domestic spending (excluding major structural reforms of the large entitlement programs—Social Security, Medicare, and Medicaid) to help balance the federal budget.[8] This paper builds upon that effort, with some modifications.

- *Entitlements.* Two-thirds of federal spending is mandatory, which is up from about one-third in the 1960s. Spending discipline is particularly important for these programs to ensure the budget does not become consumed by programs that are on auto-pilot, constraining congressional budgetary options. The first set of proposals offered here would achieve savings in this largest category of federal spending.

- *Discretionary spending.* The rest of the proposals suggested in this paper are in domestic discretionary appropriations and are divided into the same categories as provided in RFS 2004.

    - *Subsidies.* The federal government provides funding for a wide range of economic activity. These proposals are aimed at reducing spending that distorts market decisions in ways that are inappropriate and counter-productive.

    - *State and Local Grants.* Many federal spending programs are transfers to states to help finance a state-run domestic program. These reforms are aimed at rebalancing the financial relationship between the federal contribution and the state effort.

    - *Low-Value Investments.* A number of federal programs have been evaluated carefully and found inadequate in terms of performance and return to taxpayers. These proposals reduce spending on some of these programs.

    - *Waste Reduction.* The federal budget continues to support wasteful spending practices, particularly excessive appropriations earmarking. Earmarking has become so prevalent in the spending process that curbing it could contribute substantially to deficit reduction.

In the 1990 bipartisan budget agreement between Congress and President George H.W. Bush, spending caps were established for discretionary appropriations, with separate ceilings for defense, international, and domestic programs and agencies. These statutory caps were allowed to expire in recent years, but should be re-established to improve enforcement of budget agreements. For instance, a cap on domestic discretionary appropriations could be set to allow spending at the current baseline levels less the savings achieved from the proposals offered here. Caps on discretionary spending can be adjusted to reflect truly unanticipated and emergency spending needs.

Indeed, it is much more likely that Congress and the president would agree to re-establish caps on domestic appropriations before agreeing on a series of cuts. Securing these caps would force the political compromises that are necessary to cut spending on programs that otherwise enjoy some level of political support. The proposals offered here should be viewed as good candidates for program cuts to hit these caps, but other proposals may very well be easier to pass due to political considerations.

It should also be noted that this paper does not attempt to achieve savings in national defense or homeland security programs, which would appear at this time to require more resources in the years ahead than contained in CBO's baseline projections.

Entitlements

A substantial portion of federal spending is mandatory. Although structural reforms to major entitlement programs are outside the scope of this paper, there are still savings to be achieved in the near-term even without needed structural reforms.

<u>Improve inflation adjustment for Social Security</u>
Since 1972 Social Security benefits have been indexed annually to keep up with inflation. There is widespread consensus in Congress that inflation protection is an important provision in the program, as retirees would generally have few options to compensate for price increases eroding the value of their annuity. The measurement of inflation used to index benefits, however, is a highly technical undertaking. Over the years, some corrections have been made to correct for flaws that inadvertently over-indexed benefit payments. More recently, economists Henry Aaron and Peter Orszag endorsed indexing Social Security benefits to a new, more accurate measure of inflation.[9] The new measure (known as the Chained Consumer Price Index for all Urban Consumers) corrects for the upper-level substitution bias present in the current measure.[10] Although some critics may contend that such a switch would be unduly harmful to retirees, the RFS 2004 authors correctly note that technical adjustments in the late 1990s that had the effect of reducing Social Security benefits went largely unnoticed. According to estimates provided in RFS 2004, the switch would reduce Social Security spending by about $70 billion over ten years. Using this earlier estimate as a point of reference, switching to a more accurate price index is estimated to reduce spending by $25 billion over the period 2008 to 2012.[11]

<u>Adopt the U.S. proposal for agricultural price support reductions</u>
In October 2005, the Bush administration offered a bold proposal to dramatically downsize U.S. domestic agricultural price subsidies as part of the Doha round of international trade negotiations. The proposal is, in effect, contingent on securing an international agreement on lower tariffs, which is a significant and highly uncertain condition. Nonetheless, the proposal provides a concrete and realistic roadmap toward more open trade and lower crop price supports, with substantial benefits for American consumers and taxpayers as well as worldwide economic growth.

The proposal would reduce grain, oilseed, and cotton loan rates and dairy price supports by 7 percent and target price supports by 11 percent over a five-year period. The Food and Agricultural Policy Research Institute (FAPRI) at the University of Missouri has modeled the effects of this proposal in a global agricultural context. They estimate that these policies would substantially lower U.S. farm support spending when fully implemented, saving about 24 percent compared to current law.[12] Based on this estimate, adopting the Doha proposal would provide approximate savings of $4 billion per year, or $20 billion over five years.

