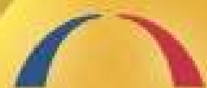
RESTORING AMERICA'S FUTURE

Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System

The Debt Reduction Task Force
Senator Pete Domenici and
Dr. Alice Rivlin, Co-Chairs
November 2010



BIPARTISAN POLICY CENTER

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AN OPEN LETTER TO THE AMERICAN PEOPLE

November 17, 2010

To Our Fellow Citizens:

We believe that America is facing two huge challenges that can only be surmounted if both political parties work together: recovery from the recession and restraining the soaring federal debt. We also believe that these two challenges must be addressed simultaneously. Strong action to curb the mounting debt will reinforce the recovery, not impede it.

The federal budget is on a dangerous, unsustainable path. Even after the economy recovers from this deep recession, federal spending is projected to rise substantially faster than revenues and the government will be forced to borrow ever-increasing amounts. Federal debt will rise to unmanageable levels, which will push interest rates up, endanger our prosperity, and make us increasingly vulnerable to the dictates of our creditors, including nations whose interests may differ from ours.

This alarming prospect was created by the actions of both political parties over many years, with strong public approval. Promises to provide benefits and services through Medicare, Medicaid, Social Security and many other spending programs, as well as reductions in taxes, were extremely popular and both parties took credit for them. But now, with an aging population and increasingly expensive health care, federal spending will rise much faster than revenues if those popular policies are not changed. However, the actions needed to reduce the growth of national debt and bring deficits back to manageable levels are all unpopular. Neither party can take the required actions alone without suffering adverse political consequences. The only hope is for the two parties to come together around a bipartisan plan – which liberals, moderates, and conservatives alike see as fair – and work together to make it a reality.

On January 25th, 2010, the Bipartisan Policy Center – founded by former Senate Majority Leaders Howard Baker (R-TN), Tom Daschle (D-SD), Bob Dole (R-KS), and George Mitchell (D-ME) – launched a Debt Reduction Task Force to develop a long-term plan to reduce the debt and place our nation on a sustainable fiscal path. The BPC asked us to co-chair the Task Force and we were honored to accept.

The two of us share strong beliefs that America must learn to live within its means, that the current budget path endangers the future of our country, and that bipartisan action is urgently needed. Each of us played a significant role in the successful bipartisan efforts that brought the federal budget into surplus for four years in a row starting in the late 1990s and reduced the debt held by the public. Senator Domenici was a leader in bipartisan negotiations that crafted the Budget Enforcement Act of 1990 and the Balanced Budget Act of 1997. Alice Rivlin was part of the

Clinton Administration's effort, working first with a Democrat-led and then a Republican-led Congress that achieved those surpluses.

We know from personal experience that bipartisan budget agreements are extremely difficult to create – neither side gets what it wants – but they are possible. The budget outlook is even more threatening today than it was then, but we have faith that our political leaders will see the urgency of working together to take the difficult actions that will restore America to economic health and constructive world leadership.

Our Task Force – 19 Americans from across the country, with diverse backgrounds and views – has examined a broad range of spending and revenue options for the federal government. Today we are releasing our plan, "Restoring America's Future." We believe that it provides a comprehensive, viable path to restore our economy and build a stronger America for future generations and for those around the world who look to the United States for leadership and hope.

We offer this plan as proof that a group of Republicans, Democrats, and Independents can work together to create a balanced package of spending cuts and revenue increases that solves the debt crisis. Other groups might prefer other combinations of policies to reach the same ends. We created this plan to show that it can be done – and thereby encourage others from both political parties to bring their ideas to a constructive, respectful, and ultimately successful dialogue.

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Former Chairman, Senate Budget Committee (R-NM)

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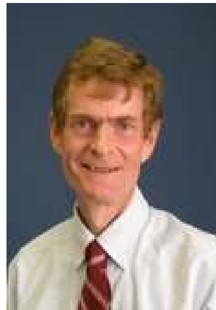

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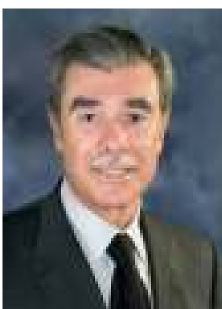

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EXECUTIVE SUMMARY

To arrive at consensus on a plan of this size and complexity, each of the Task Force members made significant compromises. Not every member agrees with every element of this plan. But, each member agrees on the urgency of economic recovery and stabilizing the debt and believes that, as a whole, this plan offers a balanced, effective, and reasonable approach to the twin challenges at hand. Perhaps most importantly, the plan demonstrates that at this time of political uncertainty, a bipartisan group can craft a comprehensive and viable blueprint to tackle the nation's most serious economic challenges.

Overview

America is the strongest, most prosperous, and most resilient nation in history. However, America's leadership and greatness, our strength and prosperity, are not guaranteed. We face two huge challenges simultaneously.

First, we must recover from the deep recession that has thrown millions out of work, slashed home values, and closed businesses across the country.

Second, we must take immediate steps to reduce the unsustainable debt that will be driven by the aging of the population, the rapid growth of health care costs, exploding interest costs, and the failure of policymakers to limit and prioritize spending.

These two challenges must be addressed at the same time, not sequentially. We need immediate action to sustain the recovery and create jobs, but we cannot delay putting in place measures that will restrain the buildup of debt. If we do not control the debt, the recovery will not be sustainable.

With current policies in place, even when we recover from the recession, the debt will grow far larger than the economy itself, forcing the nation to borrow enormous and unprecedented sums of money, increasing our dependence on China and other foreign lenders, diminishing our living standards, raising risks of an economic crisis, and reducing America to a second-rate power.

At stake are both our economic security and our national security. Federal Reserve Chairman Ben Bernanke warns that threats to our economy are "real and growing" and that our path is "unsustainable" because, at some point, our creditors will refuse to lend to us. Joint Chiefs of Staff Chairman Mike Mullen calls the debt "the single biggest threat to our national security."

That's why we face a fundamental choice:

We can close our eyes, keep avoiding the problem, and generate more debt that will threaten our economy, mortgage our children's future, and diminish our leadership around the world.

Or, we can choose a new course – one that can revive our economy, create new and better jobs, restore our financial independence, and ensure that America remains the world's preeminent economic, military, and political power.

This report, "Restoring America's Future," is a plan for that new course that we believe will meet both the short- and the longer-run challenges simultaneously. It was developed by the Bipartisan Policy Center's Debt Reduction Task Force, which is chaired by former Senate Budget Committee Chairman Pete V. Domenici and former White House Budget Director Alice M. Rivlin, and includes 19 leading citizens from across America.

The Task Force members are former White House and Cabinet officials, former members of Congress, former governors and mayors, business and labor leaders, economists and budget experts. They are Democrats, Republicans, and Independents. They are Americans from across the country, with widely diverse views about public policy and the role of government.

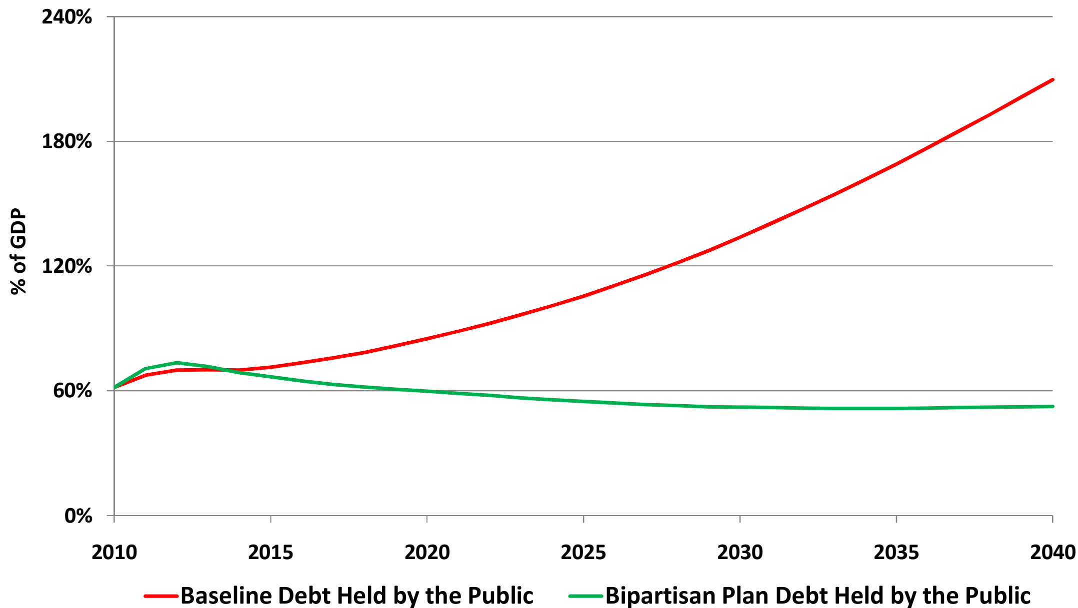
The Task Force members understood that the key to stabilizing the debt begins with a strong economy that reignites demand for goods and services and encourages businesses to invest and create jobs.

Currently, millions of Americans cannot find jobs or are underemployed. That's why this bipartisan plan calls for suspending Social Security payroll taxes for one year (in 2011) – called a "payroll tax holiday" – which will immediately add money to employee paychecks while incentivizing companies to hire new workers. This tax cut of nearly $650 billion will provide a big shot in the arm to revive our economy and create jobs.

At the same time, we must restore optimism about the economy's future in order to boost investment. A comprehensive debt-reduction package will assure investors worldwide that America is back on track, with a solid plan and a stable economic future.

In that regard, the plan will reduce and stabilize the national debt below 60 percent of the gross domestic product (GDP) – an internationally recognized standard – by 2020 and ensure that the

debt stops growing faster than our economy.



Source: CBO's "Alternative Fiscal Scenario" constructed from the August 2010 Budget and Economic Outlook, additionally assuming that troops in Iraq and Afghanistan are reduced to 30,000 by 2013.

The plan will balance the "primary budget," the budget other than interest payments, by 2014. On a "unified budget basis" (i.e., including interest), the plan will ensure that future budget deficits are small and manageable.

But, above all, it will ensure a strong economy for future generations of Americans.

The Task Force approached its task as not just a challenge, but also as an opportunity to recommend significant and sorely needed changes to both taxes and spending.

On the spending side, this plan fixes Social Security, which is on an unsustainable path, reins in rising health care costs, and freezes both defense and domestic discretionary spending.

On the tax side, this plan dramatically simplifies taxes by eliminating years of accumulated tax preferences – allowing major tax rate reductions, while raising additional revenues to reduce the debt. Lower corporate rates will make America more competitive, and lower individual rates with a simplified tax system will give taxpayers renewed confidence that our system is fair and understandable. A Debt Reduction Sales Tax (DRST), along with the plan's spending cuts, will reduce our debt.

Restoring America's Future will:

- Revive the economy and **create 2.5 to 7 million new jobs** over two years with a one-year payroll tax holiday.
- Balance the primary budget in 2014, reduce deficits including interest to small and manageable levels, and **stabilize the debt below 60 percent of GDP by 2020**.
- Create a simple, pro-growth tax system that broadens the base, reduces rates, makes America more competitive, and raises revenue to reduce the debt.
- Reduce the unsustainable rate of growth in health care costs.
- Strengthen Social Security to ensure that it will pay benefits for 75 years and beyond, while not increasing the retirement age and protecting the most vulnerable elderly.
- Freeze domestic and defense discretionary spending.
- Cut other spending, including farm and government retirement programs.

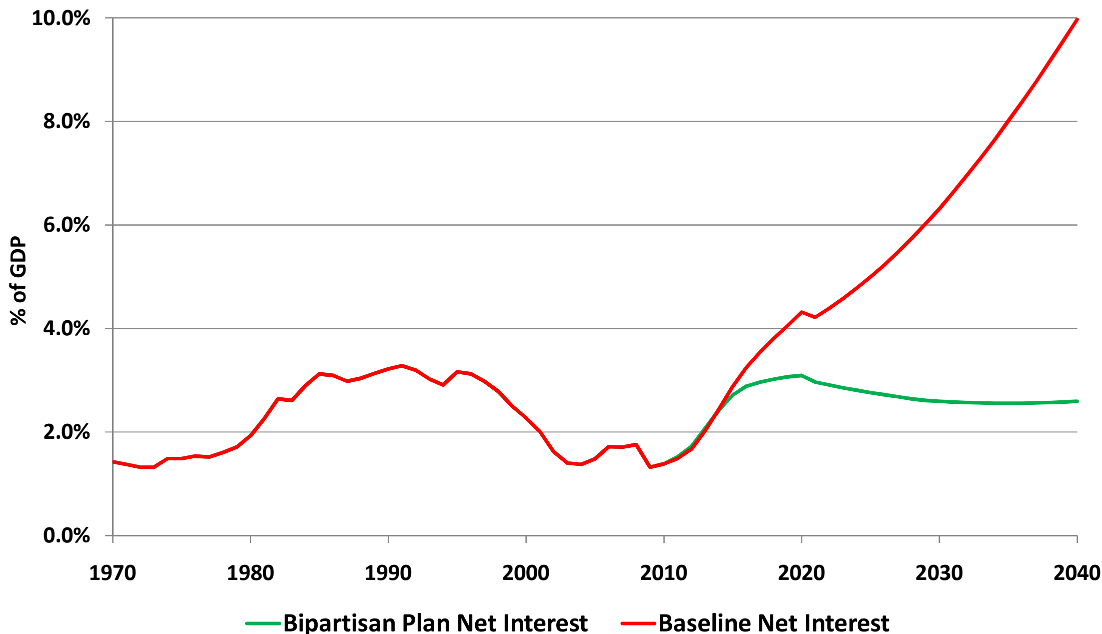
Our Growing Debt and the Risks of Inaction

Without action, growing deficits and debt will create serious problems for our economy, our prosperity, and our leadership role in the world.

First, the higher the debt, the more interest we have to pay. At the moment, interest rates are at historically low levels because of our weak economy and because the fiscal problems of other countries leave investors around the world few attractive alternatives to U.S. Treasury securities. But as our economy recovers and other nations address their problems, interest rates will return to higher levels, which will increase interest costs on our debt significantly.

In 2020, the federal government will pay $1 trillion – 17 percent of all federal spending – just for interest payments. Viewed another way, the federal government will have to allocate about half of all income tax receipts to pay interest, and interest payments will exceed the size of the defense budget.

Net Interest Payments Drop Dramatically Under Bipartisan Plan



Source: CBO's "Alternative Fiscal Scenario" constructed from the August 2010 Budget and Economic Outlook, additionally assuming that troops in Iraq and Afghanistan are reduced to 30,000 by 2013.

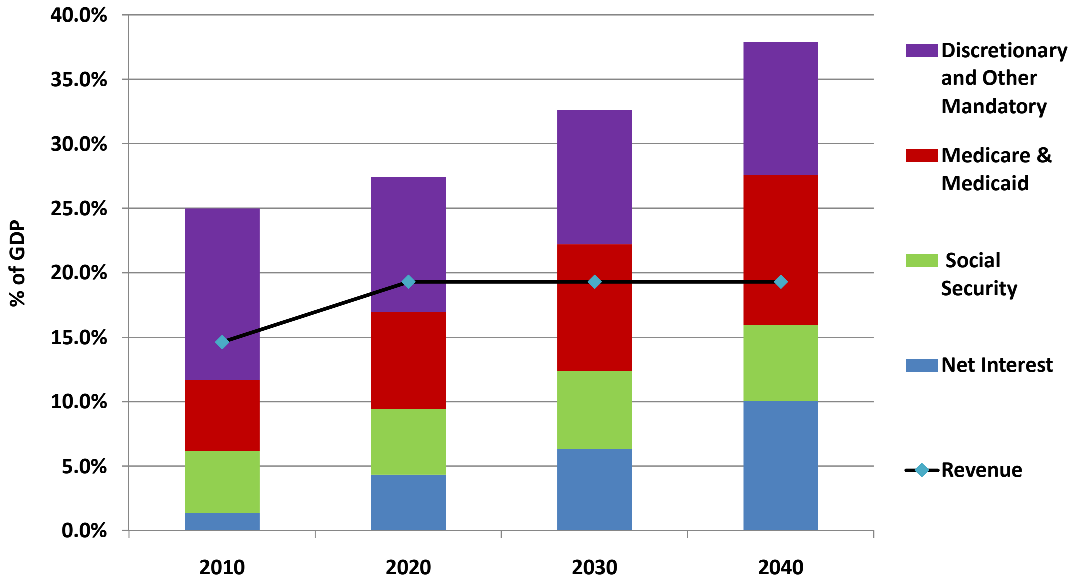
Moreover, by 2025, federal revenues will be completely consumed by the combination of interest payments, Medicare, Medicaid, and Social Security. The Treasury will have to borrow money to finance all of its other obligations – including defense, homeland security, law enforcement, food and drug inspection and other vital operations.

These projections are based on fairly moderate assumptions about future interest rates. The nation's outlook will grow far more ominous if America's creditors lose confidence in the federal government's commitment to address its debt problem – which will increase interest rates. A loss of confidence in the markets could also send the value of the dollar plunging overseas, which could trigger runaway inflation and still higher interest rates.

Rising debt and rising interest costs could evolve into a "death spiral," with the two feeding off one another in an ever-more vicious cycle. No one knows when such a catastrophe might occur, but no prudent nation would put itself at such risk.

Even without a crisis, rising debt will increase our reliance on foreign lenders, raising a host of other economic and national security issues. Already, more than half of U.S. federal debt is foreign-owned and China is the largest foreign holder.

Revenues Completely Consumed by Major Entitlements and Interest by 2025



Source: CBO's "Alternative Fiscal Scenario" constructed from the August 2010 Budget and Economic Outlook, additionally assuming that troops in Iraq and Afghanistan are reduced to 30,000 by 2013.

Rising deficits and debt will weaken the nation in other serious ways as well. Federal deficits soak up private savings that would otherwise be available for investment in factories, equipment, and jobs.

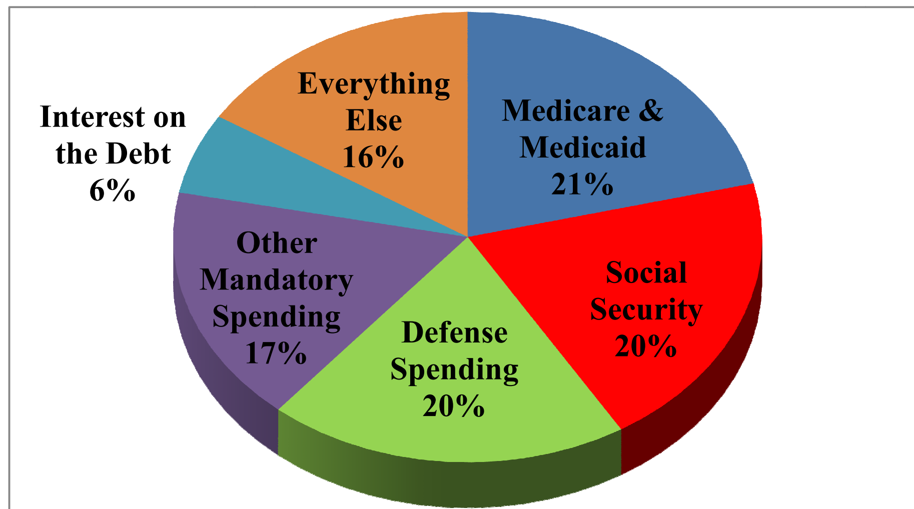
At some point, without a change in policy, the federal government's out-of-control borrowing will have to stop. The only question is whether policymakers address the debt problem now in a deliberative and thoughtful manner, or whether they will be forced to do so by a sudden economic crisis.

No Easy Answers

Most Americans would be reluctant to cut several key categories of federal spending. In fiscal year (FY) 2010:

- Medicare and Medicaid consumed **21 percent** of federal spending;
- Social Security consumed **20 percent;**
- Defense consumed **20 percent**;
- Other mandatory spending (for example, veterans' compensation, unemployment insurance, and food stamps) consumed **17 percent**; and

- Interest on the debt consumed **6 percent**.
- That leaves **only 16 percent** for everything else – veterans' health care, homeland security and law enforcement, education and student aid, roads and bridges, food and drug inspection, energy and the environment, and so on. Clearly, there are no easy answers to the debt crisis.



Policymakers cannot solve the debt crisis simply by eliminating congressional earmarks (less than one percent of the discretionary budget) or foreign aid, which is less than one percent of the total budget.

Nor can policymakers significantly reduce the debt by eliminating "waste, fraud, and abuse," although they surely should undertake efforts to eliminate as much waste, fraud, and abuse as possible.

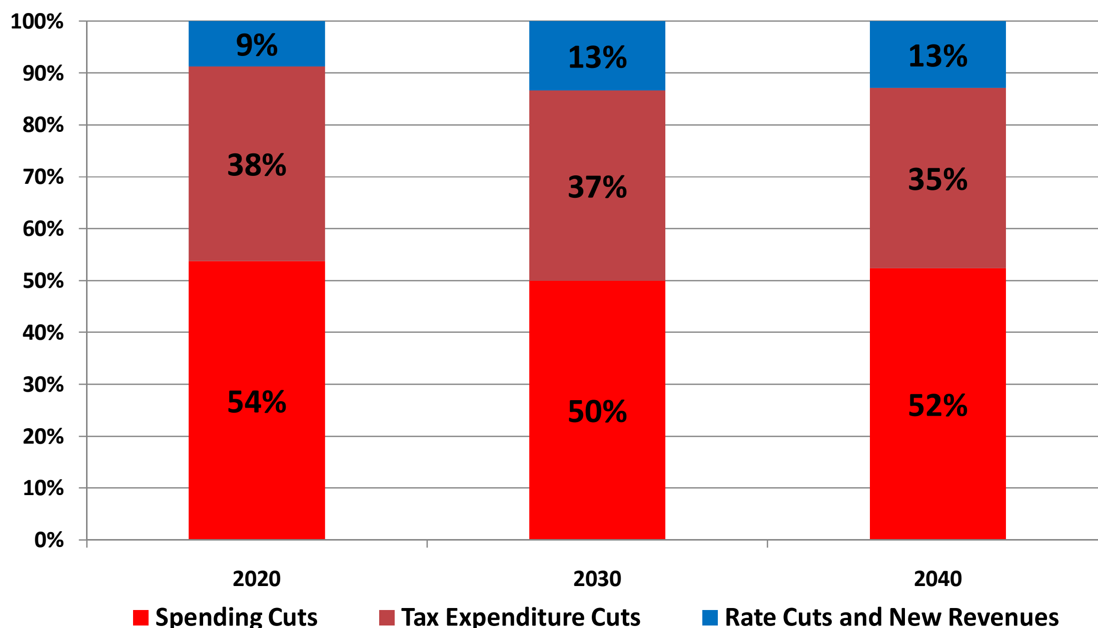
Nor can policymakers realistically solve the problem simply by cutting domestic discretionary spending. Stabilizing the debt by 2020 through domestic discretionary cuts alone would require eliminating nearly all such spending – everything from law enforcement and border security to education and food and drug inspection.

Nor can policymakers rely on hopes of a strong economy to "grow our way out of the deficit." Just to stabilize the debt at 60 percent of GDP, the economy would have to grow at a sustained rate of more than 6 percent per year for at least the next 10 years. The economy has never grown by more than 4.4 percent in any decade since World War II.

Nor can policymakers solve the problem simply by raising taxes on wealthy Americans. Reducing deficits to manageable levels by the end of the decade though tax increases on the most well-to-do

Americans would require raising the top two bracket rates to 86 percent and 91 percent[1] (from the current 33- and 35 percent rates).

There are no easy answers, no quick fixes. Following is a bipartisan, fair and reasonable plan that calls for reforms to every part of the budget and the participation of all Americans to restore America's future for our children and grandchildren.



[1] Rosanne Altshuler, Katherine Lim, and Roberton Williams, *Desperately Seeking Revenue*, Tax Policy Center, January 29, 2010, http://www.taxpolicycenter.org/UploadedPDF/412018_seeking_revenue.pdf.

Summary of Recommendations

1. **Revive the Economy and Create Jobs**

   - Enact a "payroll tax holiday" for one year (2011) – excusing employers and employees from paying the 12.4 percent tax into the Social Security Trust Funds.

   - Under Congressional Budget Office (CBO) assumptions, this will **create between 2.5 and 7 million new jobs**.

   - The tax holiday will not impact the solvency of the Trust Funds, which will be reimbursed in full from general revenues at the same time that they would have received payments in the absence of the holiday.

2. **Reduce and Stabilize the Debt**

   - By 2020, reduce and stabilize the federal debt below 60 percent of GDP, an internationally recognized standard for fiscal stability, and reduce annual budget deficits to manageable levels.

   - The plan will balance the primary budget (the budget other than interest) by 2014.

   - On a "unified budget basis," which includes interest, the plan will ensure that future budget deficits are small and manageable. But, above all, it will ensure a strong economy for future generations of Americans.

   - Reduce federal spending from a projected 26 percent of GDP to 23 percent by 2020, with revenues at 21.4 percent.

   - These fiscal changes will enable the Federal Reserve to hold interest rates down longer in order to strengthen the economic recovery.

3. **Create a Simple, Pro-Growth Tax System**

   - Cut tax rates; broaden the tax base; boost incentives to work, save, and invest; and ensure, by 2018, that nearly 90 million households (about half of potential tax filers) no longer have to file tax returns.

     - ✓ Cut individual income tax rates and establish just two rates – 15 and 27 percent – replacing the current six rates that go up to 35 percent.

- ✓ Cut the top corporate tax rate to 27 percent from its current 35 percent, making the United States a more attractive place to invest.
- ✓ Eliminate most deductions and credits and simplify those that remain while making them better targeted and more effective.
- ✓ Replace the deductions for mortgage interest and charitable contributions with 15 percent refundable credits that anyone who owns a home or gives to charity can claim.
- ✓ Restructure provisions that benefit low-income taxpayers and families with children by making them simpler, more progressive, and enabling most recipients to receive them without filing tax returns.

- Establish a new 6.5 percent national Debt Reduction Sales Tax (DRST) that, along with the spending cuts outlined in this plan, will reduce the debt and secure America's economic future.

- These reforms, taken together, will make the tax system more progressive.

4. **Restrain Rising Health Care Costs** (Savings through 2020: $756 billion, excluding interest)

- Incentivize employers and employees to select more cost-effective health plans:

  - ✓ Cap the exclusion of employer-provided health benefits in 2018, and then phase it out over 10 years.

- Control Medicare costs in the short term:

  - ✓ Gradually raise Medicare Part B premiums from 25 to 35 percent of total program costs (over five years).
  - ✓ Use Medicare's buying power to increase rebates from pharmaceutical companies.
  - ✓ Modernize Medicare's benefits package, including the copayment structure.
  - ✓ Bundle Medicare's payments for post-acute care to reduce costs.

- Preserve Medicare for the long term:

  - ✓ Transition Medicare, starting in 2018, to a "premium support" program that limits growth in per-beneficiary federal support (to GDP-plus-1 percent, as compared to current projections of GDP-plus-1.7 percent). The new system maintains traditional Medicare as the default, but will charge higher premiums if costs rise faster than the established limits. Alternatively, beneficiaries can opt to purchase a private plan on a health insurance exchange. Competition among plans will improve the quality of care and increase efficiency.

- Control Medicaid costs in the short term:

  - ✓ Apply managed care principles in all states to aged Supplemental Security Income (SSI) beneficiaries.

- Control Medicaid costs in the long term:

  - ✓ Beginning in 2018, reduce the amount by which Medicaid is growing faster than the economy (that is, reduce annual per-beneficiary cost growth by 1 percentage point).
  - ✓ There are various approaches to achieving these savings. One option would be to reform the shared financing arrangement between the federal and state governments, which has led to gaming of the matching payment system and rising health care costs. Through a federal-state negotiation, allocate program responsibilities between the federal government and the states, so that each will fully finance and administer its selected components of the Medicaid program. This will restore incentives for cost containment, and slow future program spending growth.

- Reform medical malpractice laws:

  - ✓ Cap awards for noneconomic and punitive damages for medical malpractice.
  - ✓ Start large-scale testing of systemic reforms, including safe harbors for practices that conform to accepted guidelines, specialized malpractice courts, and administrative proceedings to resolve disputes.

- Help reduce long-term health care spending to treat obesity-related illnesses – including diabetes, heart disease, cancer, and stroke – by imposing an excise tax on the manufacture and importation of beverages sweetened with sugar or high-fructose corn syrup.

- The Task Force plan accommodates a permanent fix to the sustainable growth rate (SGR) mechanism that currently requires unrealistic automatic cuts in physician payments (which Congress has been annually delaying).

5. Strengthen Social Security

In order to guarantee that Social Security can pay benefits for the next 75 years and beyond:

- Gradually raise the amount of wages subject to payroll taxes (currently $106,800) over the next 38 years to reach the 1977 target of covering 90 percent of all wages.

- Change the calculation of annual cost-of-living adjustments (COLAs) for benefits to more accurately reflect inflation. (This is a technical change that will be applied in all government programs that use COLAs, including the indexation of tax brackets.)

- Slightly reduce the growth in benefits compared to current law for approximately the top 25 percent of beneficiaries.

- Increase the minimum benefit for long-term, lower-wage earners, and protect the most vulnerable elderly with a modest benefit increase. The former is particularly targeted to address the needs of long-time laborers who are unable to remain in the workforce due to the demanding nature of their work.

- Beginning in 2023, index the benefit formula for increases in life expectancy and require the Social Security Administration to ensure that early retirees understand that they are opting for a lower monthly benefit. These changes will increase the incentive to work longer, while not changing either the age of full retirement or the early retirement age from those in current law.

- Cover newly hired state and local government workers under the Social Security system, beginning in 2020, to increase the universality of the program.

6. **Freeze Domestic Discretionary Spending** (Savings through 2020: $1 trillion, excluding interest)

   - Freeze domestic (i.e., non-defense) discretionary spending for four years and cap at GDP thereafter.

   - Implementing the freeze will require policymakers to terminate ineffective programs and set priorities across the broad range of government programs. Savings can also be achieved through adopting state and local best practices, modernizing the federal government's regional office structure, and sharing human resources, procurement, and other services across federal agencies.

   - Enforce the freeze through statutory spending caps, which, if exceeded, trigger automatic across-the-board cuts in all domestic discretionary programs.

7. **Freeze Defense Spending** (Savings through 2020: $1.1 trillion, excluding interest)

   - Freeze defense discretionary spending for five years and cap at GDP thereafter (baseline assumes reduction of troop levels deployed in combat to 30,000 by 2013).

- Among the options for achieving the required savings are streamlining military end strength, prioritizing defense investment, maintaining intelligence capabilities at a reduced cost, reforming military health care, and applying the savings from Secretary Gates' efficiency measures to deficit reduction.

- Implement the freeze through statutory spending caps, enforceable through automatic across-the-board cuts in all defense programs.

8. **Other Savings** (Savings through 2020: $89 billion, excluding interest)

- Reduce farm program spending by eliminating all farm payments to producers with adjusted gross incomes greater than $250,000, imposing limits on direct payments to producers, consolidating and capping 16 conservation programs, and reforming federal crop insurance.

- Reform civilian retirement by calculating benefits based on a retiree's annual salary from his or her highest five years of government service; and reform the age at which career military can retire to be consistent with federal civilian retirement.

- Achieve other cost savings by raising fees for aviation security, actuarially adjusting flood insurance subsidies for risk, adjusting Pension Benefit Guaranty Corporation fees to better cover unfunded liabilities, and adopting a more accurate inflation measurement to calculate COLAs for all federal programs.

9. **Enforce the Budget, Reform the Process**

- Enforce the four-year domestic discretionary freeze and the five-year defense discretionary freeze, and the limits in annual growth in the years thereafter, by imposing statutory caps on both categories of spending.

  - ✓ Exempt emergency spending from the caps – but strictly limit such emergencies to specific situations, subject to certification by the President and Congress.
  - ✓ Require the Office of Management and Budget (OMB), by law, to impose across-the-board cuts in all programs within the relevant category (i.e., domestic or defense programs) if spending exceeds the caps in any fiscal year.

- Prevent new tax cuts or new entitlement spending from worsening the fiscal situation by enacting a strict, statutory "pay-as-you-go" (PAYGO) requirement:

- ✓ Require policymakers to fully offset new tax cuts, expansions of existing mandatory spending, or new mandatory spending with increases in revenues or reductions in mandatory spending.
- ✓ Trigger fully offsetting automatic cuts in predetermined mandatory programs if policymakers violate the requirement.

- Convert the federal budget process from annual to biennial budgeting.

- Enact explicit long-term budgets for the major entitlement programs.

  - ✓ Create a Fiscal Accountability Commission that will meet every five years to assess whether program growth is remaining within the long-term budgets and, if not, to propose measures to restore long-term sustainability.

	Cumulative Savings:			
(Fiscal Years, Billions of Dollars)	**2012-2020**	**2012-2025**	**2012-2030**	**2012-2040**
TOTAL: SPENDING POLICY REDUCTIONS	**$2,677**	**$5,728**	**$10,197**	**$25,895**
TOTAL: TAX EXPENDITURE CUTS	**$1,873**	**$4,046**	**$7,483**	**$17,160**
TOTAL: NEW REVENUES	**$435**	**$1,487**	**$2,738**	**$6,389**
TOTAL DEBT SERVICE SAVINGS	**$877**	**$3,184**	**$8,271**	**$34,160**
TOTAL DEBT REDUCTION*	**$5,866**	**$14,498**	**$28,852**	**$84,171**

* The budget savings from covering newly-hired state and local workers under the Social Security program is included in this total, but not in any of the subtotals because it is a coverage provision.

