### **Fiscal Solutions:**

# A Balanced Plan for Fiscal Stability and Economic Growth

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The Peterson Foundation convened organizations with a variety of perspectives to develop plans addressing our nation's fiscal challenges. The American Enterprise Institute, Bipartisan Policy Center, Center for American Progress, Economic Policy Institute, The Heritage Foundation, and Roosevelt Institute Campus Network each received grants. All organizations had discretion and independence to develop their own goals and propose comprehensive solutions. The Peterson Foundation's involvement with this project does not represent endorsement of any plan. The final plans developed by all six organizations were presented as part of the Peterson Foundation's second annual Fiscal Summit in May 2011.

## Introduction

Our country faces a serious fiscal crisis. According to President Obama's National Commission on Fiscal Responsibility and Reform, the nation is on an unsustainable fiscal path, with spending well above tax revenue. The Congressional Budget Office projects that, under current policies, federal debt will soar from 62 percent of annual GDP in 2010 to 87 percent in 2020 and 185 percent in 2035.

The plan presented here represents the collaboration of its four authors and does not reflect the position of the American Enterprise Institute or any other organization. The individual authors do not fully agree with every provision of the plan, but we join in presenting it as a way to address the fiscal imbalance while promoting economic growth.

Our plan re-establishes a balance between federal spending and revenue that achieves long-term fiscal stability and promotes economic growth. We cannot simply tax our way to a balanced budget without suffering the consequences of a sluggish economy and reduced prosperity. We also cannot simply cut spending without risking the loss of essential services for an aging population, undercutting our infrastructure on which economic growth builds, and reducing our ability to defend the country against its enemies.

Our plan limits the national debt to 60 percent of annual GDP in 2035. Ambitious cuts in federal spending are required to achieve that goal while minimizing tax burdens on the American people and the drag that high marginal tax rates impose on long-run economic growth.

We are under no illusion about the difficulty of this task. These policies will require real sacrifices of many families and will be politically unpopular, but some version of our plan is necessary.

The major entitlement programs—Medicare, Medicaid, and Social Security—will account for most of the unsustainable growth in long-term federal spending. The Affordable Care Act (ACA) introduces a new subsidy for health insurance in 2014 that will add to the fiscal pressure and contribute to the inflationary pressures that make health care increasingly unaffordable. Spending also must be reduced in other federal programs, but fiscal stability cannot be achieved without reforming our health and retirement programs.

The growth of federal health spending is widely agreed to be our largest fiscal challenge.<sup>3</sup> The technical challenge is to identify policies that can successfully harness Medicare's spending growth with the least impact on access to services and quality of care. The political challenge is to muster the will and bipartisanship necessary to take difficult policy actions in a program that will serve a rapidly growing number of voters.

<sup>&</sup>lt;sup>1</sup> National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, December 2010.

<sup>&</sup>lt;sup>2</sup> Congressional Budget Office, *The Long-Term Budget Outlook*, June 2010, p. 7. The projection is based on CBO's alternative fiscal scenario.

<sup>&</sup>lt;sup>3</sup> See Bipartisan Policy Center, *Restoring America's Future*, November 2010; and William A. Galston and Maya MacGuineas, "The Future is Now: A Balanced Plan to Stabilize Public Debt and Promote Economic Growth," Brookings Institution, September 30, 2010.

Our proposed health reforms are intended to slow the growth of spending—both federal and system-wide—while maintaining access to high quality health services. The reforms establish a clear understanding that there are binding resource constraints without imposing burdensome regulations that impose unnecessary restrictions on consumer choice.

Incentives, rather than controls, promote greater efficiency and allow patients and their health care providers to make the best individual decisions within a responsible budget framework. That requires shifting away from the defined benefit approach that characterizes Medicare and Medicaid today to a defined contribution philosophy that places a limit on federal spending while recognizing the changing needs of the population.

To develop an effective plan, it is necessary to repeal the ACA and replace it with a new set of policies based on market principles and budget realities. Nonetheless, the major objectives of that legislation (such as creating an organized marketplace for insurance, better information for consumers, and expanded federal insurance subsidies for those most in need) are reflected in new policies better able to achieve those goals.

The Social Security reform is designed to make the program more effective in protecting low earners, simpler for individuals of all earnings levels to understand, more conducive to saving and longer work lives, and better aligned with the work and retirement conditions that will prevail in the coming decades. That will make Social Security solvent and sustainable over the long term while reducing program outlays to better accommodate rising costs for other priorities, including health care.

Our plan eliminates unnecessary and duplicative programs government-wide, and focuses the remaining programs on their core missions to maximize their value and efficiency. That does not preclude expanding some programs that are particularly effective while contracting others whose value is lower. Defense spending is subject to these budgetary restraints, but our plan maintains adequate military capacity to protect U.S. and allied interests. Moreover, in the event of significant new threats, we assume that adjustments in other programs would be made to ensure our country's security.

The federal government raises much of its revenue from the individual and corporate income taxes, which are biased against saving and investment. Our proposed tax reform replaces the income tax system and the estate and gift tax with a progressive consumption tax, thereby eliminating the tax penalty on saving and investment. To address environmental concerns in a more market-friendly manner, our plan replaces an array of energy subsidies, tax credits, and regulations with a carbon tax.

The impact of our plan can be better understood by comparing it to the baseline path specified for the Peterson Foundation exercise, which is based on Congressional Budget Office projections. As shown below, this baseline features rising taxes, soaring spending, and increased deficits and debt.

#### **BASELINE**

	2021	2035
Revenues	20.8	23.3
Spending	24.0	28.3
Deficit (-)	-3.2	-5.0
Debt Held by the Public	76.7	91.5

Relative to this baseline, our plan significantly lowers taxes, spending, deficits, and debt.

#### **BALANCED PLAN FOR FISCAL STABILITY AND GROWTH**

	2021	2035
Revenues	19.5	19.9
Spending	20.9	22.8
Deficit (-)	-1.3	-2.9
Debt Held by the Public	62.6	59.6

In summary, our plan brings federal spending and revenue into closer alignment, thereby sparing future generations from the explosive growth of federal debt. At the same time, it promotes economic growth by emphasizing spending cuts and by using an economically efficient consumption tax to raise the revenue that is needed.

# **Health Policy**

# **Background**

Health care spending represents a large and rapidly growing part of the federal budget, amounting to nearly \$920 billion in 2009 and nearly doubling by 2019. Medicare, Medicaid, and the Children's Health Insurance Program provide the bulk of federal funding for health services. Federal programs also finance public health activities, medical research, and investment in health sector infrastructure. In addition, tax preferences for health insurance and other health spending reduced federal revenues (including income and payroll tax receipts) by some \$290 billion in 2008.

If we expect to achieve long-term fiscal stability for the government and affordable health care for Americans, we must find ways to slow the growth of health spending. Rising health costs are driven in part by the medical needs of an aging population. Over the next two decades, Medicare spending will increase sharply as more than 30 million baby boomers enroll in the program. The demand for Medicaid services (including long-term care services) will also increase as the population ages. In addition, the ongoing development of new medical technologies that provide more effective treatment to more people will increase program costs. Against this backdrop, we propose policy changes intended to provide incentives for value-conscious use of health services and to promote greater efficiency in the way care is delivered.

