

2012 | POST-ELECTION

THE FISCAL CLIFF AND BEYOND

SPONSORED BY THE PETER G. PETERSON FOUNDATION

THE SOLUTIONS INITIATIVE II
NOVEMBER 2012

AMERICAN ACTION
FORUM



Center for American Progress




Peter G. Peterson
Foundation
Our America. Our Future.

About The Peter G. Peterson Foundation

The Peter G. Peterson Foundation's mission is to increase public awareness of the nature and urgency of key fiscal challenges threatening America's future and to accelerate action on them. To address these challenges successfully, we work to bring Americans together to find and implement sensible, long-term solutions that transcend age, party lines, and ideological divides in order to achieve real results.

The Foundation serves as a reliable source of nonpartisan information, a convener of thought leaders and citizens, and a supporter of innovative projects. (To learn more about the Foundation and our initiatives, please visit www.pgpf.org.)

Absent changing our current path, our debt and deficits will destroy the American dream. We must come together as a nation to put in place a bipartisan plan to put our nation on a sustainable fiscal path.

America has overcome great challenges in the past and the Peterson Foundation strongly believes that we can do so again.

Introduction to Executive Summary Booklet

As elected officials turn their attention from the campaign trail to the demands of governing, the convergence of fiscal events at the end of the year present an important and pressing challenge.

The so-called “fiscal cliff,” comprised of a series of automatic tax increases and spending cuts that go into effect in early January 2013, has the potential to significantly affect the United States’ economic outlook. If the changes are allowed to proceed, budget deficits would be substantially reduced. However, deficit reduction would be achieved through a set of policies that neither party advocates – and most economists forecast that going over the cliff would throw the economy quickly back into recession.

Despite this danger, the fiscal cliff represents a critical opportunity, and a potential turning point for the country. The consensus against these automatic changes creates an opportunity for potential compromise on a better way forward – a sustainable long-term fiscal plan for the nation. Instead of sending our economy over the cliff or once again postponing action, elected leaders have a chance to pass a comprehensive plan that both avoids the near-term economic dangers and also puts the nation on a path for a stronger fiscal and economic future.

Fortunately, there are many potential paths forward.

The Solutions Initiative II

In 2011, the Peter G. Peterson Foundation launched the Solutions Initiative, which convened policy organizations from across the ideological spectrum to develop plans to achieve long-term fiscal sustainability through the year 2035. This year, to better inform the debate over the fiscal cliff and America’s economic future, the Foundation asked five organizations to participate in a second phase of the Solutions Initiative, addressing near-term fiscal challenges and offering updated long-term plans.

The organizations involved – the American Action Forum, the Bipartisan Policy Center, the Center for American Progress, the Economic Policy Institute, and The Heritage Foundation – have proposed specific measures for resolving the fiscal cliff impasse and putting the nation on a sustainable long-term fiscal path. They have also identified and analyzed potential obstacles to achieving a budget deal and implementing their plans. And each organization has recommended top policy priorities for the 113th Congress and the incoming presidential administration.

This second phase of the Solutions Initiative shows once again that progress on our fiscal challenges – both near term and long term – is possible. Although the solutions vary widely, it is clear that the United States does not have to endure a damaging drop off the edge of the fiscal cliff, nor do we have to be complacent in the face of an unsustainable long-term trajectory. Our nation can rise above its current challenges and lay a foundation for a prosperous economy for generations to come.

Solutions Initiative II Plans – Summary

The Solutions Initiative II: The Fiscal Cliff and Beyond

The Peter G. Peterson Foundation asked the five organizations taking part in the second phase of the Solutions Initiative to confront both long-term and near-term challenges.

The long-term challenge: America's fiscal path is unsustainable by any measure. As the population ages and health care costs continue to grow rapidly, spending on Medicare, Medicaid, and Social Security will climb, but revenues will not keep pace. If left unaddressed, federal government debt will soar well beyond sustainable levels and harm economic growth.

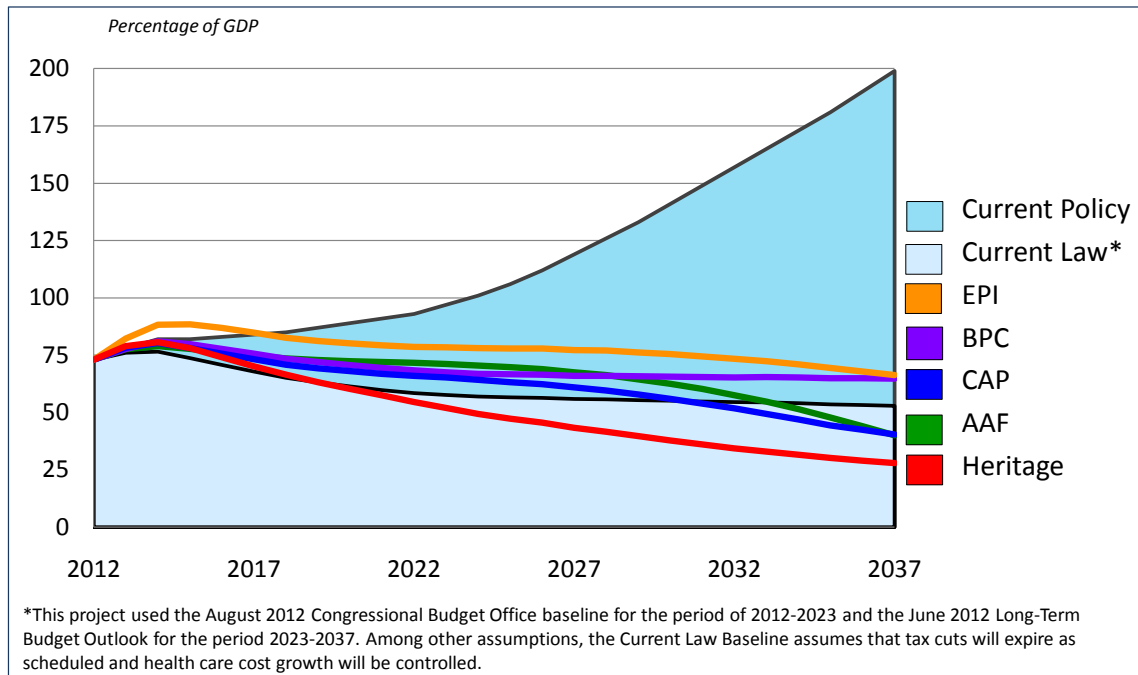
As our deficits continue, the federal government's interest costs are expected to rise dramatically. Under current policies, by 2023, we could be spending \$1 trillion a year on interest alone, and by 2054, interest costs could consume every dollar of federal revenue – meaning that all other obligations of the government, from Social Security to Medicare to national defense, would be financed by borrowing.

As that situation develops, we will likely face one of two types of fiscal and economic crisis: a sudden fiscal crisis driven by plummeting confidence in U.S. debt among global investors – a crisis that would force sharp cuts in government services and increases in taxes, with little thought to how those changes affect the most vulnerable – or a slow-growth crisis, in which the weight of additional federal debt and interest costs gradually crowds out other public and private investments, sapping the economy and slowly eroding living standards.

But there is a more optimistic scenario. If we stabilize our long-term debt burden, and begin to reduce it over time, we can boost global confidence in our nation's future, lay the foundation for greater investment and stronger economic growth, and ensure that vital safety net programs are sustainable for current and future generations. Moving down this path will require leadership and compromise from both parties in Washington.

We asked our Solutions Initiative II partners to look ahead 10 and 25 years and propose changes to tax and spending policy that would bring debt to sustainable levels. All five plans address this challenge and the ideas contained in the plans represent potential ingredients toward consensus in Washington.

Solutions Initiative II Plans: Projected Federal Debt (As a percentage of GDP)



(As a percentage of GDP)

Solutions Initiative II Plans: Projected Budget Levels in 2022 and 2037					
	AAF	BPC	CAP	EPI	Heritage
2022					
Revenue	19.4	20.9	20.8	23.0	18.5
Spending	21.8	22.3	22.4	25.3	17.6
Deficits	-2.4	-1.5	-1.6	-2.3	0.9
Debt held by the public (end of year)	71.7	68.3	66.0	78.6	54.5
2037					
Revenue	21.2	22.6	23.1	25.3	18.5
Spending	18.8	25.0	22.5	26.3	18.3
Deficits	2.4	-2.4	0.6	-1.0	0.2
Debt held by the public (end of year)	40.1	64.8	40.4	66.3	28.0

Addressing the Fiscal Cliff

The immediate concern facing members of Congress and the President is the series of tax and spending policies scheduled to take effect in January 2013 – popularly known as the “fiscal cliff.” Unless Congress and the President enact laws to do otherwise, many income tax rates and other tax provisions passed since 2001 will expire; dividend, capital gains, and estate tax rates will rise; the alternative minimum tax (AMT) will be applied to tens of millions of taxpayers; the Social Security payroll tax rate reduction will expire, as will numerous other tax provisions that affect individuals and corporations; new taxes from the Affordable Care Act will kick in; Medicare’s Sustainable Growth Rate formula will force an immediate 27 percent cut in reimbursement rates to doctors serving seniors; extended emergency unemployment benefits will end; and across-the-board spending cuts, or sequesters, from last year’s Budget Control Act (BCA) will take effect, trimming federal outlays on defense and other priorities by \$54 billion in 2013.

In total, these tax and spending policy changes would result in a fiscal consolidation of nearly \$500 billion in 2013. The nonpartisan Congressional Budget Office forecasts that if America goes over this fiscal cliff, the U.S. economy would plunge back into recession next year and the unemployment rate would increase.

However, the policies contained in the fiscal cliff would put America on the path of declining debt over the long term. The fiscal cliff, therefore, starkly illuminates a tension present in the discussion over fiscal policy in recent years – how to effectively address our long-term fiscal challenges without harming economic growth in the near term.

We asked the Solutions Initiative II organizations to provide their recommendations for how to deal with specific policy items included in the fiscal cliff. The groups’ answers can be viewed in the following table. Their solutions make clear that Congress and the President have many options to put America on a better fiscal and economic path.

How Do the Solutions Initiative II Plans Address the Fiscal Cliff?

Elements of the Fiscal Cliff	AAF	BPC	CAP	EPI	Heritage
Expiration of the 2001- 2010 tax cuts	Replace income tax with progressive consumption tax. Provide transition relief	Current rates all extended, followed by fundamental tax reform	Current rates extended for incomes less than \$250,000 (couples), followed by fundamental tax reform	Full expiration of current rates, replace with enhanced work and family credit for low- and middle-income taxpayers	All current rates extended, followed by fundamental tax reform
Budget Control Act: Automatic sequestration in 2013	Repeal and replace with other reforms	Repeal and replace with other reforms	Repeal	Repeal and replace with other reforms	Repeal for defense, and replace with other reforms
Medicare Sustainable Growth Rate (SGR) formula	Eliminate SGR as part of Medicare reform	Eliminate SGR and replace with other health care savings	Eliminate SGR and replace with provider payment reforms	Eliminate SGR and maintain physician payments at current levels	Eliminate SGR as part of Medicare reform
Expiration of Social Security payroll tax cut	Allow to expire	Allow to expire: Replace with income tax rebate for 2013	Allow to expire: Replace with more targeted measures for job creation	Allow to expire: Replace with more effective stimulus	Extended for one year
Alternative Minimum Tax “patch”	Eliminate AMT as part of broader tax reform	Eliminate AMT as part of broader tax reform	Extend patch then move immediately to broader tax reform	Extend patch	Extend patch then eliminate as part of broader tax reform
Expiration of extended unemployment benefits	Allow to expire as scheduled	Allow to expire as scheduled	Extend	Extend	Slowly reduce extended benefits

Priorities for Congress and the Administration in 2013

In addition to asking the Solutions Initiative II groups to address the long-term fiscal outlook and the fiscal cliff, we also asked each to identify top priorities for the new Congress and the Administration in 2013. In each group's plan, you will see three to five recommendations for policy priorities that should be taken up over the next year. If we take just the first priority identified by each group, we see key themes emerge.