A note on the data: For assumptions about the path of deficits and debt under current federal policies, the Task Force adopted the "Alternative Fiscal Scenario" of the Congressional Budget Office (CBO), based on CBO's August 2010 Budget and Economic Outlook. In addition, the Task Force adopted CBO's assumption that the number of U.S. troops deployed in combat would fall to 30,000 by 2013. All tax estimates have been provided by the Tax Policy Center and Social Security estimates by the Chief Actuary of the Social Security Administration.

BIPARTISAN POLICY CENTER

RESTORING AMERICA'S FUTURE:
THE PLAN

Revive the Economy, Create New Jobs

Two Simultaneous Challenges: Economic Recovery and Stabilizing the Debt

We face two huge challenges simultaneously. We must recover from the deep recession that has thrown millions out of work, slashed home values and closed businesses across the country. We also must take immediate steps to reduce the unsustainable debt that will be driven by the aging of the population, the rapid growth of health care costs, exploding interest costs, and the failure of policymakers to limit and prioritize spending and to pay for new programs.

Some observers have argued that policymakers need to choose between economic stimulus and deficit reduction. The Task Force, however, firmly believes it is important to take action on both fronts at once – accelerating the recovery and phasing in deficit reduction.

Because the deficit reduction necessarily phases in slowly, we should not delay its implementation. Moreover, having a strong deficit reduction effort in place actually will help the recovery because it will stimulate confidence in the economy that is essential to investment and the creation of new jobs.

Consequently, the Task Force calls for adoption in 2011 of a payroll tax holiday that will become effective immediately and is estimated to create between 2.5 and 7 million new jobs, along with a comprehensive package of deficit reduction measures that will begin to phase in starting in 2012.

The Task Force also considered, but ultimately chose not to include, a proposal to establish a threshold "trigger" mechanism that would delay implementation of deficit reduction measures until unemployment declines to a specified level.[2] This was not adopted because of the prevailing view that adoption of the payroll tax and the debt reduction package will be mutually reinforcing measures that will revive the economy, create jobs, and control the runaway debt.

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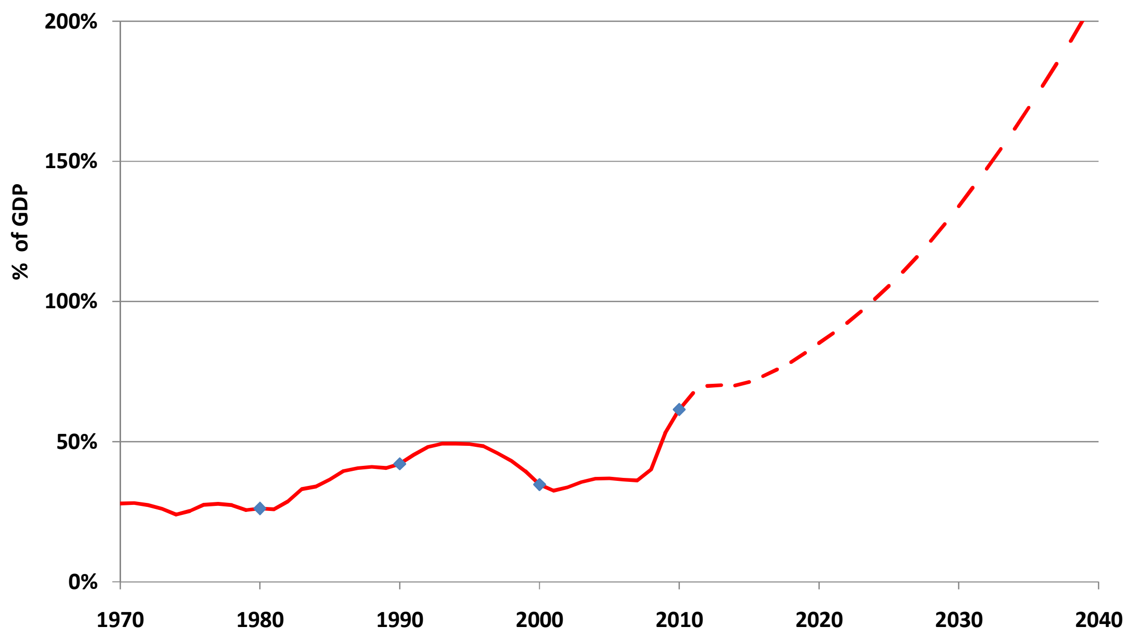
[2] In addition to supporting the payroll tax holiday (estimated to create between 2.5 and 7 million new jobs), Task Force Member Ed McElroy supports adoption of a trigger mechanism that would tie effective dates for the debt-reduction measures to unemployment rates.

The Risks of Runaway Debt

To put the current situation in historical context, U.S. public debt reached unprecedented heights during World War II, and peaked at almost 109 percent of gross domestic product (GDP) in 1946. However, the economy grew strongly and the debt fell below 60 percent of GDP by 1953 – bottoming at less than 24 percent in 1974 – and averaged 37 percent of GDP from 1960 to 2000.

Today, the debt has risen to about 60 percent of GDP – returning to that level for the first time in 57 years – and it is growing quite rapidly. Under current tax and spending policies, it will reach a projected 100 percent of GDP by 2024, an unthinkable 200 percent by 2039, and even 300 percent by 2050.

Debt Held By The Public



Source: CBO's "Alternative Fiscal Scenario" constructed from the August 2010 Budget and Economic Outlook, additionally assuming that troops in Iraq and Afghanistan are reduced to 30,000 by 2013.

The federal borrowing required to finance this debt will slow economic growth and reduce our living standards by draining our nation's pool of savings that otherwise would be available for investment in factories and equipment and new business ventures that boost productivity and raise living standards. Phrased another way, large deficits put upward pressure on interest rates over the long run, making investment more costly. Less investment means lower productivity and diminished prosperity for future generations. High debt service costs require higher taxes, which blunt incentives and distort business decisions, just to pay the resulting interest costs.

Today, U.S. interest rates are at historically low levels, both because of our own weak economy and because the economic problems of other major countries make our U.S. Treasury securities the "least-bad" place for many investors, private and public, to put their money. But, as our economy recovers, if interest rates rise merely to historically average levels, debt service costs will jump very significantly. Under current policies, **by 2020, interest on the public debt will reach $1 trillion per year.** By 2025, ***all*** federal revenues will be consumed entirely by interest payments, Medicare, Medicaid, and Social Security. The federal government will have to borrow to finance every other fundamental public purpose.

Beyond our economic security, runaway deficits and debt threaten our national security. Joint Chiefs of Staff Chairman Mike Mullen has identified the debt as "the single biggest threat to our national security." If current trends continue, deficits and the borrowing that they require will crowd out of the budget the appropriate spending for our nation's defense, not to mention the administration of justice, the safety of our food and water, medical research, transportation, and all other public purposes at home. In fact, by 2018, spending on interest to service the debt would exceed spending on defense.

Maintaining such massive borrowing will increase our dependence on foreign lenders. Today, overseas creditors own more than half of our public debt. Unlike the interest payments that the federal government makes to domestic lenders, which transfer purchasing power from one American entity to another, interest payments to foreign lenders represent a net reduction in our standard of living, because those payments are not available for U.S. consumption or investment. Moreover, the largest foreign holder of our debt is China, a nation that does not necessarily share either America's values or America's strategic interests.

Over time, if we do not change course, the stature of the United States as a world leader will gradually erode. Gradually, that is, unless our growing deficits and debt lead to a financial crisis. As Federal Reserve Chairman Ben Bernanke said recently, "Creditors would never be willing to lend to a country in which the fiscal debt relative to the national income is rising without limit."

If America's creditors lose confidence in the federal government's commitment to address its debt problem or even to service the debt, they will demand sharply higher rates of return on their lending – that is, much higher interest rates – to lend us more. The value of the dollar will plunge, which could trigger runaway inflation and still higher interest rates in a potentially never-ending vicious cycle.

The Chilling Effect on the Private Sector

The prospect of excessive public deficits and debt weighs heavily on the private sector, chilling its decisions. Over the long run, economic growth requires risk taking, which generates investment and jobs in the near term and productivity growth and rising wages in the long term. When

government creates uncertainty through imprudent fiscal behavior, it hinders risk taking and economic growth, which worsens the outlook for deficits and debt, which weakens the economy, and so on, in a brutal cycle of the kind that we face today.

Under the cloud of fiscal uncertainty, lenders will not engage in productive economic risk taking, and borrowers and entrepreneurs facing unfavorable credit terms will not borrow. Consumers, seeing less business risk-taking and investment and a resulting slowdown in job creation, cut back on their consumption – which today, notably includes a sharp drop in home buying. Businesses – even profitable ones – see the cutback in consumer spending and freeze their own hiring and investment. The elements of this economic stalemate reinforce one another, and the human costs of this vicious cycle are severe.

Our current economic problems require action on two fronts: a short-term jump-start to growth and a commitment to long-term deficit reduction that makes stimulus credible. This report recommends carefully timed action on both fronts.

A Payroll Tax Holiday to Create Up to 7 Million New Jobs

The prospect of enormous federal credit demands in the future creates anxiety and uncertainty that weaken the effectiveness of short-term fiscal stimulus. However, the plan outlined in these pages will address the nation's long-term fiscal problems, providing the essential credibility for additional action to accelerate near-term growth and job creation.

This plan begins with a strong step to restore consumer spending and confidence. Specifically, the plan calls for a one-year "payroll tax holiday" – that is, a suspension of Social Security payroll taxes for both individuals and businesses for 2011. Under CBO assumptions, the tax holiday will create between **2.5 and 7 million new jobs** over two years.[3]

At the same time, the plan calls for beginning to phase in the various elements of its debt reduction plan starting in 2012. The gradual implementation will give the payroll tax holiday time to revive the economy, setting the foundation for the fiscal plan that, over time, should strengthen the economy even more.

The payroll tax holiday will apply to Social Security taxes paid by both employees and employers. For employees, the holiday will give workers a steady and predictable stream of additional take-home pay to boost their confidence and their consumer demand. For employers, the holiday will temporarily reduce their labor costs, giving them an incentive to hire new workers, or hire them sooner than they otherwise might have.

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[3] Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in the Short Term*, Testimony of Director Douglas W. Elmendorf for the Joint Economic Committee, U.S. Congress (Washington, DC: February 23, 2010), http://www.cbo.gov/ftpdocs/112xx/doc11255/02-23-Employment_Testimony.pdf.

A payroll tax holiday offers several benefits. Because all of the stimulus will be delivered in the first year, it will produce benefits faster than most alternatives. The benefits will go to all wage earners. However, because the Social Security portion of the payroll tax itself is capped, the amount of the benefit from a payroll tax holiday is capped as well, so that the highest-paid workers will receive less benefit as a share of their wages than will average-wage workers.

This payroll tax holiday will not deprive the Social Security Trust Fund of needed revenue or deny a single penny to beneficiaries. The Task Force plan provides that the general fund will credit the Social Security Trust Funds in real time for the revenues that would have been deposited, so that there will be no loss of tax receipts, or the interest income on them, to the Trust Fund.

The program of fiscal responsibility outlined in the following pages, when coupled with this near-term economic stimulus, will help to revive our economy and generate greater investment, prosperity, and jobs.

Reduce and Stabilize the Debt

The debt reduction plan outlined in these pages will reduce (and then stabilize) the public debt below 60 percent of GDP. Our nation must address this problem now, when calm and thoughtful deliberation is possible – rather than wait until a new and even more intense financial crisis occurs.

The plan will also balance the "primary budget" – the budget other than interest payments – by 2014, a year ahead of the goal that President Obama set for his fiscal commission.

On a "unified budget basis," which includes interest, the plan will ensure that future budget deficits are small and manageable. But above all, it will ensure a strong economy for future generations of Americans.

Why 60 percent of GDP?

When economists consider fiscal policymaking, they commonly refer to the size of a nation's debt relative to its GDP, which is a bit like measuring a family's mortgage and other debt relative to its total income. Our GDP is the total production of our economy, out of which the interest on our debt must be paid.

Based on that standard metric, the Debt Reduction Task Force chose a medium-term target debt ratio of 60 percent of GDP.

To be sure, a higher target than 60 percent would be easier to attain. But the higher the target, the greater are the required interest payments on that debt, and thus, the greater the drag on economic growth – and the greater the probability of a financial crisis if and when the nation has to struggle to meet its debt service obligations.

A lower target, on the other hand, would provide a greater margin of safety in a period of adverse economic developments or emergencies. (However, even lower targets do not necessarily provide margins of safety. Evaluating data that cover 44 countries over 200 years, Carmen M. Reinhart and Kenneth S. Rogoff have found that more than half of debt crises have occurred in countries with debt ratios of less than 60 percent.[4]) However, a low target may require excessively tight budgets for too long, sacrificing essential services or public investments and enduring excessive tax burdens, thus reducing society's well being and economic growth.

[4] Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009), p. 24.

In the view of the Task Force, a 60 percent target reasonably balances these considerations and is consistent with globally recognized standards for fiscal stability. Unfortunately, debt held by the public is now rising rapidly – up from about 40 percent of the economy in 2008 and 53 percent in 2009, to a projected 67 percent in 2011, 85 percent of GDP by the end of the decade, and 100 percent by 2024. Clearly, slowing the growth and then reducing and stabilizing the debt below 60 percent of GDP will be no easy task.

Create a Simple, Pro-Growth Tax System[5]

Introduction

Reducing the federal debt to sustainable levels will require the tax system to raise more money as a share of the economy than it historically has done. But, the current income tax is a poor instrument for generating additional revenues.

The individual income tax is riddled with deductions, exemptions, and credits that provide special benefits to selected groups of taxpayers and favored forms of consumption and investment. These tax preferences make the income tax unfair because they can impose radically different burdens on two different taxpayers with the same income.

Tax preferences also reduce the economy's productivity because decisions on earning, spending, and investment are driven by tax considerations rather than the price signals that a free market economy produces.

Moreover, tax preferences make the tax system excessively complex for honest taxpayers who are trying to comply with the law while seeking the benefits to which they are legally entitled.

Also, the many arbitrary distinctions between transactions that are taxable and those that are not encourage some individuals to alter their activities to avoid taxes or even to commit fraud.

The system is so complex that most taxpayers – even those with low incomes – now use either a professional tax preparer or tax software. The alternative minimum tax (AMT), initially designed to ensure that all high-income taxpayers paid some income tax, has become the poster child for the tax system's failure, requiring Congress to enact annual and increasingly expensive temporary patches to prevent the AMT from ensnaring millions of middle class households (especially those with children) in a web of pointless complexity, high tax rates, and unfairness.

The corporate income tax also combines high rates with many narrow tax provisions, which encourage companies to make investments and production decisions based on taxes rather than the underlying economics, thereby diverting scarce capital to less productive uses. Because the U.S. corporate tax rate is now among the highest in the Organisation for Economic Co-operation and Development (OECD), the tax encourages an outflow of capital from the United States, reducing U.S. output and real wages. The elevated rate also encourages U.S. and foreign-owned corporations to engage in transactions that shift reported profits from the United States to low-tax jurisdictions.

[5] See Appendix A for a summary of the core provisions of the Task Force's tax reform plan.

Revenue Estimates of Tax Reform Plan:	Cumulative Savings:		
	2012-2020	2012-2030	2012-2040
TAX EXPENDITURE CUTS / REFORM THE TAX CODE			
Restructure itemized deductions and eliminate most tax expenditures	$3,544	$11,091	$23,511
Tax all capital gains and dividends as ordinary income (top rate of 27%), with $1,000 exclusion for capital gains (or losses)	$243	$806	$1,644
Restructure tax benefits for low-income families and families with children, and eliminate standard deduction and personal exemptions	-$1,914	-$4,414	-$7,995
TOTAL:	**$1,873**	**$7,483**	**$17,160**
RATE CUTS AND NEW REVENUES			
Reduce Income Tax Rates to 15% and 27%	-$1,298	-$3,873	-$7,893
Reduce Corporate Tax Rate to 27%	-$785	-$2,008	-$3,866
Repeal the Alternative Minimum Tax	-$338	-$1,031	-$2,110
Introduce a 6.5% Debt Reduction Sales Tax (DRST), phased-in over 2 years (3% in 2012, 6.5% in 2013)	$3,048	$8,764	$17,333
Adjust excise tax on alcoholic beverages to 25 cents/oz	$53	$127	$218
Index the tax system to a more accurate measure of inflation	$133	$484	$1,244
Extend Estate Tax at 2009 levels (baseline assumption)	$0	$0	$0
1-year social security payroll tax holiday for employees and employers (*cost in FY 2011: $481 billion*)	-$641	-$641	-$641
New revenues from health and Social Security policies	$263	$916	$2,104
TOTAL:	**$435**	**$2,738**	**$6,389**

The Task Force proposes a radically simplified income tax that will lower tax rates, broaden the base, and eliminate the need for millions of households to file tax returns.[6] The plan will end most deductions and credits and simplify those that remain so that they will be more effective and better targeted. Supplementing the income tax will be a new national Debt Reduction Sales Tax (DRST) that will help to reduce the debt even while individual and corporate income tax rates fall significantly.

[6] See July 14, 2010 Senate Finance Committee testimony by Task Force Member Len Burman.

Taken together, the tax reform plan will raise $2.3 trillion through 2020, while making the tax system more progressive.[7]

The main elements of the proposal are:

- Much lower marginal tax rates on individuals and corporations to improve incentives to work, save, and invest, with the top tax rate on individuals and corporations set at 27 percent;
- Reforms of major itemized deductions, making them more efficient in achieving their objectives and reducing compliance costs;
- Restructured provisions benefiting low-income taxpayers and families with children that make those provisions simpler and more transparent, and allowing most taxpayers to meet their obligations and receive tax rebates without filing tax returns;
- An end to almost all tax expenditures to offset the costs of the much lower tax rates – this will dramatically simplify the tax system and remove tax considerations from private decisions on how to work, invest, and spend, thereby improving economic efficiency and raising living standards;
- A new modest national Debt Reduction Sales Tax (DRST) to reduce deficits and debt without reducing incentives to save and invest or harming international competitiveness; and
- A temporary Social Security "payroll tax holiday" in 2011 to spur the economic recovery (as described earlier in the report).

[7] The effects of tax proposals on the progressivity of a tax system can be measured in different ways. Three alternatives are to 1) compare how the proposal affects different income groups' tax liabilities as a percentage of their income; 2) compare how the proposal affects different groups' shares of the total tax burden; or 3) compare how the proposal affects different groups' shares of after-tax income. Some tax changes would make the system more progressive by some of these measures and less progressive by others. The Task Force believes that comparing how different proposals affect after-tax income is the best way to measure changes in progressivity. By that criterion, the Task Force's proposed tax system is generally more progressive than current law, because the reform raises the share of after-tax income received by lower- and middle-income people and reduces the share received by higher-income people. At the same time, the plan maintains approximately the distribution of taxes paid by each income group as under current law.

The Task Force applauds the efforts of some members of Congress who have developed other proposals to reform the income tax system. A noteworthy example of a tax reform plan is the Bipartisan Tax Fairness and Simplification Act of 2010 (introduced as S. 3018), sponsored by Senators Ron Wyden and Judd Gregg. S. 3018 would lower the corporate tax rate to 25 percent, keep the top individual income tax rate from rising above the current 35 percent, and eliminate or reduce a number of corporate and individual preferences. Both the Wyden-Gregg proposal and the Task Force plan aim to broaden the tax base and lower tax rates, and both share the goal of a fairer and simpler tax system. However, the Task Force proposes a more far-reaching plan. It will eliminate more tax preferences than S. 3018 and shift part of the tax burden from income to consumption, making possible a lower top individual income tax rate than S. 3018 and providing an increase in revenues to help reduce deficits and stabilize the debt for America's future.

Lower Corporate and Individual Tax Rates

The current individual income tax system is progressive, meaning that individuals with higher incomes pay a larger share of their income in federal income tax than those with lower incomes. (The overall tax system, which includes payroll taxes and federal excise taxes that impose relatively larger burdens on lower-income taxpayers, is less progressive than the income tax, but still moderately progressive on balance). The graduated marginal income tax rate structure, combined with personal exemptions, a standard deduction, and credits for taxpayers with children and low-earning taxpayers, make the tax system progressive. However, provisions that provide special exclusions, deductions, credits, and favorable rates for selected forms of income or spending make the income tax less progressive than it would otherwise be. These preferences also require higher tax rates to generate the same revenue.

High individual marginal tax rates have important adverse effects. They reduce incentives to save, work, and invest. Combined with tax preferences, our current rate structure encourages taxpayers to realize income in tax-favored forms (fringe benefits and capital gains, instead of fully taxable cash earnings), spend money on selected activities, and choose tax-favored investments over others with greater market returns. High marginal rates also encourage non-compliance, which now measures an estimated 15 percent of tax liability. In general, the tax system would be fairer, simpler, and more favorable to economic growth if it raised revenue with lower marginal tax rates and fewer tax preferences. Reducing rates and broadening the tax base should also improve compliance by reducing the rewards and the opportunities for underreporting tax liability.

The current corporate income tax also needs reform. The average top corporate tax rate of over 39 percent (combining the federal top rate of 35 percent and the average top state rate) gives the United States almost the highest corporate tax rate among the developed nations in the OECD. Although tax preferences for investment offset some of the tax burden of investing in the United States, recent research shows that the combined effective tax rate on corporate investment in the United States (including the effect of preferences) is also higher than the rates of most of our major trading partners.

Relatively high tax rates on corporate income carry two ill effects. First, they reduce the incentive to invest in the United States, leading to an outflow of economic activity by both U.S. and foreign-based multinational corporations. Second, for any level of investment, the high rates encourage both domestic and foreign corporations to report less income to the U.S. federal government and more income to lower-tax foreign countries. Transfer pricing regulations place some limits on the prices companies can report for transactions between their domestic and foreign affiliates, but these regulations are not fully effective.

The Task Force plan will dramatically reduce both individual and corporate income tax rates. In place of the current six-bracket system for the individual income tax, with rates ranging from 10 percent to 39.6 percent (in 2011), the plan will substitute a simple two-bracket system with rates of 15 and 27 percent. The top corporate rate will drop from 35 percent to 27 percent, placing the United States (when including state taxes) at about the average for the OECD instead of near the top. Combined with other U.S. advantages as a place to do business (including our status as the world's central marketplace), this change will help attract investment and employment.

Reform Itemized Deductions

The current U.S. income tax system allows taxpayers to claim itemized deductions for various types of expenditures. The largest itemized deductions are those for home mortgage interest, state and local income and property taxes, and charitable contributions. There are also itemized deductions for medical expenses that exceed 10 percent of adjusted gross income (AGI), and for miscellaneous business expenses that exceed 2 percent of AGI. Taxpayers with few expenses that qualify for itemized deductions may claim a standard deduction instead; currently, about 65 percent of tax returns claim the standard deduction (and thus, receive no benefit from itemized deductions).

Itemized deductions are often called "upside-down" subsidies. They encourage some taxpayers to spend money on housing and charitable contributions and to support higher state public expenditures, but the structure of the subsidy is perverse. High-income taxpayers who are in the top tax bracket (39.6 percent in 2011) receive the largest subsidy – because an additional dollar spent on mortgage interest or given to charity costs them only 60.4 cents (after the 39.6 percent reduction in their income tax liability). The same dollar contributed by an itemizing taxpayer in the 10 percent bracket costs that taxpayer 90 cents; and the 65 percent of tax filers who use the standard deduction or have no income tax liability receive no subsidy to own homes or give to charity.

The Task Force proposal will eliminate itemized deductions and the standard deduction. Instead, it will allow all taxpayers to claim a 15 percent credit for home mortgage interest expenses on a principal residence up to $25,000. It will also allow a 15 percent credit for charitable

contributions. The credit rate will be uniform for all taxpayers, including those without income tax liability (that is, the credits will be "refundable").

Because the credits are universal, taxpayers will not have to file a tax return to claim them; rather than be reimbursed directly to taxpayers, the credits will go to the institutions. Qualifying charities will apply to the Internal Revenue Service (IRS) for a matching grant to supplement contributions from taxpayers, so that for every $85 the taxpayer gives, the charity will receive another $15. Mortgage lenders will apply for a tax credit, which will be passed through to homeowners as a 15 percent reduction in their home mortgage interest payments.

Structuring the incentives in this way permits reductions in the costs of charitable giving and mortgage interest payments to taxpayers, without requiring them to file a tax return if they otherwise would not need to. Everyone who gives to charity or has a mortgage will benefit, rather than the minority of taxpayers who benefit from these provisions under current law.

Changing the mortgage interest deduction to a refundable credit will greatly increase the number of homeowners who qualify for subsidized interest, but will reduce the subsidy rate for high-income homeowners. In addition, the proposal provides no additional subsidy for annual mortgage interest in excess of $25,000 and no subsidy for second homes. (At an interest rate of 5 percent, mortgages of $500,000 or less will qualify for the full subsidy.) Lower-income families, who most need help affording homeownership, will receive much larger subsidies than under current law, while higher-income households, who are most likely to own a home even without a subsidy, will receive smaller benefits. Therefore, this provision should increase the rate of home ownership.

Restructuring the charitable deduction will greatly increase the number of taxpayers who receive a subsidy for charitable donations, but will reduce the subsidy rate for upper-middle income and upper-income taxpayers who itemize. This provision should broaden the pool of people who donate to charity, but may alter the composition of charitable giving. Charities favored by lower-income people (disproportionately religious organizations and organizations providing services for the poor) may benefit.

The Task Force proposal will eliminate deductions for state and local income, sales, and property taxes. In general, these deductions are claimed only by higher-income people who itemize, and many of these taxes (such as local property taxes) are directly associated with public benefits that taxpayers receive. Many economists argue, therefore, that the state and local tax deduction is an inefficient way to subsidize states and localities. President Ronald Reagan proposed to end the deduction in his 1985 tax reform plan. Although his proposal was not included in the 1986 Tax Reform Act, that act did eliminate the sales tax deduction and made the state and local tax deduction a preference item under the alternative minimum tax (which reduced or eliminated the benefit of the deduction for many families).

Finally, the Task Force proposal will retain deductions for medical expenses and miscellaneous business expenses. The plan will apply a floor of 10 percent to medical deductions (as recently enacted for the regular income tax under health reform and which already applies under the AMT), raise the floor under the miscellaneous deduction to 5 percent, and subject both deductions to a fixed floor of $4,600 for married taxpayers and $2,300 for single taxpayers. Taxpayers can claim, as a medical deduction subject to the floor, employee contributions to health plans that become taxable under this proposal. Through these provisions, the proposal will limit tax benefits for health care expenses to those with large expenses in relation to their income.

Restructure Provisions to Benefit Low-income Taxpayers and Families with Children

Under current law, families with children benefit from numerous provisions of the income tax, including personal exemptions for children, the child tax credit, the earned income tax credit (EITC), the availability of head of household filing status for single parents, and the child and dependent care credit. Many low-income families qualify for the EITC, an earnings subsidy that varies with the number of children (up to three) and phases out for taxpayers with incomes above a threshold amount. The EITC is the largest cash transfer program for low-income families and raises the incomes of many low-income working families above the poverty line. But the EITC can create very large marriage penalties because a second earner's income can cause the EITC to shrink or end, and the credit can discourage additional hours of work for those with incomes in the range where the credit phases out. Moreover, the EITC is very complex. The overwhelming majority of EITC claimants use tax preparers (mostly paid preparers, but some through voluntary assistance programs) to complete their returns, but EITC claims still have a very high error rate, often due to a misunderstanding of rules for determining who can claim a qualifying child.

The Task Force proposal will replace these complex provisions with two separate provisions to help families with children and working families: a universal child credit of $1,600 per child, indexed to changes in the Consumer Price Index (CPI); and an earnings credit of 21.3 percent of the first $20,300 of earnings for each worker in the tax unit, with the threshold amount indexed to the CPI. To receive the child credit, the taxpayer will have to file once to qualify each time he or she has a child (presumably at the same time as applying for the child's Social Security number); receipt of the credit will be automatic thereafter as long as the child continues to reside in the household or attend school, and until he or she reaches adulthood.

The earnings credit will be provided through automatic adjustments to withholding. For workers with only one job, there will be no subsequent adjustment needed upon filing a tax return[8]. As a result, most taxpayers will receive these benefits in real time – a major improvement over the current system – without having to file an income tax return. There will also be no phase-outs creating marriage penalties and work disincentives. The beneficial effect of the subsidy on after-

[8] Workers can only claim the advance credit on one job. Taxpayers can claim the credits for earnings up to the cap from second or third jobs at the end of the year.

tax wages, and therefore on work incentives, will be transparent to low-income households, and most will receive the benefits automatically, without having to negotiate a complex set of rules.

The high rates for the child credit and the earnings credit will compensate low- and middle-income families for the loss of personal exemptions, the current child credit, the standard deduction, the child and dependent care credit, the repeal of education credits and deductions, and the effects of other proposals in the Task Force plan, especially the proposed debt reduction sales tax. The child credit amount will replicate, on average, the benefits that taxpayers receive for an additional child under current law.

The new structure of tax subsidies has many benefits compared with current law. The credits will be much simpler for taxpayers to claim, will deliver tax benefits in real time (instead of forcing taxpayers to wait until they file their returns – even though such low-income taxpayers need the benefit in real time to maintain adequate living standards), and will facilitate more compliance within the income tax. The Task Force plan eliminates many of the phase-outs that currently impose very high marginal tax rates on taxpayers whose income is in the range where the various tax benefits phase out. The proposal also provides a simple and flexible way to offset the effects of any changes in the tax system on low-income taxpayers.

Eliminate Tax Expenditures[9]

The Congressional Budget Act of 1974 defines tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability." In fiscal year 2010, tax expenditures amounted to over $1 trillion. Many tax expenditures substitute for programs that easily could be structured as direct spending. For example, the federal income tax provides a credit (the HOPE credit) for student expenses during the first two years of college, and another tax credit (the lifetime learning credit) with a different rate and maximum limit that covers expenses for any qualified post-secondary education. These programs could easily be structured as grant programs from the Education Department, in which case they would be counted as federal expenditures. When structured as tax credits, they appear as reductions of taxes, even though they provide the same type of subsidy that a direct spending program would, and like a spending program, must be financed either by tax increases, cuts in other spending programs, or increases in the deficit that pass the cost to future generations.

The Task Force plan eliminates or scales back almost all tax expenditures in the individual and corporate income taxes. While some tax expenditures promote important social and economic goals, others have little economic justification. Some investments (e.g., research to develop new products and production techniques that others can replicate) and some consumption goods (e.g., public education or public health) arguably produce benefits to third parties (other than benefits to

[9] See Appendix B for a list of the remaining tax expenditures.

the investor, consumer or supplier) and therefore merit government subsidy. But tax expenditures are not necessarily the most effective ways to promote these activities. Many tax expenditures, moreover, subsidize activities that generate no clear benefits beyond the rewards that private producers would receive in free markets. These tax expenditures misallocate resources by promoting over-investment in tax-favored industries and over-consumption of tax-favored goods and services. Tax expenditures also raise costs of compliance and administration and contribute to the high current levels of non-compliance. Eliminating almost all tax expenditures allows the Task Force plan to raise sufficient revenues with much lower individual and corporate tax rates than in current law.

Limit Contributions to Retirement Saving Accounts and Introduce a Refundable Savings Credit

Contributions to qualified retirement savings plans and income accrued within these plans are exempt from federal income tax. (Employer contributions are also exempt from payroll taxes.) The portion of earnings that is contributed to these accounts remains untaxed until account holders withdraw the funds in retirement, either as a lump-sum distribution or as an annuity.

Individuals can participate in a bewildering variety of qualified tax-deferred retirement plans, subject to various contribution limits, income limits for participation, timing of tax payments (deductible accounts that defer payments until distribution, or pre-paid "Roth" accounts that tax contributions but not future investment income or withdrawals), and for employer plans, "non-discrimination" rules that limit benefits for plans that do not meet tests for broad employee participation. In addition, the tax system includes a variety of tax-favored saving plans to fund future health care expenses and educational expenses. Over the years, Congress has increased the number of available tax-preferred savings vehicles, raised contribution limits, relaxed income limits for participation, and expanded "fail-safe" options for employers to satisfy non-discrimination requirements. The share of households' financial wealth held directly in tax-qualified retirement plans has risen from 17 percent in 1989 to 32 percent in 2007.

The Task Force plan will let most individuals retain the ability to contribute enough to qualified retirement plans to accumulate enough tax-free assets to purchase an annuity that replaces a substantial share of their earnings in retirement. Individuals and employers combined will be able to contribute up to 20 percent of annual earnings to qualified plans, up to a maximum of $20,000 per year, indexed to inflation. However, qualified plans will no longer be a vehicle for wealthy individuals to convert a substantial share of their assets into tax-free retirement assets. In addition, to spur saving by rank-and-file workers, the plan will introduce an expanded and refundable savings credit for taxpayers in the 15 percent bracket.

Eliminate Special Tax Rates for Capital Gains and Dividends

Capital gains and dividends are currently taxed at a maximum rate of 15 percent, compared with a top rate of 35 percent for earnings, interest income, and income from self-employment and from participating in businesses that are organized as flow-through enterprises (partnerships, limited liability companies, and subchapter S corporations). If Congress does not extend the 2001 and 2003 tax cuts, the top rate on capital gains will rise to 20 percent and the top rates on dividends and other income will rise to 39.6 percent.