U.S. agriculture producers are highly efficient compared to international competitors, with significant upside potential for greater exports. If the U.S. position were adopted in international trade agreements, U.S. producers could maintain their net farm incomes even if federal price supports are cut. According to FAPRI, the U.S. proposal would actually result in a net gain of 1.6 percent in U.S. crop income, assuming successful implementation of lower agricultural tariffs around the world.[13] According to FAPRI, U.S. agricultural businesses would gain about $6.2 billion in additional crop and livestock receipts under a scenario that assumes more open trade than under a scenario in which U.S. price supports were cut unilaterally.[14] It is therefore critically important to U.S. interests to continue to support trade liberalization aggressively.

Require defined-benefit plan beneficiaries to fully pay for insurance risk

Officially, the Pension Benefit Guaranty Corporation (PBGC) is already insolvent, with the present value of known liabilities exceeding assets by $23 billion. But PBGC's financial shortfall is actually much larger than $23 billion. Outside experts estimate that, with expected new pension fund defaults included in the calculation, PBGC's shortfall is about $92 billion in present value terms.[15] Similarly, CBO has estimated that a private sector insurer would demand additional premiums totaling $140 billion to cover currently projected and anticipated PBGC liabilities.[16]

To avoid a huge taxpayer bailout of the system—a bailout eerily similar to the one required for the nation's savings and loan industry in the 1980s—fundamental reform is needed. Recently passed legislation will reduce the government's exposure somewhat, but much more fundamental change is needed to assure taxpayers are never tapped to bail out the program.

The root of the problem is the design of the defined-benefit insurance program. PBGC insurance premiums paid by employers do not vary based on assessment of the risk that the government will have to take over the pension plan. This leads to moral hazard, with firms encouraged to take advantage of loose accounting and pension valuation rules to underfund pension obligations.

The risks of pension fund default are papered over when equity returns make pension funds appear awash in reserves. After the technology stock bubble burst in 2000, however, equity returns have been flat, leaving many pension funds well below fully funded status.

Also, in recent years, several high-profile cases have exposed the perverse incentives prevalent in the interaction of bankruptcy law and PBGC insurance. PBGC has taken on so-called legacy pension costs for several companies that negotiated overly generous pension provisions in prior years. In some cases, companies have been able to provide pension concessions to labor even as they are on the verge of bankruptcy. Once insolvent, their negotiated giveaways become the liabilities of PBGC. Having successfully shed their liabilities without alienating their labor force, these companies generally re-emerge from bankruptcy and continue operating, often with new labor contracts.

A large federal bailout of PBGC, financed on the backs of general taxpayers, would be highly inequitable and should be avoided if at all possible. At this point, the majority of American workers are not part of defined-benefit pension plans. It is not at all clear why taxpayers who do not benefit from PBGC insurance should be exposed to the large costs of covering unfunded pension promises made by a relatively small number of industries.

To prevent a bailout from ever occurring, Congress should adopt the a plan similar to that offered by Allan Mendelowitz at a recent public forum held at the American Enterprise Institute (AEI).[17] Mendelowitz's insight is that in the PBGC system, insurance primarily benefits the enrollees in defined-benefit pension plans, and the financial solution should be to ask these beneficiaries to pay premiums sufficient to cover the insurance risk. According to Alex Pollock of AEI, a monthly premium of $10 per defined-benefit plan enrollee (of which there are 44.4 million presently) would generate about $5.3 billion annually and roughly cover the credible estimates of PBGC's financial shortfall, prior to the 2006 PBGC law.[18] Pollock estimates that this new law will cut the required premium from $10 to $5 per beneficiary. Using this adjustment, the Mendelowitz plan would save about $13.5 billion over the 2008 to 2012 period.

The Mendelowitz plan could also be modified to require that premiums paid by enrollees be adjusted for the risk of the plan they are in enrolled in, which would alter the financial incentives of the program substantially. Employers who underfund their pension plans would be directly increasing the premium costs paid by their workers for PBGC insurance, leading, predictably, to significant pressure to fully fund the plans. Consideration should also be given to making the premium voluntary on the part of the enrollee: Enrollees could pay the premium to get the protection, but if they do not, the PBGC would be freed of the enrollee's pension costs should the pension fund default in the future. Either way, the PBGC financial shortfall would disappear.

Reform the National Flood Insurance Program

The widespread flood damage caused by Hurricanes Katrina and Rita has exposed the inherent flaws in the National Flood Insurance Program (NFIP). Congress has given the Federal Emergency Management Agency the authority to borrow $20.8 billion from the Treasury to pay flood claims associated with the 2005 hurricanes, and CBO estimates an additional $3 billion in borrowing authority will be needed to cover the full cost of expected claims. At current premium rates, CBO expects that by 2007 the NFIP will be unable to pay all claims and service the debt it is incurring to pay for the 2005 losses.