Fundamental Tax Reform

- The American Action Forum (AAF) recommends instituting a new progressive consumption tax that would replace both the individual and corporate income tax codes.
- The Center for American Progress (CAP) also lists tax reform as its top priority, but CAP puts the emphasis on raising adequate revenue and improving progressivity.

Health Care

- The Bipartisan Policy Center's (BPC) top priority is reforming federal health programs. In particular, BPC identifies Medicare Advantage, in which the federal government pays private insurers a set fee to cover each enrollee, as a program that needs reforms to increase competition, reduce overpayments, improve the quality of care, and strengthen Medicare's finances.
- The Heritage Foundation also lists health care reform as the top priority for Congress and the Administration. Heritage would repeal the Affordable Care Act, and replace Medicare with a market-based, premium support model that would provide income-related subsidies to beneficiaries so they can purchase health insurance from private insurers.

Economic Recovery and Growth

- The Economic Policy Institute (EPI) suggests that job creation should be Washington's top priority. EPI would repeal all of the BCA's spending reductions and instead provide fiscal stimulus through infrastructure spending, state budget relief, and a temporary extension of the Making Work Pay tax credit and emergency unemployment assistance.

Areas of Agreement

Each organization's recommendations reflect its views about the role of government and the best ways to balance the needs of economic growth and deficit reduction. There are differences in approach – some subtle, some stark. But there are also several areas of agreement:

- First, America's long-term debt projections represent a threat to economic growth and should be addressed over time. All five groups have developed plans that bring projected long-term debt down to much lower levels.

- Second, economic growth today is still too sluggish. Solutions to long-term fiscal challenges should not hinder short-term recovery and growth.
- Third, the upcoming fiscal cliff is not an optimal way to achieve fiscal consolidation. All five groups would bypass all or part of the fiscal cliff while instituting policies that bring projected debt down over the medium to long term.
- Fourth, rapidly rising health care costs must be addressed. Unless the U.S. can restrain health care cost growth, the federal budget will continue to face significant long-term challenges, and individuals, families, businesses, and state governments will also find more and more of their budgets consumed by health expenses.
- Finally, our tax code needs to be reformed. The five groups taking part in the Solutions Initiative II all agree that the code should be modified in significant ways, though there are sharp differences about how much revenue the federal government should be collecting.

Key Proposals on Critical Issues

Following is a summary of how the Solutions Initiative II organizations tackled four key components of the fiscal challenge: health care, Social Security, defense and other spending, and revenues. For full descriptions, see each group's complete proposal.

Health Care

According to the Congressional Budget Office, entitlement costs are projected to account for 100 percent of the growth in noninterest spending by the federal government over the next 25 years. Four-fifths of the increase in entitlement costs will arise from health care costs, where growth is projected to outstrip both inflation and broader economic growth. As a result, reining in the growth of health care costs will be essential to reducing debt as a share of the economy.

Any effort to restrain the federal government's health care costs without addressing systemic cost drivers is likely to founder. Costs are rising fast in both the private and public sectors, driven by a combination of factors, including: a fee-for-service payment system that encourages overuse of health care; significant disparities in the prices of certain procedures and treatments from region to region; large administrative costs; the lack of a federal health care budget; a failure to promote preventative care and healthy lifestyle changes; and a medical malpractice system that encourages doctors and hospitals to deliver additional treatments. Reining in the federal government's costs for health care will require a system-wide effort to improve the way health care is delivered in the United States, with a focus on maintaining and improving quality at lower cost.

The Solutions Initiative II grantees propose a number of ideas for reducing health care costs. The American Action Forum, Bipartisan Policy Center, and Heritage Foundation would transform the current Medicare system into a premium support model, with seniors receiving a subsidy to purchase insurance from private health insurance providers. The size and structure of the subsidy

differs among the plans. AAF and Heritage would gradually replace the traditional Medicare program, while BPC would retain it as an option for seniors. In all these plans, the annual growth of the government's costs would be limited to encourage seniors to shop for the most cost-effective care and to encourage providers to control costs within their plans. The tightness of the limit would vary among plans. Heritage would also raise the Medicare eligibility age and phase out taxpayer subsidies entirely for the wealthiest seniors.

The Center for American Progress and the Economic Policy Institute would maintain the current Medicare system, but impose stricter cost controls and empower the Independent Payment Advisory Board (IPAB) to extend its cost-capping authority beyond Medicare to the broader health care market. (Under the CAP proposal, IPAB's enhanced authority over private-sector payers would be triggered if other efforts to reduce system-wide costs over the next decade fail.)

By choosing various models to control Medicare spending in the medium and long term, all five groups would repeal the Sustainable Growth Rate provision that is set to cut reimbursements to Medicare providers by 27 percent beginning in 2013.

Other proposals for controlling health care cost growth include AAF's recommendation to limit the federal contribution to Medicaid and allow states to competitively bid out services to private providers. Heritage would apply a similar approach, though individuals, not states, would purchase coverage with the aid of refundable tax credits. Traditional Medicaid would remain an option only for people with disabilities. BPC would modify the federal-state cost-sharing formula to provide a single matching rate for all states. It would also prevent states from manipulating the system to gain higher reimbursements, while providing automatic increases in federal Medicaid spending during times of recession.

The American Action Forum and Heritage would repeal the Affordable Care Act (ACA). By contrast, BPC, CAP, and EPI would retain the ACA and strengthen the federal government's role in controlling costs. EPI would also add a federally run health insurance option (a "public option") to the health insurance exchanges created by the ACA.

BPC, CAP, and EPI would allow the federal government to utilize its vast market share to negotiate lower prices for prescription drugs under Medicare. AAF and BPC would implement medical malpractice reform to reduce costs associated with practicing "defensive medicine." They would also reform the Tricare health insurance program available to military personnel, veterans, and their families.

Several groups recommend modifying the tax exclusion for employer-provided health insurance. The American Action Forum and Bipartisan Policy Center propose phasing out the exclusion completely, while Heritage favors transforming it into a nonrefundable, income-based tax credit.

Social Security

Social Security is not sustainable for the long term. The payroll tax dollars credited to the Social Security trust fund have already been spent. Between now and 2033, we will have to borrow

trillions to pay promised benefits. Absent reforms, benefits will have to be sharply cut beginning in 2033, according to the Social Security Trustees.

All of the Solutions Initiative II participants proposed changes to Social Security designed to reform the system and make it more sustainable over the long term.

The Heritage Foundation would raise the retirement age and slowly phase in replacement of the current Social Security system with a flat benefit to ensure that no senior lives in poverty. This subsidy would phase out for higher-income seniors. AAF would also raise the retirement age, but would slow the growth of initial benefits for future retirees through so-called “price indexing”; CAP proposes a variant of that approach called “progressive price indexing” that would reduce initial benefits only for high-income earners. BPC also makes progressive changes in benefits.

AAF, BPC, CAP, and Heritage would also link annual cost-of-living benefit increases to chained-CPI, which many economists believe to be a more accurate measurement of inflation. To offset some of those changes on the most vulnerable seniors, BPC and CAP would increase the minimum Social Security benefit and raise benefits for the oldest.

To help stabilize the system on the revenue side, the Bipartisan Policy Center, Center for American Progress, and Economic Policy Institute would lift the cap on earnings subject to the Social Security payroll tax. BPC would raise, but not eliminate, the cap. EPI would eliminate the cap on Social Security taxes paid by both the employer and the employee. The Center for American Progress would eliminate the cap only on the employer share.

Defense and Other Spending

Defense spending comprises almost one-fifth of the federal budget and more than half of discretionary spending. The United States spends more on defense than the next 13 highest-spending countries combined. Yet, CBO projections already show defense spending declining as a percentage of GDP over time, and defense is scheduled (as part of the fiscal cliff) to yield another \$500 billion in savings over the next 10 years through automatic spending reductions required by the 2011 Budget Control Act.

If the 2011 BCA spending cuts are fully implemented, non-defense domestic discretionary spending would also decline sharply. According to CBO, it would fall to 2.6 percent of GDP in 2022 – almost 35 percent below its average through both Republican and Democratic Administrations over the past 40 years. Furthermore, spending in this category consists of (among other things) investments in education, R&D, and infrastructure, which many economists believe are conducive to long-run economic growth.

The American Action Forum would increase both defense and nondefense discretionary spending relative to current law, and later set each category at a fixed percentage of GDP. Income-support programs, however, would provide per-person payments that grew no faster than the inflation rate.

The Bipartisan Policy Center would retain the caps on both defense and nondefense discretionary spending in the 2011 Budget Control Act, which produced savings of \$900 billion over 10 years, but overturn the upcoming sequester and further spending reductions, which would produce another \$1.2 trillion in deficit reduction. BPC proposes numerous other changes to federal programs and would apply chained-CPI to certain mandatory programs that are indexed for inflation.

The Center for American Progress would roll back the entire sequester – both defense and nondefense spending. CAP would also increase spending in areas like infrastructure and teacher-hiring to help boost the economy. Over the longer term, CAP would limit the growth of defense spending to the rate of inflation. CAP recommends implementing by 2023 – or sooner if politically possible – significant increases in investments in research, education, clean energy technologies, transportation, and infrastructure. CAP would also increase spending on safety net programs including food stamps, disability payments, housing assistance, and children’s programs, though it recommends using chained CPI for certain programs that are indexed for inflation.

The Economic Policy Institute proposal would provide for \$200 billion in additional public investments in 2013, and then index the additional spending to GDP growth for the next ten years. An additional \$425 billion in aid to states would be provided through 2017, and \$250 billion in public works and direct employment programs would be provided through 2014. After 10 years, nondefense spending would increase with inflation and population growth. On the defense side, EPI would replace the spending caps and sequester cuts with a phase-in schedule that would achieve the same level of savings over 10 years, but reduce the potential for near-term economic drag from reduced defense spending. After 10 years, defense spending would grow with the inflation rate.

The Heritage Foundation would increase defense spending, consistent with its view that national security is the most essential function of the federal government. The BCA defense spending caps and the defense sequester would not go into effect. Longer term, defense spending would be maintained at 4 percent of GDP. Nondefense discretionary spending in the Heritage plan would be set at the BCA post-sequester level for 2013, then reduced to 2 percent of GDP, and thereafter indexed for inflation.

Finally, all groups agree that the current level of agricultural subsidies provided by the federal government should be reduced.

Revenues

Our tax code is widely seen as inefficient, and it fails to raise adequate revenues. It is filled with tax expenditures (credits, deductions, and exclusions) that complicate the code, create market distortions, and provide disproportionate benefits to higher income earners. In 2012, the federal government lost nearly as much revenue from income tax expenditures (\$1.2 trillion) as it collected in all individual and corporate income taxes (\$1.4 trillion). At \$1.2 trillion, tax expenditures cost more than defense, Social Security, or Medicare – and have become the target

of numerous efforts to improve the efficiency of the tax code, with or without raising additional revenue.