The Task Force plan will eliminate the preferential rates on capital gains and dividends. However, because the Task Force plan lowers the top individual income tax rate to 27 percent, earnings, capital gains, dividends, and business profits of individual taxpayers will be taxed at a maximum rate of only 27 percent – far lower than the top rate on ordinary income and dividends under scheduled law, and only moderately higher than that on capital gains.

Eliminating the differential between the tax on capital gains and on ordinary income will establish equal treatment among taxpayers with different sources of income and eliminate the incentive to use tax shelters to convert ordinary income into capital gains. Under current law, for example, partners in private equity firms receive a substantial share of their compensation as tax-favored capital gains, while others with variable earnings, such as salesmen on commission or executives receiving performance-based bonuses, must pay ordinary income tax rates on their compensation. Eliminating the capital gains differential will also reduce the compliance and administrative costs associated with sophisticated tax-planning strategies.

While higher capital gains rates have some disadvantages – notably the "lock-in effect" that occurs because the tax discourages sales of assets with accrued gains – at the 27 percent rate, these adverse effects should be minimal. Notably, the Tax Reform Act of 1986, favored by President Reagan, also taxed capital gains as ordinary income, subject to a top-bracket rate of 28 percent. Given the significantly lower top tax rates on individual and corporate income, this reform is also necessary to maintain the progressivity of the current tax system. In addition, the lower corporate tax rate will offset any increase in the total tax burden on corporate equity investments from raising the tax rate on realized capital gains and dividends.

Phase in a Debt Reduction Sales Tax (DRST)

The tax reforms described above greatly simplify the income tax system, and make it more fair and more economically efficient. The combination of reduced tax expenditures and lower individual and corporate rates, however, leaves federal revenue roughly unchanged through 2020 and does not raise enough revenue to reduce the debt sufficiently in the long term, as population aging and rising health care costs drive up the cost of entitlements. Building on the base of a greatly improved income tax, with strengthened provisions that support low- and moderate-wage

working families and retirees, the nation can add an additional source of revenue to reduce the debt without sacrificing fairness or economic growth.

The Task Force[10] proposes a new broad-based tax on goods and services, the Debt Reduction Sales Tax (or DRST), that will phase in over two years to a rate of 6.5 percent.[11] A national sales tax has many advantages compared to increases in income tax rates. It does not tax the return to saving and investment, so it will not provide a disincentive for long-run wealth accumulation or for the capital accumulation needed to generate economic growth. Unlike an increase in the corporate income tax rate, the sales tax does not provide an incentive to shift investment overseas.

Additionally, a sales tax is based on domestic consumption instead of production. As a result, a broad-based sales tax will not affect the relative costs of producing different goods and services in the United States, and therefore does not place some industries at a competitive disadvantage. The proposed DRST will be consistent with international norms and easy to coordinate with the tax systems of other countries, while allowing the United States to set whatever specific exemptions it deems appropriate.

The DRST will be designed roughly like the national sales taxes in effect in over 150 countries around the world, including all of our major trading partners. Businesses pay tax on all of their sales, but receive credits for taxes that their suppliers pay when they purchase materials and capital goods from other firms. Final consumers in the United States, however, will not be able to claim credits on their purchases. The resulting total tax will be the same as for a tax collected from retailers only, but collecting the tax in stages from all businesses has two very large advantages over the form of retail sales tax used by most states in the country.

First, collecting it in stages facilitates tax compliance because businesses that try to operate outside the system will lose their ability to claim credits for purchases from other firms. By contrast, under a retail sales tax, if the retailer fails to pay the tax, the tax that should have been imposed on the entire value of the goods and services he or she sells is lost to the government.

Second, collecting the tax in stages reduces the "cascading" that occurs with a retail sales tax, under which sellers have difficulty distinguishing between sales to other businesses and sales to final consumers. Under most current state retail sales taxes, an estimated 40 percent of receipts come from business-to-business sales. Consequently, some goods and services bear several levels of tax: first when sold to a business and then when resold to the final consumer. In contrast, under a multi-stage tax, there is no need to separate sales to different purchasers; all sales are taxable, but business purchasers can wipe out the tax liability from the prior sale by claiming a credit for the tax that the supplier pays.

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[10] Task Force Member Karen Kerrigan, while supporting the package as a whole and the need for both spending cuts and new revenues to stabilize the debt, does not support the Debt Reduction Sales Tax.
[11] 3 percent in 2012, and 6.5 percent from 2013 onward.

Following international practice, the DRST will exempt exports (allowing exporters to claim credits on purchases, but pay no tax on sales) and tax imports (requiring importers to pay tax on sales, but allowing them no credit on purchases). Contrary to some assertions, these rules do not amount to either an export subsidy or an import tax (and they are allowed under international trade agreements). These "border adjustments" merely ensure that the tax base is domestic consumption only. Goods and services produced for domestic use bear the same tax burden whether produced in the United States or overseas. Goods and services produced for foreign consumers bear no U.S. sales tax, whether exported from the United States or produced overseas.

The tax will fall on a very broad base that includes most goods and services. However, government services, services produced by charitable organizations, educational activities, the imputed value of financial services (services that financial institutions finance by paying reduced interest to depositors instead of charging them explicit fees – like free checking), and government subsidies to health care (Medicare and Medicaid expenses, for example) will be exempt from the tax. Housing rents will be untaxed, but sales of new homes and rental properties will be taxable. All other consumer goods and services, including privately funded health care costs, food and beverages, clothing, legal and accounting services, and many other items not typically captured by state retail sales taxes, will be included in the tax base. Overall, about 75 percent of personal consumption expenditures will be subject to tax.

Using a broad base to tax consumption follows the practice of countries that have recently adopted national sales taxes (Australia, Canada, and New Zealand), compared with those that enacted such a tax earlier (the United Kingdom, France, and other European countries), whose tax bases are typically riddled with exemptions. A broad base allows lower rates to raise the same revenue as a narrow-base tax with higher rates. The broad base also creates many fewer compliance problems, because it avoids many issues that exemptions raise in determining which items are taxable and which are not. Exemptions for items that are considered necessities (food and clothing) – intended to make the tax less regressive – have little effect on the distribution of the tax burden because higher-income people generally consume the same broad classes of products and services, just higher-quality and more-expensive versions. Thus, exemptions are typically ineffective. A better way to make a sales tax less regressive is to give taxpayers a broad-based rebate, either as a lump-sum grant or an earnings subsidy – as the Task Force plan does.

The main objections raised to a national sales tax of this type are that it is regressive; it interferes with a revenue source that has historically been used exclusively by the states; and it would be a hidden tax that would facilitate excessive growth in government spending. However, these problems are either overstated or surmountable:

- **Regressive Burden of the Tax:** Merely substituting a sales tax for our current income tax would make the tax system less progressive, raising tax burdens on low- and middle-income families and lowering tax burdens on high-income families. But, a more-modest sales tax can be one component of a tax system that is, on balance, even more progressive

than today's system, just as the regressive payroll tax is part of our currently progressive federal tax system. The Task Force plan offsets the burden of the DRST on lower-income families through enhanced tax benefits in the form of new refundable credits for children and for the first $20,300 of each worker's earnings.

- **Competition with the States:** States may object to a new multi-stage federal sales tax on the ground that it interferes with a tax base that has to date been reserved for them. But, state retail sales tax bases have been eroding over time, as untaxed services account for a growing share of economic activity, and more and more products sold on the Internet have escaped state sales tax collections. States will benefit from piggybacking their taxes on top of a broad-based federal sales tax. State tax authorities will benefit from access to IRS data from sales tax returns, just as they now rely on the IRS to help them enforce state income taxes. The recent experience with Canada's goods and services tax suggests that sales taxes of sub-national governments can co-exist with a national multi-stage sales tax within a federal system.

- **A Sales Tax as a "Money Machine":** A sales tax need not be hidden; the law can require that the amount of tax be itemized on sales receipts, as is now the practice in Canadian provinces and in many U.S. states. It would be no easier for Congress to raise the DRST than to raise income tax rates. Moreover, the 6.5 percent level of the DRST will be sufficient to keep the public debt stabilized below 60 percent of GDP for the foreseeable future.

Other Options that were Considered

Many members of the Task Force expressed a desire for the DRST to phase down over time. Therefore, the Task Force considered alternative sources of revenue that could be phased-in to help reduce the DRST. The Task Force evaluated alternative options for their ability to promote policy goals that would benefit the public. Of the alternatives considered, a tax on carbon dioxide (CO_2) emissions from fossil fuel combustion received the greatest – though not unanimous – support. The specific option that the Task Force examined would have introduced a tax of $23 per ton of CO_2 emissions in 2018, increasing at 5.8 percent annually, allowing the DRST to start at 5.75 percent instead of 6.5 percent, and phase-down to 4 percent by the end of the next decade. Staff projections estimate that this option would have raised about $1.1 trillion in cumulative revenue by 2025, while resulting in CO_2 emissions of 10 percent below 2005 levels in that year.

A tax on CO_2 emissions has a number of desirable attributes. Unlike taxes on income, payroll, or consumption, which penalize work effort by reducing real wages without any corresponding economic benefit (other than the revenue raised), a CO_2 tax could actually increase economic efficiency. By establishing a price for CO_2 emissions – which have a social cost – the tax would shift production and consumption toward less carbon-intensive goods, reducing CO_2 emissions in the process. In addition, by providing certainty regarding the cost of CO_2 emissions going

forward, the tax would relieve the uncertainty that has delayed necessary capital investments in the energy sector, while also encouraging research and development in cleaner energy technologies. A CO_2 tax would increase energy prices, however, raising concerns about impacts on energy-intensive industries and regressive impacts on households. While the Task Force plan does not include a tax on CO_2 emissions, many members believe it warrants further consideration as the nation works to address America's long-term debt.[12]

Distributional Effects of the Proposal (Progressive Tax Reform)

The Task Force plan will raise taxes on all income groups except for the bottom quintile, providing a shared sacrifice for debt reduction (see table below). On average, the tax proposals reduce after-tax incomes by about 4 percent. The percentage reduction in after-tax income from the tax plan, however, rises as income rises from the bottom of the distribution to the top 5 percent. The lowest fifth of taxpayers are held-harmless; the second fifth will see their after-tax income fall by about 2 percent; and after-tax income in the top fifth will drop by 5.4 percent.[13]

BPC Tax Reform Plan Against CBO Alternative Fiscal Scenario Baseline
Distribution of Federal Tax Change by Cash Income Percentile, 2022 Law[1]

Cash Income Percentile[2,3]	Percent Change in After-Tax Income[4]	Share of Pre-Tax Income	Share of Federal Taxes		Average Federal Tax Rate[5]	
		Percent of Total	Change (% Points)	Under the Proposal	Change (% Points)	Under the Proposal
Lowest Quintile	0.0	3.7	-0.1	0.7	0.0	5.0
Second Quintile	-2.1	8.3	0.1	4.0	1.9	12.6
Middle Quintile	-2.8	13.6	-0.1	10.3	2.3	19.8
Fourth Quintile	-4.3	19.9	0.3	18.5	3.4	24.2
Top Quintile	-5.4	54.8	-0.2	66.5	3.9	31.7
All	-4.3	100.0	0.0	100.0	3.3	26.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-6).

(1) Calendar year, at 2018 income levels. Baseline is CBO's alternative fiscal scenario. Threshold for the 27 percent tax bracket is $102,000 for married couples ($51,000 for others), indexed for inflation after 2012. Earnings credit rate

[12] Once the debt problem was fully under control, the proceeds of the carbon tax could be 100 percent rebated to taxpayers. That would leave consumers just as well off (on average), but with a strong incentive to shift their spending to less carbon-intensive goods and services.
[13] This is on top of the tax increases for higher-income taxpayers from the scheduled elimination of the 2001 and 2003 tax cuts and the new taxes on investment income under health reform – both of which the Task Force plan baseline assumes will occur.

is 21.3 percent on earnings up to a maximum of $20,300, indexed for inflation after 2012. Earnings credit is available for individuals under age 65 who cannot be claimed as a dependent on another's tax return.
(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm.
(3) The cash income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2009 dollars): 20% - 21,608, 40% - 41,284, 60% - 74,103, 80% - 129,751.
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(5) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

Restrain Rising Health Care Costs

Introduction

Health care spending is a large and rapidly growing part of the budget, mainly due to Medicare expenditures and federal matching payments to states for Medicaid. Spending for these two programs is projected to increase from 21 percent of non-interest federal spending in 2010 to 31 percent by 2020.

Federal health spending reflects trends in the overall health system. Medicare and Medicaid are intended to provide access to mainstream health care, so general trends in the delivery of health care inevitably influence spending in these programs. Long-term cuts in the rate of growth of federal health spending can come only through reform of the broader health care system.

Over time, national health spending has grown about 2 percentage points per year faster than GDP. Federal revenues, however, have grown at roughly the same rate as GDP. Consequently, federal deficits will be driven upward by federal health programs unless their rate of growth is moderated.

Slowing the growth of health spending is realistic. Other advanced countries have substantially lower health spending as a share of GDP, while still achieving measures of access and quality that often exceed those in the United States. Although a uniquely American approach is required, these comparisons show what is achievable.

Factors behind rapidly rising health care spending are well understood. Advancing technology, much of which increases spending, is a key component. Unfortunately, important new technologies often go to care for not only patients who can benefit substantially from them, but also for those who are unlikely to benefit at all. Much new technology is incorporated into standard practice without evidence that it improves outcomes.

The aging of the population is another cause behind the growth in spending, but the magnitude – about 0.4 percentage points per year – is well below what some imagine.

A key factor behind the rising *federal* health care spending projected for the next two decades is the fact that the very large Baby Boom generation is beginning to reach Medicare eligibility age. This influx of beneficiaries translates into rapidly growing expenditures for Medicare (which provides health care for seniors) and the federal-state Medicaid program (which provides long-term care for aging Americans).

Yet another important explanation for rising health care spending is the prevalent fee-for-service system, which provides strong incentives to amplify the volume of tests and procedures in order to increase revenues.

For a long time, our nation has had a sterile debate about whether to use market or regulatory approaches to address escalating health care spending. In fact, the nation has not pursued either course, allowing health spending to surge at rates that are not sustainable over the long term. We need a pragmatic approach that draws on multiple strategies.

The Task Force plan includes both demand- and supply-side approaches to slowing the growth in overall health spending and federal spending specifically. Some aspects target the health system in general, while others focus specifically on Medicare and Medicaid.

The major demand-side strategy is to cap and then phase out the tax exclusion of employer-sponsored health insurance (ESI) benefits. This policy will result in more cost-conscious choices by purchasers of health insurance. Also on the demand side is a proposal to modernize patient cost sharing in the Medicare program.

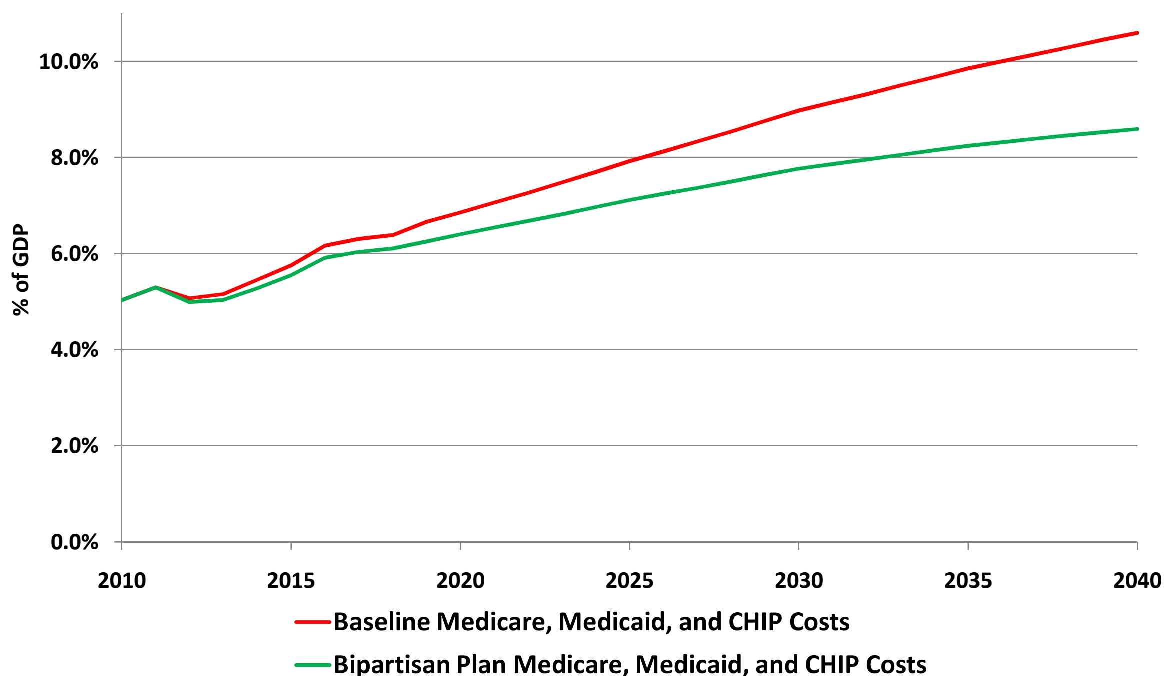
The key supply-side strategy is to reform provider payment incentives. Moving payment away from fee-for-service and toward broader payment units will incentivize providers to seek more efficient delivery systems. Health reform – i.e., the Patient Protection and Affordable Care Act (ACA) – took some very important steps toward reforming provider payments in Medicare. So, the near-term Task Force proposals are limited to a step not addressed in the ACA: bundling payments for post-acute care into the payment for inpatient care.

For Medicaid, in the short term, the Task Force proposes to remove barriers to greater use of managed care for those dually eligible for Medicare and Medicaid. For the long term, the Task Force explores the option of delinking the current federal matching payment system, and allocating Medicaid's responsibilities between the federal and state governments, thereby incentivizing each to seek efficiencies rather than shifting costs to the other.

In addition, the Task Force will reform the medical malpractice system and introduce a measure to reduce obesity-related health expenditures.

Much of the long-run cost containment in the plan will come from transitioning Medicare from fee-for-service to a premium support option. This change will have both demand and supply-side effects. Those who elect to stay in traditional Medicare will be more cost-conscious because they will be faced with an additional premium if the costs of traditional Medicare, per beneficiary, rise faster than a specific growth rate (GDP-plus-one percent), giving them a larger incentive to enroll in a plan offered on the Medicare Exchange. Competition among plans on the Medicare Exchange will incentivize plans to manage care-delivery efficiently and to offer the public evidence that their plans achieve quality outcomes at comparatively low cost.

The Bipartisan Plan's policies, described below, will "bend the curve" – significantly reducing the rate at which government health programs are growing.



Note: Under current policies, government health care spending for Medicare, Medicaid, and the Children's Health Insurance Program (CHIP) are projected to consume just over 5 percent of GDP in 2010, rising to 7 percent in 2020, 9 percent in 2030, and over 10 percent in 2040 – because health care costs are growing faster than the economy.[14]

[14] The Task Force baseline assumes a permanent fix to the sustainable growth rate (SGR) mechanism that currently requires unrealistic, automatic cuts in physician payments (which Congress has been annually delaying). The ten-year, $556 billion cost of the SGR fix is reflected in the Task Force debt projections. Specifically, the baseline assumes that the SGR mechanism is replaced with annual updates based on the Medicare economic index (MEI), with a hold-harmless provision for Part B premiums.

Incentivize Employers and Employees to Select More Cost-effective Health Plans by Capping and Phasing Out the Tax Exclusion for Employer-sponsored Health Insurance

***Description of Recommendation*:** Under current law, employer contributions to employee health benefits are not taxable to the employee – causing a revenue loss of about $250 billion per year. In addition, many employers have set up a mechanism through which employee contributions come from pre-tax income. This open-ended tax subsidy encourages overly comprehensive insurance with fewer provisions to contain health care costs. The effect of the subsidy is to make private health care more expensive, which increases spending in Medicare, Medicaid and other public programs as well. Effective in 2018, the Task Force proposal will cap contributions by employers and employees who are eligible for tax-favored treatment, and then reduce the cap each year by equal dollar amounts, so that by 2028, all contributions to employer-based health insurance will be taxed. This policy will replace the excise tax on high-premium health insurance plans (known as the "Cadillac tax") that is scheduled to take effect in 2018.

***Cumulative Budget Savings in Billions of Dollars from 2012 through*:**[15]

2020	2025	2030	2040
$113	$1,141	$3,299	$9,925

***Background*:** The current tax subsidy creates two large problems:

First, it encourages higher national health spending. The purchasing of health insurance with pre-tax income has promoted richer benefits and fewer restrictions on care. For example, why should a taxpayer making $100,000 per year choose a plan with a $1,000 deductible when the extra premium for a plan with a $100 deductible is subsidized at a rate of about 45 percent?[16] The tax subsidy probably also has discouraged the purchase of insurance plans with more-limited provider networks or greater degrees of health plan management. Private insurance products have little patient cost sharing and offer few incentives for patients to use more efficient providers. Combined with the existing "any-willing-provider" designs in Medicare and Medicaid, providers have few incentives to deliver care in an efficient way.

Second, the tax exclusion leads to very large losses in revenue. The losses in federal revenues from income taxes and payroll taxes in 2010 are $145 billion and $96 billion, respectively.[17]

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[15] While the Task Force believes that this policy will reduce federal health care spending, the scoring reflects only the increased revenues. Additionally, the numbers above do not take offsetting factors (e.g., the resulting increased Social Security benefits and increased exchange subsidies) into account, but total scoring of the Task Force plan reflects all of these effects.

[16] Taking into account federal and state income taxes and federal payroll taxes, tax-favored health insurance contributions for a couple in which each spouse earns $100,000 per year is subsidized at the rate of 44 percent.

[17] Lisa Clemens-Cope, Stephen Zuckerman, and Roberton Williams, *Changes to the Tax Exclusion of Employer-Sponsored Health Insurance Premiums: A Potential Source of Financing for Health Reform,* Urban Institute, Washington, DC, June 2009. http://www.urban.org/uploadedpdf/411916_tax_exclusion_insurance.pdf.

Additionally, states with income taxes that follow the federal practice lose revenue. With health insurance premiums growing more rapidly than the economy, future revenue losses will comprise an even larger percentage of aggregate revenue.

Moreover, the subsidy benefits high-income people more than low-income people for several reasons. First, high-earners are more likely than low-earners to have employer-based insurance. And second, high-income insurance holders also tend to have more generous policies and, therefore, higher premiums. Finally, higher marginal tax rates for those individuals lead to a much more valuable exclusion.

This issue was addressed to a limited extent in health reform. Rather than eliminate or limit the exclusion, the ACA instead imposed a 40 percent excise tax (called the "Cadillac tax") on insurers, beginning in 2018. This tax will apply to employer-sponsored plans in which employer contributions and pre-tax employee contributions exceed $10,200 for single coverage and $27,500 for family coverage. Insurers will have no choice but to pass this tax on in the form of higher premiums.

The Task Force proposal to cap and phase out the tax exclusion will replace the "Cadillac tax." Although the scheduled excise tax addresses the incentives for overly comprehensive employer-provided health insurance, its scope is quite limited.

Instead, the Task Force plan will initially cap the amounts of both employer contributions and employee contributions made through Section 125 accounts that employees can exclude from their gross income. The cap will be set at the 75th percentile of the distribution of tax-sheltered employer and employee contributions in 2018 – the same level as the ACA provision. This cap will then be reduced to zero over a 10-year period, with the cap lowered by equal dollar amounts each year. The capped and phased-out exclusion will apply to all types of health insurance, including dental and vision coverage (in contrast to the ACA which does not apply the excise tax to dental and vision coverage).

In recent years, some have proposed to end the exclusion and replace it with a refundable credit available to all taxpayers. The ACA, however, will expand health insurance coverage through Medicaid eligibility for those with incomes below 133 percent of the poverty line, and federal subsidies to purchase insurance on state-administered health care "exchanges" for people with incomes between 133 percent and 400 percent of the poverty line. These new provisions will adequately support many of the people whom the credit would have targeted.[18]

[18] In developing our estimates of the economic effects of phasing out the exclusion, the revenue gains associated with the policy are partially offset by increased exchange subsidy payments stemming from explicit estimates of the number of individuals, in both large and small businesses, who would find it more economical to obtain subsidized coverage through the exchanges, rather than continue in existing employer group health plans.

The proposal will not apply to collective bargaining agreements signed prior to the date of enactment. This plan also will disallow new contributions to Health Savings Accounts (HSA). HSAs were created in 2003 legislation to encourage people to choose insurance plans with large deductibles (often referred to as "consumer-directed health plans"). Balances in the accounts can be used for all health expenses that are eligible for the medical expense deduction. These include not only patient cost sharing for insured services, but also many services that are typically not covered by health insurance, such as over-the-counter medications and eyeglasses.

Phasing out the exclusion will accomplish the objectives of the HSA legislation – health insurance designs that maintain consumer incentives to use health care judiciously – rendering it unnecessary. Were HSAs to continue, they would preserve tax subsidies for excessive health spending, including many services that are too discretionary or not important enough to include in health insurance policies, even as the subsidies for health insurance itself are eliminated.

By removing the incentives for more expensive health insurance, the nature of the coverage obtained through employment will change substantially. Adjustments in this direction are already appearing, even with the tax subsidy intact. They include more patient cost sharing, increased management of imaging and, most recently, networks that exclude the least-efficient providers or require additional patient payments to use them. Unlike most of these limited developments today, changes that affect many more health insurance policies, such as altering the tax treatment of health insurance, will stimulate more innovative steps by providers of care to reduce their costs (thereby keeping down health insurance premiums). Public programs will benefit as well from the greater efficiency.

This proposal will increase federal income tax revenues substantially, especially from higher-income people. Those with the lowest incomes, who do not benefit from the exclusion, will not be affected. The Task Force plan also will increase payroll tax revenues and state income tax revenues. Indirectly, the phase-out of the exclusion – producing more taxable earnings – will lead to higher Social Security benefit payments in the future.

The revenue increase will come from a combination of taxes on health insurance contributions and taxes on increased cash compensation. The shift to lower-premium health insurance plans will be accompanied by a shift in compensation away from health benefits and toward other tax-favored benefits – such as retirement contributions – and cash compensation.

To the degree that this proposal streamlines the delivery of health care, federal spending on Medicare, Medicaid, military health care, and veterans' health care will also be reduced. Individuals covered by employer-based health programs and these government programs all use the same health care delivery system, so incentives for efficient treatment of large segments of patients will improve overall performance as well.

Impact on Employer-sponsored Insurance

In theory, market approaches could raise costs for lower-income people, but recent changes of law will prevent this outcome. For example, the ACA gives larger subsidies for insurance to those with lower incomes, and thus, the market approach in this plan primarily removes a tax subsidy that disproportionately advantages high-income people.

Ending the tax exclusion could reduce employment-based coverage. Before health reform, a declining role for employers would have raised concern; the alternative was the individual market, which has much higher administrative costs and no risk pool to protect those who are older or sicker. But, ACA has created health insurance exchanges, which are potentially more efficient markets for individual insurance. They regulate how much higher premiums can be for older people, and preclude charging higher rates for those who have health problems. If effectively administered, the exchanges will provide a viable – perhaps even superior – alternative to employer coverage.

Many see a shift from employer-based coverage to individual choice of plans on exchanges as a positive development. For many consumers, especially those in small and medium-sized firms, employer-based coverage limits the selection of plans that are available. Firms that are too small to offer choices must find "least-common-denominator" coverage – ***one*** plan that satisfies ***all*** of their employees. Having a single plan also inhibits innovative features that might have strong appeal to some employees – such as selective networks of coordinated, efficient doctors and hospitals that charge less, and thereby pass the savings on to patients who are willing to choose from a shorter list of providers.

Even with the phase-out of the employer-sponsored insurance exclusion, employers may continue to offer health insurance benefits. Employers, at least large ones, can bring significant skills and experience to the complex task of purchasing health insurance. These employers also possess purchasing power that can help attain better prices. Large corporate purchasers, in particular, might encourage innovation in insurance products. If these advantages prove important, larger employers will continue to provide coverage even without the tax exclusion.

Smaller employers, on the other hand, have been much less successful in covering their employees – even with the tax exclusion – simply because of their less-attractive risk pools and lack of administrative economies of scale. These businesses will be less likely to continue to provide coverage.

Control Medicare Costs in the Short Term

Scoring Note: The following four reforms will generate near-term Medicare savings beginning in FY 2012 and will remain in place permanently. However, for scoring purposes, beginning in FY 2018, all of the Medicare savings in the Task Force plan are attributable to the "premium support option" described later in this section. Scoring explanation: Beginning in 2018, the premium support option will hold Medicare growth per beneficiary to GDP-plus-one percent (compared to the baseline of GDP-plus-1.7 percent). The four Medicare near-term reforms yield savings less than the premium support savings, and therefore do not score as independent savings after the premium support option is in place.

1. Gradually Raise Medicare Part B Premiums from 25 Percent to 35 Percent of Program Costs over Five Years

***Description of Recommendation*:** Premiums for Medicare Part B, which cover physician services, hospital outpatient services and services provided in other outpatient settings, are set at 25 percent of costs. This proposal will raise the premiums to cover 35 percent of Part B costs, phased in over a five-year period. Protections for low-income beneficiaries – including payment of the premiums by Medicaid programs for those eligible and preventing dollar-amount premium increases that are greater than an individual's annual increase in Social Security benefits – will remain intact.

***Cumulative Budget Savings from 2012 through 2018*: $123 billion**

***Background*:** When Congress created Medicare, Part B premiums were set at 50 percent of the cost of program benefits. In 1972, responding to higher-than-expected increases in the costs of Part B benefits, Congress limited annual percentage increases in premiums to the cost-of-living adjustment for Social Security benefits. Over time, the percentage of Part B costs covered by premiums fell to less than 25 percent. In 1997, after a series of short-term changes that kept the percentage at or above 25 percent, Congress set the percentage at 25 percent. Starting in 2007, higher-income beneficiaries have paid premiums that covered 35, 50, 65, or 80 percent of the costs of the program depending upon income, but only 3.4 percent of all beneficiaries pay these higher premiums.

This proposal will raise the Part B premium from 25 percent to 35 percent – rising by 2 percentage points per year over five years – for those not already subject to the higher rates. With the nation's ominous fiscal outlook and the large number of baby boomers soon to become eligible for Medicare, the current rate of subsidy is no longer sustainable. Higher-income beneficiaries will continue paying premiums ranging from 35 percent to 80 percent of program costs.

2. Use Medicare's Buying Power to Increase Rebates from Pharmaceutical Companies

Description of Recommendation: The ACA increased required rebates in Medicaid for single-source drugs from 15.1 percent to 23.1 percent. In Medicare Part D, having private health plans negotiate rebates is less effective, with the rebate for 2006 averaging only 8.1 percent. This proposal will apply the Medicaid approach to Medicare Part D, effectively increasing the rate of rebates by 15 percentage points.

***Cumulative Budget Savings from 2012 through 2018*: $100 billion**

Background: Under Medicare's Part D program that covers prescription drugs, shopping for the best prices on single-source drugs has been delegated to the private insurers that provide the drug coverage. Each insurer negotiates rebates with manufacturers (often through pharmacy benefit managers or PBMs) based on its ability, through tiered benefit designs, to shift volume to those manufacturers that offer the largest rebates. Part D's first year of operation – 2006 – produced rebates that averaged 8.1 percent for drugs not available as generics. The federal government can more effectively use its potential purchasing power by requiring a minimum rebate for all single-source drugs, and thereby achieve substantial budget savings.

3. Modernize Medicare's Benefits Package, Including the Copayment Structure

Description of Recommendation: Medicare's benefit structure, specified in legislation, has changed little since the program was implemented in 1966. In many areas, it has become obsolete. For example, prescription drug coverage was widely adopted by private insurance companies during the 1970s, but was not included in Medicare until 2006, when a separate program (Part D) was implemented. Medicare also has not reflected trends in private insurance, such as protection against the costs of catastrophic illness and increased patient cost sharing. Patient cost sharing in Medicare is uneven, with very high deductibles for inpatient care and no cost sharing at all for home health and laboratory services. Bringing the benefit structure up to date can reduce outlays while improving some dimensions, such as providing catastrophic protection and reducing the very high deductible for hospitalizations.

***Cumulative Budget Savings from 2012 through 2018*: $14 billion**

Background: Some features of Medicare's benefit structure reflect the best thinking of 50 years ago and have not been updated since. For example, a large hospital deductible is assessed for each spell of illness and a separate deductible applies to Part B services. Home health and laboratory services have no deductible. This proposal will create a modern benefit structure for Medicare that is calibrated in a way that reduces spending overall. The modernized benefit structure will include a combined annual deductible of approximately $560 in 2011. Once the deductible is met, a coinsurance rate of 20 percent will apply to all services, up to an annual out-of-pocket maximum

of $5,250. The deductible and out-of-pocket maximum will be indexed to increases in spending per beneficiary.

To avoid having the modernized benefit structure become outdated, the Independent Payment Advisory Board (IPAB), which ACA created to contain Medicare spending, will review the benefit structure every two years and recommend changes to parallel developments in the private insurance market. These recommendations will become law unless Congress acts to block them. If private insurance continues to increase patient cost sharing and IPAB reflects this in its recommendations for Medicare, then savings from the proposal would be greater than what is reflected in the scoring.

This plan will provide more protection from the high costs of medical care associated with serious illness, while at the same time supplying beneficiaries with incentives to use medical care more judiciously. Individuals with multiple hospitalizations during a year will be better off, although those using other services may pay more for their care. The change might reduce beneficiaries' interest in purchasing private supplemental insurance (Medigap), because they will – for the first time – have catastrophic protection through Medicare and premiums for Medigap will increase. Because Medigap coverage increases Medicare spending, less Medigap usage could further increase savings from this proposal (although these potential savings are not reflected in the scoring). The changed benefit structure will not impact the approximately 18 percent of beneficiaries with the lowest incomes, because Medicaid covers their Medicare cost sharing.