Our goal is to slow the growth of health spending (both federal and system-wide spending) while maintaining and improving access to high-quality services. Although that was a stated objective of the Affordable Care Act, the new law failed to address the structural problems in Medicare and Medicaid that have led to an unsustainable trend in spending.

Instead, ACA's major objective was to expand insurance coverage for low and middle-income families through a series of new subsidies and regulations, including a mandate requiring individuals to obtain health insurance. The health reform law created a new entitlement to insurance subsidies administered through health insurance exchanges and it expanded Medicaid eligibility. The additional cost of these expansions is paid for through increased taxes and reduced Medicare payments to health care providers. Medicare remains an unlimited entitlement to benefits, with most beneficiaries enrolled in the traditional fee-for-service program. Other initiatives, such as accountable care organizations, are intended to slow federal health spending, but they remain controversial and untested.<sup>6</sup>

That financing strategy cannot succeed. Inadequate revenue is not the main health system problem, excessive spending is. Price controls might slow the growth of Medicare spending temporarily, but the program's fee-for-service system provides strong incentives for the use of more services (and more

<sup>&</sup>lt;sup>4</sup> Andrea M. Sisko et al., "National Health Spending Projections: The Estimated Impact of Reform Through 2019," *Health Affairs*, October 2010.

<sup>&</sup>lt;sup>5</sup> Joint Committee on Taxation, *Background Materials for Senate Committee on Finance Roundtable on Health Care Financing*, JCX-27-09, May 8, 2009.

<sup>&</sup>lt;sup>6</sup> Ricardo Alonso-Zaldivar, "Obama plan for health care quality dealt a setback," Yahoo News, May 11, 2011.

expensive services). Moreover, the Medicare actuary has warned that the size of those price cuts is "unsustainable." Over the past eight years, Congress has been unwilling to enforce sharp reductions in Medicare physician payments required under the law. It seems unlikely that Congress will change its behavior by enforcing the substantial payment cuts imposed by ACA.

A new approach is needed if we hope to set federal health spending on a fiscally sound path. Instead of the implicit promise of unlimited payment for benefits, Medicare and Medicaid would be placed on reasonable budgets. Tax preferences available only to workers whose employers contribute to their health insurance premiums would be replaced by refundable tax credits available to everyone purchasing private insurance. Our plan shifts federal health financing from its current defined-benefit philosophy to a defined contribution system. That change does not, by itself, guarantee sufficient budget stringency in health programs to ensure overall fiscal stability, but it makes the financial stakes more clear in the public debate over spending priorities.

Based on market principles and budget realities, our plan corrects long-standing structural problems in federal health programs. To be clear about the proper direction for policy, we assume that ACA is repealed and we are starting with a fresh slate. Nonetheless, the major objectives of ACA (such as creating an organized marketplace for insurance, or expanding federal insurance subsidies for those most in need) would be reflected in new policies better able to achieve those goals.

In general terms, our plan caps federal subsidies for insurance, promotes effective competition and innovation in the health sector, reduces regulatory burden, develops better consumer information, and lowers unrealistic expectations on the part of everyone. Subsidies in all federal health programs would be made more progressive, helping those who most need the help. We anticipate that such policies will provide strong incentives for the private sector to develop new ways to deliver care that will improve efficiency and lower the cost per unit of service.

Our plan significantly slows the growth of federal health spending over the next 25 years. However, the trend continues to rise even with the implementation of stringent budget constraints because of population aging, continued medical progress, and the willingness of people in a growing economy to devote more of their resources to health care. The spending reductions, relative to the current budget baseline, that we project are substantial, but we expect that quality of care and access to essential services will be maintained thanks to increasing efficiency in the health sector.

<sup>&</sup>lt;sup>7</sup> Richard S. Foster, "Estimated Financial Effects of the 'Patient Protection and Affordable Care Act,' as Amended," Centers for Medicare and Medicaid Services, April 22, 2010.

<sup>&</sup>lt;sup>8</sup> A reduction of 5.4 percent in Medicare physician payment rates under the sustainable growth rate (SGR) formula was implemented in January 2002. Since then Congress has reduced or deferred SGR cuts every year. See Cristina Boccuti et al., "The Sustainable Growth Rate System: Policy Considerations for Adjustments and Alternatives," Medicare Payment Advisory Commission, February 23, 2011.

### **Provisions**

### 1. Medicare reform

Medicare provides health benefits to all Americans age 65 or older and some disabled persons. Beneficiaries may enroll in the traditional fee-for-service program or in Medicare Advantage, which provides a choice of private health plans. The traditional program covers inpatient and other services under Part A, physician and most outpatient services under Part B, and prescription drug coverage that beneficiaries may purchase under Part D. Traditional Medicare pays doctors, hospitals, and other providers for individual services. In contrast, Medicare Advantage plans are paid a fixed "capitated" payment for all covered services provided to enrollees.

Our proposed Medicare reform restructures the traditional Medicare program, creates level competition for all Medicare plans (including the traditional program), and replaces the open-ended entitlement with a defined-contribution system called premium support. Traditional Medicare is not eliminated, but its benefit structure is modernized and it competes with private Medicare plans under premium support rules.

In addition, Medicare's eligibility age would be increased gradually, consistent with a similar policy in Social Security. This reflects the increasing longevity among the elderly and greater opportunity for individuals to extend their work lives, thanks to better health and the shift towards less physically-demanding employment. The eligibility age is increased two months each year starting in 2014 until it reaches 67 in 2025. As another work incentive, the Medicare payroll tax would be eliminated for people age 62 or older. This policy is phased in along with the parallel policy for Social Security.

#### **Restructure traditional Medicare**

The benefit structure in traditional Medicare is unlike that of comprehensive health insurance plans offered to people under age 65. Private insurance typically requires enrollees to pay a deductible (often amounting to \$1,000 or more) before a benefit is paid. After the deductible is satisfied for the year, enrollees are usually required to pay either a fixed-dollar amount or a percentage of the cost of covered services.

Traditional Medicare has a \$1,140 deductible for inpatient hospital stays and a separate \$168 deductible for outpatient services. It also has a complex set of coinsurance requirements that vary depending on the medical service, and it places a lifetime limit on the number of days a beneficiary is covered for inpatient hospital care. Traditional Medicare does not provide protection against catastrophic health care costs; beneficiaries are potentially at risk for unlimited costs even though they are covered by Medicare.

Most beneficiaries in traditional Medicare are protected from the confusion and financial risk of this structure through supplemental insurance—Medigap, retiree coverage, or Medicaid. As a result, most beneficiaries pay little or nothing out of pocket for their care. The patient's lack of cost awareness coupled with fee-for-service incentives for the provider has contributed to the rapid growth of Medicare spending.

Our plan corrects these problems. Medicare cost-sharing requirements are simplified, with a single deductible for inpatient and outpatient services and a 20 percent coinsurance rate for all services. Instead of maintaining separate programs under Medicare Parts A, B, and D, traditional Medicare would offer a comprehensive set of benefits including coverage for prescription drugs and catastrophic costs.