The American Action Forum and The Heritage Foundation would replace the current tax system with versions of a consumption tax (effectively, a tax on income that is not saved). Both AAF and Heritage would replace the individual and corporate codes, and Heritage would also replace the payroll tax. AAF would adjust the new tax brackets according to chained-CPI, provide an exemption for lower-income earners, reform a variety of tax expenditures, and increase the gas tax to cover projected shortfalls in the highway trust fund. Heritage, as an effect of implementing its reform, would eliminate most tax expenditures, with the exception of the Earned income Tax Credit and the health insurance tax exclusion, which would be reframed as a nonrefundable tax credit for individuals to purchase private insurance.

The Bipartisan Policy Center would implement tax reform similar to the approach endorsed by a bipartisan supermajority of the Bowles-Simpson commission that broadened the tax base, lowered tax rates, and raised additional revenue for deficit reduction. The BPC plan would have two rates of 15 percent and 28 percent, and a variety of refundable tax credits. BPC would reform the corporate income tax system by reducing corporate tax expenditures and lowering the corporate tax rate to 28 percent. BPC would also tax sweetened beverages.

The Center for American Progress would allow the Bush-era tax rates to expire for higher earners and would reduce tax expenditures. It would make the tax code more progressive by replacing tax deductions (which provide larger benefits to high-income taxpayers) with tax credits (which provide more evenly distributed benefits). A carbon tax, an alcohol tax, a bank tax, a financial transactions tax (beginning in 2023), and an oil import fee would also be introduced. And CAP would pursue corporate tax reform by reducing industry-specific tax expenditures, such as those for the oil industry.

The Economic Policy Institute would allow all the Bush-era rates to expire, but would provide two new refundable credits to enhance progressivity in the tax code. EPI would also add two additional tax rates – 45 percent on incomes above \$2 million and 50 percent on incomes above \$10 million – as well a new tax on net wealth. The home mortgage interest and charitable deductions would be turned into refundable tax credits, while the value of most other itemized deductions would be capped at 28 percent beginning in 2014, falling to 15 percent in 2017. In addition, EPI would tax alcohol, sweetened beverages, financial transactions, and highly leveraged banks. EPI's corporate tax reform would be modeled on President Obama's proposal, but would not reduce rates; any increased revenue would be devoted to deficit reduction.

All of the plans would address the near-term challenges created by the Alternative Minimum Tax (AMT), which could affect 30 million taxpayers if the current law is not changed. AAF, BPC, CAP, and Heritage propose eliminating the AMT; EPI proposes to limit the effect of the AMT by raising the income threshold at which the tax kicks in. That would reduce the number of middle-income taxpayers who would otherwise have to pay the AMT.

The tax code contains many additional provisions and each group offers a wide variety of changes that cannot be summarized in a brief overview. For complete details, see the groups' plans.

Conclusion

The five organizations taking part in the Solutions Initiative II have presented comprehensive proposals for addressing America's near-term and long-term fiscal challenges. Policymakers should consider them carefully in the months ahead. We are grateful for the groups' work, and for the rigorous analysis provided by the Tax Policy Center and former acting director of the Congressional Budget Office Barry Anderson.

At the Peter G. Peterson Foundation, we believe the best approach to avoiding the potential negative economic effects of the fiscal cliff is to enact a credible, bipartisan plan to reduce long-term debt and deficits – a plan that can be implemented gradually when the economy is on more solid ground. Passing such a plan would not only build confidence and boost the current recovery, but also put the nation on a sustainable fiscal path for the long term.

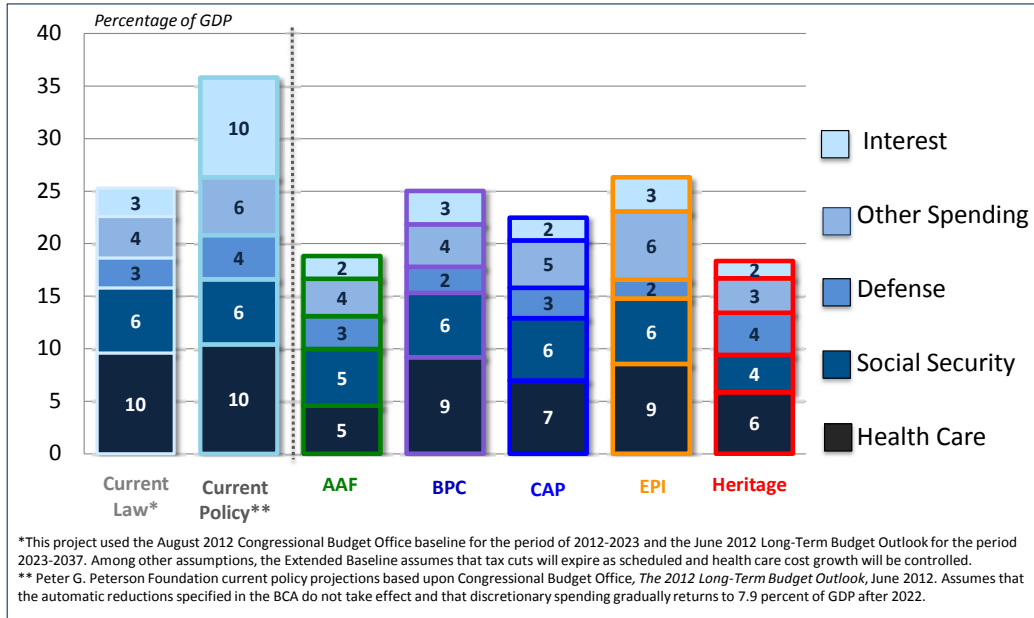
All of the Solutions Initiative II participants agreed that changes should be made to the policies that are set to go into effect under the fiscal cliff. The cliff presents a critical opportunity to policymakers, and could mark a meaningful turning point for the country. Instead of allowing our economy to go over the fiscal cliff, or once again avoiding action on our nation's long-term debt and deficits, leaders should seize this opportunity to pass a comprehensive, bipartisan plan to deal with our long-term structural debt and build a stronger economic future.

(In billions of dollars)

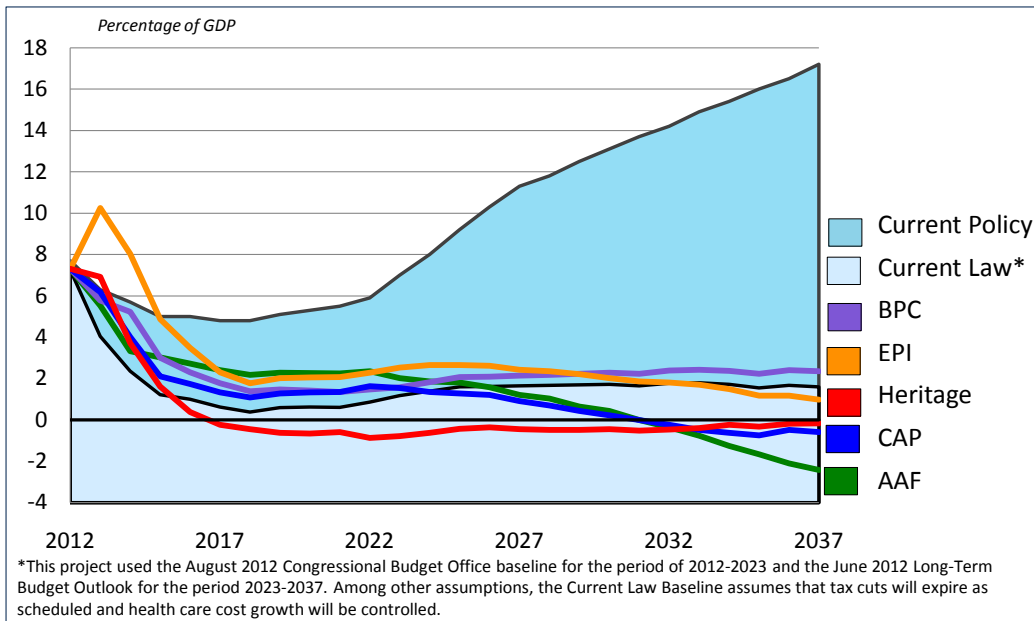
Solutions Initiative II Plans: Deficits and Deficit Reduction—2013-2022											
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Total: 2013 -2022
Plan Deficits											
<i>Current Policy Deficits</i>	-1,037	-924	-810	-832	-833	-870	-1,003	-1,102	-1,200	-1,362	-9,975
AAF	-877	-543	-528	-507	-473	-452	-498	-518	-535	-584	-5,515
BPC	-917	-856	-523	-429	-348	-289	-322	-323	-320	-367	-4,692
CAP	-980	-658	-369	-324	-261	-225	-279	-304	-319	-404	-4,124
EPI	-1,625	-1,315	-849	-648	-454	-368	-442	-469	-494	-566	-7,230
Heritage	-1,098	-608	-280	-72	48	92	133	148	139	214	-1,283
Deficit reduction¹ Under Each Plan:											
AAF	160	381	282	325	360	418	505	584	665	778	4,460
BPC	120	68	287	403	485	581	681	779	880	995	5,283
CAP	57	266	441	508	572	645	724	798	881	958	5,851
EPI	-588	-391	-39	184	379	502	561	633	706	796	2,745
Heritage	-61	316	530	760	881	962	1,136	1,250	1,339	1,576	8,692
<i>Memo: Current Law Deficits</i>	-641	-387	-213	-186	-123	-79	-130	-142	-144	-213	-2,258

¹ Amounts shown are changes in deficits compared to current policy deficits. Positive numbers reflect deficit reduction (lower deficits). Negative numbers reflect deficit increases (higher deficits).

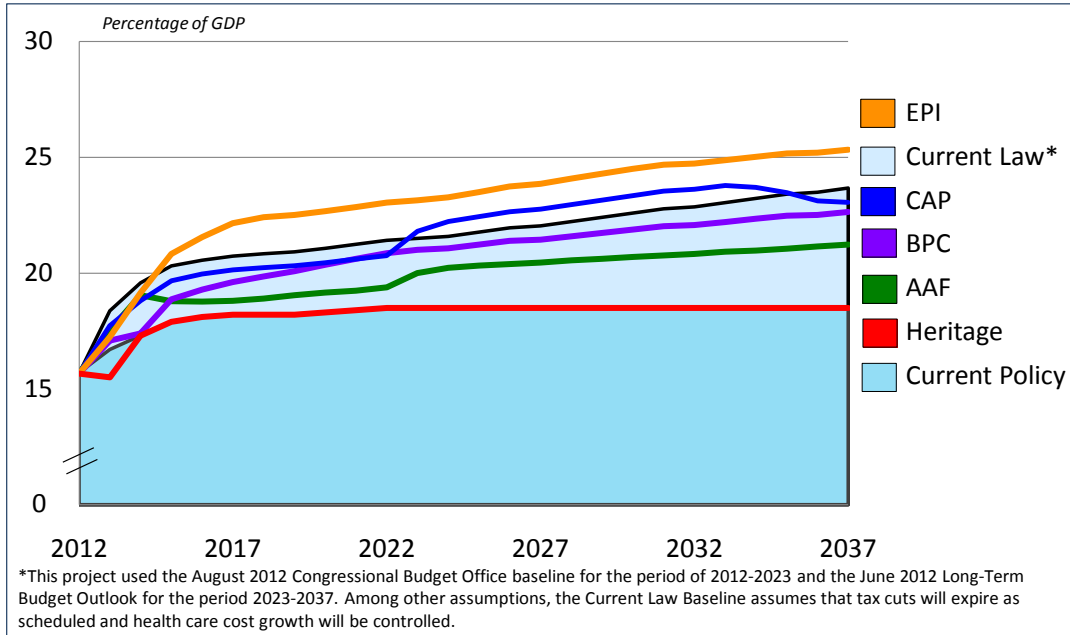
**Solutions Initiative II Plans:
Composition of Projected Federal Spending in 2037**
(As a percentage of GDP)