4. Bundle Medicare's Payments for Post-acute Care to Reduce Costs

***Description of Recommendation*:** Medicare's inpatient prospective payment system provides an undesirable incentive to hospitals to shorten lengths of stay and discharge patients to skilled nursing facilities or rehabilitation facilities. This motivation can be corrected by broadening the applicability of the inpatient Diagnosis Related Group (DRG) payment to post-acute services. A larger DRG payment will go to the hospital providing acute care, which will also be responsible for the costs of post-acute services. The new bundled payment rates will be budget neutral, with a plan to capture 80 percent of the efficiencies gained from the broader payment unit for the program and allow hospitals to retain 20 percent.

***Cumulative Budget Savings from 2012 through 2018*: $5 billion**

***Background*:** In general, broader units of payment can encourage providers to take into account the costs incurred by others in treating a patient, and therefore motivate coordinated care. The ACA takes a number of steps toward broader units of payment for Medicare, but more can be done. These savings opportunities might be particularly large for post-acute care, because payment limitations for inpatient care on a per admission basis likely already induce hospitals to discharge patients to post-acute facilities as early as possible, even if overall costs are inflated as a

result. The payment bundles can be broadened to include post-acute care by raising payments to DRGs based on historical experience of use of post-acute care, and then requiring hospitals to cover payment for these services. Broadening the bundle will likely increase efficiency, partly by engaging hospitals as potentially sophisticated purchasers of post-acute care. These efficiency gains can be captured by the program through monitoring changes in the use of post-acute services and adjusting DRG payment rates to reflect the changing experience. Hospitals can either develop contractual relationships with select post-acute facilities or provide the services themselves in facilities that the hospitals purchase or create.

Strengthen Medicare for the Long Term: Transition to a Premium Support Option

***Description of Recommendation*:** Currently, Medicare is a fee-for-service system that pays for a set of benefits specified in legislation, including hospital services, physician services, home health services and certain other categories. Provider payment rates are set by the government, and patients are subject to some cost sharing, such as deductibles. In a fee-for-service system, neither patient nor provider has much incentive to hold down costs or provide services in the most efficient way. This proposal will transition Medicare to a premium support program, and will control the growth of the total cost of the program. Starting in 2018, federal support per Medicare enrollee will be limited to the 2017 level and will be allowed to grow no faster than a five-year moving average of GDP growth plus one percentage point.

Like today, Medicare enrollees will be in the traditional fee-for-service program unless they choose a private plan. However, if federal spending per enrollee for the benefits specified in legislation rises faster than GDP growth plus one percent, beneficiaries will have to pay an additional premium to cover the difference. They can avoid that additional premium, however, and potentially get higher quality health care, if they choose a private health plan offered on a new Medicare Exchange. The expectation is that increased competition among plans fostered by the Medicare Exchange, and increased beneficiary interest in these plans, will keep costs from rising rapidly and result in higher quality, more cost-effective health care.

***Cumulative Budget Savings in Billions of Dollars from 2012 through*:**

2020	**2025**	**2030**	**2040**
$172	$858	$2,089	$7,147

***Background*:** Like all health care spending, the per-enrollee cost of benefits in Medicare has risen faster than per-capita GDP – on average, 1.7 percentage points faster per year from 1985 to 2008. With federal revenues growing at roughly the rate of increase in GDP, outlays for Medicare are growing sharply as a percentage of the federal budget.

This proposal will limit growth in federal support for Medicare per beneficiary[19] to one percentage point per year higher than a five-year moving average of GDP growth. If Medicare spending per enrollee for the benefits specified in legislation rises at a faster rate, enrollees will have the option of paying an additional premium to cover the difference and remaining in the traditional Medicare program, or selecting a private insurance plan from the Medicare Exchange.

While the proposed premium support option resembles the current structure of Medicare Advantage, there are differences. Competition among plans will be enhanced by creating a federal Medicare Exchange, which will facilitate beneficiary choice and enrollment and increase the competitiveness of the market, leading to lower premiums.

[19] After adjustment for changes in the size of the beneficiary population.

Premium support will be set at the same initial level – and grow at the same rate – both for individuals entering the Exchange and for those who remain in traditional Medicare. Individuals whose Part B and Part D premiums are paid by Medicaid programs will not be affected. Budget savings come from the difference between projected trends in Medicare spending per enrollee under current law (averaging GDP plus 1.7 percent) and GDP growth plus 1 percentage point per year under this proposal. To promote stability, the proposal calls for employing a five-year historical trend of per-capita GDP rather than the change over a single year.

This proposal will provide incentives for Medicare Exchange plans to develop products that will save beneficiaries money. Today, if a Medicare Advantage plan has very low costs, it cannot pay a rebate to enrollees; instead, it must increase benefits. Under this proposal, Medicare Exchange plans can offer beneficiaries relief from rising Medicare premiums. The Task Force plan might also increase political support – by Medicare beneficiaries, their children, and those approaching Medicare eligibility – for federal policies that promote cost containment in health care.

Asking beneficiaries to pay more for their Medicare coverage (or shift to a lower-cost plan) mirrors what has happened in private insurance over the past decade, with increases in patient cost sharing to keep premium growth from exceeding income growth by too large a margin. Employers have generally opted to increase patient cost sharing rather than increase the percentage of the premium that employees contribute. The former keeps employees enrolled in the plan and encourages more judicious use of health services.

Impact of the Proposal

Similar to any proposal that increases what individuals have to pay for Medicare, higher costs may be challenging for those with lower incomes, although individuals with the lowest incomes will not be affected because Medicaid programs pay their premiums. Additionally, beneficiaries will be able to mitigate that burden by choosing from an array of plans on the Medicare Exchange, which generally will offer an economically attractive package, but often involve some reduction in provider choice to steer consumers to the most efficient providers. The Medicare Exchange, by making the market more competitive than the current market for Medicare Advantage plans, will increase the attractiveness of private plans to beneficiaries.

The long-term impacts will depend on whether the trend of Medicare spending slows appreciably. If the Task Force's short-run health proposals, along with other reforms embodied in recent legislation, help to slow health care costs as anticipated, then reductions in support from this proposal will not have a significant impact. For example, if capping and phasing out the tax exclusion for employer-sponsored insurance curbs the growth of health care costs, Medicare spending could slow enough that additional premiums are not triggered.

Control Medicaid Costs in the Short Term: Eliminate Barriers to Enrollment for Medicare/Medicaid Dual Eligibles in Managed Care Options

Description of Recommendation**:** Under current law, states have made substantial progress in enrolling mothers and children in managed care programs, which typically expand treatment options available to low-income families while moderating the growth in benefit costs. Among the Medicare/Medicaid dual-eligible population, however, managed care enrollment has been limited: in 2008, only 12.6 percent of dual eligibles were enrolled in comprehensive managed care plans. While some of the constraints on managed care enrollment for this population flow from the characteristics of the population and the inadequate availability of appropriate programming, many states seeking to establish or expand managed care programs for duals have encountered barriers to doing so. This proposal will create a pathway around those barriers for states seeking to implement such measures by providing a fast-track channel for waiver applications, and eliminating barriers created by the present upper payment limit rules on provider reimbursement.

Cumulative Budget Savings from 2012 through 2018**:**[20] **$5 billion**

Background**:** Since the early 1990s, states have effectively used managed care benefit designs to improve the access of Medicaid beneficiaries to medical care, while helping the states to control costs.

Before the expansion of managed care options, Medicaid beneficiaries could choose among only a small group of physicians, due to the typically low payment rates that state Medicaid programs offered providers. Before Medicaid managed care, many physicians refused to accept Medicaid patients, while underserved areas with high concentrations of Medicaid patients had difficulty attracting providers. The combined effect of these access barriers forced beneficiaries to seek care in institutional settings – often on an emergency basis. Therefore, many beneficiaries received care that was both inefficient and medically inappropriate.

Enrolling beneficiaries in managed care options – including commercial health maintenance organizations (HMOs) – gave Medicaid beneficiaries a route around these access barriers. The networks offered by managed care plans typically paid physicians rates that were more comparable to commercial market rates, relying on the ability to manage health care utilization – rather than provider rate restraints – to control costs. The managed care model, centered on assigning each beneficiary to a primary care physician as his or her care manager, offered Medicaid beneficiaries a "medical home" in which they could seek care before problems became emergencies. Other managed care program features, such as 24x7 nurse hotlines, gave beneficiaries viable alternatives to emergency room visits. Policy analysts broadly agree that managed care has led to substantial improvements in physician access for many Medicaid patients.

[20] The Task Force does not score any savings from this proposal past 2018 (when the Medicaid program is decoupled) because it is not known whether the states or federal government will take responsibility for the aged SSI population.

States also found managed care contracting more cost-efficient than unmanaged fee-for-service. Many states offered contracts at discounts to Medicaid fee-for-service rates; other states used multi-year contracting to constrain the growth of benefit spending over time. Most evaluations of Medicaid managed care waiver programs during the initial rollout in the 1990s showed success in controlling costs.[21]

Consequently, managed care options for low-income mothers and children spread rapidly across states, and commonly expanded within states to reach an ever-larger share of that population. As of June 2008, 71 percent of Medicaid beneficiaries – some 33.4 million Americans – received at least some services through managed models.[22] Of these, 65 percent were in full-risk plans.[23]

Expansion of managed care options for other subsets of the Medicaid population, however, has been much less rapid. While many states have innovative programs for blind and disabled individuals (who are eligible for Medicaid through enrollment in the Supplemental Security Income (SSI) program), aggregate enrollment of this population in full-risk plans is not significant. Among the aged dual-eligible population, roughly one-third receives some kind of services via managed care models, but only 12.6 percent are enrolled in full-risk plans.

Across states, enrollment of dual eligibles in full-risk managed care models varies substantially. As of June 2008, 23 states had no dual eligibles enrolled in full-risk plans. Even within the other 27 states, only 16.7 percent of the dual population was enrolled in full-risk plans.

The Task Force proposal will provide a route around many of the barriers for states that are motivated to expand the use of managed care plans. The proposal calls for a new pathway for presumptive approval of program designs that meet basic criteria for enrolling dual eligibles in risk contracts.[24] Armed with a clear picture of what the federal government will or will not approve, state policymakers can work within those known constraints to fashion a program that most closely accommodates state-level interests.

The proposal will also modify the rules determining the upper payment limit (UPL) – the rules on aggregate reimbursements to different classes of providers – to encourage institutional providers to enroll dual eligibles in risk contract arrangements. This feature of the policy will not add to Medicaid program costs because, in the absence of such a policy, there would be no change in the

[21] Menges, J. et al., *Medicaid Managed Care Cost Savings – a Synthesis of 24 Studies* (Falls Church, VA: The Lewin Group) July 2004, updated March 2009.
[22] Kaiser Commission on Medicaid & The Uninsured, *Medicaid & Managed Care: Key Data, Trends & Issues*. (Palo Alto: Kaiser Family Foundation), February 2010.
[23] In this presentation, the term "full-risk plans" includes plans in states that carve out some benefits (e.g., outpatient prescription drugs) from the benefits package.
[24] To implement such a policy, Congress could add a new paragraph to §1915(b), creating such a pathway in statute. The Secretary could also use the existing authority under §115 to establish such a pathway via regulation.

total amount of match enhancement states achieve under so-called UPL programs. The policy will, however, permit more states to expand the role of managed care contracting for delivering Medicaid benefits to dual eligibles.

The Task Force has assessed the fiscal impact of this proposal conservatively. Our estimates assume that the proposal will not affect dual enrollments in managed care in those states that already have increased dual enrollments beyond the managed care participation rate of their total population. As a proxy for the outcome of decision-making by other states after the creation of this new avenue, we assume that by 2015, managed care enrollment by dual eligibles will rise, on average, to the level of managed care enrollment in the general population.[25] Our estimates assume that managed care enrollment will rise to slightly over 43 percent of the dual eligible population.

For the 30.5 percent of the dual population that will be newly enrolled in managed care, we assume that Medicaid spending will not change in the year of first enrollment, but that per capita spending growth thereafter for that cohort will grow one percentage point slower than that for the balance of the dual eligible population. The savings estimates presented show the compound effect of this differential growth rate over time. As stated earlier, we do not expect the proposal to increase the managed care enrollment rate of the rest of the SSI population.

[25] Our estimates take this value as an average; we expect some states to achieve greater or lesser managed-care enrollment for duals than the general population.

Control Medicaid Costs in the Long Term:
Incentivize Government to Control Medicaid Growth

***Description of Recommendation*:** Under the Medicaid program, the federal government makes matching payments that fund most costs states incur in providing covered services to eligible individuals. This arrangement has become increasingly strained over the years. The federal government routinely lowers the cost of new health policy initiatives by requiring states to furnish them through Medicaid. States, partly in response to what they view as unfunded program mandates, have devised complex financing arrangements with providers that permit the drawdown of additional federal funds, thereby effectively enhancing the matching rate applicable to the program. Because incentives on both sides of the arrangement have motivated cost-increasing policies, this relationship has become increasingly dysfunctional.

The Task Force's goal is to reduce excess cost growth in the Medicaid program (i.e., the amount by which growth in Medicaid costs exceeds the growth of GDP) by one percentage point per year. There are multiple approaches to achieving this goal, one of which is described here. This option would break the Medicaid financial link between the federal government and the states in a budget-neutral manner. A process would be set in motion to determine the optimal allocation of program responsibilities between the two parties, at the conclusion of which the federal government and the states would divide up responsibility for fully financing different components of the Medicaid program. Making each party fully responsible for the future growth of the components under its direct control will restore incentives for cost containment, and slow the future growth of program spending.

***Cumulative Budget Savings in Billions of Dollars from 2012 through*:**

2020	2025	2030	2040
$20	$202	$655	$2,983

***Background*:** When Congress enacted the Medicaid program in 1965, the incentives of the federal and state parties administering the program were fairly closely aligned. States could determine their own eligibility levels and benefits, the costs of which the federal government shared based on a matching formula that took income variations across states into account. Payments to providers were made under standard national payment methodologies established for Medicare, meaning that the federal government had substantial control over the way payments were made. For the first 20 years of the program, federal and state cost growth, while significant, occurred in tandem.

Starting in the 1980s, federal and state perspectives on Medicaid began to diverge. As part of the major budget legislation of the early 1980s, states obtained the authority to devise their own reimbursement policies, subject to general "upper payment limits" on aggregate reimbursements to different classes of providers. Over the next 10 years, state payment methodologies for all types of providers began to differ substantially from emerging Medicare reimbursement policies.

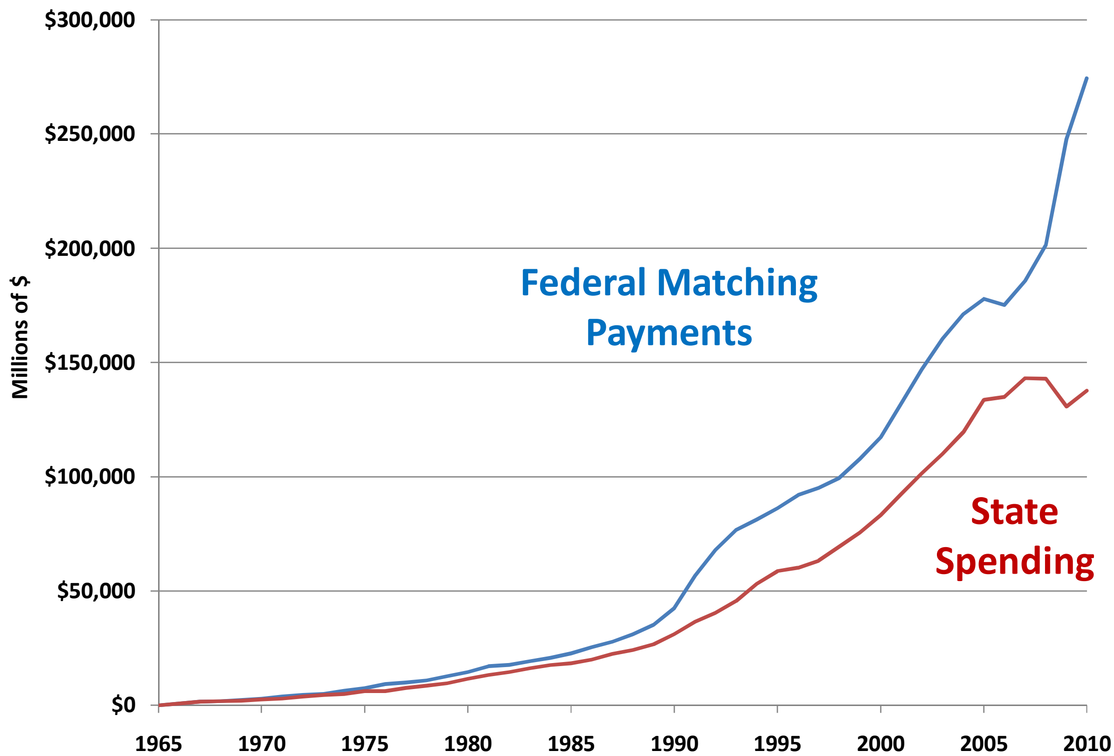
Throughout the history of Medicaid, Congress has added new eligibility categories, often employing the program as the "insurer of first resort" for beneficiaries with special needs (e.g., developmentally disabled children). In the late 1980s, federally directed eligibility expansions became more wholesale, requiring states to ratchet up their income eligibility standards for women and children to ever-higher percentages of the federal poverty income level. These requirements produced particularly large eligibility expansions in the southern states, because many had previously constrained Medicaid eligibility standards at low levels relative to the federal poverty line.

States responded to the federal directive to expand eligibility in two ways:

First, they sought every possible opportunity to amend the financing structure of state- and locally-funded health care programs to cover additional services under Medicaid, and hence receive federal matching payments for these services. While certain services, such as state mental institutions, were barred from coverage by law, states became highly creative in obtaining Medicaid coverage for health services – such as visits to the school nurse by low-income children – that were previously fully funded with state and local resources. This search for federal dollars, referred to as "Medicaidization," brought dozens of new provider types and service categories under Medicaid.

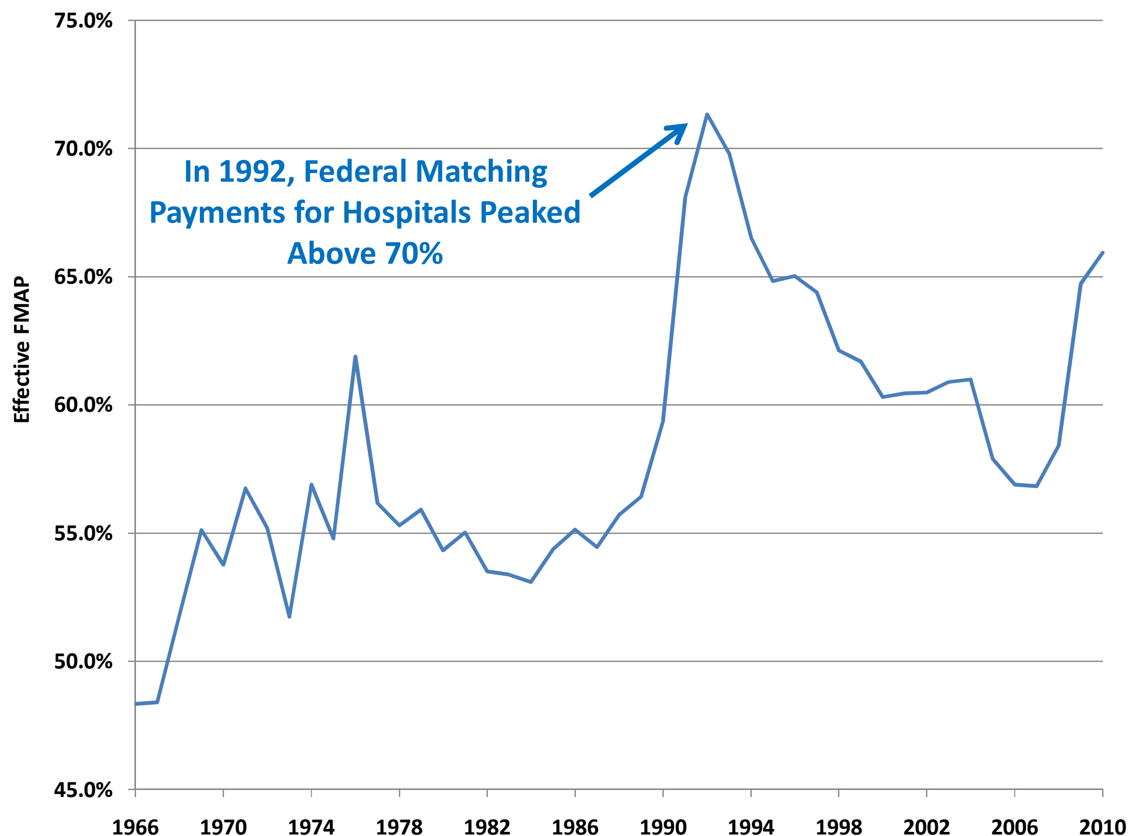
Second, states invented creative financing schemes that, in effect, increased the federal matching rate for Medicaid. By way of illustration, providers (e.g., hospitals) were asked to contribute to state matching payments under Medicaid. States then increased reimbursement rates for providers who contributed to offset (or more than offset) the amount transferred – with much of the funding for these increased reimbursement rates coming from the federal government. Under these arrangements, donor hospitals were better off, and the states achieved a substantial amount of fiscal relief – at the price of increasing federal matching payments. By the late 1980s, virtually every state had some form of "match enhancement" program, under which the states collectively made tens of billions of dollars of supplemental payments to providers, particularly hospitals, to enhance their effective matching rates. The graph below shows the effect of these changes in payment policy.

Growth in Federal and State Spending on Medicaid, 1966-2009



After the mid-1980s, federal and state expenditures on Medicaid – which had grown in tandem from 1966 to about 1985 – began to diverge. The growth in federal payments became greater and the growth in state payments became lower than the overall growth in Medicaid program costs. As shown in the graph below, a large share of this divergence came from "match enhancement." By the early 1990s, the effective matching rate for hospital services exceeded 70 percent far more than the national average matching rate of 56 percent that had prevailed throughout the first 25 years of the program.

Federal Medicaid Matching Payments to States, 1966-2010



Alarmed by this cost growth, Congress in 1992 outlawed the "voluntary donations" and "provider-specific taxes" that states were using to operate these financing schemes, and capped the amount of disproportionate share hospital (DSH) payments that states used to circumvent the upper payment limits. States responded by restructuring their programs around public providers (e.g., state- and locally-owned hospitals) to finance match enhancement payments via inter- and intra-governmental transfers of funds, which Congress could not constitutionally limit. Over the ensuing decade, Congress tightened the limits further on upper payment limit programs – the mechanisms that states invented to enhance the federal match via payments to public providers.

Still, a shoving match between the two parties continues. In 2010, when the federal government elected to increase the amount of rebates paid by pharmaceutical manufacturers under Medicaid, Congress elected to make the new incremental rebate payments 100 percent federal. In exchange, the first few years of a major Medicaid expansion are financed with a 100 percent federal match, but states will be required to contribute to the cost of this new benefit mandate beginning in 2017.

As history makes clear, the federal and state governments are working at cross purposes in Medicaid. Both parties understand that their short-term advantage is to obligate the other party to

increase payments under the program. In the medium-and longer-term, however, the growth in Medicaid costs is pushing state governments to the brink of insolvency, while federal Medicaid payments represent the fastest-growing component of the unsustainable growth in health care entitlement costs. As long as the present matching relationship continues, there will be incentives for Medicaid costs to grow faster than if either party were fully responsible for managing program costs.

The Task Force proposal reduces excess cost growth in the Medicaid program (i.e., the amount by which growth in Medicaid costs exceeds the growth of GDP) by 1 percent per year.

One option that could achieve this cost control would set up a process to allocate current Medicaid responsibilities between the federal government and the states – in a budget-neutral manner. By 2019, the federal government would finance 100 percent of the future cost of a set of programs whose cost is, at that point, equal to what the federal government would have spent under the matching relationship. Similarly, the states would assume 100 percent of the future cost of the remaining program base, at an initial cost that is equal to what they would have spent under the current matching arrangement. Because the per-capita cost of Medicaid varies across states, the state payments in the early years would have to be equalized to ensure that every state has an adequate initial fiscal base to run the nationally uniform set of programs that the states would be required to assume. Over time, states could obtain fiscal relief by effective management of these programs – and from the elimination of the federal threat to encumber state resources further through new Medicaid mandates. They could not, however, back away from the obligation to provide the allocated services at an adequate level.

There are multiple ways in which responsibilities could be allocated between the federal government and the states: The split could assign entire population groups to one level of government or another, or allocate based on the type of benefit (e.g., long-term care versus acute-care services), or based on provider types (e.g., responsibility for payments to non-medical providers). The process also should permit federal and state negotiators to go beyond Medicaid and assign other programs for low-income populations that make sense in light of the policy logic informing the allocation.

The allocation itself should be based on formal negotiations between federal officers and a set of state officers chosen to represent state interests nationwide. Creating an effective allocation and devising a legal framework to implement it would take three or four years. Congress should consider the implementing legislation under "fast track" authority. If the negotiating body fails to devise implementing legislation by a time certain, the Secretary of Health and Human Services would have the authority to submit implementing legislation, under a comparable fast-track process. This proposal assumes that the first full year of implementation would be in 2019.

Delinking Medicaid financing from the matching relationship should permit the federal government to slow future cost growth by one percentage point per year. This is not an overly

ambitious target; over the 1985-2009 period, an equivalent goal could have been achieved simply by lowering the Medicaid annual growth rate (7.83 percent) halfway toward that of the federally administered Medicare program (5.65 percent).

This proposal is offered only as an illustration of one way to contain the future growth of Medicaid. One concern is the possibility that some states might give inadequate support to the programs allocated to them, so maintenance of effort requirements might be warranted. Other approaches are possible and should be explored.

Additional Health Care Reforms

1. Require States to Cap Awards for Noneconomic and Punitive Damages for Medical Malpractice

***Description of Recommendation*:** States will receive substantial incentives to reform their tort laws governing medical malpractice so that caps are applied to noneconomic and punitive damages. Savings will come from lower liability premiums for physicians and hospitals and a reduction in defensive medicine. The federal government will provide substantial grants to states to fund the development and testing of major reforms in the medical liability system, such as safe harbors for practicing in accordance with accepted practice guidelines, specialized medical liability courts, enterprise liability, and special administrative procedures for handling most medical malpractice claims.

***Cumulative Budget Savings in Billions of Dollars from 2012 through*:**

2020	2025	2030	2040
$48	$81	$130	$299

***Background*:** The current tort system to adjudicate injuries to patients from medical malpractice does an insufficient job of deterring poor care and compensating patients who have been injured by it. Less than two-thirds of malpractice insurance premiums actually go to injured patients, with the rest going toward administration. This split inflates premiums for physicians, an effect that is then passed through in charges to patients, and limits the compensation paid to injured patients. Another cost is defensive medicine – physicians' use of unnecessary services to reduce the probability of being sued. According to recent research, physicians perceive the probability of a lawsuit as much higher than it actually is, but these fears likely lead to both defensive medicine and reluctance to take steps to control costs. Some states have successfully kept malpractice premiums low by capping awards for noneconomic and punitive damages. Research has shown a modest reduction in defensive medicine from these caps.

The Task Force proposal provides a strong financial incentive to states, such as avoiding a cut in their Medicaid matching rate, to enact caps on noneconomic and punitive damages. However, the proposal does not address some of the root problems of the medical malpractice system, and therefore the Task Force proposes that this policy be accompanied by a substantial federal effort to pilot more systemic reforms by states. For example, one promising reform appears to be creating a safe harbor for physician actions that conform to broadly accepted practice guidelines.[26] Others include specialized medical liability courts, enterprise liability, and use of administrative procedures to resolve claims for medical malpractice. Because these approaches must be piloted

[26] See Michele Mello and Allen Kachalia, *Evaluations of Options for Medical Malpractice System Reform*. Medicare Payment Advisory Commission, Contractor Report No. 10-2, April 2010.

prior to broad implementation, the savings estimate above does not include potential reductions in spending from these broader reforms.

2. Introduce an Excise Tax on the Manufacture and Importation of Beverages Sweetened with Sugar or High-fructose Corn Syrup (Non-diet Soft Drinks, Sweetened Fruit Drinks, etc.) to Reduce Obesity-related Health Care Costs[27]

***Description of Recommendation*:** Over the past several decades, the percentage of Americans who are overweight or obese has increased dramatically. This increase has serious implications, not only for the general welfare and productivity of the population, but also for federal spending on health care. In addition, per-person spending on obesity-related diseases has risen faster than the overall rate of health care spending.

To help reduce health costs that are associated with growing obesity in America, this proposal will impose an excise tax in 2012 of 1 cent per ounce, indexed to inflation after 2018, on the manufacture and importation of beverages sweetened with sugar, high-fructose corn syrup, or similar sweeteners. The tax will not apply to artificially sweetened soft drinks – for example, those sweetened with aspartame or saccharine. Sugar-sweetened fountain-drink syrup will be taxed at a higher rate per ounce, such that the rate per ounce of fountain drink will be roughly equivalent to the tax rate on ready-to-drink soft drinks.[28]

While sweetened beverages are not solely responsible for the increasing numbers of overweight and obese people, medical research has found that these drinks are a contributing factor, and that soft-drink consumption may also be directly associated with diabetes. Research on the effects of existing state excise taxes on manufacturers of soft drinks indicates that a federal tax of the size proposed in this option will have a small but quantifiable effect on the national average body mass index (BMI, a standard measure of obesity).[29] By helping to reduce BMI and health problems associated with obesity – such as heart disease, diabetes, strokes, and cancer – this policy should reduce federal spending on health care, although the magnitude of this effect is difficult to project. The budget effects shown below reflect only the direct revenue impact of the excise tax.

***Cumulative Revenue in Billions of Dollars from 2012 through*:**

2020	2025	2030	2040
$156	$260	$375	$644

[27] See Congressional Budget Office, *Budget Options, Volume I: Health Care* (December 2008), 192, http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf.
[28] "Fountain-drink syrup" refers to concentrated, flavored syrup that is sold in bulk to establishments such as restaurants and then is mixed with water at the point of purchase.
[29] Congressional Budget Office, *Budget Options, Volume I: Health Care*, 192.

Background: The increasing number of overweight and obese individuals has serious implications for federal spending on health care. Overweight and obese individuals are at greater than average risk of developing serious illnesses, including coronary heart disease, diabetes, and hypertension. Being overweight can also aggravate chronic conditions and create complications with other less serious diseases. A number of researchers, as well as a recent Congressional Budget Office report, have estimated that average spending on health care for obese individuals is nearly 40 percent higher than spending on health care for individuals at a normal weight.[30] In addition, spending by overweight and obese individuals on health care grew roughly 1.7 times faster than spending by those at a normal weight since 1987.

Since 1987, the number of obese adults in America has more than doubled, rising from 13 percent of the population in 1987 to 28 percent in 2007. During the same time period, the share of adults who were either overweight or obese rose from 44 percent to 63 percent. Currently, 67 percent of adult Americans are considered overweight and 33 percent are considered obese. If these trends in obesity persist, some research suggests that 86 percent of American adults will be overweight or obese by 2030.[31]

These fundamental changes reflect not only demographic factors, such as the aging of the population – which can lead to generally higher numbers of the overweight and obese due to natural lifestyle and physiological changes – but also a significant rise in the average daily caloric intake of Americans. From 1970 to 2000, the median age in the country rose from 28.1 years to 35.3 years and the percentage of Americans over 65 rose from 9.9 percent to 12.4 percent.[32] The Centers for Disease Control reports that, over the same period, Americans increased their daily caloric intake from an average of 1,996 calories in 1971 to 2,248 calories in 2000 – nearly a 13 percent increase. Some of this increase comes from greater snacking and the consumption of higher-calorie food options, but Americans as a whole are shifting a greater proportion of their daily calorie intake into sweetened beverages. From 1997 to 2002 alone, the percentage of total caloric intake from beverages rose from 14 percent to 21 percent.[33] Over the past three decades, children have increased their consumption of sweetened fruit juices and non-diet soda from about eight ounces per day in 1977 to roughly 16 ounces by 2006. During the same period, adults increased their consumption of sweetened juices and non-diet sodas from five ounces in 1977 to 13 ounces in 2006.[34]

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[30] Noelia Duchovny and Colin Baker, "How Does Obesity in Adults Affect Spending on Health Care?" *CBO Economic and Budget Issue Brief* (Congressional Budget Office, September 2010): 5, http://www.cbo.gov/ftpdocs/118xx/doc11810/09-08-Obesity_brief.pdf.

[31] See Travis Smith, et. al. "Taxing Caloric Sweetened Beverages: Potential Effects on Beverage Consumption, Calorie Intake and Obesity," (U.S. Department of Agriculture, Economic Research Service), Report Number 100, (July 2010), for a summary of the literature.

[32] Frank Hobbs and Nicole Stoops, "Demographic Trends in the 20th Century," *Census 2000 Special Reports* (U.S. Department of Commerce, U.S. Census Bureau, November 2002): 57, http://www.census.gov/prod/2002pubs/censr-4.pdf.

[33] Smith, et. al. "Taxing Caloric Sweetened Beverages: Potential Effects on Beverage Consumption, Calorie Intake and Obesity," 4.