NFIP's premium structure has contributed to the current insolvency of the program. According to CBO, the NFIP charges premiums well below the actuarially sound rate for about 25 percent of policyholders, or 1.2 million property owners. CBO estimates this subsidy value at about $1.3 billion annually.[19] The presence of this subsidy has increased the number of properties located in flood zones, exacerbating the shortfall. The subsidy was originally justified on the grounds that some property owners acquired their buildings before clear information was available on flood risks. Three decades later, the subsidy is counterproductive as it discourages decisions that would mitigate potential flood damage.

Congress should move quickly to establish actuarially fair rates for the flood insurance program and mandatory participation in insurance. Mandatory participation is necessary in this program because it is highly likely that Congress, in the event of a future flooding disaster, will compensate all property owners in flood damaged areas, even if they did not purchase the insurance. Actuarially fair rates for all structures will provide much greater incentives to property owners to purchase structures in less risky areas. Over time, these changes should reduce annual NFIP subsidy costs to zero. The cost estimates used in this paper are based on a phased elimination of the $1.3 billion subsidy estimate, as provided by CBO, saving $4.9 billion over five years.

Provide a fixed amount for Medicaid administrative funding

The Medicaid program is an open-ended federal matching program. Most Medicaid spending is for medical and long-term care services. However, some spending is for state administrative expenses. For every dollar that is spent by a state to run Medicaid, the federal government generally pays 50 cents. This financing structure provides strong incentives at the state level to shift as many administrative costs as possible under the Medicaid umbrella. And, in fact, state Medicaid administrative costs have increased rapidly over the years.

CBO's baseline projections assume this trend will continue into the indefinite future. Between 2005 and 2016, CBO projects the federal share of state Medicaid administrative costs will more than double, from $8.5 billion to $17.9 billion.[20]

This proposal would remove Medicaid administrative financing from the federal matching program. States would instead get the amounts they received in 2006 for administrative costs in a fixed block grant for the years 2008 to 2012. Beyond 2012, the block grant amount would be indexed to inflation plus growth in the number of Medicaid beneficiaries. The savings of $14.6 billion over five years reflected in this paper is based on the difference between the CBO's baseline projections and the block grant totals implied by this set of policies.

Removing Medicaid administrative funds from federal matching programs would reverse the current incentives in the program toward more spending. States would seek to make their administrative structures for Medicaid as efficient as possible. If more resources were needed to run Medicaid well, states would have the option to provide state-only resources for the job. The proposal would also align Medicaid's administrative funding with the approach taken for the large welfare block grant, Temporary Assistance for Needy Families.

Limit government contributions for federal employees' health care

The federal government's employee health benefits program (FEHB) is, in many ways, a model for how to reform private health insurance. Workers get an annual choice of competing plans, with an increasing array of relevant consumer information to help make good choices.

One major flaw in the program, however, is the muted incentives for price sensitivity due to the government's contribution formula. Under current law, the government pays 75 percent of the premium, and workers must contribute 25 percent toward the full cost of the plan. This financing structure allows workers to get 75 percent of the cost of a higher-cost plan paid by the government, even though it was their choice to enroll in a more expensive plan. Workers would have stronger incentives for price shopping if the government contribution were limited to a fixed amount independent of plan choice. This greater price sensitivity among workers would immediately translate into more aggressive price competition among FEHB plans, which may lead to more intense efforts to achieve efficient outcomes in the health care delivery networks employed by those plans.

The proposal offered here would set the government's contribution rate in 2008 at the average contribution paid in 2007, and then index that amount to inflation in the ensuing years. Implementing this option would save $6.5 billion over five years[21] and the proposal would produce both entitlement and discretionary savings in the budget (agency budgets could be reduced in the future to reflect lower personnel costs). Only the entitlement savings are reflected in table 2, the discretionary savings are reflected in table 7.

Table 2. Estimated Savings from Entitlements Proposals

(in billions of dollars)
Compared to CBO's March 2006 baseline

	2008	2012	Five-Year
Improve inflation adjustment for Social Security	-1.0	-9.0	-25.0
Adopt the U.S. proposal for agricultural price support reductions	-4.0	-4.0	-20.0
Require defined-benefit plan beneficiaries to fully pay for insurance risk	-2.5	-2.9	-13.5
Reform the National Flood Insurance Program	-0.3	-1.3	-4.9
Provide a fixed amount for Medicaid administrative funding	-1.3	-4.6	-14.6
Limit government contributions for federal employees' health care	-0.3	-2.3	-6.5
Subtotal, Entitlements	**-9.4**	**-24.1**	**-84.5**

Subsidies

While there are numerous subsidies in the federal budget, four programs in particular should be a focus of spending cuts due to their inappropriate and counterproductive distortion of market decisions: Amtrak, the Advanced Technology Program, a grant program of the Small Business Administration, and the Tennessee Valley Authority (table 3).