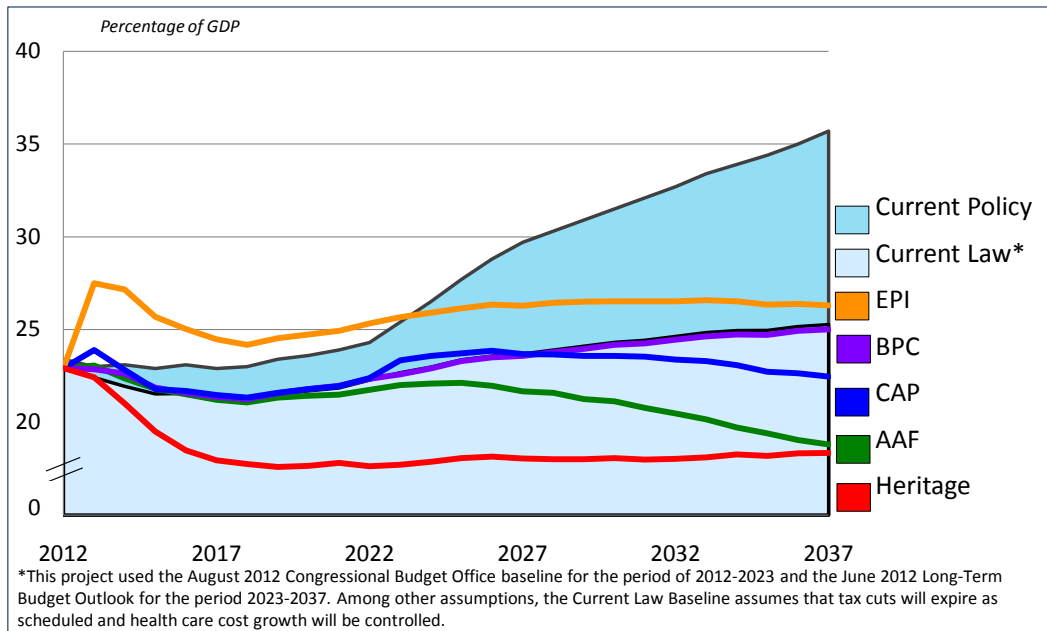
Solutions Initiative II Plans: Projected Federal Deficits
(As a percentage of GDP)



Solutions Initiative II Plans: Projected Federal Revenues (As a percentage of GDP)



Solutions Initiative II Plans: Projected Federal Spending (As a percentage of GDP)



PETER G. PETERSON FOUNDATION SOLUTIONS INITIATIVE II: COMPARING POLICY PROPOSALS

	American Action Forum	Bipartisan Policy Center	Center for American Progress	Economic Policy Institute	The Heritage Foundation
HEALTH					
MEDICARE	Convert to premium support. Retain traditional Medicare as option for current retirees	Add premium support. Retain traditional Medicare as an option	Retain Medicare	Retain Medicare	Convert to premium support that is adjusted by income. Retain traditional Medicare as option for current retirees
		Negotiate lower drug prices. Bundling and various payment reforms	Negotiate lower drug prices. Transition from fee-for-service with various payment reforms	Negotiate lower drug prices. Bundling. IT and effectiveness investments	Raise eligibility age and link to longevity
MEDICAID	Use competitive bidding and limit growth of federal contribution	Reallocate financing between states and federal government	Use competitive bidding for health care products. Increase generic drug use. Avoid and collect improper payments		Convert nursing home/disability into flexible but limited-budget block grant to states; direct assistance for others
HEALTH REFORM	Repeal ACA	Maintain ACA	Maintain ACA. Exchanges active purchasers and offer tiered insurance plans	Maintain ACA. Add public option.	Repeal ACA

PETER G. PETERSON FOUNDATION SOLUTIONS INITIATIVE II: COMPARING POLICY PROPOSALS					
	American Action Forum	Bipartisan Policy Center	Center for American Progress	Economic Policy Institute	The Heritage Foundation
HEALTH					
TAX EXPENDITURES	End tax exclusion of employer-sponsored insurance	Phase out tax exclusion of employer-sponsored insurance	Maintain tax exclusion	Maintain tax exclusion	Replace tax exclusion of employer-sponsored insurance with tax credits
OTHER CHANGES	Reform malpractice laws	Reform malpractice laws	High cost growth triggers expansion of IPAB authority	Expand IPAB authority to private sector. Make IT and effectiveness investments	
SOCIAL SECURITY					
CHANGES TO BENEFITS	Reduce growth of initial benefits; update COLAs using chained CPI	Reduce growth of initial benefits for high earners. Adjust benefits for longevity. Enhanced benefits for very old and poor. Update COLAs using chained CPI	Reduce growth of initial benefits for high earners. Enhanced benefits for very old and poor. Update COLAs using chained CPI	None	Gradually transition to a flat benefit to protect against poverty. Phased out for high-income retirees
OTHER	Raise retirement age				Raise retirement age and link to longevity
					Auto-enrolled, voluntary savings accounts

PETER G. PETERSON FOUNDATION SOLUTIONS INITIATIVE II: COMPARING POLICY PROPOSALS					
	American Action Forum	Bipartisan Policy Center	Center for American Progress	Economic Policy Institute	The Heritage Foundation
CHANGES TO PAYROLL TAXES	Fringe benefits taxed	Increase cap to 90% of earnings. Fringe benefits taxed	Eliminate cap for employers	Eliminate cap for employers and employees	Eliminated tax; finance program from Heritage New Flat Tax
DEFENSE					
	Remove sequester, but maintain BCA caps	Remove sequester, but maintain BCA caps	Remove sequester, but maintain BCA caps	Remove sequester and BCA caps, but save an equivalent amount using a more gradual path of cuts over 10 years	Remove sequester and BCA caps
	Hold at 3% of GDP in long term		Grow security spending with inflation plus 1% after 2022	Grow defense spending with inflation after 2022	Hold at 4% of GDP
	Reform military health benefits	Reform military health benefits	Reform security budgeting process	Force modernization	Reform military health benefits. Force modernization

PETER G. PETERSON FOUNDATION SOLUTIONS INITIATIVE II: COMPARING POLICY PROPOSALS

	American Action Forum	Bipartisan Policy Center	Center for American Progress	Economic Policy Institute	The Heritage Foundation
INCOME SECURITY, EDUCATION, TRANSPORTATION, AND OTHER GOVERNMENT PROGRAMS					
	Remove sequester, but maintain BCA caps	Remove sequester, but maintain BCA caps	Remove sequester, but maintain BCA caps	Remove sequester and BCA caps	Maintain sequester and BCA caps
	Reform income support programs to provide a limited cash subsidy	Increased fees for flood insurance, aviation, PBGC. Lower Fannie and Freddie loan limits, reform post office	Increases in public investment: education, energy, infrastructure. Increase anti-poverty programs	Increases in education, energy, and infrastructure to provide immediate stimulus, including fiscal relief for states. Extend and expand unemployment benefits, and create a public works jobs program	Devolve transportation to states; cut, eliminate, consolidate, or privatize many other programs. Cap and reform anti-poverty spending
	Reforms to federal pensions	Reforms to federal pensions			Reforms to federal compensation and pensions
	Reform and reduce farm subsidies	Reform and reduce farm subsidies	Reform and reduce farm subsidies	Reform and reduce farm subsidies	Reform and reduce farm subsidies

PETER G. PETERSON FOUNDATION SOLUTIONS INITIATIVE II: COMPARING POLICY PROPOSALS

American Action Forum	Bipartisan Policy Center	Center for American Progress	Economic Policy Institute	The Heritage Foundation
TAX REVENUES -- Individual				
Replace with progressive consumption tax. Provide transition relief	Simplify income tax system. Broader base and two tax rates: 15% and 28%. Tax dividends and capital gains as ordinary income	Simplify income tax system. Broader base. Top rate 39.6 percent. Tax dividends and capital gains as ordinary income	Let 2001/2003 tax cuts expire, but add new tax credits for low and middle income. Tax dividends and capital gains as ordinary income. New tax rates for millionaires. Enact Buffett Rule	Replace with New Flat Tax on income used for spending; savings and senior benefits untaxed. Provide transition relief
TAX REVENUES -- Corporate				
Replace with tax on domestic net cash flow (investment not taxed). Provide transition relief	Broaden base and lower tax rate	Broaden base but keep tax rate the same	Broaden base but keep tax rate same	Replace with tax on domestic net cash flow (investment not taxed). Provide transition relief
TAX EXPENDITURES				
Eliminate most. Phase out mortgage interest and replace with homebuyer credit. Replace charity with a credit. Replace child and Earned Income Tax credits with rebates	Eliminate most. Replace mortgage interest and charity with credits	Replace with a \$5,000 standard credit or 18% credit for itemized expenses	Limit value of itemized deductions to 28% initially, then to 15% over time. Replace mortgage interest and charity with credits. Replace muni exclusion with a direct subsidy	Eliminate most. Keep Earned Income Tax Credit. Replace health exclusion with a credit. Exclude seniors' benefits. Modify mortgage deduction

PETER G. PETERSON FOUNDATION SOLUTIONS INITIATIVE II: COMPARING POLICY PROPOSALS					
	American Action Forum	Bipartisan Policy Center	Center for American Progress	Economic Policy Institute	The Heritage Foundation
OTHER TAXES					
	Increase gas tax		Carbon tax; oil import fee	Carbon tax; increase gas tax	Devolve gas tax to states
			Tax financial transactions and large financial institutions	Tax financial transactions and large financial institutions	New tax system caps total tax revenues at 18.5 percent of GDP
	Repeal estate and gift taxes		Restore estate tax to earlier levels	Adopt excise tax on wealth above \$10 million and set estate tax exemption to \$2 million and rate at 50%	Repeal estate and gift taxes
	Repeal ACA taxes	Tax sweetened beverages. Repeal some ACA taxes	Increase taxes on alcohol, tobacco	Tax sweetened beverages. Increase tax on alcohol. Replace some ACA taxes with broader progressive taxes	Repeal ACA taxes and all other non-dedicated excises

American Action Forum
“Balanced”
Douglas Holtz-Eakin, Gordon Gray

INTRODUCTION

Unless Congress and the Administration act, in January of 2013, a fiscal contraction in excess of \$600 billion will occur. This so-called “fiscal cliff” stems primarily from the expiration of current tax policies and scheduled across the board spending reductions. Given the large federal debt levels and their even more daunting projected increases, some find such an automatic contraction appealing.

Unfortunately, these scheduled tax increases and spending reductions are so large and sudden that the combined effect would likely spell recession for the United States economy. The simplest approach to avoiding the economic distress would be to simply extend all expiring tax relief measures, and forestall all spending reductions.

Unfortunately, the United States faces a dual challenge. Avoiding the fiscal cliff does dodge a recession, but the fiscal challenge confronting the United States is daunting and failure to address it in a credible way would likely generate alternative negative economic effects through higher interest rates. Indeed, the Congressional Budget Office has noted this compound challenge in addressing the fiscal cliff: “eliminating or reducing the fiscal restraint scheduled to occur next year without *imposing comparable restraint in future years* would reduce output and income in the longer run relative to what would occur if the scheduled fiscal restraint remained in place.” It is therefore necessary to pair any mitigation of the fiscal cliff with meaningful budget restraint in future years.