[34] Ibid, 5.

Many have suggested taxing sweetened beverages in order to discourage their consumption and help ameliorate some of the higher medical costs associated with obesity. The U.S. Department of Agriculture estimated that a 20 percent price increase in the cost of these beverages, resulting from an excise tax, could cause an average reduction of 37 calories per day, or 3.8 pounds of body weight over a year for adults. The cost increase was also projected to result in an average reduction of 43 calories per day, or 4.5 pounds over a year, for children. These decreases in calorie intake, the Agriculture Department said, will lead to a reduction in adult overweight prevalence from 66.9 to 62.4 percent, as well as a reduction in obesity from 33.4 percent to 30.4 percent. These figures reflect strictly the effect of reduced consumption resulting from the tax.

While obesity is certainly only one of many contributors to elevated national health costs, the Task Force believes that this price increase for sweetened beverages is a step in the right direction toward addressing this factor.

Strengthen Social Security

Introduction

Social Security has served as a foundation for retirement for hundreds of millions of American workers ever since its creation in 1935. By any reasonable standard, it has been the most successful antipoverty program in the nation's history. Upon signing the measure into law, President Franklin Roosevelt said:

> We can never insure one hundred percent of the population against one hundred percent of the hazards and vicissitudes of life, but we have tried to frame a law which gives some measure of protection to the average citizen and his family against the loss of a job and against poverty-ridden old age.[35]

With the recent financial meltdown and deep recession continuing to affect the lifetime savings of millions of Americans, this message of economic security remains just as relevant today as it was 75 years ago.[36]

The Social Security program has two distinct parts: Old-Age and Survivors Insurance (OASI), and Disability Insurance (DI).[37] OASI consists mainly of the retirement security system with which most people are familiar, while DI serves Americans who become disabled during their working years and can no longer be gainfully employed. Both parts are funded with payroll taxes that are levied on working Americans and collected in the Social Security Trust Funds.[38] From those Trust Funds, payments are then made to retirees, survivors of deceased workers, and disabled workers in the form of monthly benefits – the amounts of which are determined by a formula tied to a worker's average wages over a career. In short, Social Security disburses among society the cost of providing basic retirement and disability guarantees to nearly all working Americans.

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[35] Franklin Delano Roosevelt, signing statement for the Social Security Act, August 14th, 1935. Additional quotes by Roosevelt on the subject of Social Security can be accessed online at http://www.ssa.gov/history/stool.html.

[36] The importance of Social Security in maintaining the economic well-being of elderly and disabled Americans cannot be overstated. According to the Social Security Administration (SSA), in 2008, Social Security benefits constituted 36.5 percent of total income for the elderly. A majority of aged beneficiaries attributed more than one-half of their income to benefits. Even more striking is the fact that a significant share of the elderly population (21 percent of married couples and 43 percent of unmarried individuals) relied on Social Security for at least 90 percent of their incomes. As such, Social Security has been a major force in reducing the elderly poverty rate from over 35 percent in 1959 to less than 10 percent in 2009 (SSA).

[37] Although the following changes to Social Security are largely targeted toward the OASI program, the Task Force recognizes the urgency of addressing the fast-approaching depletion of the DI Trust Fund (2018, under the most recent projections). Some components of the Task Force plan add revenues (e.g., increasing the amount of income subject to payroll taxes) or reduce spending (e.g., changing to a more accurate COLA calculation) for the DI program over the next decade, but those changes alone will not forestall the exhaustion of the Trust Fund for long. Further review and adjustments to the DI Trust Fund will be necessary.

[38] "Social Security Trust Funds" refers to two separately managed accounts: the OASI Trust Fund and the DI Trust Fund – each of which funds the corresponding program. Payroll taxes are split percentage-wise between the two.

Social Security's fiscal outlook, however, is unsustainable[39] due largely to three factors. First and foremost, the Baby Boom generation is on the cusp of retirement, carrying with it a wave of new beneficiaries who will draw upon (rather than contribute to) the Trust Funds. The ratio of workers to retirees has been stable for many years, but the retirement of the baby boomers will rapidly shrink this ratio over the next two decades.[40]

Second, Americans are living longer than their predecessors. But, today's workers are, on average, actually retiring earlier than previous generations. Therefore, workers are contributing fewer years of payroll taxes to the Trust Funds, while retirees are collecting more monthly benefits.

Third, due to the rising distributional disparity in wages, a smaller percentage of the nation's income is subject to the Social Security payroll tax, eroding funding for the program.

This combination of demographic, benefit, and revenue effects is already reducing the solvency of Social Security. In almost every year of the program's existence, it has collected more revenues from payroll taxes than it has paid in benefits to retirees. This year, however, that is not the case. In 2010, for the first time in many years, the Trust Funds will run a deficit and will have to draw on the interest flowing from the program's "savings" that have accrued from prior payroll tax contributions. Furthermore, this deficit will persist in most upcoming years so that the Trust Funds will be completely exhausted by 2037. At that point, current law would prohibit the program from borrowing additional monies to continue disbursing scheduled payments; thus, an across-the-board 22 percent cut in monthly benefits would occur, undoubtedly accompanied by severe consequences and hardship for millions of Americans.

In the early 1980s, Social Security was in similarly difficult straits. President Reagan formed a bipartisan commission that produced a package of proposals, including benefit adjustments, revenue increases, and coverage expansions that served as the core of reforms that Congress enacted. This collaboration is evidence that Social Security can be maintained and strengthened in a bipartisan manner, but the current prospects of the program, only 25 years later, show that it was not altered in a sustainable manner for the long run.

To ensure that Social Security can provide benefits for future generations of retirees, we must avert the impending drop-off in benefits and return the program to long-term solvency. Doing so will require bipartisan cooperation and a modest amount of sacrifice by workers and retirees, but addressing the problem now in a rational and equitable manner will be far easier than waiting until the crisis is near, when much more severe actions would be necessary. Public policy analysts from across the political spectrum acknowledge that Social Security must be adjusted to remain

[39] The program is unsustainable with current law scheduled benefits and tax rates.
[40] In particular, the U.S. birth rate fell off of its post-war high and appears to have settled at a permanently lower level thereafter. Thus, there have not been a sufficient number of workers joining the workforce to compensate for the impending exit of the baby boomers (SSA).

viable in the face of demographic and economic changes and that acting soon is preferable to waiting.[41] Enacting a plan within a year and slowly phasing-in the solution over the coming decades will require only limited changes and will also permit future retirees to anticipate the changes and prepare for them. Waiting until close to 2037 to put Social Security on a sustainable path would necessitate much larger changes in revenues or benefits and cause anxiety and uncertainty for those approaching retirement age.

After considering an extensive list of options, the Task Force has carefully assembled a package that achieves two critical goals: ensuring the ability of the Trust Funds to pay out benefits for each of the next 75 years (and beyond), and providing necessary support to the most vulnerable retirees, as well as to those who have contributed to society through their labor for many years. The first objective is aided by Task Force proposals in other policy areas, most significantly the phase-out of the tax exclusion for employer-sponsored health insurance. Taxing these insurance premiums paid by employers (or the increased wage compensation) as regular income enables Social Security to collect additional revenues from payroll taxes, which allows for fewer benefit adjustments than would otherwise be necessary.

Similar to the 1983 reform, the Task Force package includes modifications to benefits, revenue increases, and the incorporation of currently uncovered populations into Social Security. This set of proposals directly addresses both the benefit-side issue of increasing life expectancies, and the revenue-side problem of a deteriorating tax base. The changes also will help ease the financial burden imposed by the retirement of baby boomers.

While proposing policies to guarantee the financial health of Social Security, the Task Force acknowledges the need for Americans to work longer before retirement. Specifically, the plan encourages longer working lives through education and stronger incentives – but it does not propose to change either the age of full retirement or the earliest retirement age as specified in current law. Not only do more workers with longer years in the workforce help the economy, but for many retirees, working longer can also make the difference between poverty and a comfortable standard of living in old age.

Social Security's Chief Actuary has verified that the Task Force proposal, outlined below, achieves "sustainable solvency"[42] – a metric that the 1983 reform failed to meet – meaning that the plan will stabilize the program's finances for the reasonably foreseeable future.[43] The Task Force

[41] Charles Blahous and Robert Greenstein, "Social Security Shortfall Warrants Action Soon," Pew Economic Policy Group (2010), http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic_Mobility/PEW-Social-security-paper.pdf.

[42] The Task Force plan produces sustainable solvency for the OASDI Trust Fund. In order to ensure that both Trust Funds are sustained for the next 75 years and beyond (given DI's particular financial difficulties), however, an increased percentage of the 12.4 percent Social Security payroll tax must be allocated to the DI Trust Fund.

[43] The Chief Actuary's scoring of the package is shown in Appendix C. Dollar savings from Social Security proposals are based on SSA models, but have been modified to conform to TPC calculations and the CBO baseline that the Task Force uses.

also has included provisions to protect both long-term, lower-wage workers and older beneficiaries who outlive their savings and fall into a state of poverty that, still today, confronts too many retirees.

Social Security is a defining piece of the social fabric and an incredibly successful program. It does not need to be fundamentally altered; rather, it needs only modest adjustments so that it can continue to serve as a financial foundation for millions of retirees, survivors, and disabled workers across the country. The Task Force plan will restore the faith of younger generations in the program and the belief that it will be there for them in their old age, and thus fulfill the commitment that society owes to the current generation of American workers, as well as its children and grandchildren.

How Are Social Security Benefits Calculated?

When a worker becomes eligible to receive Social Security benefits, the monthly amount is determined through a two-stage process. First, the worker's lifetime average monthly earnings are calculated by taking annual earnings (up to the maximum amount covered under Social Security) for the 35 highest-earning years, adjusting each one by the subsequent increase in the average wage level. The 35 years of adjusted earnings are then averaged and divided by 12. The result is the worker's lifetime average indexed monthly earnings.

Second, Social Security's progressive benefit formula is applied to the worker's average indexed monthly earnings. This formula, for an individual reaching age 62 in 2011 equals:

- 90 percent of the first $749 of the worker's average monthly earnings;
- plus 32 percent of any average monthly earnings between $749 and $4,517;
- plus 15 percent of any average monthly covered earnings above that.

The dollar amounts of $749 (at which the 90 percent replacement rate ends and the 32 percent replacement rate begins) and $4,517 (at which the 32 percent rate ends and the 15 percent rate begins) are known as the program's "bend points." The placement of the "bend points" is adjusted each year to reflect the change in average wages.

If a worker retires before the normal retirement age (currently 66), the monthly benefit is actuarially reduced, whereas if the worker retires past the normal retirement age, the monthly benefit is actuarially increased. Once a retiree's initial Social Security benefit is established, the benefit level is adjusted in each succeeding year for inflation. This guarantees that once an individual retires and begins to draw benefits, that benefit level will retain the same purchasing power.

To see very clear examples of how benefits are calculated for two hypothetical retirees, go to: http://www.socialsecurity.gov/OACT/ProgData/retirebenefit1.html

Gradually Raise the Amount of Income Subject to Payroll Taxes

***Description of Recommendation*:** The payroll tax that funds Social Security is currently collected on wage income only up to a maximum of $106,800 – a level that, under normal economic conditions, encompasses about 83 percent of total national wages. This proposal will raise the cap very gradually, over a 38-year period, to a level covering 90 percent of national earnings. At current income levels, this would be equivalent to about $180,000. After reaching the 90 percent target, the cap will be adjusted annually to maintain the 90 percent standard.

***Cumulative Budget Savings in Billions of Dollars from 2012 through*:**

2020	**2025**	**2030**	**2040**
$107	$278	$542	$1,461

***Background*:** In the 1977 amendments to the Social Security Act, Congress attempted to stabilize the taxable share of covered earnings at the 90 percent level by raising the cap and then indexing the dollar amount of the cap to average annual wage growth.[44] Over the past quarter-century, however, earnings at the top of the wage scale have grown much faster than average wages.[45] As a result, the share of earnings above the cap (and thus untaxed) has grown. This proposal, which has been widely discussed in academic and political circles, will raise the cap to cover roughly its intended percentage of earnings. Thereafter, adjusting the cap to maintain the 90 percent target will protect the base for Social Security revenues against further deterioration.

Gradually raising the taxable earnings cap will make the payroll tax less regressive by placing the additional tax burden entirely on the most affluent taxpayers. Upon retirement, however, these beneficiaries will be partially reimbursed for their additional contributions through moderately increased benefits. This principle – that workers get at least some return on *all* taxes paid in – has been a bedrock of Social Security and should remain so.

As the baby boomer generation retires and America's worker-to-retiree ratio falls substantially, these additional revenues will help ensure that Social Security has the funds to endure as the foundation for retirement for all American workers in their old age.

[44] Geoffrey Kollmann, "Social Security: Summary of Major Changes in the Cash Benefits Program," *CRS Report for Congress* (Library of Congress, Congressional Research Service), RL30565, (May 2000), http://www.policyarchive.org/handle/10207/bitstreams/1045.pdf.
[45] Congressional Budget Office, *Historical Effective Federal Tax Rates: 1979 to 2003* (Congressional Budget Office, December 2005), http://www.cbo.gov/ftpdocs/70xx/doc7000/12-29-FedTaxRates.pdf.

Change to More Accurate Annual Cost-of-living Adjustment (COLA) Calculation

***Description of Recommendation*:** The current measure of inflation used to calculate cost-of-living adjustments (COLAs) for Social Security does not accurately capture changes in consumer spending patterns, and it overstates overall inflation. This proposal will shift the calculation of annual COLAs from the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) to the "chain-weighted" Consumer Price Index for All Urban Consumers (CPI-U), an alternative measure of inflation developed by the Bureau of Labor Statistics (BLS). The Congressional Budget Office projects that per year, on average, the Chained CPI-U will grow an estimated 0.3 percentage points more slowly than the CPI-W.

This COLA modification is a technical adjustment, and it is consistent with the proposals that the Task Force makes for the annual indexing of income tax brackets and those for COLAs in other mandatory government programs.

***Cumulative Budget Savings in Billions of Dollars from 2012 through*:**

2020	**2025**	**2030**	**2040**
$92	$257	$527	$1,452

***Background*:** As required by law, the Social Security Administration (SSA) adjusts recipients' monthly benefits each year for inflation. Currently, the adjustment is based on the increase in the CPI-W, which is calculated by the BLS. The CPI-W, however, can overstate inflation because it does not fully account for changes in patterns of consumer spending. (For example, when the price of apples goes up, people can reduce the impact by substituting oranges.) The Chained CPI-U, by contrast, accounts for such changes in consumers' purchasing patterns when prices grow at different rates.

Because the CPI-W overstates inflation, this technical refinement will improve the accuracy of the Social Security formula and help ensure that the program has the necessary funds to fulfill its obligation to future beneficiaries. Unlike most other benefit adjustments that the Task Force proposes, this one will apply to current beneficiaries as well as future ones.

Slightly Reduce the Growth in Benefits for Roughly the Top One-quarter of Beneficiaries

***Description of Recommendation*:** A balanced package of changes that guarantees the future health of Social Security must make some adjustments to benefits as well as generate new revenues. Beginning in 2023, this proposal will reduce the replacement percentage in the top bracket of the benefit formula from 15 percent to 10 percent over a 30-year period. This proposal will affect only about the top 25 percent of beneficiaries.

***Cumulative Budget Savings in Billions of Dollars from 2012 through*:**

2020	**2025**	**2030**	**2040**
$0	$0	$5	$59

***Background*:** This proposal will phase down the current 15 percent factor to 10 percent by 2052. Thus, under this option (and momentarily ignoring that it will be phased in over time), the benefit formula for an individual turning age 62 in 2011 will equal:

- 90 percent of the first $749 of the worker's average monthly earnings;
- plus 32 percent of any average monthly earnings between $749 and $4,517;
- plus 10 percent of any average monthly covered earnings above that.

This moderate reform is a particularly progressive change to the benefit structure, and will hold harmless approximately the bottom 75 percent of beneficiaries. While not a major part of the solution, the formula adjustment will help boost Social Security's sustainability by reducing program costs.

Index the Benefit Formula for Longevity

Description of Recommendation: Life expectancies at older ages are rising in the United States and other developed countries. This clearly positive development does, however, increase spending under Social Security. Beginning in 2023 (after the scheduled increase of the normal retirement age to 67 is completed), this proposal will adjust the benefit formula to improvements in life expectancy. Specifically, the replacement rates used to calculate benefits each year for new beneficiaries will be 99.7 percent of what they were in the previous year[46] – which offsets about two-thirds of the additional costs associated with estimated longevity increases.[47]

Cumulative Budget Savings in Billions of Dollars from 2012 through:

2020	**2025**	**2030**	**2040**
$0	$0	$12	$240

Background: Average life spans have grown throughout American history and are expected to continue growing in the years to come.[48] People who turn 65 decades from now will, on average, live longer (and thus collect more months of Social Security benefits) than those who turn 65 this year. Thus, a commitment to give retirees a certain monthly benefit at age 65 in 2030 is more costly than is that same commitment to today's beneficiaries.

Current law, however, does not address this fundamental issue. Therefore, this proposal marginally reduces the replacement rates for each successive cohort of beneficiaries, meaning that retirees will receive very slightly smaller monthly benefits, but for longer periods of time.

Unlike the progressive benefit adjustment, retirees across the income distribution will be affected by this modification for longer life expectancies. But, the updated special minimum benefit (described below) will offset and supersede this effect for most lower-income beneficiaries who have spent a sufficient number of years in the workforce.

The ongoing, gradual stretching out of benefits to account for longevity under this proposal will not apply to recipients of DI benefits. However, once DI beneficiaries[49] reach the normal retirement age and begin to collect OASI benefits, they will be impacted – precluding any additional long-term advantage[50] from claiming disability benefits instead of old-age benefits.

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[46] This reflects the Social Security Actuaries' estimates for longevity increases.

[47] Specifically, the adjustment will be calculated based on the increase in life expectancy at age 67, and will be designed to have the same actuarial effect as a specific retirement age change that keeps constant the ratio of years after the normal retirement age to adult years up to the normal retirement age.

[48] U.S. Census Bureau, *Population Profile of the United States*, http://www.census.gov/population/www/pop-profile/natproj.html.

[49] Under this proposal, upon reaching the normal retirement age, DI beneficiaries will have their benefits recalculated under a blend of the current law and the longevity-adjusted formulas.

[50] Under this proposal, a DI recipient who began collecting benefits just before reaching the normal retirement age will collect a benefit similar to that which he would have received had he chosen to collect standard retirement

Compensating for increasing life expectancies is the single most important step to ensure Social Security's sustainability for future generations. Essentially, indexing for longevity compensates the Trust Fund for the aggregate life expectancy increase, but protects retirees from individual risk by providing an annuitized benefit that is unaffected by how long they live. Indexing the benefit formula for longevity, as opposed to increasing the age at which a worker can claim benefits, importantly will retain the option to retire at age 62 for those who are unable to work longer, while at the same time, keeping the program sustainable.

benefits – thus, there will be little incentive for workers to file for DI benefits late in their careers simply in an attempt to exploit the system.

Expand Social Security Coverage to Newly Hired State and Local Workers

***Description of Recommendation*:** About 96 percent of all workers contribute Social Security payroll taxes and are eligible for benefits upon retirement. The largest group of workers that is not covered consists of about one-quarter (5.7 million in 2007) of state and local government employees. Unlike private-sector workers and some public-sector workers, these employees are not required to enroll in the system. This proposal will require that all newly hired employees of state and local governments after 2020 be covered under Social Security. Additionally, the proposal will require state and local pension plans to share data with the SSA until the transition is complete.

***Cumulative Budget Savings in Billions of Dollars from 2012 through*:**

2020	2025	2030	2040
$4	$53	$163	$566

***Background*:** In 1986, Congress enacted legislation to cover – under Medicare, but not Social Security – the new hires of all state and local governments. Today, many government employees remain outside of the Social Security system, instead relying on their public retirement pension programs for income security upon retirement.

Incorporating these new government employees reflects the goal of increasing the universality of Social Security, which was pursued throughout the second half of the 20th century. Placing them in the system will provide better disability and survivor insurance protection for many workers who move between government employment and other jobs.

Due to the poor fiscal condition of state and local governments, and the significant underfunding of public employee pensions, the effective date of this proposal will be delayed until 2020. This grace period will give governments time to shore up and reform their pension systems. Over the long run, covering all of their employees under Social Security could help states and localities get their fiscal houses in order through transitioning to more sustainable pension programs.

Update the Special Minimum Benefit and Protect the Most Vulnerable Elderly

Description of Recommendation: Social Security's special minimum benefit is outdated because it was not indexed to wages. Starting in 2012, this proposal will update the special minimum benefit to 133 percent of the federal poverty level for retirees with at least 30 years of creditable work.[51]

In addition to long-term lower-wage workers, one of the other most vulnerable retiree categories consists of workers who outlive their savings and face increasing medical costs in old age. This proposal will address that issue by providing beneficiaries with a modest benefit bump – equivalent to 1 percent of the average worker's monthly benefit amount – in each year between ages 81 and 85.

Cumulative Budget Savings in Billions of Dollars from 2012 through:

2020	2025	2030	2040
-$73	-$149	-$260	-$651

Background: Social Security began to provide the special minimum benefit in 1972 to raise benefits for people who had low earnings over a long working lifetime. The concept behind it was similar to the principle behind Social Security itself: Americans who have contributed to the economy with a full career should be protected and kept free from poverty in retirement.

Unfortunately, the minimum benefit is now outdated. The original minimum level was indexed to prices, whereas benefits under the standard Social Security formula are indexed to earnings. Because earnings have grown faster than prices over the years, the standard benefits have risen in real terms while the minimum has not, and the minimum benefit no longer provides any additional support to lower-income retirees. Moreover, the standard Social Security formula has consistently failed to provide decent assistance for career minimum-wage earners; in fact, their benefits put them below the poverty line.

Updating the minimum benefit will reinforce the program for many retirees in the bottom half of the earnings distribution who will have contributed their labor to society for many years. Additional consideration will be given to long-term workers who take time out of their careers to care for young children. Providing these retirees with a reasonable level of assistance also will help support their successful transition into the reformed Medicare system.

[51] The revised special minimum benefit will ensure that a long-term low earner is eligible for a benefit equal to 133 percent of the federal poverty level (about $1,200 per month) at the normal retirement age. Earnings required for a year of qualifying coverage will remain at 20 percent of the "old-law" taxable maximum ($15,880 in 2010), but a creditable year will be worth $40 per month (i.e., 30 years * $40 = $1,200/mo.), rather than approximately $25 under current law. The credit will be indexed to average wage growth rather than prices. A maximum of 30 years of qualifying coverage can be applied, a minimum of 20 years will be required, and up to eight years of caring for a child under age six can be classified as a qualifying year.

Retirees who live the longest comprise another segment of the Social Security population that warrants particular attention. The percentage of elderly people in poverty rises with age, and the problem is especially prevalent among older women. Many elderly Americans outlive their savings and find it hard to survive on Social Security benefits alone. Older retirees tend to rely on benefits for an increasing proportion of their retirement income. With an eroding savings base and rising medical costs, seniors who live in retirement for many years often find themselves near or below the poverty line.

This proposal will provide a supplemental benefit bump to Social Security's older recipients. This benefit increase also will be progressive: a uniform dollar amount across the wage distribution. As such, the adjustment will help all retirees and give adequate support to older, low-income beneficiaries who are most in need.

In the coming years, targeted measures of assistance could lift hundreds of thousands of Americans out of poverty in retirement. By increasing the robustness of the special minimum benefit for long-term lower-wage workers and by protecting vulnerable Social Security beneficiaries through a benefit bump, this package will seal some emerging cracks in the program's foundation, guaranteeing that the system continues to provide a good standard of living in old-age for *all* working Americans.

Require the Social Security Administration to Inform Recipients More Fully about the Costs and Benefits of Taking Early Retirement

***Description of Recommendation*:**[52] Over half of American workers declare retirement and begin collecting Social Security benefits at age 62, the earliest eligibility age.[53] The Task Force believes that retirees have not sufficiently heeded the warnings from the SSA about the disadvantages of early retirement – most importantly, reduced benefits for the rest of the retiree's life. This proposal will direct the SSA to highlight the benefits of delayed retirement. Other efforts should improve the ability of older workers to stay in their jobs or transition to less strenuous occupations.

***Background*:** The nation faces a significant problem: A large share of its workers continues to claim reduced Social Security benefits as early as age 62, even as they can expect to live longer. A much higher share of Americans retire before age 63 today than in 1970.[54] Though many manual laborers surely face physical difficulties in working past that age, there is no sound justification as to why such a large number of U.S. workers overall are retiring so early. Reasons may include a lack of accurate information or patterns of behavior that have become so widely practiced that Americans are quicker to repeat them than analyze their impact.

Reversing this trend will require identifying and addressing some of these factors. Among the most significant is that many workers do not realize or do not properly weigh the lasting advantage to delaying retirement. Each additional year in the workforce translates to higher Social Security benefits each month, regardless of how long the worker lives. Years later, this benefit boost could mean the difference between poverty and a more comfortable lifestyle. Yet workers appear to be making uninformed or uncalculated decisions for reasons that are not clear.

This proposal directs SSA to revise aggressively its communications and messaging around the retirement choice. The material provided to workers during their careers about the retirement decision must more clearly show the implications of collecting benefits at different ages. It must highlight the permanent financial consequences of this choice, not only for workers, but for spouses and survivors as well. In particular, SSA should remind workers of uncertainties in retirement, such as potential health-care costs and the possibility that they may live for many years after retiring.

Furthermore, the SSA should consider providing more potent warning measures that every Social Security participant will notice. The periodic Personal Earnings and Benefit Estimate Statement (PEBES) sent to every worker should more emphatically state that delayed retirements are far

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[52] This proposal is not credited with scoreable savings, but the behavioral impacts could well produce additional revenues and higher economic growth.

[53] John Turner, *Promoting Work: Implications of Raising Social Security's Retirement Age*, Center for Retirement Research at Boston College, Boston College, MA, http://crr.bc.edu/images/stories/Briefs/wob_12.pdf.

[54] Congressional Budget Office, *Historical Effective Federal Tax Rates: 1979 to 2003* (Congressional Budget Office, December 2005), http://www.cbo.gov/ftpdocs/70xx/doc7000/12-29-FedTaxRates.pdf.

more generous on a monthly basis. Another possibility is renaming Social Security's "Early Eligibility Age" as, for instance, the "Reduced Benefit Early Option." SSA could require a signature on a boldly printed statement of understanding (acknowledging the enduring reduction in monthly benefits) from workers who choose to begin collecting before the normal retirement age.

Along with raising awareness, a second component of encouraging longer working lives must be policies that ameliorate the difficulties of many older workers. They could include a greater focus on retraining programs for workers who can no longer perform their professions (e.g., some manual laborers), or who find themselves out of work in their later years.

This combination of education and functional approaches will give workers the flexibility to continue making their own choices about retirement, but with the information and incentives to make prudent decisions. The Task Force believes that policies influencing behavior are preferable to those that force people to delay retirement.

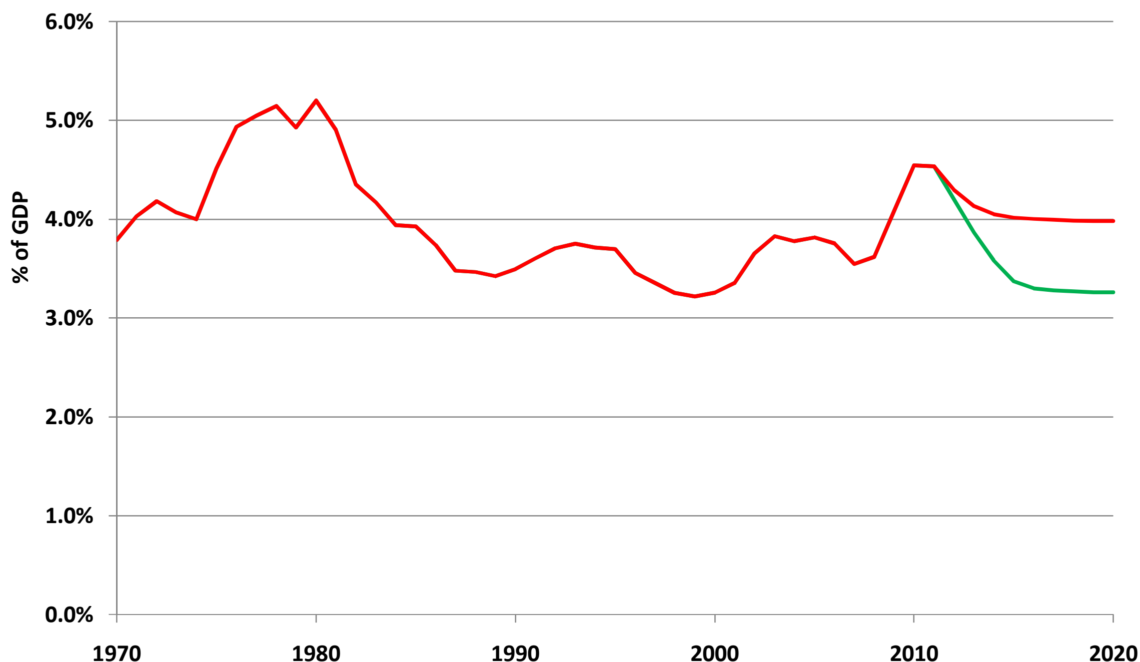
Any package to address the long-term solvency of Social Security should contribute to the broader national goal of economic growth. For this reason, encouraging longer working lives is one of the most important components of the Task Force plan. With workers spending more years in the labor force, production will rise and more retirees will have adequate savings and standards of living.

Freeze Domestic Discretionary Spending

Introduction

Domestic discretionary spending, also called "non-defense discretionary," refers to non-defense programs that Congress funds through annual decisions in the appropriations process. The programs include, for instance, law enforcement, education, homeland security, environmental protection, transportation, national parks, disaster relief, food and drug inspection, and medical research. While funding many of the essential functions of government, domestic discretionary spending constitutes less than one-fifth of the federal budget.

While domestic discretionary spending is not driving America's debt crisis (having declined in recent decades as a share of total federal spending), it nevertheless offers potential for budget savings by reducing duplicative and outmoded programs and ensuring that spending goes to the most needed and effective programs.



***Description of Recommendation*:** This proposal will freeze total domestic discretionary spending – except for emergency spending (certified as emergencies by the President and Congress) – in nominal terms for four years. This is a daunting challenge; the freeze will require that all of the costs associated with inflation, the growth and aging of the population, the growth in veterans' health care, the nation's deteriorating infrastructure, and any emerging needs must be absorbed within a total domestic budget that does not rise in nominal dollars for four years. Meeting this target will require terminating ineffective programs, reducing other programs,[55] imposing new fees to cover program costs, and adopting new financial and other management reforms to generate savings.

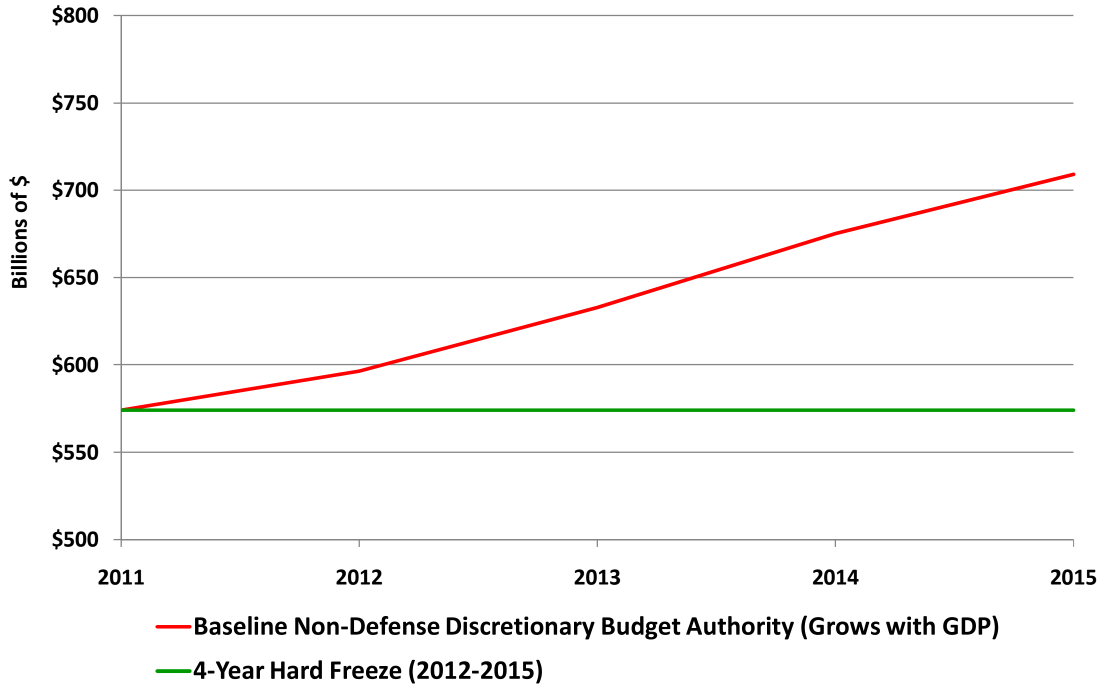
The freeze will be enforced through statutory spending caps (as explained below in the section on budget enforcement). Spending that exceeds the statutory caps will trigger automatic across-the-board cuts in all domestic discretionary programs to eliminate the excess amounts. Following the four-year freeze period, domestic discretionary spending will be allowed to rise at the rate of growth of GDP, a limit that also will be enforced through statutory caps.

