A Balanced Plan for Fiscal Stability and Economic Growth

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INTRODUCTION

The objective of this plan is to re-establish 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 proposals are intended to limit 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 proposal is necessary. None of the authors of this plan fully agree with every policy advanced here, but we have been able to reach the kind of compromise that is needed to resolve the fiscal crisis.

The major entitlement programs—Medicare, Medicaid, and Social Security—will account for most of the unsustainable growth in long-term federal spending. The Patient Protection and Affordable Care Act (PPACA) 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.

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

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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 PPACA 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 proposal 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 the proposal 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 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, the proposal replaces an array of energy subsidies, tax credits, and regulations with a carbon tax.

Our proposal seeks to bring 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 rather than tax increases and by using an economically efficient consumption tax to raise the revenue that is needed. Real federal spending would continue to increase under the proposal, but significantly slower than it would increase without these reforms.

SPENDING

Medicare, Medicaid, and other federal health programs

Our proposal caps federal subsidies for insurance, promotes effective competition and innovation in the health sector, reduces regulatory burden, develops better consumer information, and lowers everyone's unrealistic expectations. Subsidies in all federal health programs would be made more progressive, helping those who most need the help. Such policies will provide strong incentives for the private sector to develop new ways to deliver care that improve efficiency and lower the cost per unit of service. Spending reductions are substantial, requiring beneficiaries to shoulder more of the cost of their health care. However, health system improvements are expected to maintain quality of care and access to essential services.

Medicare reform. Medicare is primarily a fee-for-service program that offers little incentive to patients or providers to hold down costs. It would be converted to a premium support plan, in which a subsidy would be provided to beneficiaries who would choose 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.

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 1.2 percentage points slower growth than under current law. This policy is effective starting in 2013. It would be desirable to phase premium support in over 10 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.

Other reforms would address long-standing problems in traditional Medicare. Medicare's eligibility age would be increased gradually to 67, consistent with Social Security. Until premium support is effective, the basic premiums for Medicare Part B and Part D would increase from 25 percent to 40 percent of each program's cost. Traditional Medicare's cost-sharing arrangements would be simplified, replacing the current cost-sharing rules with a single deductible for Part A and Part B and 20 percent coinsurance for all covered services, and incentives to drop Medigap coverage would be offered to promote cost awareness.

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 costs would grow with the economy, allowing for some additional savings due to increased efficiency in the health sector.

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.

Insurance subsidy 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.

Other reforms. 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. 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

The proposal will reduce the growth rate of Social Security outlays in future years to keep the program solvent and to make room in the budget for the growth of other programs, particularly the health-related entitlements. Important changes will be made to the structure of Social Security benefits, to focus more heavily on providing a safety net against poverty for the aged, disabled, and survivors, while instituting new savings accounts outside of Social Security to buttress retirement preparation for middle- and high-earning individuals.

The core element of the reform is a flat dollar benefit that would be paid to all retirees, disabled persons, and survivors regardless of their earnings history. The benefit is based on the current elderly poverty threshold and indexed to wage growth. In addition, percent of each worker's earnings would be paid into a retirement savings account, with equal contributions from the worker and employer. The combined benefits would roughly replicate the generosity and progressivity of Social Security under current law, but would provide significantly better poverty protections for low earners while reducing the tax burden on the economy. These reforms would be introduced gradually, taking full effect only when an individual entering the workforce today reaches retirement age.

The reforms also would encourage delayed retirement to ameliorate the effects of population aging on the economy and on government budgets. The early retirement age would gradually increase from 62 to 65 and the 12.4 percent Social Security payroll tax would be eliminated for all workers age 62 and older. The combined effect would enhance both individuals' retirement income and the economy.

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. The proposal 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. The proposal 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. The proposal 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 2.9 percent of GDP to 2.6 percent.

REVENUES

Recognizing the costly 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 is 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 this proposal. We also propose fundamental tax reform to ensure that additional revenues are raised in a manner conducive to long-run economic growth.

Replacement of income and estate taxes by Bradford X tax

A Bradford X tax would be instituted, along the lines of the Progressive Consumption Tax plan discussed, but not endorsed, by the 2005 Tax Reform Panel. 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. The X tax would replace the individual and corporate income taxes and the estate and gift tax on January 1, 2013, subject to transition rules

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 savings. 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 on new saving at either the firm or household level, the X tax is a consumption tax.

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 will apply 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.

Households would be allowed a 15 percent refundable credit for charitable contributions, in excess of an annual floor of $500; a nonrefundable $500 child credit; the earned income tax credit, generally computed under 2012 tax rules; a refundable health insurance credit, as detailed above; and deductions for some child care and employee business expenses.

All investment, including equipment, structures, land, and inventories, would be expensed under the firm-level tax. With minor exceptions, the tax would be real-based and disregard financial transactions. Business tax preferences, except a reformed and permanent research tax credit, would be abolished.

Changes to payroll taxes

Employer-provided health insurance and other fringe benefits would be subject to payroll taxes. Workers aged 62 or older would be exempt from payroll taxes.

Replacement of energy subsidies, credits, and regulations by carbon tax

Subsidies for ethanol and other alternative fuels would be abolished (except some basic research on renewable energy), along with energy tax credits and regulations intended to lower greenhouse gas emissions. Instead, a carbon tax would be imposed in 2013, phased in at a uniform pace over five years, so that the 2017 tax would be slightly more than $26 per metric ton of CO_2 equivalent. The tax would then increase 5.6 percent per year through 2050.

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 proposal narrows the fiscal imbalance, limits the size of government, and adopts a more growth-friendly tax code. Although these policies will require difficult choices, they will ensure a vibrant economy and fiscal stability, now and in the future.

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Percent of GDP	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