FIVE PRIORITIES FOR CONGRESS AND THE PRESIDENT

1. Moving Beyond the Current Tax Debate

The scheduled expiration of the 2010 tax extension will bring tax policy into immediate focus for the next Congress. Looking past the current tax code, there is wide agreement that the U.S. corporate tax is an international outlier and in need of reform. However, the proliferation of pass-through businesses suggests that a corporate tax reform approached in isolation of the broader tax code may be too narrow in scope, and possibility induce further distortion.

There is broad consensus that the corporate rate is too high – that consensus does not persist in a discussion of the individual rates. To the extent that coordinating the individual and corporate tax policy debate is necessary, a progressive consumption tax would afford that opportunity while retaining the progressivity that has animated that president’s approach to existing tax policy. A wholesale reform could be approached beyond the sclerosis of any tax policy debate that is a zero-sum game for certain constituencies, induce needed pro-growth reforms, while addressing revenue considerations as part of a larger budget reform. This effort would necessarily include transition relief.

2. Sequestration: Reprioritizing Federal Spending

As in the first priority related to tax reform, the second priority for the next congress is a permanent replacement of the scheduled sequesters. The sequester has been widely acknowledged as poor policy – a failed “stick” to induce more substantive reforms that the “Super-Committee” ultimately failed to deliver. The sequester is heavily biased towards discretionary cuts, and further still towards defense reductions that, following initial defense cuts, would materially damage U.S. readiness. Across the board reductions in domestic discretionary spending are poorly conceived.

3. Revisiting the Affordable Care Act

As noted above, the looming fiscal cliff requires immediate attention to addressing expiring tax law and scheduled, largely discretionary spending cuts. Addressing those priorities narrowly is not feasible in light of other budgetary challenges, and must therefore be addressed in concert with other elements of the federal budget. No area of federal expenditure is in greater need of reform than the nation’s health programs.

Changes to health programs face steep political hurdles, which is why they remain sufficiently unreformed as to remain on perilous financial trajectories. However, no meaningful approach to at once address the fiscal cliff and fiscal sustainability can be successful without such changes.

4. Addressing Retirement

It has been nearly 30 years since the last major Social Security Reform. Social Security is now running perpetual cash-flow deficits. As such, despite claims to the contrary, Social Security is currently contributing to federal budget deficits and has done so since 2010. The Combined Trust Funds will exhaust in 2033, 3 years earlier than last year’s projection. More daunting, the 21 years until Fund exhaustion is the shortest since 1982, when the programs were facing immediate solvency challenges. Absent reform, Social Security revenue will fund only 75 percent of promised benefits in 2033.

5. Reorienting the Social Safety Net

This plan reaffirms the need for a social safety net – a series of federal assistance programs to support and encourage productive enterprise, and provide assistance to needy families. These programs are not the primary causes of the nation’s fiscal challenges. However, that should not preclude needed reforms to better rationalize and target federal assistance programs.

SPENDING

Medicare, Medicaid, and other federal health programs

This plan includes the repeal of the Affordable Care Act – on both the tax and spending sides of the federal ledger. The plan would restore provider reductions to Medicare, DSH payments to Medicaid, while eliminating the planned expansions in Medicaid and the creation of new health subsidies. The plan also repeals the narrow, industry-level taxes, as well as the new Medicare investment tax, and the health insurance surtax. In terms of budgetary effects of specific policy changes, this repeal is effectively a wash. \$95 billion of the estimated \$107 billion in increased

deficits associated with a repeal are the result of off-budget effects entirely unrelated to health programs.

Instead, the plan would take the approach of beginning with cost containment. This means a more modest approach to coverage relative to the costly coverage expansions associated with the Affordable Care Act. However, the approach taken addresses the underlying challenges confronting the nation's health care system: cost and the associated pressure on federal resources. This plan would provide states with resources to engage private markets in Medicaid coverage through the private bidding process, yielding savings. Similar market forces would be brought to bear on Medicare. Research suggests that competitive bidding in a reformed premium support program could yield savings approaching 10 percent (relative to a baseline that excludes the changes made by the Affordable Care Act).¹ The approach taken by this plan would gradually phase in with new Medicare enrollees, ultimately yielding significant savings over time. Medicare's outsized share of the health care market should introduce additional cost savings throughout the health sector. Reform to medical liability should also further constrain cost growth.

Social Security

Avoiding sharp benefit reductions is the goal of any Social Security reform. Gradual reforms that *slow the growth* in promised benefits – not cut them outright – is the responsible approach to the challenge of an aging population and projected benefits that significantly exceed program income. This plan suggests a combination of policy changes that would address the structural imbalance in Social Security over the long-term. It would not achieve this balance within the ten-year budget window, nor even by 2037. To do so would require higher payroll taxes that run afoul of other competing policy objectives or benefit reductions incompatible with the stated objective of Social Security reform.

Defense and Non-Defense Discretionary

The plan *increases* both defense and non-defense discretionary spending, albeit modestly, compared to current law, while implementing reforms to constrain growth in civilian and military health costs. The discretionary component of the budget also includes reforms to better target Pell grants. Both Defense and Non-Defense discretionary spending is fixed as a percentage of GDP at the end of the 10 year window, and grown at GDP thereafter.

Other Mandatory

Reform of these programs would see the major income and family support reappropriated to two principal assistance regimes: work support and family support. The earned income tax credit, SSI, and unemployment insurance would constitute work support programs. Real, per-capita benefits would be maintained as under current law. The earned income tax credit would be repealed as a tax measure, but reinstated as a work incentive payment on a dollar for dollar basis. The same approach would be taken with major family assistance programs to include the Child Tax credit, which would be added to support a regime of family assistance programs, such as

¹ <http://www.aei.org/outlook/health/healthcare-reform/competitive-bidding-can-help-solve-medicares-fiscal-crisis/>

SNAP. Over ten years, these programs would see comparatively minor savings relative to aggregate program expenditures. Greater savings would accrue over the long-term. The plan also includes limitations to mandatory agriculture program spending, as well as additional savings from federal student loan programs.

REVENUES

The plan includes a progressive consumption tax in the style of David Bradford's X-tax and built on a recent proposal by the American Enterprise Institute. The plan would eliminate the current individual and corporate tax code. On the business side, the tax base would be cash flow of all businesses, corporate and noncorporate. Firms would be able to deduct, among other items, purchases from other businesses and employee compensation. The rate applied to the remaining income is flat and set at the same top rate for household portion of tax.

On the individual side, tax rates for joint filers would be 15 percent on first \$50,000; 25 percent on next \$100,000; and 35 percent over \$150,000. Brackets for all unmarried taxpayers are half these amounts. All brackets indexed after 2013 by chained CPI – consistent with other elements of reform on the spending side of the budget. We would provide an exemption for 100 percent of poverty up to a family of 2. This limit would grow at CCPI.

We should note that this plan does not retain preferential tax treatment for employer provided health insurance. We believe that this reform is consistent with the goal of addressing health costs first, rather than significant coverage expansions.

The only credits allowed would be for: a new credit of 15 percent of charitable contributions in excess of \$500 (indexed by CCPI after 2013) and a new refundable credit for first-time homebuyers (as defined for the ARRA credit) of 15 percent of the value of the purchased home, claimed in five equal installments (i.e., 3 percent of the value) in each of the first 5 years of ownership. The existing mortgage interest deduction would be phased out for existing mortgages over 10 years.

We would also provide for an increase in the gas tax to cover projected shortfalls in the Highway Trust and Fund.

The goal of this plan is to average 18.9 percent over the first ten years– or about the average amount of revenue recouped in the year the U.S. last ran a surplus and the preceding 4 years. Revenues would continue to rise as a percent of GDP in the future. This plan incorporates a five percent, across the board rate reduction beginning in 2023. To the extent revenue continues to increase and surpass outlays, additional rate reduction should be pursued.

CONCLUSION

This approach seeks to address conflicting policy goals – the need for near-term aversion of the fiscal cliff coupled with long-term debt stabilization. Relative to current law – which assumes the fiscal cliff will occur – this plan will *increase* deficits in the near-term by precluding scheduled

major tax increases and spending reductions. However, over the long term, through a combination of reforms, deficits are reduced to below one percent of GDP, well below the necessary threshold to diminish debt as a share of the economy. A central part of the plan is a fundamental restructuring of the tax code – a restructuring that would significantly broaden tax collection to a more economically efficient consumption base, increase simplicity, and generate economic growth. The plan relies heavily on reforms to major health entitlement programs, which are the principle drivers of our long-term fiscal challenge. The plan would propose modest reforms to Social Security that would ultimately balance the program over the long term. The plan also imposes modest savings on “other mandatory” programs through reforms that would seek to sustain real per-capita benefits for eligible participants. The plan *increases* both defense and non-defense discretionary spending, albeit modestly, compared to current law, while implementing reforms to constrain growth in civilian and military health costs.

Taken together, these changes would set forth a credible and gradual improvement in the U.S. fiscal position. It is indeed this gradual approach that properly balances the near term impact of unduly precipitous fiscal contraction, with the need to address the longer term drivers of our economic challenges.

American Action Forum

Percent of GDP		
	2022	2037
Revenues	19.4	21.2
Spending	<u>21.8</u>	<u>18.8</u>
Deficit (-)	-2.4	2.4
Debt held by the public	71.7	40.1



BIPARTISAN POLICY CENTER

Bipartisan Policy Center Domenici-Rivlin Debt Reduction Task Force Plan 2.0 Senator Pete Domenici and Dr. Alice Rivlin

INTRODUCTION

In 2010, the Bipartisan Policy Center (BPC) convened a Debt Reduction Task Force (DRTF) of 19 former elected officials and experienced citizens with diverse backgrounds from across the political spectrum. We co-chaired the task force with the goal of addressing the projected explosion of U.S. federal debt. As we released our report, the National Commission on Fiscal Responsibility and Reform, led by former Sen. Alan Simpson and former White House Chief of Staff Erskine Bowles, also delivered their plan.

These bipartisan groups came to similar conclusions: First, the present debt trajectory of the United States federal government cannot be sustained and poses grave dangers to the American economy; second, policymakers must make difficult decisions to get our fiscal house in order; and third, any realistic solution must include structural reforms to entitlements and fundamental tax reform that raises significant new revenue.

These bipartisan proposals have increased awareness of the nation's severe fiscal problems. Further, Congress has passed components of these plans into law – most notably, the caps on annually appropriated spending contained in the Budget Control Act of 2011. But much work remains and that is why we are updating our proposals and renewing our effort with the release of Domenici-Rivlin 2.0.

No debt reduction plan can be sustained without strong and steady economic growth. The financial crisis caused a protracted economic downturn, and unemployment remains unacceptably high. We continue to believe that the economy needs additional near-term support. To that end, we recommend an immediate, large income tax rebate, similar in structure to those used in 2001 and 2008, to spur economic activity by putting money into the pockets of those most likely to spend it. Importantly, while we believe lawmakers must agree to a debt reduction plan in 2013, many of the provisions ought to be phased in over time as employment and economic growth return to more typical levels.

FIVE PRIORITIES FOR THE 113TH CONGRESS AND THE PRESIDENT [1 page]

- 1. Use Medicare's leadership to accelerate the transition from fee-for service reimbursement toward rewarding quality and positive health outcomes throughout the health care system.** We currently face immense budgetary pressures from the combination of rising per-capita health care spending and an aging cohort of baby boomers. To reduce the growing pressure on all budgets — federal, state/local, business, and household — we must control the growth of health care spending. Fee-for-service reimbursement, which dominates health care delivery, rewards volume of services rather than quality and effectiveness, and it leads to waste, duplication, and poor coordination of care. As the country's largest health care payers and spending drivers, Medicare and Medicaid urgently need reform and could help transform the whole health care system.