Annual Appropriations Reduction (Budget Authority) in Billions of Dollars and Percentage Reduction in each of the Freeze Years:*

2012	**2013**	**2014**	**2015**
$22	**$59**	**$101**	**$135**
4%	9%	15%	19%

* Compared to a baseline that grows with GDP.

[55] Task Force Member Ed McElroy would like to see education and infrastructure protected within domestic discretionary spending.



Cumulative Budget Savings (Outlays) in Billions of Dollars from 2012 through*:

2015	**2020**	**2025**	**2030**	**2040**
$261	$1,022	$1,968	$3,135	$6,345

Note: Budgetary savings continue to accrue after the four-year freeze period because adjustments for GDP growth post-2015 are based on a starting point of $574 billion instead of $709 billion (see the graph above).

* Compared to a baseline that grows with GDP.

***Background*:** Domestic discretionary spending consists of all programs that are annually funded through appropriations bills, and Congress sets funding levels each year. This annual review is contrasted with "mandatory" spending – most of which consists of entitlement programs – where the law that created the program spells out a funding formula that is effectively on auto-pilot until Congress steps in and changes the program.

For example, Social Security is a "mandatory program" because benefits are paid according to a statutory formula that entitles beneficiaries to payments based on a formula tied to years worked and income levels. By contrast, funding for the operations of the Social Security Administration are "discretionary," that is, Congress decides each year how much funding to provide through the appropriations process.

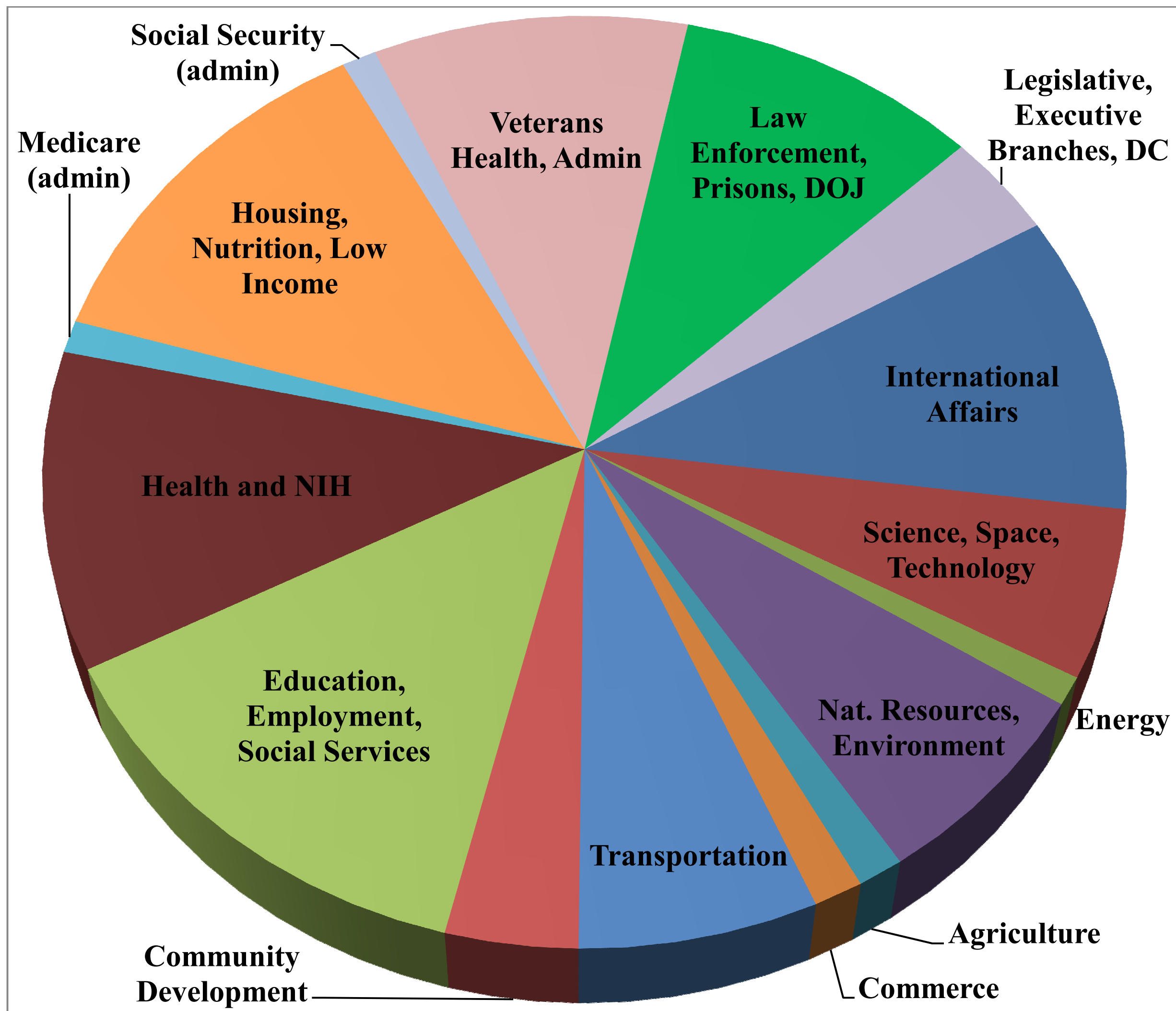
"Domestic" discretionary spending refers to all discretionary spending that is non-defense. Domestic discretionary includes international affairs programs and homeland security programs.

Following is an overview of the larger domestic discretionary programs, with FY 2010 funding levels (rounded to the nearest billion). These are the programs that appropriators will need to scour for budget savings in order live within a freeze – which means absorbing the costs of inflation, the costs of a growing and aging population, growing homeland security needs, growing veterans' health costs due to the wars, as well as addressing the enormous backlog of infrastructure needs.

Domestic Discretionary Spending Programs Funded at Over $1 Billion per year in FY 2010		
Budget Function (Category of Spending)	Program or Program Categories	FY 2010 Budget Authority (rounded to nearest billion)
International Affairs		
	International Development and Humanitarian Assistance	$32 billion
	International Security Assistance	$6 billion
	Conduct of Foreign Affairs	$16 billion
	Foreign Information and Exchange Activities	$2 billion
General Science, Space and Technology		
	National Science Foundation (funds basic research)	$7 billion
	Dept. of Energy Science Programs	$5 billion
	Dept. of Homeland Security Science & Technology	$1 billion
	NASA	$18 billion
Energy		
	Energy Supply (fossil, nuclear, renewable, etc.)	$3 billion
Natural Resources and Environment		
	Corps of Engineers Water Projects	$5 billion
	Bureau of Reclamation (dams, hydroelectric, water)	$1 billion
	Forest Service	$5 billion
	Management of Public Lands	$1 billion
	Conservation Operations	$1 billion
	Fish and Wildlife Service	$2 billion
	Recreational Resources	$3 billion
	EPA	$10 billion
Agriculture		
	Farm Income Stabilization	$2 billion
	Research and Education	$2 billion
	Animal and Plant Inspection	$1 billion
Commerce and Housing Credit		
	Small and Minority Business Assistance	$1 billion
	National Institute of Standards and Technology	$1 billion
Transportation		
	Highways	$27 billion (in FY 2009)
	Airports and Airways (FAA)	$12 billion
	TSA (however, much of this is offset by security fees)	$5 billion
	Marine Safety and Transportation	$8 billion
Community and Regional Development		
	Community Development	$4 billion
	Rural Development	$1 billion
	Indian Programs	$2 billion
	Disaster Relief	$5 billion
	FEMA State and Local Grants	$4 billion
	Disaster Assistance Grants	$1 billion
Education, Training, Employment, and Social Services		
	Title 1 Grants for Schools in High Poverty Areas	$16 billion
	Impact Aid Replacing Lost Revenues from Federal Bases	$1 billion

Education, Training, Employment, and Social Services (cont.)		
	School Improvement Programs	$5 billion
	Special Education for Children w/ Disabilities (IDEA)	$13 billion
	Vocational and Adult Education	$2 billion
	Indian Education	$1 billion
	Innovation and Improvement, Charter Schools	$5 billion
	Higher Education Including Student Aid	$5 billion
	Library of Congress, CPB, Smithsonian, Other	$4 billion
	Training and Employment Services	$8 billion
	AmeriCorps, Senior Service Corps, Learn & Serve	$1 billion
	Children, Family, and Aging Services	$11 billion
Health (Other than Medicare, Medicaid, CHIP)		
	Substance Abuse, Mental Health Services, SAMHSA	$3 billion
	Indian Health	$4 billion
	Community Health Centers	$2 billion
	Ryan White AIDS Grants	$2 billion
	Centers for Disease Control and Prevention	$6 billion
	National Institutes of Health (basic research)	$31 billion
	Food Safety and Inspection Service (USDA)	$1 billion
	Occupational and Mine Safety and Health	$1 billion
	Food and Drug Administration	$2 billion
Social Security and Medicare (Administrative Costs)		
	Medicare Administrative Costs and Fraud Control	$6 billion
	Social Security Administrative Costs	$6 billion
Income Security		
	Unemployment Insurance: Administrative Expenses	$4 billion
	Rental Housing Assistance (Section 8)	$27 billion
	Public Housing	$7 billion
	Homeless Assistance	$2 billion
	WIC: Nutrition for Women, Infants, Children	$7 billion
	Other Nutrition Programs	$1 billion
	Low Income Home Energy Assistance (LIHEAP)	$5 billion
	Child Care Block Grant	$2 billion
Veterans' Benefits and Services		
	Veterans' Health Care	$47 billion
	VA Administration	$6 billion
Law Enforcement, Prisons, Administration of Justice		
	Criminal Investigations (FBI, DEA, and DHS)	$6 billion
	Alcohol, Tobacco and Firearms (ATF)	$1 billion
	Border and Transportation Security	$18 billion
	Secret Service	$1 billion
	Federal Litigation and Judicial Activities	$11 billion
	Federal Prison System	$8 billion
	State and Local Law Enforcement Assistance	$2 billion
Legislative, Executive Branches		
	House, Senate, GAO, Library of Congress, GPO	$4 billion
	Internal Revenue Service (IRS)	$12 billion
	Other (including White House and DC Government)	$4 billion

Domestic Discretionary Spending Distribution by Budget Function:



The Four-Year Freeze

Although a four-year freeze might, on the surface, not seem very difficult to sustain, this proposal is daunting for several reasons.

Population Growth

A key challenge to living within a freeze is that our population is expected to grow by 15 million over the next five years (to 326 million by 2015). More kids will be in high school, more entrepreneurs will be filing for patents, and more people will be seeking benefits such as housing and nutrition assistance.

An Aging Population

The number of people receiving Social Security and Medicare is expected to grow from 53 million in 2010 to 61 million in 2015. As a result, the costs of operating Social Security and Medicare – programs that are administered through discretionary spending – will grow by hundreds of millions. These additional costs will have to be absorbed under the annual caps.

Infrastructure Needs

Highway passenger miles are expected to grow significantly over the next five years. Moreover, the Federal Highway Administration already estimates a current backlog of $381 billion in necessary improvements to our roads and bridges.

Similarly in public transportation, the Department of Transportation (DOT) expects almost 800 million additional transit rides in 2015 compared to 2010. The Department completed an assessment of the nation's transit systems this year and concluded that the industry faces a backlog of $80 billion to restore a state of good repair. Freeing up funds to invest in America's future will require tough choices in other areas of discretionary spending.

Veterans' Health Care

Another major challenge is the rapidly growing cost of veterans' health care, which has risen from $24 billion to $41 billion, or 71 percent, over the last five years. Since veterans' health care is funded through a domestic discretionary program, this very rapid cost growth either must be slowed, or other domestic programs will have to be cut.

Absorbing Inflation under a Budget Freeze

Costs associated with inflation also must be accommodated within the four-year freeze. Inflation is projected to grow at close to 2 percent per year between 2012 and 2015, according to the Congressional Budget Office. This decline in purchasing power must be addressed within individual program budgets, or else by reducing other domestic discretionary programs.

Maintaining America's Leadership Abroad

Finally, a four-year freeze must accommodate the rising costs associated with maintaining America's diplomatic leadership abroad through diplomacy and support for allies and partners, as well as assistance in strengthening fragile states.

The Freeze Requires Tough Decisions and Prioritizing Expenditures

Taken together, the challenges outlined above will require policymakers to take a hard look at the functions of our government and evaluate priorities and programs on a prudent basis. Living under the freeze will necessitate a combination of terminating lower priority, duplicative, or ineffective programs; reducing funding for other programs; imposing new fees to cover some program costs; and adopting new financial and other management reforms to generate savings. Although difficult decisions will have to be made, this debt reduction plan presents the country with an opportunity to restructure our spending and make our government more efficient.

Appendix D includes, for illustrative purposes only, a list of programs that the current or previous administrations or the Congressional Budget Office have recommended for consolidation, termination, or reduction.

Despite the disproportionate amount of political rhetoric that is devoted to congressional earmarks, they comprise less than 1 percent of total discretionary spending. Adhering to a domestic discretionary freeze will require far more than simply eliminating earmarks.[56] The caps will call for an honest determination of ineffective and overly costly programs that are in need of modification or elimination.

Appendix E includes, for illustrative purposes only, examples of fees that could be considered by policymakers. New or higher fees for the services that an agency or program provides is another way to meet the constraints of a four-year freeze. Higher fees, in effect, allow for a cut in a program's annual appropriation, or allow for a program to accommodate growing demands due to population growth, inflation, or an increasing need for services.

Most members of the Task Force also support a two-year civilian pay freeze[57] to help live within the discretionary cap. A serious debt reduction plan will require a modest amount of shared sacrifice from all Americans, and the federal government must show that it too is tightening its belt and is not exempt from the mission.

[56] In fact, eliminating earmarks as a stand-alone policy produces zero savings. Earmarks are requested and appropriated after the annual discretionary spending allocations have already been established. Therefore, if an earmark is eliminated in the budget process, the funds simply revert to the allocation available for appropriation in that fiscal year.

[57] Task Force Member Ed McElroy does not support a civilian pay freeze.

Management Reforms to Achieve Budget Savings

The following are examples of management reforms that agencies could use to offset the costs of inflation and population growth during the freeze period.

- **Investigate the Application of State and Local Best Practices:** A number of state initiatives – including the Empower Kentucky program, the statewide revenue transformation in Florida, and the transformation of human services in Texas – have used management reform techniques to achieve significant cost savings. The Massachusetts state government saved funds by integrating the delivery of services. The City of Toronto Amalgamation Project yielded annual savings of an estimated $153 million per year by eliminating 35 percent of existing management positions.

- **Modernize the Regional Structure:** There are significant opportunities to reorganize and scale down the federal regional government structure. The regional structure was created when technologies and communication capabilities were much different than today, under a philosophy that close proximity to the states allowed federal staff to more readily travel to the states as a federal overseer. The structure remains the same, even though almost all of those conditions have changed.

- **Shared Services:** There is no reason why each and every major agency needs its own financial system, human resources system, procurement system, contracting operation, budgeting system, etc. A number of states have implemented comprehensive shared services programs, under which one organization that performs a business process particularly well is authorized to perform that service on behalf of all agencies. Such a process enables states to achieve economies of scale, while spreading best practices across the state enterprise.

Freeze Defense Spending

Introduction

The United States today remains the world's foremost military power and will continue to be so in the foreseeable future. Over the past decade, U.S. defense spending has grown with few fiscal constraints, reaching roughly $700 billion a year, a sum virtually equal to the defense spending of all other countries combined. Such growth is no longer possible, however, as the nation faces increasingly pressing problems of economic recovery alongside unprecedented debts and deficits. As Admiral Michael Mullen, chairman of the Joint Chiefs of Staff, has noted, today the U.S. debt is the "single-biggest threat to our national security."[58]

The Defense Department and its secretary, Robert Gates, have begun to recognize the need for greater fiscal discipline. While Secretary Gates continues to seek real growth in the defense budget, he has begun a process of terminating some investment programs, closing the Joint Forces Command and two other agencies, reducing spending on support contracting, lowering the number of flag officers, freezing some civilian personnel levels, and reforming the acquisition process.

The Task Force welcomes all of these steps, but believes that discipline in defense spending will need to go further in order to help meet the broader goal of reducing the federal deficit and controlling the debt. Therefore, this plan recommends that defense resources be frozen at FY 2011 levels for the succeeding five years and then limited to growth at the rate of the economy thereafter.

Achieving this goal will require going well beyond the Gates efficiencies. The Task Force believes that the Pentagon is capable of setting the priorities needed to make these decisions while ensuring that the U.S. military remains a globally superior force well into the foreseeable future. Now is the optimal time to make these choices, as the deployments in Iraq and Afghanistan are beginning to end, therefore allowing the U.S. to make new decisions about the range of its global military missions and priorities. And, as with all countries, the U.S. has to meet both its military and economic security needs by making choices and living within fiscal constraints.

The attached options for defense planning and budgeting illustrate the choices that might be made and the priorities that could be set to meet this five-year cap. The potential package is designed to ensure that the U.S. continues to field a first class, globally unsurpassed force, while living within its financial means. Not everyone will agree with all of these illustrative options, but we believe they are worthy of consideration as steps that any defense planner will need to consider in order to maintain both optimal military capabilities and fiscal discipline.

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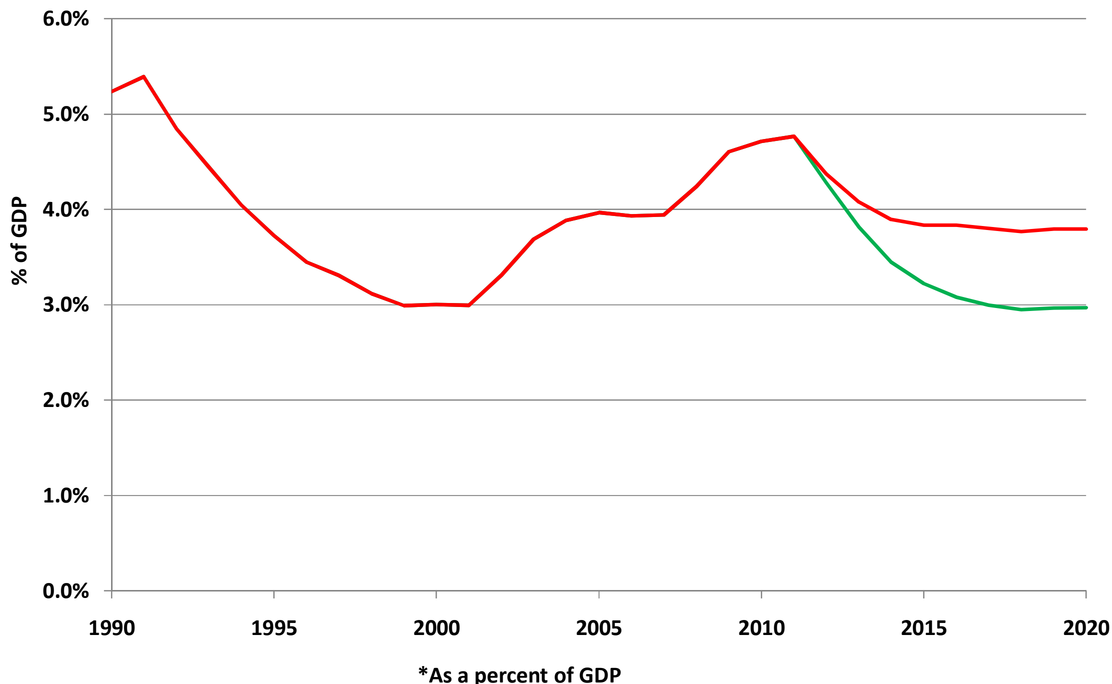
[58] Adm. Michael Mullen, "JCS Speech at Detroit Economic Club Luncheon," [Remarks at the Detroit Marriot at the Renaissance Center, Detroit, August 26, 2010], http://www.jcs.mil/speech.aspx?ID=1445.



Should these options be implemented, the remaining U.S. military forces would continue to be superior in technology, capability, and size to those of any other country, and continue to be capable of military operations on a global basis.[59] The United States still would be the only nation able to patrol the world's oceans, deploy hundreds of thousands of ground forces to any point on the globe, and dominate the global airspace with superior combat fighters, long-range bombers, and unmanned aircraft. Supporting this overwhelming force, the U.S. would retain the world's only global military transportation, communications, logistics, and intelligence capabilities.

At roughly 60,000, U.S. special operations forces alone would be larger than the militaries of more than half the world's countries. More broadly, the U.S.' entire post-reform active duty force of 1.21 million would be larger than the forces of any other country except for China and India.[60] Unsurpassed technological capabilities and budgets would enable this force. In FY 2009, U.S. military research and development spending alone exceeded China's entire defense budget, the

[59] China and India would have larger ground forces than the U.S., but significantly smaller air and naval forces and no global reach.

[60] For U.S. special operations force numbers, see page 3 of Special Operations Commander (SOCOM) ADM Eric Olson's testimony before the House Armed Services Committee from March 17, 2010. ADM Olson describes growing his force by 4.7 percent, or 2,700 troops, allowing for the computation that the FY 2011 force will top 60,000. For world troop numbers, see *The Military Balance 2010: The annual assessment of global military capabilities and defense economics*, The International Institute for Strategic Studies (London: Routledge, 2010).

world's second largest, by $10.5 billion.[61] And post-reform U.S. defense outlays, at $628 billion in FY 2018, would exceed (in real terms) U.S. defense outlays at any point during the Cold War, be it the 1968 peak (5.5 percent higher) or the peacetime average (50 percent higher).

Setting mission priorities and accounting for the fiscally constrained environment must be a part of defense planning discipline. After the kind of force and budgetary restructuring that we discuss here, the Task Force believes that the U.S. would have a military tailored to meet the priority missions that it will be asked to perform after the conflicts in Iraq and Afghanistan conclude. The options described here are based on an evaluation of the strategic and military risks that the U.S. might face in the future. The illustrative package gives top priority to counter-terror and cyber-security operations, and assigns significant priority to deterrence and reassurance, sea patrol, humanitarian relief, and peacekeeping. Conversely, the options assign low priority in the future to counterinsurgency, stabilization, and governance. The plan also provides a sizable and important hedge for conventional combat and strengthens the military "tooth" (combat forces) relative to the support "tail." Setting these priorities allows for a reduction of 275,000 in the active duty force. Approximately 1.21 million troops would remain – a large, modern, and more deployable force than any other country in the world.

This force would be armed with technology surpassing that of any other country, at sea, in the air, in space, or on land. The tough choices to terminate or delay several investments would focus on programs that provide an excessive hedge for potential adversaries or are significantly underperforming relative to expectations. Investment priorities could include deferring or terminating such programs as the F-35 fighter jet, V-22 tilt-rotor aircraft, Virginia Class submarine, and ballistic missile defense, even while the U.S. retains substantial and superior capabilities in all of these areas. In addition, investment in non-major military procurement and research and development would decline in proportion to the changed end strength, but still leave in place significant budgets.

The options described below also begin to tackle two of the most difficult management and spending issues that the Pentagon faces: health care and military retirement (addressed under "Cut Spending in Other Programs"). Both benefits are very attractive to service-members, but their exponentially increasing costs are posing growing fiscal dilemmas to the Department, as Secretary Gates has repeatedly pointed out. Defense retirement and health care reforms have been discussed without action for years, but may be more feasible in the context of the broader health care and retirement reforms that the Task Force suggests. Hence, these options include reforming cost

[61] U.S. Research and Development, Test, and Evaluations (RDT&E) outlays in FY 2009 totaled $80.78 billion. After the U.S., China had the world's largest defense budget in 2009, totaling $70.3 billion. The year 2009 is used as a reference point because data on world military spending for 2010 is not yet available. See "National Defense Budget Estimates for FY 2011 (Green Book)," Department of Defense: Table 6-11; *Military Balance 2010: The annual assessment of global military capabilities and defense economics*, The International Institute for Strategic Studies (London: Routledge, 2010): p. 398.

sharing for the Pentagon's health insurance system (TRICARE) and transitioning from the current military retirement system to one more similar to that in which federal civil servants participate.

The illustrative package also proposes management reform in the intelligence world that would maintain intelligence capabilities at a reduced cost by utilizing the newly-granted authority for the Director of National Intelligence (DNI) to eliminate duplication and increase efficiency.

Finally, the options accept the efficiency savings already announced by Secretary Gates. Rather than returning those savings to the services to increase funding for forces and investment as the Secretary proposes, this option would include them in the overall effort of deficit reduction.

Any attempt to discipline defense resources or lower the defense budget will be criticized by some as reducing America's defenses in a dangerous world. The Task Force believes that the options suggested here do no such thing. They are designed to tailor defense capabilities to acceptable levels of risk in the world after our missions in Iraq and Afghanistan conclude. The reforms would leave a globally superior military force in place, while reshaping that force consistent with our resources.

Mission priorities and the goal of efficient and effective management shape these options. The Pentagon has a history of managing such a reduction, most recently in the period from 1989 to 1998, when deficit reduction efforts and a major global transition (the end of the Cold War) coincided. Over those years, national defense spending fell 28 percent in constant dollars, the active duty force shrank by more than 700,000, the force structure was consolidated, the defense civilian workforce dropped by over 300,000, and procurement budgets fell in excess of 50 percent.[62] Though some criticized the result, the force that emerged from successful Pentagon management remained globally superior: capable of two major deployments that targeted regime changes. The military's technology remained dominant and its global deployability was clear. The Task Force believes that the coming transition can be equally well-managed.

[62] Office of Management and Budget Historical Table 3-1 (deflated per Table 10-1); "National Defense Budget Estimates for FY 2011 (Green Book)," Department of Defense: Tables 6-11 & 7-5.

Description of Recommendation: Freeze defense discretionary spending beginning in 2012 for five years and cap at GDP thereafter. The freeze level assumes that the number of troops deployed in Iraq and Afghanistan, or in other war-related activities, falls to 30,000 by 2013.[63] Within this capped level of spending, policymakers will have to set priorities. As one illustrative example, the defense department could live within the capped level of spending with the following set of policies:

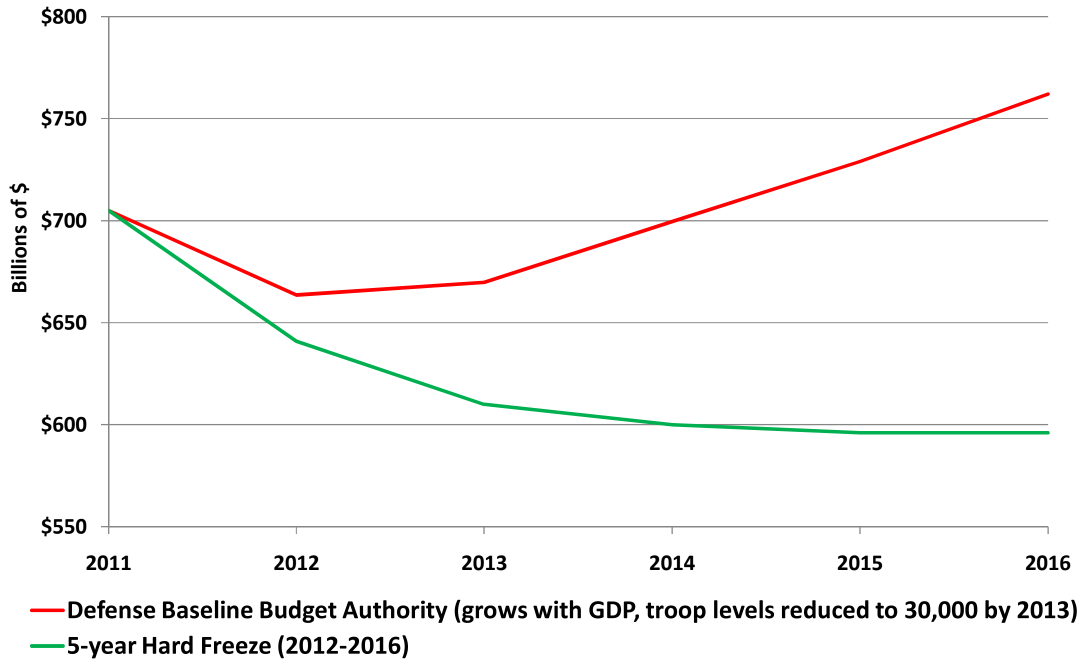
- ✓ Reduce active duty end strength by 275,000, of which 92,000 would come from reversing the ground force buildup of the past 10 years, 80,000 would come from withdrawing additional U.S. forces in Western Europe and East Asia, and 100,000 would come from eliminating infrastructure positions held by uniformed personnel in the Department of Defense.
- ✓ Cancel or defer certain major hardware programs, and reduce funding for minor procurement and research and development.
- ✓ Maintain intelligence capabilities (funded in the defense budget) at a reduced cost by utilizing the newly-granted authority for the Director of National Intelligence (DNI) to eliminate duplication and increase efficiency.
- ✓ Impose greater cost sharing in military health care (TRICARE).
- ✓ Apply Secretary Gates' proposed efficiency savings to overall spending discipline rather than reprogramming to other spending.

Annual Appropriations Reduction (Budget Authority) in Billions of Dollars and Percentage Reduction in each of the Freeze Years*:

2012	2013	2014	2015	2016
$23	**$60**	**$99**	**$133**	**$166**
3%	9%	14%	18%	22%

*Compared to a baseline that grows with GDP, and assumes that troops deployed for overseas combat operations are reduced to 30,000 by 2013.

[63] "The Budget and Economic Outlook: FY 2010-2020," Congressional Budget Office, January 2010: Table 1-5.



Note: The (green) path of defense appropriations during the freeze years reflects CBO's assumption that the number of troops deployed for overseas combat operations are reduced to 30,000 by 2013.[64]

***Cumulative Budget Savings (Outlays)* in Billions of Dollars from 2012 through*:**

2020	2025	2030	2040
$1,114	$2,201	$3,541	$7,229

*Compared to a baseline that grows with GDP, and assumes that troops deployed for certain overseas combat operations are reduced to 30,000 by 2013.

[64] Under this assumption, "future funding for operations in Iraq, Afghanistan, or elsewhere would total $134 billion in 2011, $70 billion in 2012, $39 billion in 2013, $29 billion in 2014, and then about $25 billion from 2015 on – for a total of $416 billion over the 2011-2020 period." Congressional Budget Office, *The Budget and Economic Outlook: An Update,* August 2010, p. 25.

***Background*:**

Streamline Military End Strength

The Defense Department's recent strategic planning has expanded U.S. military missions without setting priorities or calculating the extent to which varying degrees of risk should be tolerated.[65] This widening mission scope has led to increases in active duty end strength and, because that end strength is the central driver of defense budget planning, it has also led to higher spending. Thus, limits on resources will need to focus, in part, on the size of the force. Planning and budgetary priority should be given to those missions that are urgent, probable, consequential, and achievable.

This option gives priority to forces that are needed to confront pressing asymmetric threats (especially the Al Qaeda network and cyber-security); to provide for U.S. security through deterrence, reassurance, sea lane patrols, and support to civil authorities; and to contribute to international peacekeeping and humanitarian relief operations. The illustrative proposal gives low priority to counterinsurgency and stabilization missions on the basis that the U.S. will choose them less often, and to governance missions because they are not an appropriate function for the military. The option additionally shrinks the U.S. posture for conventional combat operations based on the projection that the U.S. will face a low conventional threat in the visible future and on the assessment that the U.S. will retain adequate forces to deal with such contingencies even after the suggested reductions.

Today's active duty military force consists of 1.48 million service-members.[66] Of these, 92,000 are soldiers or Marines added during the combat operations in Iraq and Afghanistan and justified based on these wars.[67] Another 136,083 personnel are serving in a peacetime capacity at permanent overseas stations, principally in Western Europe and East Asia.[68] The United States' deployed forces and others engaged in inherently military tasks are supported by 500,000 service-members in infrastructure positions, including, for example, 85,000 troops in the health profession, 57,000 in personnel administration, and 43,000 in departmental management.[69]

This option would reduce the active duty end strength by 275,000 to a total of 1.21 million, including a reduction of 100,000 infrastructure positions, bringing the U.S.' ratio between the military "tooth" and its "tail" closer to that of other major militaries.[70] Another 80,000 would be drawn down from U.S. forces in Western Europe and East Asia. This reduction would restructure

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[65] Quadrennial Defense Review," Department of Defense, February 1, 2010: pp. 89-95.
[66] "National Defense Budget Estimates for FY 2011 (Green Book)," Department of Defense: Table 7-5.
[67] Bush, George W. "State of the Union Address," January 23, 2007. The troops included in this increase began entering the service in FY 2002 via temporary positions approved above the legislated end strength, but have since been authorized as part of the force.
[68] "Base Structure Report: FY 2009 Baseline," Department of Defense: p. 94.
[69] "Defense Manpower Requirements Report for FY 2010," Defense Department: Table 2-1.
[70] Gebicke, Scott and Samuel Magid. "Lessons from around the world: Benchmarking performance in defense," McKinsey & Company, Spring 2010: Exhibit 3.

U.S. overseas forces toward East Asia, taking the larger share of the reduction in Germany, Italy, and the U.K. (50,000, or 71 percent of the current deployment) and the smaller share in Japan and South Korea (30,000, or 50 percent of the current deployment). The military status of Western Europe makes a smaller presence possible, while current indigenous military capabilities in Asia are adequate for security needs. A rollback of the 92,000-person increase in ground forces that was justified based on wars in Iraq and Afghanistan, both of which are winding down, would bring the total reduction to 275,000.[71] This drawdown could take place gradually and evenly over five years.