<u>Cut Amtrak subsidies in half</u>
After years of promising financial self-sufficiency—seemingly always just around the corner—Amtrak now believes it will always remain dependent on federal support to keep the trains running. In the late 1990s, Amtrak worked to lower the federal contribution to as low as $251 million in 1999, but the 2006 appropriation was back up to $1.3 billion.

This proposal would phase down the federal contribution to half of the 2006 level and force Amtrak to make choices, saving $2.5 billion over the 2008 to 2012 period. To begin, Amtrak must force passengers taking the most subsidized routes to pay more of the cost or get reduced service. Estimates indicate that Amtrak's five most unprofitable lines lose $250 million annually, with implicitly large subsidies accruing to the small number of travelers on those lines. Amtrak's cost cutting will have to reach beyond those lines to improved efficiency and higher margins on its other, more heavily traveled lines as well.

Eliminate the Advanced Technology Program

The Advanced Technology Program (ATP) provides grants to private firms to help finance the translation of basic research findings into marketable commercial products. There is no reason to believe that the federal government can assess the commercial potential of research discoveries better than investors who must weigh market risk. In fact, annual U.S. venture capital investments—$10.6 billion—far exceed the size of the ATP, making it clear that ATP spending could be financed with private resources if the investments were viewed as meritorious by the private sector. The presence of the ATP in the marketplace serves only to subsidize some firms over others, with inequitable market distorting consequences. Eliminating the ATP saves $0.5 billion over the five-year period 2008 to 2012.

Terminate Small Business Administration loan guarantee program

As recently outlined in a paper by Veronique de Rugy of AEI, the Small Business Administration (SBA) loan guarantee program creates market inequities by subsidizing a very select number of small business operators.

Under current law, SBA issues federal guarantees on loans secured by small businesses. These loans—totaling about $28 billion annually—are intended to help small businesses that otherwise would have trouble securing credit in the marketplace. However, less than 1 percent of all small business loans in any year are guaranteed by the SBA, which means that 99 percent of small businesses get their financing in the marketplace reflecting their market risk.[22] SBA loan guarantees, therefore, are subsidizing some small businesses at the expense of their small business competitors.

Federal budgetary scoring rules make it difficult to determine the exact exposure these loan guarantees represent to taxpayers. Under current budget practice, the cost to the federal government is determined by estimating the effective federal subsidy value of the guarantee, which is much less that total amount of loans secured by small businesses. Even so, as noted by de Rugy, CBO estimated in 2003 that the federal loan guarantee cost could grow to $1 billion over ten years.[23] The savings assumed in this paper from elimination of the program takes this CBO estimate as the starting point and assumes an average savings of $0.1 billion per year, or $0.5 billion over the 2008 to 2012 period.

Sell the Tennessee Valley Authority

The Tennessee Valley Authority (TVA) has evolved from its original flood control and economic development roots and is now essentially a large, government-subsidized commercial enterprise with little federal regulatory control or oversight. TVA owns a large number of transmission and power generation facilities, including nuclear power plants, and has investments in many additional enterprises. Ownership of the TVA implicitly provides a subsidy to the TVA's ratepayers, who gain financially from the lower credit costs associated with federally backed corporations.

This proposal would raise substantial resources by selling the commercially-viable assets of the TVA—assets that are typically found in the private sector. Although a sale of TVA's assets would generate receipts, CBO estimates that some portion of the agency's outstanding debt would be retained by the government, with costs beyond the budget window. Selling the TVA to the private sector will force more market-based controls on TVA investments and protect taxpayers from poor business decisions that sometimes occur when there is implicit federal backing of an enterprise. For instance, $6 billion of TVA's current debt is due to previous investments in the construction of additional nuclear facilities that were never completed and provided no return.[24] CBO has estimated the market value of TVA's electric power assets at about $16 billion, which could be counted as federal receipts should TVA be sold to private sector bidders.[25] The savings in the budget would be somewhat lower, according to CBO, due to ongoing payments by the government on TVA debt that would remain a government obligation. The net savings over five years would be $15.2 billion, as estimated by CBO.

Table 3. Estimated Savings from Curtailing Subsidies

(in billions of dollars)
Compared to CBO's March 2006 baseline

	2008	2012	Five-Year
Cut Amtrak subsidies in half	-0.3	-0.6	-2.5
Eliminate the Advanced Technology Program	-0.0	-0.1	-0.5
Terminate SBA loan guarantee program	-0.1	-0.1	-0.5
Sell the Tennessee Valley Authority	-0.0	-15.2	-15.2
Subtotal, Subsidies	**-0.4**	**-16.1**	**-18.7**

State and Local Grants

Given states' relative fiscal health in recent years, and the over-balance of federal funding for some programs that primarily benefit local communities, $54.1 billion can be saved over five years by cutting federal highway and education grants to states and localities (table 4).

