



Saving the American Dream: The Heritage Plan to fix the Debt, Cut Spending, and Restore Prosperity

The Heritage Foundation
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INTRODUCTION

America must change course. We face a staggering fiscal problem that threatens the very future of our nation. Unless we act wisely, massive spending and surging public debt will destroy the foundations of our economy and darken the American dream for our children and grandchildren. But this grim future is not inevitable. The Heritage fiscal plan will solve America's twin crises of debt and spending with reforms that are consistent with the principles of democratic governance and deeply held American values.

The plan does this by cutting government down to size, re-energizing American enterprise through fundamental tax reform, and transforming entitlement programs to provide real economic security without passing along a crushing financial burden to younger generations. Our plan achieves the following:

- **Balances the federal budget in 10 years and keeps it balanced forever at no more than 18.5 percent of GDP.** Americans have made clear to Washington over many decades how much they are willing to pay for government. We keep it at that level.
- **Reduces the debt to 30 percent of GDP within 25 years and puts it on track to continue falling thereafter.** Lower debt will remove the threat of financial crisis and restore the confidence of citizens, investors, and lenders. It will also sharply reduce the debt burden on future generations and help to secure our prosperity.
- **Replaces the complex and unfair tax code with a completely new tax system.** We replace the current Byzantine tax system, including the payroll tax, with a much simpler single-rate system that minimizes tax distortions and perverse incentives.
- **Protects America and its interests around the globe by ensuring full funding for national defense.** Defense is a core constitutional responsibility of the federal government and essential to preserving American liberty and prosperity. Waste and inefficiency should be rooted out, but the resulting savings should be used to meet defense needs.
- **Creates a health care system that is affordable both for the nation and for individuals and families.** We replace the Obama reform with a system that fosters individual choice, competition, and state innovation to control underlying health costs while assuring

continuous and portable coverage. By overhauling subsidies and tax breaks for health care, we ensure that all Americans can afford adequate coverage.

- **Redesigns Social Security and Medicare as sustainable programs so that they protect seniors but will be around for our children and grandchildren.** Today’s retirement system cannot pay for all of its promised benefits without inundating our children with debt. Accordingly, we transform these defined-benefit entitlement programs into budgeted “real insurance” programs that focus on those who need them for retirement security, with checks and assistance phased down by income for those who do not really need them. We adjust benefits to recipient need without raising taxes on current and future Americans.
- **Provides strong incentives for working Americans to save and invest.** Our tax and Social Security reforms provide new ways for Americans to save for their future security and to create capital for enterprise.

SPENDING

Social Security

The Heritage Social Security plan provides strong retirement security for seniors that is affordable and thus assured for future generations. Unlike today, the plan provides complete protection for seniors against poverty and assures Americans that they will have a secure retirement.

Social Security will gradually be transformed from an “income replacement” system back to its original purpose of providing economic security for seniors. Social Security benefits will evolve over time into a flat payment system to keep seniors out of poverty throughout their retirement and supplement the savings and income of middle-class retirees. Our plan will also create important incentives for workers of all income levels to save more for retirement.

Because the new Social Security is a real insurance system, designed to be affordable and to protect seniors from hardship, retirees with high non-Social Security incomes will receive a smaller check. Affluent seniors who do not need Social Security to prosper will receive no check, ensuring that checks will be available to future retirees. Currently, the IRS income-adjusts Social Security checks surreptitiously even for modest-income seniors. We end that. Our income adjusting is transparent and it will not touch the checks of modest-income seniors.

The Social Security early and full retirement ages will be raised gradually and then indexed to life expectancy, creating a more reasonable balance between the number of years a person works and the years he or she receives Social Security benefits.

To encourage people to stay in the workforce longer, Americans who work beyond the full retirement age will receive a substantial tax deduction, leading to a higher level of after-tax income than today’s if they are not claiming benefits.

Medicare

The Heritage plan transforms Medicare from an open-ended and unsustainable defined-benefit entitlement into a properly budgeted program that focuses Medicare subsidies on those who need them most. The new Medicare program would look much more like the Federal Employees Health Benefits Program (FEHBP), the health care system for members of Congress and federal employees.

Over a five-year period, the plan transforms Medicare into a defined-contribution system (known as premium support), with strong health security for the poor and less healthy and new protections against catastrophic costs for all enrollees. Seniors will be able to use the contribution toward a plan of their choice or for premium-based, fee-for-service coverage. Stronger competition and consumer choice will replace government regulation as the tool to reduce costs and spending. This premium support will be income-adjusted using the same parameters as Social Security.

Like the Social Security adjustments in retirement age, Medicare's eligibility age will gradually be raised to 68 in 10 years and will be indexed thereafter for increases in longevity.