Prioritize Defense Investment

The following options for defense investments (weapons systems and research and development) recommend considering cancellation or deferral of certain major hardware programs, as well as reductions in the Defense Department's currently projected investment in minor procurement and research and development. The Department's resources instead would be focused on the same mission priorities cited above, emphasizing equipment needed to confront asymmetric threats, provide for U.S. security, and contribute to global public goods. Equipment used for counterinsurgency, stabilization, and governance, meanwhile, would be somewhat curtailed. The recommendations below also scrutinize programs for capabilities that might exceed the needs for a mission, that are unduly costly for the capacity they deliver, or that have manifestly failed to fulfill performance expectations.

Each of the illustrative divestments identified here can be seen as an overinvestment for the mission of major conventional war, and many of the funding reductions could be justified on multiple grounds. In virtually every category of military technology, U.S. capabilities far exceed those of any other country in the world, including China. Indeed, in most areas, the U.S. appears to be in a race only with itself. A slow-down in this pursuit is justified by current global security conditions, where the significant challenges are asymmetrical, rather than conventional.

Major hardware procurement savings could accrue from canceling the Medium Extended Air Defense System (MEADS; theater missile defense), an Army surveillance blimp (JLENS), the V-22 Osprey tilt-rotor aircraft, the Marine Corp's amphibious expeditionary fighting vehicle (EFV), and the F-35 fighter jet.[72] Additional savings could include deferring Virginia-class attack submarines and halving funding for research on national missile defense.[73] Other alternatives

[71] In addition, another 1,250 troops would return from permanent stations elsewhere in the world (32 percent of the deployment). End strength would be reduced further in proportion to possible terminations of JFCOM, proposed by Secretary Gates, and the Combined Joint Task Force – Horn of Africa.
For information on the Iraq withdrawal, see Article 24 of the U.S.-Iraq Status of Forces Agreement (November 17, 2008). For Afghanistan, see Presidential Address at the United States Military Academy (December, 1 2009).
[72] For the purpose of this analysis, "major hardware" is defined as the equipment listed in the December 2009 Selected Acquisition Report that was delivered to Congress (pp. 21-23).
[73] All of the major hardware divestments listed here are for illustrative purposes only and do not constitute specific endorsements of programmatic cuts by the Task Force. They are provided based on the following justifications:
MEADS: MEADS is a multilateral program for theater missile defense funded with Germany and Italy. The project,

surely could complement this list or substitute for items on it, but these programs deserve special attention and amply demonstrate the feasibility of investment reductions.

Significant savings also could be obtained by lower funding for two other leading categories of defense investment: minor procurement and research and development. Sixty percent of the procurement budget is consumed by minor equipment and services that cover, among other items, the kit that individual troops use in the field. Some service contracting to support troops also is funded through these accounts. Because these goods and services are directly linked to forces and their operations, minor procurements fluctuate with the size of the force.

Research, Development, Test, and Evaluation (RDT&E) funding is the source of military technological innovation. Funds are allocated according to the level of effort that the Department wants to maintain. RDT&E budgets have increased significantly, from $49.2 billion in FY 2001 to $80.2 billion in FY 2010 (a 63 percent increase).[74]

This option would reduce minor equipment/services procurement and RDT&E proportionally to the reduction in the size of the forces, or 18.5 percent. This level reflects the lower demand for minor equipment/services that results from reduced end strength. For RDT&E, a reduction would impose greater discipline in research investments, while continuing to budget significantly more resources than any other country's military RDT&E budget.[75]

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however, duplicates the Army's Patriot capabilities. All three partners may be unenthusiastic about continuing the program. <u>*JLENS*</u>: The JLENS Army blimp is intended to provide extended-range radar surveillance and tracking of low-altitude cruise missiles. There are other means of detecting such an attack, and few countries are capable of such a strike. Those that are (e.g., France, UK, Russia, and China) are unlikely to launch such an attack on the U.S. <u>*V-22*</u>: The V-22 Osprey is a tilt-rotor aircraft designed to take off and land vertically like a helicopter and fly forward like an airplane. The amphibious mission for which it was planned has not been conducted by the Marines in decades. For other lift missions, helicopters are increasingly a more cost-effective alternative. <u>*EFV*</u>: The Expeditionary Fighting Vehicle is designed to land Marines on shore in support of amphibious assaults, but this tactic is unlikely to be used. The vehicle has experienced numerous critical failures and been unable to meet reliability requirements. <u>*F-35*</u>: The F-35 next-generation fighter jet is intended to provide air superiority over an adversary's air forces and close air support to land forces. Current generation F-15s, F-16s, F-18s, and AV-8B's remain superior or competitive with any other fighter program in the world and capable of penetrating air defenses. F-35 costs have risen sharply, leading it to breach cost-control standards applying to Department of Defense (DOD) procurement. <u>*VA-class submarine*</u>: Virginia class is the next-generation attack submarine, designed to engage enemy submarines and ships, as well as attack targets on land with cruise missiles. There is relatively little naval threat to justify growth in the U.S. submarine fleet. The program could be slowed. <u>*Ballistic Missile Department (BMD)*</u>: The BMD program is intended to provide global capability to intercept sub-orbital ballistic missiles, which may be nuclear-armed, at any stage of their trajectory, regardless of their range and size. The threat of a ballistic missile attack against U.S. territory has declined significantly since the program began. Iranian missiles lack the range to strike any major, permanent U.S. base, much less U.S. territory. North Korean missiles may have the range to reach U.S. territory, but their test program suggests that they lack the precision to do so. Continuing the program at roughly $5 billion a year is an adequate hedge against surprise and uncertainty.

[74] "National Defense Budget Estimates for FY 2011 (Green Book)," Department of Defense: Table 6-11.

[75] The RDT&E funding discussed here excludes R&D on ballistic missile defense, which is discussed in the following paragraphs.

Maintain Intelligence Capabilities at a Reduced Cost

Based on recommendations from the "9/11 Commission,"[76] Congress passed and the President signed the Intelligence Reform and Terrorism Prevention Act of 2004 (IRTPA), which created a Director of National Intelligence (DNI) as head of the intelligence community. The Act granted the DNI new and important budgetary authorities over the National Intelligence Program, including the power to develop and determine the intelligence budget. While the DNI and Secretary Gates recently announced that the total U.S. intelligence budget amounts to approximately $80 billion per year, the details of the intelligence budget are classified. Of course, this makes it difficult to judge how effectively the intelligence agencies are spending their appropriations from Congress.

While making specific recommendations with regard to the intelligence budget is difficult given the lack of available information, part of the rationale for establishing the DNI as a position was to eliminate wasteful duplication within the intelligence community. Fulfilling this objective would allow the United States to fully maintain its high-quality intelligence capabilities, while also streamlining programs to jettison any extraneous or duplicative activities.

This proposal would urge the DNI to fully utilize these authorities granted in IRTPA, with the expectation that savings would result. Specifically, the DNI could consider the following areas:

1) Consolidating operational infrastructures, such as computer systems and acquisitions;
2) Refining the "requirements and feedback systems" to tie intelligence more closely to user needs;
3) Improving the "wheat-to-chaff ratio" of intelligence from intercepted electronic communications; and
4) Placing a greater reliance on newer imagery technologies (such as commercial imagery) while phasing out older ones as they become obsolete.

The Task Force also notes that the 9/11 Commission called for strengthening the intelligence community's oversight committees, in part, to improve scrutiny over intelligence appropriations. The Task Force recommends that Congress take further steps to improve its oversight functions and ensure that the intelligence community's allocation of resources meets U.S. national security needs in an effective and efficient manner.

Reform Military Health Care

Secretary Gates has warned of the growing impact of defense health care costs on the wider defense budget. The Defense Department health care program has more than doubled over the

[76] Formally known as the Report of the National Commission on Terrorist Attacks Upon the United States.

past decade, from $24 billion to $51 billion,[77] and the Pentagon projects it to continue growing disproportionately, at an annual rate of 5 to 7 percent through 2015.[78] Active duty personnel and their dependents, a cadre that consumes less than half (42 percent) of the program's total cost, pay no premiums or co-pays.[79] The adjustment discussed below would not change that. Instead, it would focus exclusively on retirees and their dependents, for whom benefits have expanded without a significant change in cost sharing.

Retirees fall into two groups based on whether they are eligible for Medicare. When TRICARE was established in 1995, retirees who were not yet eligible for Medicare and their dependents were expected to pay approximately 27 percent of program costs. They have not seen any cost increase since then, however, allowing the combined effects of medical inflation and policy changes to reduce their cost sharing to approximately 11 percent.[80] Medicare-eligible retirees and their dependents, by contrast, currently do not share in their TRICARE costs.

Taken together, the Pentagon views rapid TRICARE cost increases as the result of inelastic cost sharing formulas, overconsumption of health care, significant expansions of the eligibility pool, and a decision on the part of pre-Medicare military retirees (now employed elsewhere) to favor cheaper TRICARE coverage over their employer-offered benefit.

Adjusting the cost sharing formulas would offset these cost drivers by reducing demand for non-urgent care and providing an incentive for pre-Medicare retirees to seek coverage through their current employer. There are also normative reasons for these changes. They would maintain equity among retirees – both among different cohorts of military retirees and between military retirees and the wider community of seniors that also faces higher costs. Since retiring from the military implies that an individual reached a senior rank, most of the affected beneficiaries will have higher-level retirement packages and can afford this increased cost share.

This illustrative recommendation takes two steps toward reining in those expenses by ensuring cost sharing for the administration of the health care (TRICARE) program.[81] First, the proposal would restore the expectation from1995 that retirees not yet eligible for Medicare and their dependents would provide 27 percent of the cost share through enrollment fees and co-pays, up from the 11 percent cost sharing that exists today. Second, this recommendation would introduce minimal cost sharing for Medicare-eligible retirees and their dependents who use TRICARE as a supplement, currently with no cost sharing.

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[77] In constant 2010 dollars.
[78] "Department of Defense FY 2011 Budget Request: Overview," February 1, 2010: p. 3.
[79] "Health care for Military Retirees Task Group Report to the Secretary of Defense," Defense Business Board, December 2005: Slide 5.
[80] "Report of the Tenth Quadrennial Review of Military Compensation: Volume II," Department of Defense, July 2008: p. 46.
[81] For a general overview of TRICARE cost sharing formulas, see "The Effects of Proposals to Increase Cost Sharing in TRICARE," Congressional Budget Office, June 2009: pp. 9-12.

Apply Secretary Gates' Efficiency Measures to Deficit Reduction

Secretary of Defense Robert Gates announced earlier this year that he plans to find more than $100 billion in budget authority savings over the five years from FYs 2012-16. The Secretary hopes to reduce inefficiencies and waste within the U.S. military infrastructure and move those resources to defense investments and force structure.

Secretary Gates has not itemized individual savings from each of his proposed efficiencies and further announcements may yet be made. The most visible reduction has been the decision to close the Joint Forces Command (JFCOM), with roughly 2,800 military and civilian employees, 3,000 contractors, and $240 million a year in operating costs. In addition to JFCOM, two Pentagon agencies will be terminated, and the number of employees in certain parts of the military bureaucracy will be frozen, including Secretary Gates' own office. More broadly, Secretary Gates proposed to cut funding for service contractors by 10 percent in each of the next three years, though this would not include contractors in war zones. He also proposed cutting the number of admirals and generals by at least 50 and the number of several senior civilian executive positions by at least 150.

Secretary Gates and Undersecretary Ashton Carter also have announced plans to streamline the acquisitions process by controlling cost growth, enhancing productivity, promoting real competition, improving procedure for buying services, and cutting red tape.

This recommendation would accept the Secretary's estimate of the savings, but apply them to overall spending discipline rather than reinvesting them.

Other Savings

1. Reduce Farm Program Spending

Introduction

Agriculture has always been a fixture of the American landscape and a critical piece of the nation's economy. In the 20th century, the United States rose to the forefront of global agricultural production, serving as a major supplier of food to countries ravaged by war, and pioneering production techniques that transformed farming methods worldwide. Today, with 2.2 million domestic farms – of which 97 percent are family-owned – the United States remains a net exporter of agricultural goods.

The federal government plays an important role in the farm sector because agricultural markets do not always efficiently balance supply and demand in the way that one would expect normal markets to behave. Consumers typically do not respond to changes in the price of staple food items by buying proportionally smaller or larger quantities of food, and farmers cannot easily respond to price changes by reducing or increasing production. These imbalances are exacerbated by the long time lag between crop planting or livestock breeding and harvest, as well as agriculture's innate susceptibility to shocks from environmental changes or natural disasters.

In light of these factors, the Agriculture Department (USDA) provides support to U.S. farmers through various programs, including: three types of commodity payments aimed at stabilizing farm income; crop insurance to protect against crop failure and disaster relief; direct and guaranteed loans to make credit available for planting and marketing; agricultural research and education; regulatory programs to preserve the integrity of the food supply from pests and diseases; conservation programs to protect soil, water, and other natural resources; marketing and export promotion programs; and food aid.

This section of the report focuses on USDA activities that are classified as mandatory spending: commodity programs, crop insurance, and most of the conservation programs. As mandatory spending, funding levels for these programs are determined directly by the multi-year "farm bill" that Congress drafts every five years. These programs totaled $17.6 billion in 2009.

Commodity Programs: Price and Income Support

Given the inherent volatility of prices and production in the agriculture sector, USDA makes commodity payments to farms through the Commodity Credit Corporation (CCC) in order to help stabilize farm income. These programs shift some of the risks of market fluctuations onto the federal government.

About 38 percent of U.S. farms received some form of government payment in 2008. USDA classifies these farms into three major categories:

- *Commercial farms:* Farms with sales of $250,000 or more, in which the farm operators report farming as their major occupation. Large commercial farms make up 12 percent of all farms in the nation, and 70 percent of these farms receive some form of government assistance. Of the total share of USDA payments in 2008, commercial farms received 62 percent, at an average value of $45,400 per farm. Large commercial farms, however, produced 77 percent of all crops in that year.

- *Intermediate farms*: Farms with sales below $250,000, in which the farm operators report farming as their major occupation. Intermediate farms make up 27 percent of all U.S. farms, and 44 percent receive some form of government assistance. Intermediate farms received 19 percent of USDA payments in 2008, at an average of $11,900 per farm.

- *Rural residence farms*: Farms in which the farm operator's major occupation is not farming. Rural residence farms make up 61 percent of U.S. farms, and 30 percent of these farms receive government assistance. In 2008, rural residence farms received 19 percent of government payments, at an average of $4,700 per farm.

Because the payments compensate farmers for highly variable commodity prices, CCC outlays can vary dramatically from year to year. Each commodity payment, however, has an annual payment limit per farm or farmer.

Crop Insurance and Emergency Assistance

The Federal Crop Insurance program protects farmers from losses caused by drought, flooding, pest infestation, and other natural disasters. USDA's Risk Management Agency (RMA) administers this program, which allows farmers to choose among insurance policies that provide various levels and types of protection. The insurance policies are sold and serviced by private insurance companies that receive federal reimbursements for administrative expenses. The insurance companies share the underwriting risk with the federal government and, in theory, can gain or lose depending on the extent of crop losses and claims.

Conservation Programs

USDA's conservation programs are designed to protect soil, water, wildlife, and other natural resources. USDA's Natural Resources Conservation Service (NRCS) and the Farm Service Agency (FSA) administer 20 distinct conservation programs that provide technical or financial assistance to farmers who wish to practice conservation on their agricultural lands. Most of

USDA's conservation programs respond to existing resource problems. Some funding pays landowners to retire land from production for a period of time. Other funding is designed to improve resource conditions through contour farming, nutrient management, controlling soil erosion, groundwater and wetlands conservation, grasslands conservation, wildlife habitat protection, tree planting, pest control, irrigation, and waste management.

Proposals

A. Reduce and Limit Payments to Commercial Farms and Certain Producers

***Description of Recommendation*:** USDA's commodity payments to agriculture producers put small farms at a disadvantage, with 62 percent of commodity payments going to large commercial farms even though those farms comprise only 12 percent of all farms. This disproportionate share of commodity payments creates incentives for large commercial farms to expand their operations by buying out smaller farms, because the risks of expansion are being shared by the federal government. Because of this disadvantage (on top of other struggles), smaller farms have difficulty surviving in the marketplace.

This proposal seeks to remedy the aforementioned inequity by: (1) eliminating all payments based on production history to large commercial producers (with combined farm and non-farm adjusted gross incomes (AGI) of greater than $250,000); and (2) lowering the cap on direct payments based on production history from its current $40,000 level to $20,000 (although counter-cyclical payments will remain intact). These changes will reduce average government payments per commercial farm by about $20,000 and promote greater distributional equity in payments to farms, as smaller farms will still benefit from the payments.

***Cumulative Budget Savings in Billions of Dollars from 2012 through*:**

2020	2025	2030	2040
$15	$27	$42	$87

***Background*:** USDA gives price support to producers, concentrated in five commodities: corn, wheat, cotton, rice, and soybeans. Beneficiaries must share the risk of producing a crop and comply with land and resource conservation requirements. USDA helps producers in three ways: direct payments based on production history (as opposed to market prices), counter-cyclical Average Crop Revenue Election (ACRE) payments based on the average state revenue for that crop, and guarantees of minimum prices per bushel or pound for certain crops covered by the Commodity Credit Corporation (CCC). Capped since 1970, the limits for direct payments are set at $40,000 (separate from counter-cyclical payments). There are proportional caps for ACRE payments and no limits on CCC payments.

B. Reform Federal Crop Insurance Program (FCIP) and Reduce Premium Subsidies

***Description of Recommendation*:** Since 2000, the Federal Crop Insurance Program (FCIP) has seen a significant increase in federal expenditures to insurance providers that subsidize their administrative and operating costs (A&O). During the same period, however, higher crop prices and increased coverage on acreage yielded higher premium revenues for insurance companies without a corresponding increase in administrative costs. As such, the A&O subsidy and companies' share of underwriting gains – profits that remain after paying claims and expenses – more than doubled from $1.8 billion in 2006 to $3.8 billion in 2009. At the same time, the number of policies serviced actually fell. The average rate of return for crop insurance companies from 2004 through 2008 was 24 percent, as opposed to 11 percent for private property and casualty insurance companies over the same period.

This proposal will reduce FCIP administrative and operating costs (A&O) subsidies to levels consistent with recent studies that estimate a reasonable rate of return for crop insurance companies. The Task Force plan will also reduce the FCIP premium subsidy for farmers from its current 60 percent level to 50 percent. This change will not substantially affect the quantity or quality of services provided to farmers because total insurance premiums and government subsidies have been rising faster than administrative costs. Reducing the premium subsidy to 50 percent will equalize the sharing of costs and risks between the government and the producer.

***Cumulative Budget Savings in billions of dollars from 2012 through*:**

2020	2025	2030	2040
$9	$17	$26	$53

***Background*:** FCIP protects farmers from losses caused by drought, floods, pest infestation, and other natural disasters. Farmers can choose various amounts and types of protection (for example, against yield losses only or against yield losses and low prices) in policies sold and serviced by private insurance companies; 80 percent of farms participate in this program. USDA spends about $6.5 billion per year on crop insurance for farmers; however, a Government Accountability Office (GAO) study found that 40 cents of every dollar in this program goes to the private companies that sell and service policies and does not reach farmers.

C. Consolidate and Cap Agriculture Conservation Programs

***Description of Recommendation*:** There is significant overlap among the various conservation programs that USDA funds, which creates inefficiencies that strain the federal budget. This proposal will eliminate that overlap by consolidating 16 of the programs into one capped entitlement that grows with inflation. By consolidating redundant programs, USDA should generate savings without severely affecting its ability to meet conservancy goals. Additionally, consolidation could reduce confusion about the programs, as their overlap creates a difficulty for

farmers in distinguishing one form of assistance from another. Under the transformed landscape, constituents will clearly understand which program to tap for conservation purposes.

Programs considered for consolidation include: the Conservation Technical Assistance Program, Soil Surveys, Snow Surveys and Water Supply Forecasts, Plant Material Centers, the Grazing Lands Conservation Initiative, Agricultural Management Assistance, the Chesapeake Bay Watershed Program, the Cooperative Conservation Partnership Initiative, Environmental Quality Incentives (EQUIP), the Agricultural Water Enhancement Program, Conservation Innovation Grants, Grown and Surface Water Conservation, the Farmable Wetlands Program, the Conservation Reserve Enhancement Program, Emergency Forestry Conservation Reserve Program, and the Voluntary Public Access and Habitat Incentives Program.

***Cumulative Budget Savings in Billions of Dollars from 2012 through*:**

2020	**2025**	**2030**	**2040**
$6	$12	$21	$45

***Background*:** The FSA and the NRCS administer 20 distinct conservation programs that provide technical or financial assistance to farmers who wish to practice conservation on their lands. Payments from conservation programs tend to go to smaller- and mid-sized producers, as opposed to large ones. By 2020, expenditures for mandatory conservation programs that USDA funds will nearly exceed direct and counter-cyclical price-support programs for producers.

2. Reform Civilian Retirement

***Description of Recommendation*:** The federal government calculates pension benefits using the average of an employee's highest three consecutive years of earnings. This proposal offers a technical adjustment to that formula, replacing the current metric with the average of an employee's highest five consecutive years of earnings.

***Cumulative Budget Savings in Billions of Dollars from 2012 through*:**

2020	2025	2030	2040
$4	$9	$18	$49

***Background*:** The federal government has two major retirement plans for civilian employees: the Civil Service Retirement System (CSRS), which covers federal employees hired before 1984, and the Federal Employees Retirement System (FERS), which Congress instituted in 1986. Both systems provide benefits that are based on the average of an employee's highest three consecutive years of earnings. This proposal extends the calculation for both programs to a five-year average. Using the longer period will better align federal pension practices with those in the private sector, which commonly uses a five-year average to calculate base pensions. The change will also generate budget savings without reducing current retirees' benefits, and will create an incentive for some federal employees to work longer in order to boost their pensions, thereby helping the government retain experienced personnel.

3. Reform the Military Retirement System

***Description of Recommendation*:** This proposal will gradually replace the current military retirement system's defined-benefit plan with one modeled on the Federal Employees Retirement System (FERS). FERS includes Social Security, a modest defined-benefit plan, and a defined-contribution plan in which employee contributions are matched by the federal government. The proposed military plans also will allow vesting before 20 years of service and provide protection from inflation. Military retirees could receive benefits as early as age 57 (depending on their length of service), as is the case for civilian retirees. Military personnel with more than 15 years of service will remain a part of the current system, but all others will transition into the new structure.

***Cumulative Budget Savings in Billions of Dollars from 2012 through*:**[82]

2020	2025	2030	2040
$3	$16	$40	$131

***Background*:** The current military retirement system operates with a "cliff-vesting" benefit schedule: service members who retire after 20 or more years of service are 100 percent vested and receive full benefits from the moment they depart, while service members who separate at any point before 20 years receive no benefit. Under the present system, members who serve for 20 years receive immediate, inflation-protected annuities for life at an accrual cost[83] of more than 30 percent of basic pay, a rate that is far above that of civilian pension programs.

This retirement system is inequitable because most members do not complete 20 years of service and thus receive no benefits, inefficient because it uses deferred compensation rather than current pay to incentivize service member retention, and costly because payments begin immediately upon leaving the service. Military personnel typically retire in their early- to mid-40s and move to second careers. The cliff-vesting provisions also result in an inflexible military manpower system, with excess personnel in the cadre that have 12-20 years of service – many of whom would naturally have chosen to retire from the military had they been eligible for retirement benefits at an earlier point in their careers.

Recent Pentagon proposals have concurred with the concept of transitioning to a FERS-styled program.[84] A reformed system will improve equity by providing retirement benefits for all personnel who serve at least 10 years, and enhance efficiency by using current pay and bonuses to incentivize retention. Under any such plan, current pay will have to rise to make up for the reduced incentive for members to remain in the service, and separation pay will be needed to ease

[82] The decision to grandfather service members with more than 15 years of experience postpones the accrual of any savings until service members from the new cohort reach 20 years of service in 2017.
[83] "Accrual cost" refers to the sum of the present value of benefits earned in each year plus annually accrued interest on benefits earned in prior years.
[84] See Quadrennial Review of Military Compensation, "Report of the Tenth Quadrennial Review of Military Compensation: Volume II," Department of Defense, July 2008.

the transition to civilian life. Even with such adjustments, however, this reform is projected to reduce the retirement system’s cost by at least 50 percent.

4. Increase Fees for Aviation Security

Description of Recommendation**:** The 2001 Aviation and Transportation Security Act greatly increased transportation security measures and made the federal government responsible for aviation security procedures that were previously handled by airports and airlines. The fees that the act authorized to pay for this expanded federal responsibility, however, now cover less than half of federal costs. This proposal will increase fees for aviation security to a flat fee of $5 per one-way trip in order to cover a greater portion of federal aviation security costs.

Cumulative Budget Savings in Billions of Dollars from 2012 through**:**

2020	2025	2030	2040
$19	$32	$48	$91

Background**:** The 2001 Aviation and Transportation Security Act made the federal government, rather than airlines and airports, responsible for screening passengers, carry-on luggage, and checked baggage. Implementing these new standards required hiring screeners who were more highly trained and qualified, necessitating higher compensation, and raising overall costs to the government.

To help pay for increased security, the law authorized airlines to charge passengers $2.50, capped at $5 for a one-way trip, each time they boarded a plane. The government was also authorized to impose fees on the airlines themselves and to provide funding to reimburse airlines, airport operators, and service providers for the additional costs of security enhancements. The Task Force proposal will raise the fee for a one-way trip to a flat level of $5.

The public, in general, benefits from airport security, because greater security reduces the risk of terrorism. Recognizing the general public benefit from airport security, this fee increase shifts a greater share of security costs to users but still provides some subsidy from public funds.

The current situation, in which security costs are covered partly by users of the aviation system and partly by general taxpayers, provides a large subsidy to air transportation. The main beneficiaries of transportation security enhancements, however, are the users of the system, and thus they should pay for most of the associated expense. Security is a basic cost of airline transportation, in the same way that fuel and labor costs are.

5. Actually Adjust Flood Insurance Subsidies for Risk

***Description of Recommendation*:** The National Flood Insurance Program's (NFIP) premium subsidy for structures that were built before the completion of regional flood insurance rate maps (FIRMs) was designed to encourage the purchase of flood insurance by property owners who were previously unaware of the flood risks they faced due to the lack of public knowledge. This subsidy, however, has outlived its original purpose. Regional flood insurance rate maps have been drawn for virtually the entire nation, and property owners can easily find information on the flood risks and associated insurance rates for their area.

This proposal will phase out all pre-FIRM flood insurance premium subsidies over five years. By eliminating the subsidy, the NFIP will charge actuarially fair rates to all flood insurance policyholders. This will make policyholders of these older structures pay a fair share for their insurance protection, or create appropriate incentives for them to relocate. Currently, the NFIP must pay a considerable portion of annual premium receipts to service a debt of $19.3 billion borrowed after Hurricanes Katrina and Rita in 2005. Because the remaining premium revenue is less than the average cost of annual claims, a large backlog of claims awaiting payment is developing. Increasing premiums will reduce the program's shortfall and also allow the NFIP to reduce the backlog in claims.

***Cumulative Budget Savings in Billions of Dollars from 2012 through*:**

2020	2025	2030	2040
$10	$20	$34	$70

***Background*:** The NFIP is administered by the Federal Emergency Management Agency (FEMA) to insure buildings and their contents against losses due to flooding. The program charges two sets of premiums. The first set applies to "pre-FIRM" structures – buildings erected before 1975 or before the completion of a community's official FIRM. These premiums are heavily subsidized; the government pays an average of about 60 percent of their cost. The other set of premiums applies to "post-FIRM" buildings. Post-FIRM premiums are designed to be actuarially sound (i.e., they cover the costs of all insured losses). Post-FIRM premiums are calculated under a formula that assesses the risk of flooding in a particular building, given the structure's elevation relative to the flood level. Pre-FIRM structures are not subject to the same risk assessment, despite constituting more than 20 percent of NFIP's insurance policies. This proposal will create parity between insurance rates on pre-FIRM and post-FIRM structures.

6. Adjust Pension Benefit Guarantee Corporation Fees to Better Cover Unfunded Liabilities

***Description of Recommendation*:** Pension Benefit Guarantee Corporation (PBGC) expenses rose considerably with the 2008 financial crisis, as a large number of firms went bankrupt or were forced to terminate their pension plans without sufficient assets to pay promised benefits. This proposal seeks to improve the PBGC's long-term financial condition, and align premium costs more closely with the risks that participating companies pose. To accomplish this goal, the PBGC should increase the fixed-rate premium by 15 percent and raise the variable-rate premium from $9 to $12 per $1,000 of underfunding.

Additionally, although not reflected in the savings estimates below, the Task Force recommends that the PBGC base the variable premium partly on the riskiness of a private pension plan's investment allocation (e.g., how much is invested in stocks versus bonds).

***Cumulative Budget Savings in Billions of Dollars from 2012 through*:**

2020	2025	2030	2040
$5	$6	$7	$12

***Background*:** The PBGC is a federal agency that insures participants in private employers' defined-benefit pension plans against losses if their plans are terminated without sufficient assets to pay promised benefits. In such a case, the PBGC assumes the plan's assets and liabilities, and makes monthly annuity payments to qualified retirees. The PBGC assesses fees on participating firms, consisting of a fixed annual payment ($34 in 2009) for each participant (worker or retiree) in the plan; for an underfunded plan, a variable payment equal to $9 for each $1,000 by which the plan is underfunded; and, for a plan terminated in or after January 2006, a $1,250 payment for each participant in each of the first three years after the company exits bankruptcy.

In 2008, the PBGC reported a deficit of about $11 billion, meaning its assets were $11 billion less than the present value of benefits owed to workers and retirees in terminated plans (or plans whose termination the agency viewed as "probable"). This proposal will adjust both the fixed and variable components of the premiums to improve PBGC's long-term financial outlook. The fixed-component increase can be done either by raising the current fee per covered individual from $34 to $39, or by changing the assessment base to some measure of insured benefits and setting the premium at a rate that yields 15 percent more in collections.

Meanwhile, raising the variable-rate premium will raise the cost for employers who maintain underfunded plans or plans that are heavily invested in more volatile assets. This will provide a further incentive for employers to fully fund their plans, and to invest in assets less likely to experience large swings or heavy losses. This change can be made through an adjustment of the variable premium rate that is based on the percentage of a pension portfolio's assets invested in stocks versus bonds. Greater allocations in bonds will reduce the volatility of portfolio assets, and

therefore reduce future claims to the PBGC. Companies can still choose to invest in the stock market, where they might see higher returns than in bonds, but, in doing so, they – rather than the government – will bear more of the consequences of the investments' risk.

7. Use a More Accurate Cost-of-Living Adjustment (COLA) for All Federal Benefit Programs

***Description of Recommendation*:** The COLA for all federal benefit programs (e.g., federal and military pensions) is linked to changes in the Consumer Price Index for Urban Wage Earners (CPI-W). Many analysts and economists, however, believe that the CPI-W can overstate inflation because it does not fully account for changes in consumer spending resulting from increases in prices.

This proposal recommends switching the basis for COLA adjustments in these programs from the CPI-W to the "chain-weighted" Consumer Price Index for All Urban Workers (CPI-U). This alternative measure more accurately reflects price changes due to inflation and will grow at an estimated 0.3 percentage points more slowly than the CPI-W over the next 10 years. Using the Chained CPI-U will reduce federal outlays while still providing better protection against inflation than most private pensions.

***Cumulative Budget Savings in Billions of Dollars from 2012 through*:**

2020	2025	2030	2040
$19	$55	$117	$359

***Background*:** Many federal benefit programs provide annual COLAs that protect beneficiaries against inflation-driven price increases. Currently, the COLA for these programs is linked to changes in the CPI-W. The CPI-W, however, can overstate inflation because it does not fully account for changes in patterns of spending. (For example, when the price of apples goes up, people can reduce the impact by substituting oranges.) Many experts have proposed shifting the calculation of annual COLAs from the CPI-W to the C-CPI-U, an alternative measure developed by the Bureau of Labor Statistics (BLS) that typically grows at a slower rate than the CPI-W.

Enforce the Budget, Reform the Process

Statutory Caps on Discretionary Spending

***Description of Recommendation*:** This proposal will require that any breach of the discretionary spending caps (i.e., spending levels exceeding those specified in the five-year defense freeze or the four-year non-defense freeze) will trigger automatic reductions in discretionary spending, sufficient to eliminate the excess amount. The only exception will be "emergency spending," which will have to meet specific definitional requirements and be certified as such by the President and Congress.

While this proposal imposes caps on "defense" and "non-defense" discretionary spending, the Task Force urges policymakers to strongly consider redefining these categories as "security spending" and "non-security spending." Security spending will include defense, international affairs, and homeland security spending – recognizing the inherent and frequent interaction of those programs. Non-security spending will include all other discretionary programs.

***Background*:** The Task Force proposal will re-establish the statutory spending caps that were in place in the 1990s. The goal of discretionary spending limits, first established under the 1990 Budget Enforcement Act (BEA), was to set statutory ceilings for discretionary spending (i.e., spending controlled through annual appropriations bills) in each fiscal year. Congress established limits on both budget authority and outlays at levels consistent with the goal of bringing projected deficits under control.

The key to the statutory spending limits was their enforcement mechanism. If the Office of Management and Budget (OMB) determined that appropriations legislation exceeded the statutory limits, the President was required by law to execute an automatic across-the-board cut ("sequester") to eliminate the excess amount. In general, both Congress and the administration worked hard to keep spending within the caps.