To reduce the financial impact of additional service use induced by supplemental insurance, anyone enrolling in traditional Medicare with such coverage would pay a premium surcharge. In addition, until traditional Medicare is restructured and the premium support system becomes effective, premiums for Medicare Parts B and D would be increased from 25 percent to 40 percent of each program's costs on average. Premiums would continue to be income-related, with higher premiums for beneficiaries with higher incomes.

### Shift to market pricing in traditional Medicare

Traditional Medicare uses various methods to establish the prices for individual medical services. Except in limited circumstances when competitive bidding has been tried, traditional Medicare is the price setter and prices do not adjust readily to changes in market conditions. There is a tendency for prices to be set above the market-clearing level, both to ensure beneficiary access to services and because only those who think they have been paid too little complain to Congress.

Policymakers have had particular difficulty with Medicare's physician payment, which is subject to the sustainable growth rate (SGR) formula. The SGR has called for increasingly large reductions in Medicare's payment rates, which Congress has consistently overturned. Faced with a nearly 30 percent reduction in fees in 2012 and budget savings that will never be realized, physicians and policymakers want a permanent "doc fix"—a stable payment system that is not subject to arbitrary and unreasonable cuts.

Our plan stabilizes physician payment rates and allows them to increase with general inflation. To introduce an element of market pricing, restrictions on "balance billing" would be lifted. Physicians would be permitted to charge any amount over the Medicare payment for their services (subject to their ability to command higher prices in the market), as long as they disclose their prices in advance. In addition, restrictions on physician ability to provide services to Medicare beneficiaries outside of program rules (referred to as "private contracting") would be lifted.

### Medicare premium support

Medicare would be placed on a budget through premium support, in which a subsidy would be provided to beneficiaries choosing from among competing health plans. Larger subsidies would be paid to beneficiaries who are in greater financial need or who have higher health risks. Those selecting more expensive plans (including traditional Medicare, which would remain available but at a premium commensurate with its cost) would be responsible for any premium amount above the subsidy.

<sup>&</sup>lt;sup>9</sup> Congressional Budget Office, *The Sustainable Growth Rate Formula for Setting Medicare's Physician Payment Rates*, Economic and Budget Issue Brief, September 6, 2006.

This mechanism eliminates traditional Medicare's open-ended subsidy and places all plans into competition with each other. Within limits, competing health plans could adjust their benefits, provider networks, cost-sharing requirements, and premiums to attract enrollees.

Since seniors live on limited incomes, plans will be motivated to find more efficient ways to deliver services that cut cost without unduly burdening patients. They cannot simply order more tests or procedures to increase their profits, as is the case in a fee-for-service world, because the total payment for an enrollee is limited. That provides a strong incentive to seek ways to deliver care that are both more efficient and attractive to consumers.

In order to compete, traditional Medicare would be granted new authority to manage its benefit. That could mean giving Medicare the power to adjust cost-sharing or to offer services through provider networks at reduced cost to consumers as an optional alternative to the virtually unlimited provider network now available.

As part of Medicare premium support, the bidding process for Medicare Advantage would be changed. Traditional Medicare would bid along with private plans in each market area, and the federal subsidy for premiums would be determined relative to those bids. Employer plans could participate in this bid process if they opened enrollment to all comers; otherwise, they could remain closed to anyone not otherwise eligible for the plan and accept the premium support payment determined through the bidding process.

The annual growth in the premium subsidy would be determined by Congress in conjunction with decisions about other spending priorities. Total Medicare spending would average about a 1.2 percentage point slower growth than under current law. This policy is effective starting in 2013. It would be desirable to phase premium support in over ten or more years, allowing individuals and the health system time to adjust to placing Medicare on a budget. However, a phase-in period also delays the spending reductions needed to achieve our long-term fiscal goal.

### 2. Medicaid reform

The federal government subsidizes state Medicaid programs through matching payments that cover about 57 percent of total costs on average. States have developed complex financial arrangements that allow them to draw more federal funds without necessarily providing more or better services. Replacing matching payments with block grants eliminates this perverse incentive and permits states to manage their Medicaid programs more efficiently. Federal Medicaid cost would grow with the economy, allowing for some additional savings due to increased efficiency in the health sector.

In exchange for this cap on federal payments, states would be granted new flexibility to manage their Medicaid programs. If states find more efficient ways to deliver services, their federal payment is not reduced as it would be under the current matching grant approach.

States would be permitted to offer premium support for private insurance to Medicaid beneficiaries, on a voluntary basis. In addition, benefit payments for individuals who receive both Medicaid and Medicare benefits (the "dual eligibles") would be converted into fixed payments for insurance plus a contribution

to a medical savings account. Dual eligibles may enroll in either a Medicaid or Medicare managed care plan, rather than drawing fee-for-service benefits from both programs.

### 3. Insurance reform

Workers currently are not taxed on contributions for health insurance made by their employers. That creates an open-ended and regressive subsidy that has promoted first-dollar coverage and rapid growth in health spending. The health reform legislation establishes a new subsidy for individuals with incomes below 400 percent of poverty who buy insurance through the exchanges. Both programs would be replaced by a refundable health insurance tax credit that provides a flat dollar subsidy, with higher payments to those with lower incomes and greater health risk. That eliminates the current system's incentive to purchase more expensive coverage and its favoritism toward higher-income purchasers.

Financing reforms must be accompanied by a host of other changes in the design and operation of the health system. Organized insurance markets, similar in concept to the exchanges but with less federal control that would stifle innovation and competition, are needed to foster effective consumerism. Limits on the use of health savings accounts coupled with high-deductible insurance would be lifted. Interstate insurance sales would be permitted to encourage states to drop unnecessary regulations. Better information on treatment options, including information on cost and provider performance, is necessary for patients to make informed decisions in conjunction with their doctors. Medical liability reforms are needed to reduce defensive medicine and to give all patients fairer recourse if medical errors occur.

# **Social Security Policy**

# **Background**

The Social Security program accomplishes three main goals:

- 1. Require that all workers save a portion of their earnings for retirement;
- 2. Supplement benefits for individuals who could not provide a decent standard of living based on their own savings, such as the poor, the disabled, and survivors; and
- 3. Protect against the risk of running out of money late in life by paying benefits as an annuity that lasts as long as you live.

Since 1935, Social Security has pursued these goals through a single, integrated program that is financed on a pay-as-you-go basis. Going into the future, however, we can best serve Social Security's goals by changing the form and structure of how it is financed and how it pays benefits.

Social Security provides benefits in retirement, disability, and following the death of an eligible worker. Benefits are calculated as a progressive replacement of average lifetime earnings, meaning that the system is both earnings based and redistributive. Higher earners receive larger absolute benefits, but smaller benefits relative to their prior earnings or their contributions.

The proposed changes to the Social Security program follow three central precepts:

- Make the program solvent and sustainable over the long term. Sustainable solvency is necessary, meaning that without it any other changes are undermined, but by itself solvency is not a sufficient measure of a successful reform.
- Modernize the program to make it more effective in protecting low earners, simpler for individuals of all earnings levels to understand, more conducive to saving and longer work lives, and more generally better aligned with the work and retirement conditions of the mid-21<sup>st</sup> century rather than the early 20<sup>th</sup> century.
- 3. Reduce program outlays over the long-term to better accommodate rising costs for other government programs, in particular health-related entitlements. In other words, cost levels are chosen not in isolation, but in the context of the other fiscal burdens the government must bear in the coming decades.