Medicare's traditional fee-for-service system also changes during the five-year transition. Deductibles and other out-of-pocket costs are adjusted. Building on current income-adjustment policy, premiums for Parts B and D rise according to income, and an income-adjusted premium for Part A is phased in—with the highest-income seniors paying full, unsubsidized premiums.

Health care for families

The Heritage plan ensures that everyone, regardless of job situation, is eligible for a tax credit or other help in purchasing health insurance. This means that people can buy, own, and keep the health care plans of their choice.

The current individual tax exclusion for employer-sponsored health insurance and other tax mechanisms is replaced with a nonrefundable fixed tax credit for households to purchase health coverage. The credit is phased out as income rises and eliminated for upper-income households. The switch from the exclusion to the credit system is revenue-neutral to the federal government. By contrast, today's tax code provides unlimited tax breaks only to workers who receive coverage through their employers, with upper-income workers receiving the largest tax break.

For low-income Americans, the plan provides direct assistance for coverage, paid for with reductions in other federal spending. Low-income, able-bodied adults and their children currently on Medicaid would no longer participate in Medicaid; instead, they would be able to enroll in private coverage. Meanwhile, low-income individuals who are not currently eligible for Medicaid would receive a voucher. This ensures that everyone who needs it receives assistance in purchasing health insurance.

The Heritage plan transforms the remainder of today's Medicaid program—for the frail, elderly, and disabled—into a health care safety-net program rather than today's catch-all, patchwork

program. In addition, we replace the open-ended federal-state financing arrangement with a more consistent and sustainable capped allotment. In exchange for the capped allotment, states are given much more flexibility to redesign health services for the disabled and the elderly poor so that they can provide better and more integrated services at lower cost.

Other spending

Under the Heritage plan, non-defense discretionary spending—appropriated programs such as foreign aid, K–12 education, transportation, health research, housing, community development, and veterans health care, which today account for 4.5 percent of GDP—is reduced to 2 percent of GDP by 2021. These reforms will reduce the burden of government, empowering families and entrepreneurs and boosting prosperity.

Antipoverty spending is scaled back to its 2007 level, adjusted for inflation. Agriculture and education programs are structurally reformed, and highway spending is devolved to the states. The central goal for defense is to guarantee national security as prudently and economically as possible. With improvements in efficiency, we estimate that defense needs will require spending approximately 4 percent of GDP for the foreseeable future.

TAX REFORM

A stronger economy plays a vital role in improving federal finances. It means sustained, normal levels of tax revenues. It also reduces the number of Americans who need help because they are temporarily distressed as a result of unemployment. A stronger economy with better wages and more jobs is also the most powerful antidote to persistent poverty, and less poverty reduces the demands for anti-poverty spending. Thus, tax reform to spur economic growth is a critical component of the Heritage plan.

A Unified Single Tax Rate. The Heritage tax reform plan builds on previous well-known tax reform proposals. The Heritage plan replaces today’s individual and corporate income tax systems and eliminates the estate tax. In lieu of the current array of taxes, our plan institutes a simple, single-rate tax on individuals and businesses. It also folds today’s federal payroll taxes for Social Security and Medicare into the single-rate income tax. In addition, it replaces all federal excise taxes except those dedicated to specific trust funds.

A Simplified System. The basic structure is simple. With its single rate, it taxes uniformly all income sources that are spent on consumption. This means that taxable income includes all labor compensation, net withdrawals from savings and investment accounts, and net borrowing.

Encouragement of Savings. The net amount put aside in savings is subtracted from income to determine net taxable income. Thus, the more individuals or families save, the lower their taxes; they pay tax on savings only when savings are used to pay for goods and services.

Few Deductions or Credits. Under this plan, the individual income tax has only three deductions instead of the legion of deductions under current law.

- **Higher education.** As higher education is a form of savings and investment in human capital, a deduction is allowed for tuition and expenses for higher education up to the average annual cost at a four-year public college or university.
- **Charitable donations and gifts.** As per current law, gifts to nonprofit organizations are tax-deductible if the organizations are recognized as tax-exempt for tax purposes. Gifts to individuals and transfers through inheritance are deductible to the donor but become taxable to the recipient when spent on consumption. Thus, there is no estate tax in our tax reform.
- **Mortgage interest.** Under current law, homeowners can deduct mortgage interest while the lender continues to be taxed on mortgage interest income—so it is taxed once. Our plan does give homeowners the option of foregoing the deduction, in which case the lender is not taxed on mortgage interest income. Market pressure would encourage the lender to offer a lower mortgage interest rate in this case.

Protecting Low-Income Seniors. For Medicare-eligible senior citizens, the calculation of taxable income in the Heritage plan is modified to ensure that the income-adjusted, flat benefit amounts for Social Security and the Medicare defined contribution are tax-free. Today, part of the Social Security benefits of even modest-income seniors is taxed. Thus, lower-income seniors will no longer be pushed back into poverty by the tax system. During the lengthy transition period for the Heritage plan’s Social Security reform, some seniors above certain incomes with relatively high benefits will pay tax on part of those benefits, but they will pay less than most do today. Thus, our plan includes important senior-specific features.