Restrain federal highway spending
The 2005 reauthorization of the federal interstate highway law contained substantial increases in contract authority—a form of mandatory funding for state highway construction. By 2010, the increase in this spending authority will be nearly 25 percent higher than previous baseline estimates.

Even with the 2005 law in place, Congress and the president can still effectively control the spending flow of the highway program by setting tight limits on annual obligations through the appropriations process. This proposal would effectively hold those "obligation limitations" to levels consistent with inflation growth, not a rapid increase as envisioned in the 2005 law.

Overspending on highways at the federal level is problematic for several reasons. Road financing should come mainly from the beneficiaries of those roads. An overemphasis on federal aid undermines incentives for state and local governments to set priorities and secure financing from the taxpayers who will benefit most from road improvement. With too much federal aid, the odds increase that states will use these funds for lower priority projects that might otherwise not have been cost-effective.

Moreover, the Government Accountability Office and others have found that additional highway funding can, in some instances, simply displace funding that would otherwise occur at the state and local level. With most states now in far better fiscal condition than the federal government—forty-five states have posted budget surpluses in the last year, with an estimated $57 billion in revenue above previous state projections—it is appropriate to rebalance financial commitments to place more of the burden on those taxpayers closest to program administration.[26] Holding annual appropriations to levels consistent with inflation growth based on 2005 funding saves the federal government $52.1 billion over five years.

Restrain Title I funding

Federal efforts to improve educational outcomes for disadvantaged elementary and secondary school students have been disappointing. Since 1965, the primary tool the federal government has used to leverage higher student performance has been the funding provided through the Title I program of the Elementary and Secondary Education Act (ESEA).

Systematic evaluations of Title I have reported that virtually no progress had been made toward closing the so-called "achievement gap" between students in low- and high-poverty schools. For instance, in 1997, Abt Associates issued a thorough assessment of Title I and found that "despite its ambitious mandate, the program has been a relatively minor educational intervention."[27] Moreover, using scores on standardized tests for reading vocabulary and comprehension and math concepts and applications, Abt found that students receiving Title I help performed below students who received less Title I assistance and that Title I students did not close the student outcome gap with their more advantaged classmates.[28]

It is perhaps not surprising that Title I funding has made little difference in educational outcomes. Although it remains the largest funding stream for primary and secondary education provided by the federal government, it is a small source of financing for schools compared to all state and local resources (federal support makes up about 8 percent of total school resources).[29]

It is entirely appropriate that the financing of public schools remain largely a state and local effort. The beneficiaries of good schools are the parents of the children and the communities where they reside. Moreover, the more the federal government takes on the responsibility of financing schools, the more state and local governments will become dependent on those resources and look to increase them rather than make more difficult budgetary decisions on their own. Evenly divided financing responsibility between the federal government and the states could also lead to a division of political accountability that would undermine school quality over time.

However, retaining a limited financing role for the federal government does not mean that the federal government has no legitimate interest in elementary and secondary education. In fact, the federal government has a legitimate interest in education due to concerns for a skilled labor force and responsible electorate.

Recognizing this legitimate federal role, the landmark 2001 No Child Left Behind law sought more accountability from states and local schools for educational progress using standardized and objective measures of student performance. The jury is still out on how successful a rigorous testing regime will be in improving student outcomes nationwide. But early reports show some promising signs. For instance, 17 out of 23 states under study showed a higher percentage of fourth graders meeting or exceeding the expected math proficiency level in 2003 compared to 2000.[30]

However, to secure passage of this new law, the Bush administration agreed to authorize large spending increases in Title I funding. Consistent with the authorization law, Title I appropriations have increased from $8.8 billion in 2001 to $12.7 billion in 2006.

The proposal offered here freezes in place the current federal Title I for a few years, saving $2 billion from 2008 to 2012. This level of spending will be consistent with the spirit of No Child Left Behind while preventing states and local school administrators from expecting an ever higher level of federal resources for education.

Table 4. Estimated Savings from Reducing State and Local Grants
(in billions of dollars)
Compared to CBO's March 2006 baseline

	2008	2012	Five-Year
Restrain federal highway spending	-3.7	-13.8	-52.1
Restrain Title I funding	-0.4	-0.4	-2.0
Subtotal, State and Local Grants	**-4.1**	**-14.2**	**-54.1**

Low-Value Investments

Careful evaluation of certain federal programs has found a lack of adequate return to investment. Reducing funding to these programs will save $31.6 billion over five years (table 5). Although these saved dollars are put toward deficit reduction in this paper, some of the savings could also be directed to proven programs for which federal resources may not currently be adequate.