In general, the largest changes to the Social Security benefit structure are introduced so they would be fully implemented only as new entrants to the workforce today reach retirement.

### **Provisions**

#### Flatten the basic benefit

Description: For individuals entering the workforce this year, the benefit at retirement or disability would be a flat payment equal to the single over-65 poverty threshold (approximately \$850 per month),

wage-indexed forward to rise with the standard of living in the economy as a whole. The policy change would be implemented by first granting the flat minimum benefit, which would be fully phased in by 2017, then gradually reducing the traditional PIA replacement factors from 2020 through 2050 until all beneficiaries receive the flat benefit payment. The benefit would be granted to all individuals reaching retirement age, regardless of work history, and would assume the responsibilities of both the redistributive element of Social Security as well as the pure welfare approach of Supplemental Security Income (SSI). The base benefit would be equal to approximately 25 percent of the average wage of workers at the time. Because the benefit is a fixed value, it would be relatively more generous to lower earning individuals. Effectively immediately, survivors would receive 75 percent of the couple's total benefit when both spouses were alive, better enabling the widow or widower to retain their prior standard of living. In effect, the flat benefit payment would guarantee that no Social Security beneficiary was forced to live below the poverty line. Relative to current law, where roughly 10 percent of the elderly live in poverty, the Social Security safety net would be strengthened considerably. However, this flat benefit would come at the cost that middle and high earning individuals must save more for retirement, as they would receive lower benefits than under current law.

Discussion: The current Social Security benefit formula is exceedingly complex, which leads to two problems. First, households with the same level of lifetime earnings and payroll tax contributions may receive very different levels of benefits depending upon the length of their work lives, relative earnings between spouses, length of marriage and so on. This variation is greatest among low earners, meaning that many low-income households receive lower benefits than one would assume. Second, the complexity of the benefit formula makes it difficult for many workers to accurately predict their future benefits, even with the assistance of the annual Social Security Statement, so much so that many have no real idea what their benefit will be until the first check arrives. This complexity complicates decisions regarding how much to save and when to retire. A simpler benefit structure will ensure that the safety net is more robust and individuals have better knowledge what they will receive when they retire.

Variations: As constructed, the basic benefit is a universal pension paid to all and thus is designed as a strong floor against poverty. This approach, admittedly, is a change from Social Security's approach of paying benefits based upon earnings and, to some degree, labor force participation. Alternate iterations could retain the same flat benefit level, but pro-rate it based upon years in the workforce or years of residence in the country.<sup>13</sup> Likewise, the flat benefit level might be placed at the Federal Benefit Rate used by SSI (\$674 for a single individual in 2011).

<sup>10</sup> Implementation of this provision should produce savings within the SSI aged benefit program, although they are not calculated explicitly here.

<sup>&</sup>lt;sup>11</sup> See Biggs, Andrew G. "Will Your Social Insurance Pay Off? Making Social Security Progressivity Work for Low-Income Retirees," AEI Retirement Policy Outlook, January 2009.

<sup>&</sup>lt;sup>12</sup> See Biggs, Andrew G. "Answer quickly: How much do you think you'll get from Social Security," AEI Retirement Policy Outlook, June 2009.

<sup>&</sup>lt;sup>13</sup> Canada's basic pension, for instance, is based upon years of residence in the country.

### **Universal retirement saving accounts**

Description: To supplement the basic benefit, each worker would automatically be enrolled in a defined contribution retirement saving account funded with 5 percent of worker's earnings, with a contribution of 2.5 percent of individuals earnings matched 2.5 percent by employers. If invested in government bonds, the total combined benefit would approximately equal both the generosity and the progressivity of the current law benefit formula. However, the default investment portfolio could be a relatively conservative "life cycle" portfolio that gradually shifted from stocks to bonds over time.

Discussion: While Social Security acts as a redistributive program toward low earners and the disabled, for middle and higher earners much of what Social Security does is simply mandate saving for retirement. If we were designing a social security program from scratch for the 21<sup>st</sup> century, it is likely that the mandatory saving element of the system would take place through individual saving, not a pay-as-you-go government. Universal individual saving is less distortionary than taxes paid to the government, thereby encouraging labor force participation. Individual saving also increases the capital stock and economic growth, while pay-as-you-go financing reduces it. Finally, individual investment portfolios can be adjusted to match the risk preferences of the saver, while a centralized approach is necessarily one-size-fits-all.

It should not be expected that individual retirement savings accounts would generate a net increase in retirement saving equal to 5 percent of earnings. As many or most Americans are already saving sufficiently for retirement, these individuals may reduce their non-Social Security saving to keep their targeted retirement income constant. The retirement accounts would impose a true "tax increase," albeit a tax increase that individuals paid to themselves, only on individuals currently saving less than 5 percent of their pay for retirement. Because most individuals *should* save at least 5 percent of earnings for retirement, the individual welfare costs of mandatory retirement accounts are likely to be small.

Variations: With regard to participation, the individual savings accounted envisioned here would be compulsory, which both facilitates administration of the accounts for both employers and the government and ensures that individuals do not drop out and leave themselves unprepared for retirement. Others have favored automatic enrollment over compulsion, and auto-enrollment would meet most of the goals outlined here. A middle ground might be "soft compulsion," such as outlined for the United Kingdom's universal pension accounts, in which individuals would be automatically enrolled and would have to annually make an active decision to opt out. With regard to funding, account contributions are envisioned here as being split evenly between workers and employers. Alternate specifications are possible, including a government contribution. Once the Social Security program was restored to cash balance, annual surpluses could be used to increase total account contributions, substitute for part of the employee/employer contribution, reduce payroll taxes for defined benefits, or supplement the Medicare program depending on need. Finally, at retirement, withdrawals (up to a limit) that were converted to an annuity could be exempted from income taxes, while withdrawals in general would be treated as Social Security benefits for tax purposes.

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<sup>&</sup>lt;sup>14</sup> On current retirement income preparedness, see Biggs, Andrew G. "Will You Have Enough to Retire On?: The Retirement Security Crisis," AEI Retirement Policy Outlook, February 2009.

#### Work and retirement incentives 1

Description: The Earliest Eligibility Age (generally referred to as the early retirement age) would gradually be increased from 62 to 65 for those born in 1966 and retiring in the 2030s. The normal retirement age would not be affected. While individuals could in general not claim retirement benefits prior to 65, their benefits would be increased to account for the mandatory delay in claiming. To assist those who could not work longer, disability benefits would remain available and the age of eligibility for SSI aged benefits would be reduced from 65 to 62. <sup>15</sup>

Discussion: Even as life expectancies have increased and work and health conditions have improved, Americans claim Social Security earlier today than they did in the 1950s (age 63 today versus over age 68). Claiming at 62 generates a 25-30 percent benefit reduction that lasts for life, leaving some individuals with too little to live on in old age. This is a particular danger given the substantial chance of living significantly longer than the average (a typical 65 year old survives to age 83, but one in four will survive to 90 and one in ten to age 95). There is an almost 20 percent chance that at least one member of a retiree couple will live to age 95, and a five percent chance of one spouse surviving to 100. Preventing individuals from claiming early retirement would generate an average 17 percent increase in Social Security benefits. As individuals also would spend more time in the workforce building personal savings, total annual retirement income would rise by around \$5,000 for retirees in the 2050s. Moreover, the increased labor force would generate higher economic output; the PSG models estimate GDP in 2035 to be 3 percent higher than under the baseline. Higher earnings also would generate significant non-Social Security tax revenues.