Our proposal for Medicare (described in more detail below) improves the cost effectiveness of traditional Medicare through innovations in reimbursements and other incentives while strengthening competition among comprehensive, integrated health plans. Increasing competition and reducing government overpayments – using Medicare Advantage (MA) as a vehicle (through the application of competitive bidding among traditional Medicare and private MA plans) – can produce savings, while simultaneously improving quality and preserving the Medicare guarantee.

2. Reform the corporate and individual tax codes by eliminating or curbing nearly all tax expenditures, lowering marginal rates, and raising significant new revenues for deficit reduction, while maintaining progressivity. Every plausible route to long-term fiscal sustainability includes substantial additional revenue. At the same time, however, we can reform the tax code to spur economic growth through a simpler system that stops picking winners and losers. The relevant Congressional committees should build broad, bipartisan support around such a reform.

3. Promote short- and medium-term economic growth through an income tax rebate. Long-term fiscal sustainability requires reforming and cutting government spending programs, raising additional revenues, and spurring the economy to create more jobs and increase investment. Near-term growth can be boosted through a wide array of policies, but few of them are likely to garner bipartisan support in the current polarized environment. We believe that an income tax rebate, similar in structure to those implemented in 2001 and 2008, could appeal to both parties and be effective. This one-time rebate, which should be similar in size to the expiring reduction in the payroll tax, will boost consumption and investment to accelerate the recovery. Of course, this and any other policies that add to the short-term deficit should be paired with a long-term debt reduction agreement rather than be enacted in isolation.

4. Pass a balanced package of policies that achieves sustainable Social Security solvency. Social Security reform should not be approached from the vantage point of deficit reduction but rather with the goal of securing and strengthening a critical safety net for future generations. Without adjustments, the program will soon reach a point at which benefits must be slashed across the board or large transfers from general funds will be required. Accordingly, both parties in Congress should work with the president to adjust benefits and enhance revenues to set the program back on sound financial footing.

5. Improve the oversight and efficiency of federal expenditures by reforming the congressional budget and oversight process. Between mandatory or “entitlement” programs and tax expenditures – spending through the tax code – roughly three-quarters of all federal spending runs on autopilot with no periodic review. The budget process must establish a long-term spending trajectory for each such component and regularly evaluate whether actual spending exceeds those benchmarks. If it does, automatic adjustments should take effect unless Congress and the president enact legislation to replace them. Additionally, we recommend a regular, systematic analysis by Congress of each area of discretionary spending to identify those programs that deserve reauthorization and those that can be made

more efficient. For example, analysts from across the political spectrum have called for reform of procurement within the Department of Defense. These periodic reviews will improve the effectiveness and accountability of government.

SPENDING

The only realistic way to close the gap between how much the federal government spends and how much it collects is to reduce outlays and increase revenues. On the spending side, in addition to structural reforms to the major health entitlement programs, this requires sensible adjustments to nearly all discretionary and mandatory spending programs. Although we recommend that policymakers enact these changes as soon as possible, they should not take effect until 2014 or later so as not to damage the fragile economic recovery.

Domestic Discretionary. The Budget Control Act of 2011 (BCA) already imposed ten years of caps on this category of spending – reductions that are roughly consistent with the restraint recommended by our original Task Force plan. We do not feel that any additional cuts to this area would be prudent.

Defense. Similarly, the BCA also established ten years of caps on defense spending similar to the DRTF proposal. Experts from across the political spectrum believe that the procurement and retirement components of the U.S. defense budget require major reforms. We agree on the need for these changes, and believe that they can produce some additional savings from the Department of Defense. We do not believe, however, that they will provide major additional deficit reduction.

Health Care. Most of the nation’s long-term fiscal imbalance is the result of unsustainable growth in health care costs. The federal government must play a significant role in health system change, not only to reduce budget deficits, but to help restrain the growth in health care costs and improve health care quality system-wide.

The centerpiece of our Medicare reform proposals is the Domenici-Rivlin Protect Medicare Act, which would establish competition on the basis of quality and price between traditional Medicare and Medicare Advantage plans. Public and private plans would compete in a well-regulated Medicare Exchange where the cost and quality of all plans would be presented clearly to beneficiaries. The federal contribution would be based on the cost of the second-least expensive plan or traditional Medicare, whichever is less expensive, and the growth of the per-beneficiary federal support would be capped at GDP + 1%. (Under current law, however, CBO projects costs to grow, on average, more slowly than that rate for the next two decades, in which case the cap would not come into play. In fact, we are confident that competition will save more than the cap would in the long run, and that the cap therefore will never bind.) The competition among plans could be introduced as part of a reform of Medicare Advantage. Efficiency in the private sector will be encouraged by slowly phasing out the tax exclusion for employer-provided health benefits. This tax expenditure, in addition to being regressive, encourages expensive plans with inefficient cost-sharing, helping to drive unsustainable growth in health care costs.

We also propose a variety of reforms to Medicare, Medicaid, and other federal health programs to encourage greater efficiency, quality and consumer protections. In Medicare, we would modernize the benefit structure to have uniform cost-sharing and, for the first time, implement an out-of-pocket maximum to protect beneficiaries from catastrophic costs. We would end first-dollar supplemental coverage, increase Part B premiums over five years from 25% to 35% of total program costs, and use Medicare's buying power to reduce the program's drug costs. We would bundle Medicare payments for post-acute care to encourage care coordination and reward efficiency. In addition to deficit reduction, these cost savings could permanently replace the Sustainable Growth Rate (SGR) formula for Medicare physician payments.

We propose two major changes to Medicaid federal-state financing. We would replace the current matching funds system, in which the federal and state governments split the cost of care for different beneficiaries at different rates, with a single, blended rate for each state that would automatically rise in times of recession and decline in times of growth. We would bar states from gaming the system to collect matching funds based on provider taxes, which are invariably returned to the providers after the states spend the federal matching dollars.

Our other proposals improve parts of the health system where costs are particularly high. To address public health and the rising costs of obesity, we would establish a two cents per ounce excise tax on sugary beverages. We would cap medical liability awards for noneconomic damages and launch large-scale tests, including safe harbors for following professional guidelines and administrative claims processing systems. We would accelerate savings in the Medicare home health program and reduce special Medicare payments that cover bad debts, graduate medical education, and rural hospitals, all of which will benefit from expanded coverage from the Affordable Care Act. We would increase TRICARE premiums and drug copayments. We would limit Medicaid reimbursement for durable medical equipment to Medicare rates. Finally, we would crack down on "pay for delay" agreements that restrict access to generic drugs and shorten the exclusivity period for brand name biologics.

Other Mandatory Spending. Many other programs run on autopilot, with no recurring oversight by Congress. We propose reforms listed below to constrain the growth of these programs and improve their effectiveness:

Implement a package of farm program reforms; adjust the age at which career military can retire to be consistent with federal civilian retirement; reform civilian retirement by calculating benefits based on a retiree's annual salary from his or her highest five years of government service, and increase employee contributions to the defined retirement benefit to be more consistent with the private sector; raise fees for aviation security; actuarially adjust flood insurance subsidies for risk; adopt a more accurate inflation measurement to calculate cost-of-living-adjustments (COLAs) for all federal programs; cease production of dollar bills and the one-cent piece, while increasing production of dollar coins; index mandatory user fees to inflation; restructure the power marketing administrations to charge market rates; sell non-hydropower Tennessee Valley Authority electric utility assets to private investors; gradually lower the conforming loan limits for Fannie Mae and Freddie Mac and increase the fees they charge; reform the Postal Service; and sell unneeded federal property.

Social Security. Our balanced package of policies achieves sustainable solvency, prevents the program from adding to the deficit in the coming decades, and, even more importantly, preserves and strengthens it for future generations. Changes include:

Gradually raise payroll taxes to cover 90 percent of all wages; use a more accurate calculation of annual COLAs (which applies to all indexed programs, including the tax code); implement modest additional means testing for high-income beneficiaries; increase the minimum benefit; index the benefit formula for increases in life expectancy; and cover newly-hired state and local workers under Social Security.

REVENUES

BPC's Tax Reform Plan radically simplifies the current tax code and raises approximately \$1.6 trillion more than current policy (which is \$2.9 trillion less than current law, with the expiration of all temporary tax cuts). To best explain it, forget what you know about the complex current tax system, and start fresh. Outlined below are the core elements of the plan. Unless otherwise indicated, all changes are implemented beginning in 2014.

- A **two-bracket income tax with rates of 15 percent and 28 percent**. Because there is no standard deduction or personal exemption, the 15-percent rate applies to the first dollar of income.²
- The **corporate tax rate will be a flat 28 percent**, instead of the current 35 percent top rate.
- Capital gains and dividends will be taxed as **ordinary income (with a top rate of 28 percent)**, excluding the first \$1,000 of realized net capital gains (or losses).³
- To replace the overly-complex Earned Income Tax Credit (EITC) and the 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);
 - Retain the **child and dependent care credit**; and
 - Establish a **refundable earnings credit**⁴ similar in structure to the recent Making Work Pay credit, but substantially larger.
- Instead of the current system of itemized deductions, which disproportionately subsidizes the housing 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**. (These refundable credits would begin at 20 percent in 2014, and then phase down to 15 percent over five years.)
 - Eliminate the deduction for state and local taxes.

² The 28% rate applies approximately to income above \$51,000 for single filers and \$102,000 for couples.

³ \$500 for singles and heads of household

⁴ The refundable earnings credit is equal to 17.5% of the first \$20,000 of earnings.

- Provide a flat, **15-percent refundable tax credit** or a deduction (for those in the higher bracket) **for contributions to retirement savings accounts** up to 20 percent of earnings or a maximum of \$20,000.
- 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.
- Effective in 2015, cap and then phase out over 10 years the tax exclusion for employer-sponsored health insurance benefits.
- Limit the deduction for medical expenses to the amount exceeding 10 percent of adjusted gross income (AGI) (unchanged from current law).
- Limit miscellaneous itemized deductions to the amount exceeding 5 percent of AGI (increased from 2 percent in current law).
- Increase the gas tax by 15 cents and index it to inflation, dedicating the revenue to the highway trust fund.
- Increase taxes on cigarettes and alcohol.

The BPC Tax Reform Plan enormously simplifies the tax code by **aligning the top individual, capital gains and dividend tax rates with the significantly-reduced corporate tax rate, while eliminating the Alternative Minimum Tax**. Additionally, **most individuals will no longer have to file an annual tax return**⁵ beyond an initial declaration of status because the most commonly taken deductions are either converted into refundable credits, determined solely based on the number of children and earnings, or can be deducted only above a substantial floor. Despite a low top rate of 28 percent, the BPC tax system will increase progressivity and will **raise the requisite revenue to achieve our debt-reduction goal**.

CONCLUSION

This updated BPC Domenici-Rivlin deficit reduction plan addresses the nation's fiscal problem in a balanced and workable way. Our plan shows that the challenge can be met if lawmakers demonstrate leadership and put everything on the table. The changes we suggest are not easy, but they improve the quality and efficiency of government and strengthen the economy for all Americans.

⁵ According to Tax Policy Center projections, only 50% of tax units would be required to file tax returns, as opposed to 88% under the current tax system.