<u>Terminate funding for low-performing education programs</u>
Several well-intentioned education programs are not performing well enough to merit funding from federal taxpayers.

Even Start was begun as a demonstration to test the theory that combining a program for children with their parents who may need additional reading skills would improve the educational achievement of both groups. Unfortunately, the program has been evaluated carefully and shown not to work well. A recent evaluation commissioned by the Department of Education found that participants in Even Start fared worse in terms of educational gains than a control group of children and parents who did not enroll in the program. Although the program's targeted beneficiaries are in need of significant educational services, the program participants did not access enough of the services offered to achieve lasting and significant educational gains.[31] Thus, this proposal terminates federal funding for Even Start.

The vocational education program, originally established to help improve the earnings potential of high school students who were unlikely to get any post-secondary education, now suffers from confused policy goals. As the U.S. economy and education patterns have changed, so have expectations for the program. Vocational education is now expected to improve technical skills, boost academic performance among generally lower-achieving students, improve post-secondary enrollment percentages, and boost earnings and employment in the workforce. All this, even as the program provides funding equivalent to 5 percent of local resources.[32]

Unfortunately, the program, as currently constituted, is not well-suited to these assignments. As stated in the 2004 *National Assessment of Vocational Education*, the program "is not likely to be a widely effective strategy for improving academic achievement or college attendance without substantial modifications to policy, curriculum, and teacher training."[33] Moreover, vocational education's contribution to better earnings among enrollees is relatively small and may not accrue to the lowest achieving academic performers.

The program's original intent—helping students develop wage-enhancing technical skill—is ill-suited to the current U.S. educational structure. Recent high school reform efforts are focused on raising the traditional measures of academic achievement of all students, even those students who are not college bound, so that their basic skill levels in math and reading will allow them to perform well in training programs for vocational careers. The small, unfocused vocational education grants, sprinkled across most of America's high schools, do not fit well with this updated approach to improving high school performance; this proposal terminates funding for this program.

The Safe and Drug Free Schools program has been in existence for more than twenty years. Funds are provided to the states and then sent to schools to finance a wide array of efforts to combat violence and drug use. A RAND Corporation assessment determined that the size of the school funding streams are too small ($10,000 and under for more than 60 percent of grant recipients) to make much of an impact, and increasing the size of the program to increase its potential would be unwise given the widespread skepticism that any of the school-based approaches will work.[34] Moreover, the funding stream allows schools to select from a wide variety of prevention programs and approaches, with little empirical research backing the effectiveness of the programs selected. A recent Department of Education study openly questioned the quality of the programs many schools were selecting to fund with federal resources.[35] This proposal would terminate the program, leaving in place the government's more visible anti-drug-abuse message campaigns aimed at younger Americans.

The educational technology state grant program was created in 2001 out of a series of smaller, technology-related grant streams. The funds help subsidize school purchases of technology-based learning tools, which can be beneficial to student achievement. However, there are a large number of possible uses of these limited resources, and pressure is only likely to grow for the federal government to become a primary subsidy source for all manner of new tools. These decisions should remain at the state and local level, with their limited resources used to set priorities; federal funding for these grants is terminated in this proposal.

Other narrow-focus education programs have sprung up like weeds at the Department of Education in the last twenty years. From Arts in Education to Excellence in Economic Education, the federal government has initiated nearly twenty programs, each of which has spending authority of less than $50 million. These programs, while well intentioned, have little prospect of making a large-scale impact on American education. Moreover, continued funding of these small programs diverts time and attention away from more important oversight responsibilities at the department.

In total, eliminating funding for low-performing education programs saves $9.8 billion over the 2008 to 2012 period.

Reform and consolidate job-training programs

The federal government supports a large number of programs aimed at job training and education, although the exact count depends on the definition. The Bush administration includes thirty-one different programs from six different cabinet agencies in its effort to apply common performance measures to all job-training spending. Total spending for these programs is about $13 billion.

Some of the largest funding streams are in the Department of Labor's Workforce Investment Act programs, particularly the adult, youth, and dislocated worker funding streams. These programs have been through several reforms in recent decades, but they have retained the unusual characteristic of by-passing state control, by and large, with funding going to local job training bodies. This unusual funding structure has reduced political accountability for the programs at both the state and federal level and hindered coordination of the programs with other assistance aimed at the unemployed and low-income populations.

This proposal would examine the universe of federal job-training programs and reduce the number of funding streams dramatically, to perhaps one stream for adults and one for youth. It would also put the funding firmly under the control of state governments, with the states accountable for improving the critical performance measures concerning employment and wages.