- We gradually end the taxation of Social Security benefits. Seniors protected from poverty by the Social Security and Medicare reforms will no longer be placed at risk by losing some benefits through taxation.
- Encouraging seniors to stay in the workforce longer is important both for their own financial security and for the health of the economy. To achieve this, the first \$10,000 of a senior’s wages and salary is excluded from tax. This provision is especially important for low-income and middle-income seniors.

Taxation of Businesses. The tax on businesses is a simple levy on domestic net cash flow, meaning that taxable income is domestic receipts minus all business costs. It excludes all foreign-source income, which is taxed in the foreign jurisdictions according to their laws and systems. All other special provisions and credits in existing law are repealed except for the Alternative Simplified R&D tax credit.

The business tax is also “border-adjustable,” which levels the playing field between foreign and domestically produced goods and services. Specifically, the business tax is lifted from exports and levied on imports, normalizing tax levels between countries.

Family businesses especially will be helped by the tax reform. Thanks to the tax treatment of savings and gifts, proprietors and investors will have a greater incentive to build up capital for enterprises. And owners will be able to grow their businesses without worrying about whether

their heirs will have to deal with the estate tax, which is repealed.

Tax Rate. The tax system is designed to raise a permanent revenue stream of up to 18.5 percent of the economy as measured by GDP. The single rate is adjusted periodically so that it achieves that level of revenue.

We estimate that the individual and business tax rate needed will likely be between 25 percent and 30 percent, but this is comparable to or significantly below the typical rate facing an individual or family today. The reason for this is that a working family today not only pays federal income tax at rates of between 10 percent and 35 percent, but also is subject to a combined 15.3 percent payroll tax rate on all or most of their compensation.

Thus, the new tax system offers individuals and families a comparable or lower tax rate and vastly improves their savings incentives to build wealth and ensure their own financial security. It simultaneously improves the ability of the economy to raise wages and provide more job opportunities.

BUDGET PROCESS

Today's budget process does little to facilitate sound fiscal reform and in many ways actually impedes good and bold policy. The focus on just 10 years diverts lawmakers from dealing with mounting long-term challenges, such as retirement programs. The lack of firm budget controls and enforcement procedures also makes fiscal discipline very difficult.

In the Heritage plan, we change the budget process to impose enforceable caps in order to reduce total federal spending (including entitlement programs) to 18.5 percent of GDP by 2021 and then keep spending at that level. Within those overall caps we also cap non-defense discretionary spending at 2 percent of GDP. Anti-poverty spending is also capped, as described above.

We also propose amending existing federal laws that provide permanent or indefinite appropriations for federal agencies or programs (including entitlement programs), or that allow agencies or programs to spend funds they receive from fees or otherwise rather than depositing them in the U.S. Treasury, so as to retrieve congressional control of spending. Within our specific reforms for Medicare and Medicaid we also include a fixed budget amount for each program.

To make the budget process more visible, understandable, and accountable to the American people, we require Congress to estimate and publish the projected cost over 75 years of any proposed policy or funding level for each significant federal program.

CONCLUSION

Today, we face a daunting task. We struggle with huge federal deficits in the near future and huge levels of spending and debts in the future. There are two visions of how to address this challenge. One would make few changes in rapidly expanding programs while increasing taxes, increasing the size of government and threatening our economic future. The other, which we

share, is to curb the growth of spending so that a reformed federal government can operate deficit-free at the size that Americans have been prepared to finance.

Fixing the deficit and debt problem means that we must ask ourselves tough questions about how we can allocate public funds in the most effective way. We must acknowledge that everyone will need to pitch in to solve the problem. We must ask parents and grandparents to think not just of their own immediate situations, but also of the financial consequences that their children and grandchildren will have to endure if today's adults are not prepared to re-evaluate whether they need everything that has been promised them. The money is simply no longer available to pay for all of the promised benefits. That is an indictment against Washington, but it is also a fact—and one that we are now forced to address.

The good news is that we can do this. We can guarantee economic security to middle-aged and older Americans even as we reduce the crippling debt that we have piled onto the shoulders of the young. To do this, we must reduce the size of the federal government and focus it on performing its core responsibilities effectively and efficiently. And we must not allow taxes to drift higher and higher as a proportion of the economy. Instead we must rein in taxes and reform the tax system to foster both faster growth and greater economic freedom.

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Percent of GDP	2021	2035
Revenues	18.3	18.5
Spending	<u>18.1</u>	<u>17.7</u>
Deficit (-)	0.2	0.8
Debt Held by the Public	58.2	30.0