The experience of BPC fellows and staff – former elected officials, cabinet secretaries, business leaders, senior congressional staff members, and senior executive branch officials – informs our recommendations, which also benefit from the work of the Congressional Budget Office and other experts. But despite literally millions of words deployed on analysis, legislative proposals, and recommendations, the policy changes to achieve fiscal sustainability and strengthen the American economy have not yet been made.

The nation needs substantial fiscal reforms no later than the first session of the 113th Congress. BPC has proposed a legislative framework to be enacted this year to facilitate a 2013 agreement, which could be similar to the Domenici-Rivlin proposal. To provide the time lawmakers need to reach a comprehensive agreement, the fiscal cliff (automatic spending cuts and tax increases scheduled to take effect in January 2013) should be replaced with a more realistic backstop that would guarantee \$4 trillion in deficit reduction if Congress fails to act by the end of 2013. The framework limits procedural delays and removes supermajority requirements that could prevent an agreement. To show good faith, Congress should add to the framework a combination of initial spending cuts and revenue increases that offset part of the cost of addressing the fiscal cliff.

Time is running out. The election is over. The options are clear. Now our leaders must show the courage to take risks and make hard decisions, and the American people should support those who do. We stand ready to help.

Bipartisan Policy Center

Percent of GDP		
	2022	2037
Revenues	20.9	22.6
Spending	<u>22.3</u>	<u>25.0</u>
Deficit (-)	-1.5	-2.4
Debt held by the public	67.2	64.2



Center for American Progress
Budgeting for Growth and Prosperity
Michael Ettlinger, Michael Linden, Seth Hanlon

Introduction

The purpose of the Center for American Progress plan for long-term deficit reduction is to build a strong American economy that provides the best opportunities for success of any country in the world and secures the position of the United States as the leading nation of the 21st century. It will not be possible to achieve these goals without addressing the dual challenges of rising red ink and a weakening middle class. That's why our plan's primary objective is to set the budget on a path toward full balance while growing and strengthening the middle class.

Why the focus on the middle class? First, growing and strengthening the middle class, creating the greatest good for the greatest number, is obviously a goal that has value unto itself. But it is also a key to economic growth and, hence, also a critical element for getting our national fiscal house in order. Without strong growth, balancing the budget is much harder. And without a strong middle class, our economy will not grow as it should.

The middle class is, in fact, the heartbeat of the American economy. Middle-class Americans are the indispensable workforce and the all-important consumer. It is from the middle class that the great American entrepreneurs and inventors have arisen. The education and skills of the middle class are responsible for the rise in productivity that underpins our prosperity. And a stable and large middle class keeps the United States largely free from internal political turmoil while at the same time demanding vital investments in education, roads, and other economically important infrastructure. The American ascent to becoming the richest nation on the planet is fundamentally a middle-class achievement. And the future of the American economy, and our ability to pay off our national debts, is just as linked to a strong middle class now as it has been in the past.

And the federal government has a key role to play in helping grow and strengthen the middle class. That role includes making critical investments in the areas such as education, infrastructure, and scientific research—areas that provide the foundation for a middle-class lifestyle and economic mobility. It includes ensuring the basic protections of civil society are maintained, as well as maintaining an effective and fair safety net. And it also includes guaranteeing every American a dignified retirement.

While there is tension between addressing our twin challenges of balancing the budget and revitalizing the middle class, our plan shows how the arithmetic can work.

Priorities for the next president and Congress

The president and Congress will be immediately faced with a myriad of important fiscal choices after the election and into 2013. With the so-called “fiscal cliff” looming, there is enormous pressure to avoid the economic consequences of dramatic fiscal contraction while simultaneously putting in place a plan to achieve significant deficit reduction over the next decade. Threading

this needle will be challenging but it is by no means impossible. A comprehensive long-term budget deal that addresses these immediate challenges as well as the long-term needs of the country would be ideal. But at a minimum, in order to be successful, the president and Congress should enact the three policy changes detailed below.

Tax reform that generates adequate revenues and improves the progressivity of the entire tax system

The primary cause of our fiscal shortfall over the medium term is a lack of tax revenue. The primary obstacle to a large-scale budget deal over the last two years has been the refusal of conservatives in Congress to agree to any new revenue at all. The first priority must be to overcome that obstacle. If it isn't overcome, the country can forget about serious progress in addressing fiscal problems.

There are many forms that a successful tax reform can take. Our plan identifies one of them. But any reform must have two characteristics. First and foremost, it must generate adequate revenues—equal at the very least to those proposed by the chairmen of the bipartisan Bowles-Simpson commission. That plan was the product of a bipartisan negotiation, and it skewed somewhat toward spending cuts. Its recommended levels of revenue should be a minimum. Second, reform must improve progressivity, asking those with the most to pay more. Households at the top of the income ladder have seen their federal taxes drop dramatically over the past 15 years. Before we ask the middle class or the poor to pay more, we should reverse that trend.

Removing the sequester

If allowed to take effect, the automatic spending cuts known as the sequester, triggered by the failure of the “super committee” process last fall, would have a large and deleterious impact on the economy and on the federal government’s ability to carry out its most basic functions. They should not be allowed to go forward. Ideally, Congress would replace them with better targeted and less economically harmful deficit reduction. To this end, accomplishing revenue raising tax reform would help. New revenue could be used to replace the “savings” from the sequester.

Implementing new job creation measures

The unemployment rate has fallen substantially over the past year, but it still remains near 8 percent. There is no realistic path to deficit reduction with joblessness at that level. More can and should be done to jumpstart job creation and help heal the labor market. We have proposed several measures, including directing more resources toward road construction and maintenance, helping local schools rehire teachers who have been laid off, and enhancing programs that retrofit buildings to become more energy efficient. These are just a few approaches that Congress could take.

Spending

The federal government makes investments that are important to our economy, provides services to the public, and carries out a variety of activities necessary to a well-functioning society. Our

spending plan is designed to do those things well, do them efficiently, and do them at the appropriate level of public expenditure so that budget deficits are reduced to manageable levels in the medium term and eliminated entirely in the long term.

The CAP budget plan is roughly divided into two time periods: the next decade and the decades that follow. Our proposals for the next decade show a path that would bring budget deficits down to responsible levels in a manner consistent with today's political realities. We do not believe that these changes are sufficient to balance the budget, to invest appropriately in the middle class, or to address many other national challenges. Meeting those challenges will require a bolder strategy. For the purposes of this plan, we show that bolder strategy beginning in 2023. In fact, the country would be far better off if we adopted all of the policy changes recommended in our budget plan as soon as possible.

When considering changes in federal spending, it is critical to first understand that spending in one particular area—discretionary spending—has already been cut dramatically. Since January 2010 projections for federal discretionary spending over the next decade have been reduced by about \$1.7 trillion, and that does not include the sequester. As a result, by 2017 federal nondefense discretionary spending will reach its lowest level, as a share of GDP, since at least 1962. Clearly, any additional cuts to federal spending must come from other areas.

To that end, our plan includes hundreds of billions of dollars in additional savings over the next 10 years from federal mandatory health care programs. In the long run, rising costs and an aging population make health care a major driver of our deficits. Many recent proposals to control federal health care costs, however, merely shift costs onto families and individuals without addressing the underlying problems. The savings in our plan would instead encourage health care providers to be more efficient and innovative, while also making targeted improvements to Medicare and Medicaid. Many of these savings enhance those already found in the Affordable Care Act, passed in 2010. The result will be lower federal spending on health care without sacrificing quality or access.

Our plan also finds savings in a variety of other “mandatory” spending programs in departments ranging from the Department of Agriculture to the Department of Transportation. The 10-year savings from these “other mandatory” programs total approximately \$160 billion.

All together, including the discretionary cuts already enacted, the CAP plan would cut federal noninterest spending by more than \$2.2 trillion over the next 10 years.

The spending cuts discussed above, along with the tax reforms described below, will put the federal budget on far more stable footing by the end of the decade. Those changes will not be enough, however, to sufficiently address three other important challenges: investing in the middle class and economic growth, combating poverty, and fully balancing the budget. Therefore, our plan also includes significant reforms to address those challenges. We recognize that the political will to carry out these reforms may not exist right now, and in deference to that recognition, our plan assumes that these types of reforms will begin in 2023. But that does not make these changes any less pressing right now.

Starting in 2023 the CAP plan makes significant new investments in scientific research, all levels of education, clean energy technologies, and transportation and infrastructure—areas where nations around the world are making substantial commitments. Our plan makes major investments in strengthening the American middle class. All of these investments are necessary if the United States wants to avoid being surpassed as the country with the greatest opportunities, the best jobs, and the most powerful economy. They are essential if we want our nation to continue to be where the great ideas and the most innovation comes from, and to remain a nation where entrepreneurs thrive and build successful businesses both large and small.

Investments such as these are the foundation of a strong 21st century economy. The country that leads in basic scientific research obviously has a huge advantage in innovation and technology. The country that can rely on domestically produced renewable energy isn't exposed to the risks associated with relying on imports, keeps funds at home that would otherwise go abroad, and gets a leg up on what will be one of the most important industries of this century. And the country that invests in its middle class produces educated, productive, and creative workers; a strong domestic market; a motivated workforce; and a population from which the greatest innovators and entrepreneurs emerge.

The CAP plan also makes a significant new investment in patching the holes in the social safety net. We propose increasing participation in the Supplemental Nutrition Assistance Program to 85 percent of eligible people, increasing the Supplemental Security Income benefit, increasing housing assistance by 20 percent, and boosting funding for children's programs.

Finally, we believe that the default position of the federal budget should be full balance, with the red ink reserved for recessions and emergencies. Along with our proposals to sufficiently invest in the middle class and combat poverty, our plan also makes long-run changes that will result in a balanced budget by 2031. This includes a broad reform to Social Security—the details of which can be found in a previously released report entitled “Building It Up, Not Tearing It Down.”

It also includes a health care failsafe mechanism. We believe that the savings and reforms we've proposed, along with aggressive implementation of those in the Affordable Care Act, will result in dramatically lower health expenditures, both for the federal government and overall. But predicting the exact effect of the myriad test programs and reforms in the new health law is fraught with uncertainty. We therefore also include a failsafe mechanism that would ensure significant savings.

Our failsafe would be triggered if, starting in 2023, total economy-wide health care expenditures grow at a rate faster than the economy. Should that happen, we would empower the Independent Payment Advisory Board to extend successful reforms in Medicare and other public programs to insurance plans offered in the health care exchanges and then potentially to all health care plans, such that the target is met. This will ensure that costs are constrained across the health care sector, preventing cost-shifting and maintaining access for all.

Revenue

The number one priority of the next president and Congress is to pass a revenue and progressivity enhancing tax reform. Our tax reform plan makes the individual income tax simpler and fairer. Many loopholes, deductions, and exemptions are eliminated, but the ones middle-class families most rely on are replaced by better-targeted credits.

In addition, there will be a large flat “standard credit” that taxpayers can choose instead of the itemized credits. This standard credit works similarly to the current standard deduction. For most Americans, choosing the alternative credit instead of the itemized credits will both lower their overall tax bill and make filing simple and easy.

Our plan restores the top income tax rate to what it was under President Bill Clinton, which is still lower than it was during most of the postwar period. The plan also restores the top capital gains tax rate to the level signed into law by President Ronald Reagan.

Finally, the various reforms we’ve proposed will obviate the need for the alternative minimum tax and various high-income phase outs.