#### Work and retirement incentives 2

Description: Eliminate Social Security payroll tax (employee and employer share) for all individuals aged 62 and older, beginning in 2011.<sup>16</sup>

Discussion: Social Security pays extremely low returns to continued work at older ages, due to the 35 year wage averaging period and the benefit formula for spouses. <sup>17</sup> As a result, the marginal net tax rate – that is, the 12.4 percent payroll tax rate minus the present value of benefits generated by those taxes – approaches the statutory rate. At younger ages, the net tax rate is significantly lower and sometimes even negative. Eliminating the payroll tax would encourage individuals to remain in the workforce and make older workers more attractive to employers. Individuals would continue to accrue benefits as under current law, although such accruals would be small.

Variations: Depending on cost, alternatives could reduce the rate, gradually eliminate the tax at older ages, etc.

<sup>15</sup> See Biggs, Andrew G. "The Case for Raising Social Security's Early Retirement Age," AEI Retirement Policy Outlook, October 2010.

<sup>&</sup>lt;sup>16</sup> See Biggs, Andrew G. "The Case for Raising Social Security's Early Retirement Age," AEI Retirement Policy Outlook, October 2010.

<sup>&</sup>lt;sup>17</sup> See Reznik, Gayle, Weaver, David A. and Biggs, Andrew G. "Social Security and Marginal Returns to Work Near Retirement," Social Security Administration, Issue Paper No. 2009-02. April 15, 2009.

#### Work and retirement incentives 3

Description: Eliminate the Retirement Earnings Test. The RET reduces benefits for early retirees who continue to work and earn more than \$14,160 in a given year. Benefits are reduced by 50 cents for each dollar of earnings above the threshold. At the normal retirement age, the RET is stopped and benefits are adjusted upwards to compensate for any reductions due to the RET in early retirement. Over the course of a typical retirement, total benefits are the same with or without the RET.<sup>18</sup>

Discussion: Most people do not realize that benefits are increased at the normal retirement age to compensate for losses due to the RET in early retirement, and SSA and financial advisors do a poor job explaining the full provisions of the RET to retirees. Individuals tend to treat the RET as a 50 percent marginal tax rate on work, over and above the income and payroll taxes they already pay. As a result, many individuals work up to the RET earnings but not beyond. This hurts individual retirement security, the economy and the federal budget. Given the confusion, and that the RET would apply only to ages 65-67 once the early retirement age was raised to 65, it is probably more conducive to overall retirement security to eliminate the RET.

#### Accurate inflation adjustment to post-retirement benefits

Description: Beginning in 2020, reduce annual COLA payments by 0.11 percentage points to approximate the effects of using a chain-weighted version of the CPI based upon the purchasing habits of the elderly.

Discussion: Currently, Social Security benefits are adjusted each year based upon changes in the Consumer Price Index for Urban Wage Earners, or CPI-W. There are two potential problems with the use of the CPI-W for Social Security COLAs. First, most economists have concluded that the conventional CPI measures tend to overstate the true rate of inflation because they do not account for how individuals alter their purchasing habits as the relative prices of goods change. The "chain-weighted" CPI is designed to better account for this so-called "substitution bias." The chain-weighted CPI generally reports inflation around 0.3 percentage points below that of the CPI-W. Second, however, the CPI-W is based upon the purchasing habits of working age Americans, which may differ from those of Social Security beneficiaries. Specifically, Social Security beneficiaries may spend a greater share of their incomes on health care, for which prices have risen faster than other goods or services. The experimental CPI-E tracks prices changes based upon purchases made by individuals over age 65 and tends to show inflation rates around 0.2 percentage points higher than the CPI-W. A more accurate COLA for Social Security beneficiaries would be generated from a chain-weighted CPI based upon the purchasing habits of Social Security beneficiaries. It would tend to show inflation approximately 0.11 percentage point lower than the CPI-W.

Variations: Some have proposed shifting COLA calculations to the chain-weighted CPI without adjustments for the purchasing power of Social Security beneficiaries. Doing so would increase the savings from the provision, albeit at the cost of lower benefits for the oldest retirees. The provision as described above appears to reasonably capture the intuitive intent of inflation adjustment for Social

<sup>&</sup>lt;sup>18</sup> See Biggs, Andrew G. "The Social Security Earnings Test: The Tax That Wasn't," AEI Tax Policy Outlook, July 2008.

Security benefits. A second, more radical alternative could adjust Social Security benefits upward at a rate above inflation, such as by using the proposed chain-weighted CPI-E and adding the rate of real wage growth. To equalize lifetime benefits, the initial benefit amount would be lowered (and the progressivity of benefits altered somewhat so as not to disadvantage low earners, who have shorter life expectancies). This alternative approach would both discourage early retirement, by making the initial benefit lower, and better protect against poverty in old age by increasing benefits later in life. Moreover, because non-Social Security retirement income is rarely adjusted for inflation, a Social Security COLA in excess of the rate of inflation could help stabilize the value of income throughout retirement.

### **Reform Disability Insurance benefits**

The growth of costs for the Disability Insurance program has exceed that of the Old Age and Survivors component of Social Security and the DI trust fund is projected to be insolvent in 2019. This component adopts reform proposals that have been discussed by experts on disability insurance reform as a means to slow the growth of beneficiary rolls. This provision would provide for experience-rating of Social Security disability taxes paid by employers based on the propensity of their employees to claim DI benefits. This step, similar to the way that taxes for Unemployment Insurance and Workers Compensation are levied, would give employers the incentive to offer rehabilitation, retraining and other accommodations to keep workers on the job. Moreover, employers who offer private disability insurance for their employees, as suggested in a recent proposal from Autor and Duggan (2010) would receive a rebate based upon plans' ability to reduce rates of worker entering the DI rolls. <sup>19</sup> While the effects of these policies are difficult to estimate, it seems reasonable that they could reduce the disability incidence rate to a level halfway between the Trustees intermediate and low-cost projections. This provision also would indirectly benefit Medicare, as DI beneficiaries become eligible for Medicare benefits after two years on the rolls.

### **Modeling**

The effects of the proposals outlined above on system finances and benefits are projected using a suite of models developed and maintained by the Policy Simulation Group (PSG). <sup>20</sup> The PSG models, which include the SSASIM, GEMINI, and PENSIM models, are constructed on a microsimulation basis similar to the Congressional Budget Office's Long-Term model (CBOLT) and produce results comparable to those generated by CBO or SSA's Office of the Chief Actuary. The PSG models use the Social Security Trustees base economic and demographic assumptions. These differ slightly on the economic end from those used by CBO, but are qualitatively similar. The PSG models are used by the GAO for its Social Security work, the Department of Labor for analysis of private pensions, and SSA's Office of Retirement and Disability Policy.