The largest funding streams included in this consolidation would be the Workforce Investment Act programs at the Department of Labor, the adult education program at the Department of Education, smaller programs embedded in welfare spending streams, and various programs in the Departments of Defense, Housing and Urban Development, and Interior. A relatively small amount of savings is assumed from removing separate administrative structures from the various federal agencies resulting in a total of $2.5 billion in savings over five years.

Delay adoption of new NASA initiatives

President Bush announced in January 2004 an ambitious new plan for the National Aeronautics and Space Administration (NASA). The centerpiece of the vision is a plan to return human space flight to the Moon, and then to embark on human exploration of Mars. This ambitious new plan comes on the heels of series of setbacks for NASA that raised questions about the affordability and viability of current plans for human space flight. Moreover, NASA has yet to achieve previously stated goals, including plans for a more affordable means of getting humans and cargo into space other than the troubled shuttle program.

Given the many questions regarding NASA's ability to conduct current missions, it is not prudent to commit taxpayers today and well into the future to fund a plan that has so much financial cost. Decisions on an ambitious new space exploration program should be delayed until the performance of NASA's current programs improves. This delay will save $10.2 billion relative to CBO's March 2006 baseline.

Consolidate and cut federal economic development programs

The federal government's vast array of overlapping economic development initiatives is long overdue for a complete overhaul. Currently, there are at least seventeen programs in five cabinet departments (Agriculture, Commerce, Health and Human Services, Housing and Urban Development, and Treasury) roughly aimed at providing federal financial assistance for development and growth in distressed communities. While well intentioned, evaluations over many years have found these programs to be unfocused, duplicative, and without any measurable results in terms of improved economic growth. Moreover, a large portion of the funding in this category goes through the Community Development Block Grant, which is not restricted to poor communities. The result is that the federal distribution of these grants does not even meet the minimum test of redistributing resources properly. Each of these programs caters to different regional and industry constituencies, raising serious questions of equity for programs notionally aimed at helping poorer regions.

This proposal would consolidate seventeen different funding streams into one program, administered by the Department of Commerce.[36] Federal funding would be limited to demonstrably poor communities and would be focused on aid applications tied to measurable performance criteria that are clearly associated with the funding stream. Consolidating the programs saves $9.1 billion from 2008 to 2012.

Table 5. Estimated Savings from Curbing Low-Value Investments

(in billions of dollars)
Compared to CBO's March 2006 baseline

	2008	2012	Five-Year
Terminate funding for low-performing education programs	-0.8	-2.5	-9.8
Reform and consolidate job-training programs	-0.5	-0.5	-2.5
Delay adoption of new NASA initiatives	-1.0	-3.0	-10.2
Consolidate and cut federal economic development programs	-0.5	-.2.3	-9.1
Subtotal, Low-Value Investments	**-2.8**	**-8.2**	**-31.6**

Waste Reduction

Congressional "earmarking" has been a part of the federal budget process for many decades. It is not possible, or even necessary, to suggest that the practice of earmarking be banned altogether. But there is little doubt that the practice has gone well beyond the bounds of normal congressional prerogatives.

Citizens Against Government Waste (CAGW) has tracked the practice of congressional earmarking going back to 1991, and the trend in recent years is alarming. Between 1995 and 2006, CAGW estimates that the number of earmarked items in congressional appropriations bills increased from 1,439 in 1995 to 9,963 in 2006. Moreover, the cost of these earmarks increased from $10 billion in 1995 to $29 billion in 2006.[37]

Some may question CAGW's expansive definition of earmarks and dismiss their findings. But other independent organizations have reported similar findings. The Congressional Research Service estimates that the number of earmarks in the Commerce-State-Justice appropriations bill increased nearly sixfold between 1994 and 2005; similarly, earmarks increased by more than 300 percent in the defense appropriations bill and by more than 100 percent in the agriculture appropriations bill during that same period.[38] Thus, curbing earmarks could contribute substantially to deficit reduction.

Limit appropriations earmarks to $15 billion annually
This proposal would significantly roll back earmarking, but not eliminate it. Each appropriations bill would be given a proportional "earmark limit" set at roughly 50 percent of the total earmarks in the bill in 2006 and saving $79.6 over the five-year period 2008 to 2012 (table 6). There are many different proposals under consideration for scaling back congressional earmarks, including new efforts at a line-item veto. Many of these proposals deserve serious consideration. Given long-standing resistance to such statutory changes, however, it may be necessary for the president to enforce an earmark limit with his veto authority.

There may be some duplication between earmarked spending and savings suggested in this paper for other programs, particularly highway spending. This potential interaction is difficult to quantify and may require some additional restraint in selected programs to achieve the total savings suggested in this paper. Should that be the case, I would suggest further cuts in highway spending.