Under the BEA, across-the-board cuts were triggered by spending overages in only one fiscal year – 1991. This apparent success, however, was due in part to an escape valve: an exemption for emergency spending. Under the BEA, any appropriations that both the President and Congress deemed an "emergency requirement" were exempted from the discretionary spending limits. The Task Force therefore urges that re-enactment of spending caps include a rigorous definition of what spending constitutes an emergency.

Strengthening Pay-As-You-Go (PAYGO) Restraints on New Entitlement Spending and Revenue Losses

***Description of Recommendation*:** This proposal will require that policymakers fully offset any losses in revenues, expansions of existing mandatory (entitlement) spending, or new mandatory spending through reductions in mandatory spending or increases in revenues. Violation of this statutory requirement will trigger automatic reductions in non-exempt mandatory spending. This provision will prevent Congress from restoring the tax expenditures that the Task Force plan eliminates or undoing entitlement cuts that the plan imposes unless the costs are fully offset.

***Background*:** The Task Force proposes re-establishing the strong pay-as-you-go (PAYGO) restraints that Congress put in place in the 1990s, which helped to generate four straight budget surpluses starting in 1998. The concept was simple: If lawmakers wanted to enact new entitlement programs, expand existing entitlements, or enact new tax cuts, they had to find offsets to "pay for" the cost of the new benefits or tax cuts. These offsets could consist of cuts in mandatory (entitlement) spending or tax increases.

Similar to the discretionary spending limits, the teeth in PAYGO was an automatic "sequester" mechanism. The Office of Management and Budget (OMB) was required to execute automatic cuts in non-exempt mandatory spending programs if the cumulative effect of tax and entitlement legislation in a particular year was to increase the deficit. Medicare would bear the brunt of a PAYGO sequester, with farm price supports, child support enforcement, and social services block grants among other programs that would face cuts. No PAYGO sequesters of mandatory spending were ever triggered during the 1990s.

Biennial Budgeting

***Description of Recommendation*:** This proposal will move the federal government from annual to biennial budgeting, requiring the President to submit a two-year budget proposal every odd-numbered year, and Congress to adopt two-year budget resolutions and two-year appropriations bills.

***Background*:** The Budget Act – the law that governs the congressional budget process – calls for the President to submit a new budget every year, and for Congress to adopt an annual budget resolution and annual appropriations bills (currently numbering 12).

Proponents of biennial budgeting argue that it will reduce the enormous amount of time consumed by the annual budget process, giving Congress more time to review the effectiveness of programs in meeting the nation's needs. In addition, biennial budgeting should give agency program managers and recipients of federal funds more financial stability and, consequently, the potential to plan better and achieve greater efficiencies.

Administration officials, Members of Congress, and outside experts have offered a variety of proposals since the late 1970s to switch the federal budget process from an annual to a two-year, or "biennial," timetable. Most proposals call for lawmakers to use the first year of each Congress to adopt a biennial (two-year) budget resolution and biennial appropriations. The second year of each Congress will then be devoted to multi-year authorization bills and program oversight. Biennial budget proposals also typically require the President to submit two-year budgets to Congress and conduct performance reviews on a two-year cycle.

Biennial budgeting has received widespread support from all Democratic and Republican Administrations since the 1980s, various bipartisan commissions, key congressional committees, and majorities in surveys of the House and Senate, but Congress has never enacted the change.

Maintaining Entitlements at Sustainable Levels

***Description of Recommendation*:** Enact explicit long-term budgets for the major entitlement programs. Create a Fiscal Accountability Commission that will meet every five years to assess whether program growth is remaining within the long-term budgets and, if not, to propose measures that would restore long-term sustainability.

***Background*:** Long-term budget projections inherently involve a lot of assumptions about many economic and programmatic factors. The further out the projections, the more speculative they are. While the Task Force expects the policies proposed in the report to stabilize the debt below 60 percent of GDP in 2020 and beyond, this provision provides a mechanism to ensure that long-term growth of entitlement programs is carefully re-examined every five years.

Budget Estimates Through 2040

	Fiscal Years, Billions of $									Cumulative Savings:		
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2012-2020	2012-2030	2012-2040
1. Current Debt Projections (debt held by the public)												
In billions of dollars (currently at $9,031)	11,009	11,710	12,424	13,286	14,318	15,455	16,693	18,133	19,701	19,701	47,116	112,167
As a percent of GDP (currently at 62%)	69.8%	70.1%	70.0%	71.3%	73.4%	75.8%	78.4%	81.7%	85.1%	85.1%	133.9%	209.8%
2. Debt Reduction Goal (60% of GDP)	9,458	10,023	10,656	11,178	11,705	12,239	12,776	13,323	13,892	13,892	21,112	32,084
3. Required Debt Reduction (in billions of dollars) to reach 60% of GDP	1,551	1,687	1,768	2,108	2,613	3,216	3,917	4,810	5,809	5,809	26,004	80,083
HEALTH CARE SAVINGS - BENDING THE COST CURVE												
4. Cap employer health benefits exclusion in 2018 and phase out over 10 years	0	0	0	0	0	0	13	34	66	113	3,299	9,925
Transform Medicare												
Near Term:												
5. A. Phase in Part B premium increase from 25% to 35% over 5 years*	3	7	13	19	24	27	29	-	-	123	123	123
6. B. Reform Medicare's copayment structure*	0	1	2	2	2	3	4	-	-	14	14	14
7. C. Bundle payments for post-acute care (mandated instead of pilot)*	0	0	0	0	1	2	3	-	-	5	5	5
8. D. Reduce payments to Rx companies*	9	11	13	14	17	17	18	-	-	100	100	100
9. Long Term: In 2018, transition to premium support	0	0	0	0	0	0	0	82	90	172	2,089	7,147
Transform Medicaid												
10. Near Term: Broaden the use of managed care in Medicaid*	0	0	0	1	1	1	1	-	-	5	5	5
11. Long Term: In 2018, end Medicaid federal match system & allocate responsibilities between fed and states in a revenue-neutral manner	0	0	0	0	0	0	0	7	13	20	655	2,983
12. Enact medical malpractice reforms	1	3	5	6	8	8	8	5	5	48	130	299
13. Anti-obesity measure: Tax on manufacture and importation of sweetened beverages	12	17	17	17	18	18	19	19	19	156	375	644
SUBTOTAL: Health Care Budget Savings	26	39	50	60	70	77	95	147	194	756	6,794	21,244
% of total policy changes (excluding debt service)										15%	33%	43%

* Note: There are no further savings from short-term Medicare and Medicaid policies after 2018 because all savings after that accrue from the long-term policies.

	Fiscal Years, Billions of $									Cumulative Savings:		
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2012-2020**	**2012-2030**	**2012-2040**
STRENGHTEN SOCIAL SECURITY FOR FUTURE GENERATIONS												
14. Index benefit formula for longevity (begin in 2023)	0	0	0	0	0	0	0	0	0	0	12	240
15. Increase taxable base to 90% over 38 years (begin in 2012)	1	4	6	9	11	14	17	21	24	107	542	1,461
16. Change to more accurate annual COLA calculation	0	2	4	7	10	13	16	19	22	92	527	1,452
17. Adjust benefit formula (protecting bottom 75% - begin in 2023)	0	0	0	0	0	0	0	0	0	0	5	59
18. Update minimum benefit for long-term low-wage earners and protect the most vulnerable elderly with a modest benefit increase	-3	-6	-7	-7	-8	-9	-10	-11	-12	-73	-260	-651
19. Cover state and local workers (begin in 2020) / sharing pension data between states and SSA	0.0	0.0	0.2	0.3	0.5	0.5	0.4	0.4	1.5	4	163	566
SUBTOTAL: Social Security Savings (including interactions)	-2	0	2	6	8	9	12	14	23	73	748	2,768
% of total policy changes (excluding debt service)										1%	4%	6%
OTHER ENTITLEMENT (MANDATORY) SAVINGS												
20. Reform civilian and military retirement	0	0	0	0	0	1	1	2	2	7	58	180
21. Change to more accurate inflation adjustment for all federal benefit programs	0	0	0	1	2	3	4	4	5	19	117	359
22. Reform farm program spending	0	0	1	2	2	3	4	4	4	29	89	185
23. Increase fees for aviation security	2	2	2	2	2	2	2	2	2	19	48	91
24. Actuarially adjust flood insurance premiums for risk	0	0	1	1	1	1	2	2	2	10	34	70
25. Adjust PBGC fees to cover unfunded liabilities	0	1	1	1	1	0	0	0	0	5	7	12
SUBTOTAL: Other Mandatory	2	3	5	7	9	11	13	14	16	89	352	898
% of total policy changes (excluding debt service)										2%	2%	2%

	Fiscal Years, Billions of $									Cumulative Savings:		
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2012-2020	2012-2030	2012-2040
CAP DISCRETIONARY SPENDING (Budget Authority) w/ BEA enforcement*												
(Numbers reflect estimated outlay savings compared to baseline, i.e., growth at GDP levels)												
26. 4-Year Non-Defense Discretionary Hard Freeze (2012-2015) at 2011 levels, then capped at GDP	15	44	83	120	136	146	152	159	166	1,022	3,135	6,345
27. 5-Year Defense Discretionary Hard Freeze (2012-2016) at 2011 levels, then capped at GDP	15	44	80	114	148	164	175	183	191	1,114	3,541	7,229

*** Under BEA enforcement, any breach of the caps triggers automatic cuts.**

*** In order to accommodate inflation, population growth, aging of the population, and priority investments, it is expected that, within the total freeze level, individual programs would be reduced, terminated, or increased, and additional savings would be achieved through new fees and management reforms, and best practices adopted from the states.**

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2012-2020	2012-2030	2012-2040
SUBTOTAL: Discretionary Spending Savings	29	88	163	234	284	310	327	343	358	2,136	6,676	13,575
% of total policy changes (excluding debt service)										43%	33%	27%
TAX EXPENDITURE CUTS / REFORM THE TAX CODE												
28. Restructure itemized deductions and eliminate most tax expenditures	230	338	369	397	421	444	428	447	470	3,544	11,091	23,511
29. Tax all capital gains and dividends as ordinary income (top rate of 27%), with $1,000 exclusion for capital gains (or losses)	-1	2	5	29	38	40	42	44	46	243	806	1,644
30. Restructure tax benefits for low-income families and families with children, and eliminate standard deduction and personal exemptions	-155	-209	-211	-213	-216	-221	-226	-230	-234	-1,914	-4,414	-7,995
RATE CUTS AND NEW REVENUES												
31. Reduce Income Tax Rates to: 15% and 27%	-70	-109	-123	-136	-149	-161	-173	-183	-194	-1,298	-3,873	-7,893
32. Reduce Corporate Tax Rate to 27%	-71	-79	-90	-84	-89	-90	-92	-93	-96	-785	-2,008	-3,866
33. Repeal the Alternative Minimum Tax	-23	-31	-34	-36	-38	-40	-42	-45	-48	-338	-1,031	-2,110
34. Introduce a 6.5% Debt-reduction Sales Tax (DRST), phased-in over 2 years (3% in 2012, 6.5% in 2013)	105	268	326	345	364	382	400	419	439	3,048	8,764	17,333
35. Adjust excise tax on alcoholic beverages to 25 cents/oz	4	6	6	6	6	6	6	6	7	53	127	218
36. Index the tax system to a more accurate measure of inflation	2	6	8	11	13	17	21	24	29	133	484	1,244
37. Extend Estate Tax at 2009 levels (baseline assumption)	0	0	0	0	0	0	0	0	0	0	0	0
38. 1-year social security payroll tax holiday for employees and employers (*note: although not shown, this proposal costs $481 billion in FY2011*)	-160	0	0	0	0	0	0	0	0	-641	-641	-641

	Fiscal Years, Billions of $									Cumulative Savings:		
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2012-2020	2012-2030	2012-2040
TOTAL: SPENDING POLICY REDUCTIONS	43	112	199	281	344	375	398	445	480	2,677	10,197	25,895
% of total policy changes (excluding debt service)										54%	50%	52%
TOTAL: TAX EXPENDITURE CUTS / REFORM THE TAX CODE	74	131	163	213	242	263	244	261	282	1,873	7,483	17,160
% of total policy changes (excluding debt service)										38%	37%	35%
TOTAL: RATE CUTS AND NEW REVENUES[1]	-201	81	116	133	137	147	156	168	179	435	2,738	6,389
% of total policy changes (excluding debt service)										9%	13%	13%
TOTAL DEBT SERVICE SAVINGS	-9	-8	4	31	71	119	168	220	283	877	8,271	34,160
% of total debt reduction										16%	32%	44%
TOTAL DEBT REDUCTION[2]	-92	315	483	659	795	904	966	1,094	1,227	5,866	28,852	84,171
Required Debt Reduction (in billions of dollars) to reach 60% of GDP										5,809	26,004	80,083
Bottom Line (positive number indicates excess debt reduction)										57	2,848	4,087

										In Year:		
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025	2030	2040
Bipartisan Plan Debt as % of GDP	73%	72%	69%	67%	65%	63%	62%	61%	60%	55%	52%	52%
Baseline Debt as % of GDP	70%	70%	70%	71%	73%	76%	78%	82%	85%	106%	134%	210%
Bipartisan Plan Deficit as % of GDP	-6.0%	-2.5%	-1.4%	-1.2%	-1.3%	-1.2%	-1.3%	-1.6%	-1.5%	-1.4%	-1.9%	-2.3%
Baseline Deficit as % of GDP	-5.4%	-4.4%	-4.2%	-4.7%	-5.4%	-5.6%	-5.8%	-6.5%	-6.8%	-8.9%	-11.6%	-16.7%

[1] Rate Cuts and New Revenues subtotal also includes the effects from policies #13 and #15.
[2] The budget savings from covering newly hired state & local workers under the Social Security program is included in this total, but not in any of the subtotals because it is a coverage provision.

Appendix A: Bipartisan Policy Center (BPC) Tax Reform

Quick Summary

The Bipartisan Policy Center (BPC) Tax Reform Plan represents a radical simplification of the current tax code. In fact, to best explain it, forget what you know about the complexities of the current tax system, and start fresh. Outlined below are the core elements of the plan:

- A **two-bracket income tax with rates of 15 percent and 27 percent**. Because there is no standard deduction or personal exemptions, the 15 percent rate applies to the 1st dollar of income.[85]

- The **corporate tax rate will be set at 27 percent**, instead of the current 35 percent level.

- Capital gains and dividends will be taxed **as ordinary income** (**with a top rate of 27 percent**), excluding the first $1,000 of realized net capital gains (or losses).[86]

- Introduce a **6.5 percent broad-based Debt Reduction Sales Tax (DRST)**, phased-in over two years.[87]

- To replace the overly complex Earned Income Tax Credit (EITC) and to help offset the effects of the DRST and elimination of personal exemptions, the standard deduction and the child credit, the BPC Plan will establish:
  - A flat **refundable per child tax credit of $1,600** (higher than current law); and
  - A **refundable earnings credit**[88] similar to the current Making Work Pay credit, but substantially higher.

- Instead of the current system of itemized deductions, which disproportionately subsidizes the housing consumption and charitable giving of upper-income taxpayers, the BPC Plan will:
  - Provide a **flat 15 percent refundable tax credit for charitable contributions** and for up to $25,000 per year, not indexed, **mortgage interest on a primary residence**.
  - Eliminate the deduction for state and local taxes.
  - Provide a flat, **15 percent refundable tax credit** or a deduction (for those in the higher bracket) **for contributions to retirement saving accounts** up to 20 percent of earnings or a maximum of $20,000.

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[85] The 27 percent rate applies approximately to income above $51,000 for single filers and $102,000 for couples.
[86] $500 for singles and heads of household
[87] The DRST will start at 3 percent in 2012, and then increase to 6.5 percent by 2013.
[88] The refundable earnings credit is equal to 21.3 percent of the first $20,300 of earnings.

- Include 100 percent of Social Security benefits in taxable income, but:
    - Create a non-refundable credit for Social Security beneficiaries equal to 15 percent of the current standard deduction; and
    - Create a non-refundable credit equal to 15 percent of an individual's Social Security benefits.

- Allow deduction of medical expenses in excess of 10 percent of Adjusted Gross Income (AGI) (as in current law).

- Allow deduction of miscellaneous itemized deductions in excess of 5 percent of AGI.

The BPC Plan achieves a massive simplification of the tax code:

- **Aligns the top individual, capital gains and dividend tax rates**
- **Reduces the corporate tax rate**
- **Eliminates the AMT**
- **Eliminates the need to file returns for most individuals**[89]

Despite a low top rate of 27 percent, the new tax system created under the BPC Plan is **more progressive than the current system** and **raises the requisite revenue to achieve our debt-reduction goal**.

[89] According to Tax Policy Center projections, only 50 percent of tax units would be required to file tax returns, as opposed to 88 percent under the current tax system.

Appendix B: Tax Expenditures Retained in the New Tax Structure

401(k) plans, Individual Retirement Accounts, and Keogh plans, but the total amount employees and employers may contribute to tax-deferred retirement saving plans is limited to the smaller of 20 percent of earnings or $20,000.

Accelerated depreciation of buildings other than rental housing (normal tax method)

Accelerated depreciation of machinery and equipment (normal tax method)

Capital gains exclusion on home sales

Carryover basis of capital gains on gifts

Deductibility of casualty losses

Deductibility of charitable contributions is replaced by a 15 percent refundable credit for contributions that all taxpayers may claim.

Deductibility of medical expenses

Deductibility of mortgage interest on owner-occupied homes is replaced with a refundable credit of 15 percent for the first $25,000 of mortgage interest paid that all homeowners may claim. The new credit is limited to principal residences.

Deferral of income from controlled foreign corporations (normal tax method)

Deferral of interest on U.S. savings bonds

Deferred taxes for financial firms on certain income earned overseas[90]

Employer defined-benefit retirement plans

Exclusion of benefits and allowances to armed forces personnel

Exclusion of interest on public purpose state and local bonds

Exclusion of interest spread of financial institutions

Exclusion of net imputed rental income

Expensing of certain small investments (normal tax method)

Expensing of research and experimentation expenditures (normal tax method)

Income averaging for farmers

Low and moderate income savers credit is expanded. In place of a deduction, taxpayers may claim a 15 percent refundable credit. This helps those in the 15 percent bracket with no liability.

Ordinary income treatment of loss from small business corporation stock sale

Tax credit for the elderly and disabled, and additional deduction for the elderly and blind are replaced with a new tax credit for those 65 and over or blind.

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[90] The Task Force plan leaves in place the provision that allows U.S. multinationals to defer taxation of the profits of their foreign subsidiaries until those profits are repatriated to the U.S. parent (deferral). Some view deferral as an incentive for U.S.-based companies to invest overseas, but others believe eliminating deferral would damage the ability of U.S. corporations to compete with foreign-based corporations and note that most of our major trading partners have enacted territorial systems that exempt completely the active foreign income of their corporations. While the Task Force plan does not address our complex system of taxing international income flows of corporations, the substantially lower corporate tax rate that the Task Force proposes will increase the incentive for both U.S. and foreign-based multinationals to invest in the United States.

Appendix C: Actuarial Scoring of Social Security Plan

Bipartisan Debt Reduction Task Force Pan **As of November 10, 2010**	Change in 75-year Actuarial Balance	Change in 75th year Annual Balance
1) Increase taxable maximum 2 percent per year beginning in 2012 until a taxable ratio of 90 percent is achieved. Additional taxable earnings would enter in the benefit base. Current law bend points and PIA formula factors are unchanged.	0.60	0.68
2) Beginning with the December 2012 benefit adjustment, base the increase on the 3rd quarter to 3rd quarter increase in the Chain-weighted Consumer Price Index for Urban Consumers rather than the Consumer Price Index for Urban Wage-Earners and Clerical Workers. (Related 2009 solvency provision A3.)	0.49	0.70
3) Cover newly hired state and local government employees beginning in 2020.	0.16	-0.12
4) Phase out the income and payroll tax exclusion for employer-sponsored health insurance beginning in 2018. Set exclusion at the 75th percentile of premium distribution in 2018, with amounts above that subject to tax. Reduce the exclusion level by 10 percent annually with exclusion fully eliminated in 2028. (Related 2009 solvency provision F2, but phased-out over a 10-year period rather than all at once.)	0.93	1.06
5) Reduce the upper 15 percent PIA formula factor by 1/3 over a 30-year period beginning in 2023 and through 2052, with an ultimate factor of 10%. Affects OASI and DI.	0.07	0.20
6) Reconfigure the special minimum benefits to ensure that someone earning at least 20% of the old law tax max in each of 30 years would receive a PIA of 133 percent of the federal poverty level, with the formula phased up to 133 percent of poverty linearly for workers over 19 creditable years. Up to 8 years of care-giving could be used as creditable years for care of a child under the age of 6, if it is not otherwise counted as a creditable year (earnings < 20% old law tax max). Scale requirements for DIBs including child care credit years. Effective for new eligibles in 2012. Wage-index the poverty level from 2009 up to 2 years prior to benefit eligibility.	-0.09	-0.14
7) Tax all voluntary salary reduction plans like 401(k)s for payroll tax purposes, effective 2012.	0.22	0.13
8) For those attaining age 62 in 2023 and later, reduce all benefit formula factors by the increase in period life expectancy, with a 4-yr lag (2023 versus 2022 for the first year.) Apply for OASI only, with DI benefits proportionally reduced at conversion.	0.48	1.75
9) Provide the same dollar amount increase to the benefit level of any beneficiary who is 85 or older at the beginning of 2012 or who reaches his or her 85th birthday after the beginning of 2012. The dollar amount of increase equals 5 percent of the average retired worker benefit in the prior year. Phase in at 1% per year from 81 to 85.	-0.13	-0.18
10) 6.5 percent DRST and lower corporate income tax from 35 to 27 percent. Estimated to result in a 4 percent decrease in AWI, ATE.	-0.03	0.16
11) Change in personal income tax structure	-0.01	-0.06
Effect of total proposal	**2.48**	**3.64**

Appendix D: Domestic Discretionary Reductions and Terminations Recently Developed by the Congressional Budget Office (CBO), and the Obama and Bush Administrations

The lists below are presented for purely illustrative purposes. Task Force members are <u>not</u> endorsing any particular items on these lists. Also, note that the options presented by the CBO do not reflect its endorsement of any particular terminations or reductions.

<u>Examples of Programs Recently Proposed for Termination</u>

Program	Source	Five-year Est. Savings (in millions)
Agriculture Single-family Housing Direct Loans[1]	Bush Budget	$1,420
Airports: Eliminate Grants to Large and Medium-sized Hub Airports	CBO	$4,329
Automobile Fuel Cells: Eliminate Funding for the FreedomCAR and Fuel Partnership	CBO	$640
Community Service (AmeriCorps, Learn & Serve America)	CBO	$3,187
Community Development Financial Institutions Fund	CBO	$435
Drugs: Eliminate the National Youth Anti-drug Media Campaign	CBO	$350
Educational Technology State Grants[2]	Bush Budget	$555
Election Reform Grants[2]	Obama Budget	$375
Emergency Operations Center Grant Program[2]	Obama Budget	$300
Energy Conservation: Eliminate the Dept. of Energy's Grants to States for Energy Conservation and Weatherization	CBO	$1,684
EPA: Eliminate the EPA's Science to Achieve Results Grant Program	CBO	$308
Essential Air Service (air carriers serving small communities)	CBO	$599
Food and Nutrition Service - Commodity Supplemental Food Program[2]	Bush Budget	$665
Health Resources and Services Administration (3 terminations)	Obama Budget	
• Health Care Facilities and Construction[2]	Obama Budget	$1,690
• Denali Commission[2]	Obama Budget	$50
• Delta Health Initiative[2]	Obama Budget	$175
Hollings Manufacturing Extension Partnership and the Baldrige National Quality Program	CBO	$455
International Trade Administration's Trade Promotion Activities	CBO	$1,555
LEAP: Eliminate the Leveraging Educational Assistance Partnership Program	CBO	$272
Legal Services Corporation	CBO	$1,953
Mass Transit (Rail): Eliminate the New Starts Transit Program	CBO	$5,465
National Park Service: Eliminate Funding for Heritage Area Grants	CBO	$106
NSF Spending on Elementary and Secondary Education	CBO	$366

Neighborhood Reinvestment Corporation	CBO	$925
Oil and Gas Research and Development Program	Bush/Obama Budget	$230
Overseas Private Investment Corporation	CBO	$148
Regional Development Agencies	CBO	$326
Resource Conservation and Development Program[2]	Bush/Obama Budget	$51
Safe and Drug Free Schools	CBO	$1,344
Senior Community Service Employment Program	CBO	$2,400
Small Department of Education Programs (5 terminations)	Bush/Obama Budget	
• B.J. Olympic Scholarship[2]	Bush/Obama Budget	$1
• Byrd Honors Scholarship[2]	Bush/Obama Budget	$42
• Historic Whaling and Trading Partners[2]	Bush/Obama Budget	$9
• Legal Assistance Loan Repayment[2]	Obama Budget	$5
• Underground Railroad Educational and Cultural[2]	Bush/Obama Budget	$2
State Criminal Alien Assistance Program (SCAAP)[2]	Bush Budget	$1,650
Student Aid: Eliminate Administrative Fees Paid to Schools in the Campus-based Student Aid and Pell Grant Programs	CBO	$771
Supplemental Educational Opportunity Grants[2]	Bush Budget	$3,795
Surface Transportation Priorities (STP)[2]	Obama Budget	$1,465
Targeted Water Infrastructure Grants[2]	Bush/Obama Budget	$785
Tech Prep Consolidation[2]	Bush/Obama Budget	$515
Unconventional Fossil Technology Program[2]	Obama Budget	$100
Wastewater and Drinking Water: Eliminate Federal Grants for Infrastructure	CBO	$2,910

[1]Figure for this program represents the elimination of the program budget authority plus five years of the estimated 2011 direct loan subsidy outlays.
[2]Figure for this program represents five years of 2010 budget authority level.

Examples of Programs Recently Proposed For Reduction:

Program	Source	Five-year Est. Savings (in millions)
Agricultural Research Service Buildings and Facilities[3]	Obama Budget	$735
Agriculture Capital Improvement and Maintenance Program[3]	Obama Budget	$500
Amtrak: Reduce the Federal Subsidy	CBO	$1,021
Arts and Humanities (Smithsonian, CPB, NEH, NEA, National Gallery of Art, Kennedy Center): Reduce by 20 percent	CBO	$1,984
Community Development Block Grant: Drop Wealthy Communities	CBO	$2,604
Corps of Engineers Construction Projects[3]	Obama Budget	$1,070
Emergency Steel Guaranteed Loan Program[3]	Bush/Obama Budget	$215
EPA Homeland Security Activities[3]	Obama Budget	$175
Even Start Family Literacy Program: Eliminate Funding for Even Start and Redirect Some Funds to Other Education Programs	CBO	$127
Great Lakes Restoration Initiative[3]	Obama Budget	$875
Hazardous Fuels Reduction[3]	Obama Budget	$220
Home Investment Partnerships Program[3]	Obama Budget	$875
Homeland Security: Reduce Funding for Research and Development Programs in the Science and Technology Directorate	CBO	$315
Homeland Security: Restrict First Responder Grants to High-risk Communities	CBO	$353
Housing: Increase Payments by Tenants in Federally Assisted Housing (which effectively reduces federal support)	CBO	$7,904
Housing: Reduce Rent Subsidies for Certain One-person Households	CBO	$628
Justice: State and Local Law Enforcement Assistance, Justice Assistance, Juvenile Justice, COPS, and Violence Against Women	CBO	$2,380
New Construction of Housing for the Elderly and Disabled (2 reductions)	Obama Budget	
• Housing for the Elderly[3]	Obama Budget	$2,755
• Housing for Persons with Disabilities[3]	Obama Budget	$1,050
Public Housing Capital Fund[3]	Bush Budget	$426
Rural Water and Waste Disposal: Reduce Federal Spending by Capitalizing State Revolving Funds then Ending Federal Assistance	CBO	$24
Terrorism Risk Insurance Program	Obama Budget	$378
Timber Sales: Reduce Funding for Timber Sales that Lose Money	CBO	$273
Uniform Criteria for Special Monthly Pension (Veterans' Affairs)	Obama Budget	$48

[3]Figure for this program represents five years of savings at the proposed reduction in 2011 budget authority level.
[4]Figure for this program represents five years of savings from a 15 percent reduction in 2010 budget authority level.

Appendix E: Illustrative List of New Fees that Could Fund Some Domestic Discretionary Activities

Imposition of new or increased fees related to the services provided by an agency or program is a means of adjusting to the tight constraints of a four-year domestic discretionary freeze. Fees, in effect, allow for a reduction in a program's annual appropriation, or are a means of allowing a program to accommodate increasing demands due to population growth, inflation, or the growing need for services.

The list below provides examples of fees that could be considered by policymakers, but is presented for purely illustrative purposes. Task Force members are not endorsing any particular items on this list. Note: Figures represent funds that would be raised over five years.

- Army Corps: Increase fees for permits issued by the Army Corps of Engineers (CBO: $203 million)
- Banks: Charge for examinations of state-chartered banks (CBO: $497 million)
- Commodity Futures Trade Commission: Charge transaction fees (CBO: $588 million)
- Environmental Protection Agency (EPA): Fees that recover the EPA's costs related to pesticide and new-chemical registration (CBO: $114 million)
- Grazing Fees: Use state formulas to set grazing fees for federal lands (CBO: $105 million)
- Federal Aviation Administration (FAA): Increase registration fees for the FAA (CBO: $164 million)
- Food and Drug Administration (FDA): Fees to augment funding for the FDA to recover costs for drug approval (CBO: $254 million)
- Federal Housing Administration's Home Equity Conversion Mortgage Insurance: Increase fees (CBO: $272 million)
- Food Safety and Inspection Service: Fund the agency solely through fees (CBO: $4.6 billion)
- Hardrock Mining: Maintenance and location fees for hardrock mining on federal lands (CBO: $193 million)

- Inland Waterway System: Fees to finance maintenance of the system (CBO: $1.875 billion)
- Nuclear Waste: Index the Nuclear Waste Fund Fee to inflation (CBO: $143 million)
- Rail Safety: Fees to offset rail safety activities (CBO: $574 million)
- Small Business Administration (SBA): Impose fees on the SBA's secondary market guarantees (CBO: $21 million)
- St. Lawrence Seaway: Impose fees on users (CBO: $114 million)
- Trade Administration: Increase International Trade Administration fees to cover the full costs of trade promotion activities (CBO: $1.56 billion)

Appendix F: Discretionary Spending Baseline and Policy Path Details

(Billions of dollars)	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Total 2011-2015	Total 2011-2020
Assumed War Spending	164	134	70	39	29	25	25	25	25	25	25	297	422
BPC Baseline - CBO Alternative Fiscal Scenario (Discretionary Appropriations grow at GDP and combat troop levels decline to 30,000 by 2013)													
Budget Authority													
Defense	715	705	663	670	699	729	762	795	830	865	902	3,466	7,621
Nondefense	549	574	596	633	675	709	744	780	815	852	890	3,188	7,269
Total	1,263	1,279	1,260	1,303	1,375	1,438	1,506	1,575	1,645	1,717	1,792	6,654	14,889
Outlays													
Defense	692	722	689	681	692	715	749	775	803	842	879	3,499	7,546
Nondefense	666	687	677	690	719	748	781	814	849	884	921	3,521	7,770
Total	1,358	1,409	1,367	1,371	1,411	1,462	1,529	1,590	1,651	1,726	1,800	7,020	15,316
BPC Policy Path (4-year hard freeze for NDD (2012-2015), 5-year hard freeze for defense (2012-2016))													
Budget Authority													
Defense	715	705	641	610	600	596	596	622	649	677	705	3,152	6,401
Nondefense	549	574	574	574	574	574	602	631	660	690	720	2,870	6,173
Total	1,263	1,279	1,215	1,184	1,174	1,170	1,198	1,253	1,309	1,366	1,426	6,022	12,574
Outlays													
Defense	692	722	675	637	612	600	601	611	628	659	687	3,246	6,432
Nondefense	666	687	663	646	636	628	644	669	696	725	755	3,260	6,748
Total	1,358	1,409	1,337	1,283	1,248	1,229	1,245	1,280	1,324	1,383	1,442	6,506	13,180
Outlay Reduction													
Defense	0	0	15	44	80	114	148	164	175	183	191	252	1,114
Nondefense	0	0	15	44	83	120	136	146	152	159	166	261	1,022

About the Bipartisan Policy Center

In 2007, former Senate Majority Leaders Howard Baker, Tom Daschle, Bob Dole and George Mitchell founded the Bipartisan Policy Center (BPC), a non-profit organization that develops and promotes solutions that draw support from both Republicans and Democrats and generates the necessary political momentum to achieve real progress. As the only Washington-based organization promoting bipartisanship as an effective means of overcoming the challenges facing the nation, the BPC is working to restore civility and respectful discourse to the national debate.

The BPC currently has projects focused on health care, energy, national and homeland security, economic policy, and transportation. Each of these initiatives is headed by a diverse team of political and business leaders, substantive experts and academics who work closely with our staff of policy specialists and former Congressional and White House aides to develop consensus-based solutions that both Republicans and Democrats can support. The Bipartisan Policy Center Action Network, the BPC's c(4) organization, provides strategic advice and political advocacy to ensure our projects' policy recommendations have traction in Congress, the Executive Branch and the stakeholder community.

We believe it's time to revive the nation's longstanding bipartisan tradition – a tradition that in the last century produced significant achievements in energy and environmental policy, Social Security reform, and national security. Through events like Bridge-Builder Breakfasts, political summits and timely policy discussions, the BPC provides a forum to highlight policymakers and political leaders who are working collaboratively to forge bipartisan consensus on the key issues of the day.

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