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<sup>&</sup>lt;sup>19</sup> Autor, David H. and Mark Duggan. "Supporting Work: A Proposal for Modernizing the U.S. Disability Insurance System," The Center for American Progress and the Hamilton Project, December 2010.

<sup>&</sup>lt;sup>20</sup> For more information on the PSG models and model validation, see www.polsim.com.

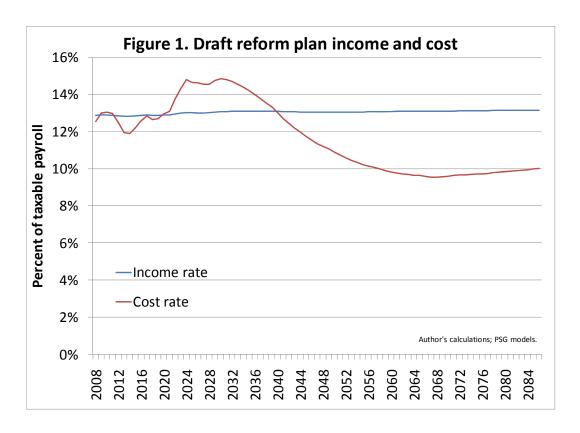
### **System finances**

Most Social Security reform proposals intend principally to balance the program's finances over the long- term. Over 75 years, Social Security faces a funding shortfall equal to 2.0 percent of taxable payroll. This implies that an immediate and permanent increase in the Social Security payroll tax from 12.4 to 14.4 percent of wages, or an equivalent reduction to benefits, would be sufficient to ensure solvency over that period. To maintain solvency over 75-years and have the program in good financial health at the end of the 75-year period—a criterion known as "sustainable solvency"—would demand an immediate and permanent tax increase of around 3.3 percent of wages, or an equivalent reduction to benefits. If action is delayed, the size of required tax increases or benefit reductions would rise.

Our plan seeks to restore long-term solvency, but also to "right size" the Social Security program in the context of rising costs for other federal obligations. Unlike Medicare or Medicaid, it is relatively easy for individuals to compensate for lower future Social Security benefits by increasing personal saving and delaying retirement. With health insurance programs, by contrast, individual supplementation of reduced government benefits is difficult due to the insurance character of health payments, the wide distribution of individual costs, and the integrated nature of health payment systems. Therefore, long-term costs are not merely returned to the current level but eventually reduced further with the intent of giving greater fiscal space for other government activities.

Over 75 years, the PSG models calculate that the reforms described above would produce an actuarial surplus of 1.6 percent of taxable payroll, making the program well more than solvent over 75-years and beyond. The program's trust fund, currently projected to be insolvent in 2037, would remain solvent in perpetuity.

On a cash flow basis, the program would remain in surplus until the early 2020s (Figure 1). It would have nearly a decade over which revenues and outlays were roughly balanced, then return to surpluses in the mid-2030s as traditional benefits began to decline to the flat minimum. By 2060, the program would run an annual cash surplus of approximately 2.5 percent of taxable payroll (approximately 1.25 percent of GDP). As noted above, those surpluses could be used to increase contributions to individual savings accounts, substitute for part of existing employer/employee contributions, or supplement revenues for other programs such as Medicare.



### **Benefits**

The reforms outlined above would institute a stronger benefit base for low earners, significant limits on traditional benefits for high earners, and supplemental individual retirement savings accounts for all.

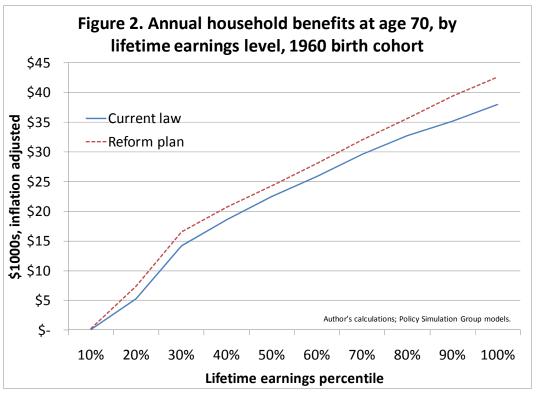
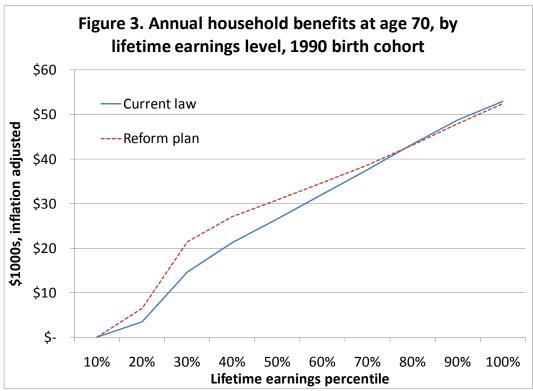


Figure 2 shows total household **Social Security** benefits, inclusive of income derived from the supplemental individual accounts, as of age 70. Benefits are shown for individuals in the 1960 birth

cohort, who would retire in the 2030s. The median benefit under the reform plan is 12 percent higher than under current law, although it should be noted that total contributions are significantly higher for members of this birth cohort. Benefits derived from individual accounts are based on the assumption of investment only in government bonds; if individuals invested in a mixed portfolio of stocks and bonds, total benefits would be significantly higher but the disparity in benefits from person to person and cohort to cohort also would be significantly higher. In general, benefits track the generosity and progressivity of the current program, although benefits for truly low earners are significantly higher. For instance, households in the bottom 20 percent of the lifetime earnings distribution receive total benefits 40 percent higher than under current law.<sup>21</sup>

Figure 3 shows the level and distribution of benefits for members of the 1990 birth cohort, who would retire in the 2050s. As above, total benefits are shown inclusive of individuals accounts, as of age 70. The median benefit for members of the 1990 cohort is around 15 percent above that scheduled under current law. Given the benefit reductions implied by insolvency, benefits would be approximately 50



percent higher than those households could expect without reform. Total benefit levels are close to scheduled levels for the highest-earning quarter of households, and significantly exceed scheduled levels for low and middle earnings. Households at the 30<sup>th</sup> percentile of the lifetime earnings distribution

as they arrived here at a very old age, or who don't collect, because they were born in the United States, but emigrated to another country. Moreover, due to limitations of the benefit model, eligibility for the flat benefit was limited individuals with at least 1 quarter of covered earnings. While almost all native born individuals satisfied

that criterion, a very small number do not.

<sup>&</sup>lt;sup>21</sup> Note: the flat benefit as currently modeled does not reach everyone at the very bottom end of the earnings distribution; these individuals appear to be mostly immigrants or emigrants, who either don't qualify for benefits,

receive average total benefits around 46 percent above those scheduled under current law, while households at the 50<sup>th</sup> percentile receive average total benefits around 24 percent above scheduled levels. Note that supplementary retirement accounts are assumed to be invested in government bonds. Using a mixed stock-bond "life cycle" portfolio, average benefits derived from accounts would be higher, but with greater variation from person to person and year to year.