Table 6. Waste Reduction

(in billions of dollars)
Compared to CBO's March 2006 baseline

	2008	2012	Five-Year
Limit appropriations earmarks to $15 billion annually	-15.0	-16.9	-79.6
Subtotal, Waste Reduction	**-15.0**	**-16.9**	**-79.6**

Conclusion

The United States faces large federal budget deficits for the foreseeable future, and these deficits will quickly become unmanageable in the next decade as population aging pushes entitlement spending to unaffordable levels.

In this environment, U.S. policymakers must begin to fundamentally rethink current federal spending assumptions to have any hope of balancing the federal budget again. The spending restraint options offered here would generate political controversy. But policymakers must weigh the political difficulty of pursuing such restraint with the political fallout that will occur if the country drifts into a period of economic stagnation driven by too much federal borrowing from abroad and rising interest rates at home.

Unfortunately, the political burden for spending restraint in the U.S. system falls almost entirely on the proponents of cuts; advocates of the status quo have to do very little to keep wasteful spending flowing. Over the long run, changing this political dynamic so that proponents of spending must carry the burden of proof would likely go the farthest toward restoring stable fiscal balance.

Table 7. Total Proposed Savings

(in billions of dollars)
Compared to CBO's March 2006 baseline

	2008	2012	Five-Year
Entitlements	-9.4	-24.1	**-84.5**
Subsidies	-0.4	-16.1	**-18.7**
State and Local Grants	-4.1	-14.2	**-54.1**
Low-Value Investments	-2.8	-8.2	**-31.6**
Waste Reduction	-15.0	-16.9	**-79.6**
FEHB Discretionary Savings	-0.4	-2.5	**-7.1**
Total Savings	**-32.1**	**-82.0**	**-275.6**

Note: FEHB discretionary savings represents the savings in personnel costs that occur from limiting government contributions for federal employees' health care.

Endnotes

1. Davis and Henrekson, 2004.
2. Congressional Budget Office (CBO), 2005a; CBO, 2006c.
3. For a discussion of long-term entitlement reform, see Capretta, 2005. Also, for a discussion of a possible approach to Social Security reform, see Capretta, 2006.
4. U.S. Department of Treasury, 2006.
5. CBO, 2006b.
6. *Economic Report of the President, 2006*, p. 285.
7. Rivlin and Sawhill, 2004.
8. Sawhill and Schultze, 2004.
9. Aaron and Orszag, 2004.
10. For an explanation of the measurement bias in the current method of indexing Social Security for inflation and details on a new, more accurate measure, see Johnson, Reed, and Stewart, 2005.
11. Author's calculation based on the first five years of savings totaling $70 billion over ten years.
12. Food and Agricultural Policy Research Institute (FAPRI), 2005.
13. FAPRI, 2005.
14. FAPRI, 2005.
15. Pollock, 2006.
16. CBO, 2005b.
17. See Allan Mendelowitz's presentation at "The PBGC and Structural Reforms," conference at the American Enterprise Institute, April 5, 2006 (www.aei.org/event1270).
18. Pollock, 2006.
19. CBO, 2006a.
20. See CBO's baseline Medicaid spending estimates from March 2006 at www.cbo.gov/budget/factsheets/2006b/medicaid.pdf.
21. See CBO, 2005c.
22. de Rugy, 2006.
23. de Rugy, 2006.
24. CBO, 2005c.
25. CBO, 2005c.
26. Lois Romano, "Most States Have Budget Surpluses," *Washington Post*, August 19, 2006, p. A4.
27. Abt Associates, 1997, p. iii.
28. Abt, 1997.
29. See an overview of the federal role in education at www.ed.gov/about/overview/fed/role.html [June 8, 2006].
30. U.S. Department of Education, 2006.
31. Abt, 2003.
32. U.S. Department of Education, 2004.
33. U.S. Department of Education, 2004, p. 2.
34. Reuter and Timpane, 2001.
35. Crosse et al., 2002.
36. The eliminated programs are: Rural Business Enterprise Grants, Economic Impact Grants, and Rural Empowerment Zones in the Department of Agriculture; the Economic Development Administration and related programs in the Department of Commerce; the Community and Economic Development and Rural Community Facilities programs in the Department of Health and Human Services; the Community Development Block Grant, National Community Development Initiative, Brownfields Economic Development Initiative, Rural Housing and Economic Development, Urban Empowerment Zones, and Community Development Loan Guarantees in the Department of Housing and Urban Development; and the Community Financial Institutions program, the Bank Enterprise Award program, and the CDFI Native Initiatives program at the Department of the Treasury.
37. Citizens Against Government Waste, "Pork Trends, 1991–2006," (www.cagw.org/site/PageServer?pagename=reports_porkbarrelreport#trends [June 7, 2006]).
38. Congressional Research Service, 2006.

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