### **Effects on the economy**

The increase in the early retirement age from 62 to 65 would effectively force some individuals to remain in the workforce longer. Longer work lives, in turn, would lead to greater economic output and, by extension, higher non-Social Security tax revenues. The PSG models are capable of estimating the effects on total earnings and output due to the increase in the early retirement age. Once fully implemented, steady-state GDP would be approximately 3 percent higher under the reform plan than under current law projections. If total non-Social Security federal taxes equal approximately 15 percent of GDP (assuming a 20 percent baseline minus approximately 5 percent for Social Security payroll taxes), then long-run non-Social Security federal taxes would increase by approximately 0.45 percent of GDP.

### Note on the estimates

Estimation of the effects of the proposed Social Security changes on OASDI outlays and revenues is complicated by two issues: first, the PSG models are calibrated to the Social Security Trustees economic projections, which produce somewhat different outcomes than using CBO assumptions; and second, the increase in the Earliest Eligibility Age in the proposal produces an increase in labor force participation, taxable payroll/GDP, and Social Security tax revenues. (The increase in labor force participation would also increase non-Social Security tax revenues but these are not estimated on an annual basis.) We adjust for these issues in the following way. First, we tabulate the dollar Social Security outlays and revenues in the PSG models, then calculate a percentage difference. Second, for outlays, we apply the percentage delta to the CBO baseline supplied in the spreadsheet. Third, we generate a Social Security revenue baseline. This involves calculating current law Trustees projections of Social Security revenues relative to GDP, then apply this percentage to the nominal GDP figures supplied in the spreadsheet. Fourth, we apply the dollar revenues percentage delta calculated in step one to the revenue baseline.

# **Defense and Other Spending**

Defense spending levels are based on the security needs of the country, rather than arbitrary budget targets. Productivity improvements and reductions in outdated, ineffective, and excessively expensive weapons systems can produce greater defense capability for less money. In addition, military personnel management and compensation policies can be modified to reduce costs. Our plan assumes that defense spending would average 4 percent of GDP over the long term.

Spending for mandatory programs (other than the health entitlements and Social Security) would be reduced by eliminating farm subsidies, reducing federal pensions, eliminating the refundable portion of the child credit, and miscellaneous cuts in such things as social services and rural investment. Our plan assumes that spending for this category of programs would be reduced annually by 0.3 percent of GDP; in 2035, spending would decline from the baseline level of 1.5 percent to 1.2 percent of GDP.

Other discretionary programs would also face budget cuts. Deep reductions would be made in community and regional development, energy and agriculture spending, and other programs. Additional savings would accrue in all programs from reductions in federal employee compensation. Our plan assumes that spending for those programs in total would be set at 2.6 percent of GDP; in 2035, spending would decline from the baseline level of 3.1 percent of GDP to 2.6 percent in 2035.

# **Tax Policy**

# **Background**

The goal of our tax reform is to eliminate the inherent bias of the income tax against saving and investment and to reduce other tax distortions. To achieve this goal, the income tax system would be replaced by a progressive consumption tax, in the form of a Bradford X tax. To address environmental externalities in a more cost-effective and market-based manner, energy subsidies, tax credits, and regulations would be replaced by a carbon tax.

# **Overall revenue target**

Recognizing the health and welfare burdens imposed by an aging population, our revenue target is 19.9 percent of GDP. Although somewhat above the historical average, this level of revenue if far below the disturbingly high levels (greater than 23 percent of GDP in 2035) that would result from leaving current law in place. Holding the revenue share to 19.9 percent will require the type of aggressive spending discipline outlined in our plan. As explained below, however, the actual revenue share is likely to be somewhat lower than 19.9 percent, due to the economic growth generated by our plan.

### **Effective date**

In general, the effective date for the new tax system would be January 1, 2013. As explained below, certain policies would require transition rules beginning on that date and the expensing of investment would begin immediately.

# Repeal of income and estate and gift taxes

The following taxes would be abolished:

- The individual income tax, including the AMT.
- The corporate income tax, including the corporate AMT.
- Estate and gift taxes, including the generation-skipping tax.
- The Unearned Income Medicare Contribution tax (abolished as part of the repeal of PPACA).

#### **Bradford X tax**

A Bradford X tax would be instituted, along the lines of the Progressive Consumption Tax plan that the 2005 Tax Reform Panel discussed on pages 182-190 of its report. The X tax consists of a flat-rate firm-level tax on business cash flow and a graduated-rate household-level tax on wages, fringe benefits, and defined-benefit pension payments.

Although the X tax is administratively similar to an income tax, the combination of two features makes it a consumption tax. First, households do not pay tax on interest, dividends, capital gains, or other income from saving. Second, firms immediately deduct business investments, rather than depreciating them over time. Economic theory indicates that there is then no net tax on a marginal new investment, because the tax savings from the immediate deduction fully offset, in present value, the tax on the

investment's subsequent cash flows. With no marginal tax, at either the firm or household level, on new saving, the X tax is a consumption tax.

The firm-level tax collects revenue only from business capital in place at the time of the reform (subject to transition relief, described below) and from above-normal returns on new business investment. It imposes no tax on the normal returns to new investment.

#### Tax rates

A constant 35 percent tax rate will apply to firms' cash flow and to wages in the highest bracket, with lower rates on other workers. Initially, a 15 percent tax rate will apply to the first \$50,000 of taxable earnings and a 25 percent rate to taxable earnings between \$50,000 and \$100,000. The 15 and 25 percent tax rates may vary over time to keep revenue at 19.9 percent of GDP in future years.

There would be no head-of-household filing status and no standard deduction.

#### Fringe benefits, pensions, and work-related expenses

Like cash wages, employer-provided health insurance and life insurance, and employer contributions to defined-contribution plans would be deducted by firms and taxed to workers. Cafeteria plans would be abolished.

Although other savings is treated on a Roth-style basis under the household tax, administrative convenience prompts the provision of front-loaded tax relief to employer-sponsored defined-benefit (DB) plans. Employer and employee contributions to DB plans would be deductible and DB benefit payments would be taxed to recipients at the time of receipt. In general, this treatment is favorable to DB plans, because many recipients will be in lower brackets in retirement than during their working years.

Households could deduct child care expenses, subject to a ceiling of \$3,000 for one child and \$6,000 for two or more children. The stated dollar amounts are for 2013 and would be indexed to the chain-weighted CPI thereafter. Households could deduct employee business expenses, subject to a 2-percent-of-wages floor.

### Other household tax issues

Social Security and unemployment compensation benefits would be fully taxable. Other government benefit payments would not be taxed. Alimony income and gambling winnings would not be taxed and alimony payments and gambling losses would not be deducted.

The following tax credits would be allowed on household tax returns:

- A 15 percent refundable credit for charitable contributions, in excess of an annual floor of \$500 (in 2013 and indexed to the chain-weighted CPI thereafter).
- A \$500 child credit, as it is scheduled to be in 2013 and beyond, but nonrefundable and with no income-based phase-out. As under current law, the credit amount would not be indexed for inflation.

- The earned income tax credit, generally computed under 2012 tax rules, but with all dollar amounts indexed to the chain-weighted CPI after 2012. Only income subject to household X tax would be included in the calculations and the maximum limit on investment income would be eliminated, but households with significant asset holdings would be disqualified from receiving the credit.
- A refundable health insurance credit, as detailed in the Health Policy section.

#### **Taxation of business firms**

The firm-level tax would be imposed on business cash flow. All investment, including equipment, structures, land, and inventories, would be expensed. Firms would deduct purchases from other firms, wages, fringe benefits, and pension contributions. With the exceptions noted below, the tax would be real-based and would disregard financial transactions.

Sole proprietors would treat their business cash flow as wages, which would be taxed on household returns at the graduated rates. Regardless of their form of legal organization, firms other than sole proprietorships would deduct reasonable compensation for labor provided by owners and owners would pay household tax on that compensation.

Firms would be allowed to carry negative cash flows back for five years and forward for an unlimited period, with interest paid on carryforwards at the one-year Treasury rate.

Business tax preferences, except a reformed and permanent research tax credit, would be abolished. The research tax credit would be a flat, non-incremental credit, with qualified research limited to research undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field. The credit rate would be set so that the research tax credit has the same cost as in President Obama's fiscal 2012 budget proposal.

### **Taxation of international transactions**

The X tax would apply to the 50 states and the District of Columbia, but not to Puerto Rico and the other four overseas possessions.

The tax would not feature a border adjustment and would therefore be origin-based. The use of the origin basis would avoid complications under international trade agreements and would also prevent a large wealth transfer to foreign equity-holders of U.S. firms. To mitigate transfer-pricing problems, transactions between domestic firms and related foreign parties would be taxed on a cash flow method that integrates real and financial transactions, as proposed by David Bradford, *The X Tax in the World Economy: Going Global with a Simple, Progressive Tax* (Washington, D.C.: AEI Press, 2004), pp. 38-40.

There would be no credit for foreign income taxes. Withholding taxes on interest and dividends paid to nonresident aliens would continue to apply in the absence of treaty provisions, but reciprocal elimination of such taxes would be aggressively pursued in bilateral negotiations.

#### **Transition policy**

The following forms of transition relief would be provided:

- Investments made from May 25, 2011 through December 31, 2012 would be expensed.
- In each of the years 2013-2037, firms would deduct 4 percent of the value of the unclaimed depreciation and cost-of-goods-sold deductions in place on December 31, 2012. The deductions would not be transferrable, even if the underlying assets were sold to other firms. Prior-law credit and loss carryforwards would be claimed on the same timetable.
- Interest on existing debt instruments, including home mortgages, would be taxed and deducted in accord with prior law, unless and until the interest rate was renegotiated.
- Alimony payments under existing court decrees would be taxed and deducted in accord with prior law, unless and until the alimony amount was modified.
- Existing traditional IRAs, 401(k)s, and other front-loaded accounts would be closed to new contributions. Withdrawals from such existing accounts would be subject to the household tax, with no penalty for early withdrawals and no minimum-required-distribution rules.
- Specific transition rules would be provided for a variety of special situations.

#### **Taxation of non-business sector**

There would be no tax on the cash flow of federal, state, and local governments and nonprofit institutions, even when they operate commercial enterprises, including universities and hospitals. Other firms would be taxed on their sales to, and deduct their purchases from, governments and nonprofits on the same terms as other sales and purchases. The wages, fringe benefits, and pensions of employees of governments and nonprofits would be subject to the household tax on the same terms as those of other employees.

The above treatment would exempt from tax only the business cash flow of governments and nonprofits; the tax base would still include the full value added at earlier and later stages of production, as well as the payroll of governments and nonprofits. In effect, there would be no tax on the existing capital of governments and nonprofits and no tax on their above-normal returns.

Households would not expense purchases of owner-occupied homes and consumer durables and would not pay tax on the imputed service flows. In economic terms, the purchase of such assets, rather than the subsequent service flows, would be treated as consumption. There would be no tax on resales of homes and durables between consumers and no tax on the existing stock of owner-occupied homes and durables.

Anti-abuse rules would prevent the tax-motivated sale of assets to governments and nonprofits and tax-motivated conversion of rental housing to owner-occupied use in anticipation of the reform. Anti-abuse rules would also prevent inflated expensing of personal assets converted to business use (including owner-occupied housing converted to rental use) after the reform.

#### **Taxation of financial intermediaries**

Transactions between financial intermediaries and household customers would be taxed on a cash flow method that integrates real and financial transactions. There would be no tax on transactions between intermediaries and business customers, unless explicit fees were charged (or the intermediary deemed

fees to be charged), in which case the fees would be taxed to the intermediary and deducted by the business customer.

# Modify payroll and self-employment taxes

Employer-provided health insurance and other fringe benefits would be subject to payroll taxes, on the same terms as they are subject to the household X tax.

Workers aged 62 or older would be exempt from payroll taxes, as discussed in the Social Security Policy section.

Self-employment earnings would be computed using X tax rules (expensing) rather than income tax rules (depreciation), with the X-tax transition rules set forth above.

# Replace energy subsidies, credits, and regulations with carbon tax

Subsidies for ethanol and other alternative fuels would be abolished (basic research on renewable energy would be funded on the same stringent terms as other basic research). As discussed above, business and household energy tax credits would be abolished. Regulations designed to lower greenhouse gas emissions would be repealed.

Instead, a tax on greenhouse gas emissions ("carbon tax") would be imposed. The tax would be similar to Revenue Option 35 in the Congressional Budget Office's March 2011 Budget Options book, but would be implemented as a tax rather than as a cap-and-trade program. The tax would take effect in 2013 and be phased in at a uniform pace over five years, so that the 2017 tax equaled the level prescribed for that year in the CBO option, slightly more than \$26 per metric ton of CO<sub>2</sub>equivalent. As prescribed in the CBO option, the tax would thereafter increase at a 5.6 percent annual rate through 2050.

# **Impact on Economic Growth**

Economic simulations have repeatedly indicated that replacing the income tax system with a consumption tax can boost economic growth, although the magnitude of the gains depends on the assumptions that are made and on the detailed provisions of the consumption tax. One widely cited study estimates a 6.4 percent gain in long-run output from the adoption of an X tax. <sup>22</sup> Our plan also reduces transfer payments to the elderly, which should further increase private saving and long-run growth.

These growth effects have not been taken into account in the estimation of our plan. Accounting for them suggests that actual revenue requirements are lower than those stated above. For example, if our plan increases long-run output by even 5 percent and if government spending does not increase in response to the expansion of output, then the actual long-run revenue requirement will be 19.0, rather than 19.9, percent of GDP. In each case, the reduction in the long-run revenue requirement would be smaller if some categories of government spending were increased along with the expansion of the economy.

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<sup>&</sup>lt;sup>22</sup> David Altig, Alan J. Auerbach, Laurence J. Kotlikoff, Kent A. Smetters, and Jan Walliser, "Simulating Fundamental Tax Reform in the United States," *American Economic Review*, 91(3), June 2001, pp. 574-595.

## **Conclusion**

There are no easy solutions to the country's fiscal crisis, and further delay will only make the decisions harder. An aging population will put increasing demand on government health and retirement programs, whose costs are borne by younger generations worried about paying for their own families' needs. The challenge is finding a balance between those competing demands. A fiscally sound policy will require greater self-reliance, but does not mean that our society will turn its back on the elderly and the less fortunate. Our plan narrows the fiscal imbalance, limits the size of government, and adopts a more growth-friendly tax code. Although this plan will require difficult choices, it will ensure a vibrant economy and fiscal stability, now and in the future.