In addition this income tax reform, our plan includes a number of other tax changes, including:

- Restoring the estate tax to earlier levels, but indexed for inflation
- Adopting the corporate revenue proposals in President Obama’s 2013 budget
- Eliminating some industry-specific tax expenditures that are effectively government spending administered through the tax system, including those for the oil industry
- Increasing some excise taxes

All together, our tax reforms would raise revenue to slightly above those proposed in the Bowles-Simpson plan.

As with the spending side of the equation, there are several additional tax measures that should be taken to ensure that the federal government can adequately address significant challenges such as investing in the middle class, combating climate change, and fully balancing the federal budget. These additional changes include:

- **Reducing greenhouse gas emissions and reliance on foreign oil by pricing carbon pollution and levying an oil-import fee.** Our plan addresses the risks and economic damage from our heavy reliance on foreign oil and the dangers of climate change by establishing a carbon tax and introducing an oil-import fee of \$5 per barrel.
- **Financial transactions tax.** Starting in 2023 our plan imposes a modest fee on financial transactions, including trading in stocks, bonds, and derivatives. The tax is applied at a very low rate—less than two-tenths of a percent on stock trades. We believe the purpose of Wall Street is to raise capital for the productive sectors of the economy



and that excessive financial speculation is counterproductive toward this purpose and harmful to stable growth in general. A financial transactions tax discourages unnecessary rapid turnaround speculation and improves incentives for long-term investment while raising revenue.

- **Social Security reform.** As mentioned above, a comprehensive reform to Social Security will be part of any plan that achieves full budgetary balance. CAP’s reform proposal includes changes to both the spending and the revenue components of the program. On the revenue side, the most notable change is that our plan would remove the cap on the employer side of the payroll tax.

Conclusion

The Center for American Progress plan will move the federal budget onto far more sustainable ground. Most importantly, it will do so without unfairly burdening the middle class and the poor. It will do so by making our tax code fairer and simpler; by rooting out inefficiencies in our federal health care programs, asking health care providers to innovate and improve; and by doing away with spending that is outdated, wasteful, or simply unnecessary. By 2023, instead of debt soaring past 90 percent of GDP on its way to 100, debt will be under 65 percent of GDP and falling.

Furthermore, our plan shows how we can achieve a fully balanced budget by 2031, while simultaneously making adequate investments in the middle class, and moving affirmatively towards a 21st century economy. And our plan would allow the country to more effectively meet great national and global challenges like poverty and climate change.

We can balance the budget while investing in growth, fighting poverty, and addressing climate change. And we can start down that path immediately.

Center for American Progress

Percent of GDP		
	2022	2037
Revenues	20.8	23.1
Spending	<u>22.4</u>	<u>22.5</u>
Deficit (-)	-1.6	0.6
Debt held by the public	66.0	40.4



Economic Policy Institute

Investing in America's Economy: A Budget Blueprint for Economic Recovery

Josh Bivens, Andrew Fieldhouse, Ethan Pollack, and Rebecca Thiess

I. Introduction

The American economy continues to struggle in the wake of the Great Recession. The economic downturn has already cost the nation an estimated \$3 trillion in foregone income and is projected to cost another \$3 trillion absent a sharp policy shift toward prioritizing job creation. If the U.S. economy continues to grow at the same rate it has over the last 18 months, it would take another decade for the labor market to fully recover.

In recent years, pundits and policymakers have obsessed over budget deficits, and, practically if not rhetorically, job creation has taken a back seat to cutting federal spending. However, warnings of a new recession following the “fiscal cliff” (a host of expiring tax provisions and spending cuts scheduled to go into effect in 2013) have served to reemphasize the destructive impact that premature fiscal contraction can have on the economy and affirm that economic recovery should be the first priority of fiscal policy.

Our proposed federal budget is driven by three fundamental truths. First, the near-term budget deficit is largely a symptom of the poor economy, and therefore any fiscal proposal must include a plan to get the economy back on track. Second, tax and budget policy should share the same goal as broader economic policy: providing rising living standards and greater economic opportunity and security for all Americans. Third, a truly sustainable budget provides future generations not only with manageable debt levels but also the building blocks of a prosperous economy: increased investments in infrastructure, education, and R&D, and a strong safety net to ensure that future generations have *at least* the same baseline levels of economic security on which millions of households currently rely.

Too many plans treat budgeting as little more than an accounting exercise, in which the goal is simply to make the spending and revenue lines cross. While this budget plan achieves a sustainable debt path, it was crafted with a broader goal in mind: to create a better economy and society.

II. Principles

1. Create jobs now

The jobs crisis isn't just a short-term problem of unemployment and poverty—it can also permanently scar the economy by depleting the nation's productive capital stock as educational attainment is deferred or forgone, poverty and malnutrition rise, human capital atrophies, businesses refrain from investing, and the physical capital stock depreciates from disuse. This makes long-run fiscal sustainability more difficult to achieve.

The main obstacle to economic growth continues to be a huge shortfall in aggregate demand. This is driven by insufficient spending by households and businesses; spending which pulled back in the aftermath of a housing bubble that wiped out trillions of dollars in household wealth and froze residential and commercial construction. Therefore, boosting aggregate demand with deficit-financed fiscal stimulus remains the most effective policy lever for addressing the jobs crisis.

The first priority for job creation is to successfully navigate the “fiscal obstacle course” (a more useful metaphor than “fiscal cliff”) by mitigating the biggest threats to demand in the near-term: the expiration of ad hoc stimulus measures (such as the payroll tax cut) and the implementation of spending cuts scheduled under the discretionary spending caps and sequestration mechanism in the Budget Control Act (BCA). Our plan repeals the BCA and finances a package of temporary, cost-effective fiscal stimulus measures that would reorient fiscal policy: increased infrastructure spending, state budget relief, a temporary extension of the Making Work Pay (MWP) tax credit, and emergency unemployment compensation. These measures would also more than offset the negligible effects of raising taxes on upper-income households by letting the Bush tax cuts expire.

2. Let the Bush tax cuts expire

The Bush tax cuts have already added more than \$3 trillion to the national debt—roughly half of the total debt added since 2001, and they will add another \$4.3 trillion over the next decade if extended. Prior to the Great Recession, these tax cuts were the signature policy presiding over the worst postwar economic expansion on record, in which real median income stagnated and income inequality grew. The Bush tax cuts are simply too expensive and ineffectual to continue. Our plan allows the Bush tax cuts to fully expire on schedule, and alleviates the minimal impact of their expiration on lower- and middle-income households by pairing the expiration with a consolidation and net expansion of refundable tax credits. Largely based on past proposals from EPI (see Robert Cherry and Max Sawicky’s 2000 report, *Giving Tax Credit where Credit is Due*) and the Bipartisan Policy Center (See Debt Reduction Task Force Co-chairs Pete Domenici and Alice Rivlin’s 2010 report, *Restoring America’s Future*), our proposal would replace the personal exemption, standard deduction, Earned Income Tax Credit, and Child Tax Credit with a work credit and a family tax credit. This swap would increase progressivity and simplify the tax code relative to current policies.

3. Preserve and strengthen the social safety net

Millions of Americans rely on the economic security afforded by Social Security, Medicare, Medicaid, and other safety net programs. Our plan proposes no benefit reductions and instead strengthens the safety net by expanding unemployment compensation, eliminating the payroll tax cap to solidify Social Security’s finances for generations, and building on the Affordable Care Act to attain long-run efficiency savings and cost containment in the provision of health care.

4. Return fairness and progressivity to the tax code

Public policy has failed to provide a robust response to the enormous rise in inequality over the last few decades. In fact, the progressivity of the tax code has been weakened over the last half century, exacerbating rather than reducing income inequality. Our plan restores fairness to the tax code by taxing wealth the same as ordinary income, reinstating more progressive estate tax parameters, adding new tax brackets on taxable income over \$2 million, and enacting a net wealth tax. Additionally, our plan adopts the Buffett rule to ensure that high-income households pay at least the same rate as middle-income households.

5. Tax goods and services that have significant social costs

Taxation creates incentives that can have beneficial outcomes for society. Our plan aims to help economic agents internalize the costs that spill over to the rest of society by pricing carbon

emissions, taxing financial transactions and leverage, and levying taxes on products that pose public health risks, notably alcohol and sweetened beverages.

III. Spending

Our spending policies are designed to promote immediate job creation, strengthen the middle class, and expand economic mobility and opportunity. Our plan includes proposals in the following categories:

Public investments and domestic spending

A balanced approach to fiscal sustainability requires boosting employment in the near term and investing in long-term growth. An excessive focus on debt ignores ways in which policies can shortchange future generations by leaving them with inadequate roads, bridges, schools, knowledge, health, or environmental quality. The current budget trajectory underinvests in physical, human, and environmental capital. Our budget repeals the entire BCA, which applies disproportionate cuts to the non-security discretionary budget, half of which consists of public investment. Our budget goes further in investing in our nation's infrastructure, education and training, and research and development by financing a permanent increase in public investments of \$200 billion in 2013, which is then indexed to nominal GDP growth in subsequent years. We additionally finance \$425 billion in state and local fiscal relief through 2017 to protect public investments at the state and local level and boost employment, as well as \$250 billion for a public works and direct employment program over 2013-2014.

Defense

Our plan replaces the frontloaded BCA discretionary spending caps and sequester for defense spending with comparable cuts phased in over a decade and in line with the cuts proposed by the bipartisan Sustainable Defense Task Force. This allows for feasible implementation and minimizes the economic drag from government spending cuts in the near term.

Social Security

Social Security has kept more seniors, disabled persons, and children out of poverty than all other social welfare programs combined, and for 75 years it has provided economic support for millions more. As businesses continue to shift risk to individuals by replacing private pensions with tax-preferred personal savings accounts, Social Security is proving an increasingly important pillar of retirement. Our plan recognizes the need to shore up Social Security while protecting benefits, and phases in a five-year elimination of the cap on both employee- and employer-side payroll tax contributions. This will also keep rising inequality from depriving the Social Security system of revenue, as it has for decades.

Medicare, Medicaid, the Affordable Care Act, and other federal health programs

Our plan protects and strengthens the social insurance programs that ensure health coverage for those who are otherwise unable to receive affordable coverage. As the cost of providing health care escalates, however, it is imperative that we slow the rate of rising *national* health care expenditures instead of simply shifting rising costs onto households or state governments. Using government monopsony (single-buyer) power to contain costs, our plan would negotiate lower Medicare Part D drug prices, offer a public insurance option, encourage bundling payments, accelerate generic drug availability, and finance investments in health information technology

and comparative effectiveness research. Furthermore, our plan would expand the jurisdiction of the Independent Payment Advisory Board (IPAB) to the private sector. This super-charged IPAB, plus our other health policies, should sufficiently contain nationwide (and thus government) health costs. If they do not, we propose an all-payer IPAB system that caps federal health spending at nominal GDP plus 1 percent beyond 2022. Lastly, our plan repeals the sustainable growth rate formula for Medicare physician payments.

Other mandatory programs

Our plan extends the Emergency Unemployment Compensation program through 2015, restoring the program's provision of up to 99 weeks of unemployment compensation in high-unemployment states. Our plan eliminates commodity payments to large farms, reduces the value of direct payments, and reforms the crop insurance program in line with Obama administration policy. Finally, many of our tax policies have associated mandatory outlay effects; these include the new universal worker and child credits, a refundable rebate from pricing carbon, the temporary reinstatement of the MWP credit, and the conversion of the charitable contribution and home mortgage interest deductions to refundable tax credits.

IV. Revenues

The current tax code fails along many dimensions. First, tax receipts have been deliberately driven down to levels that will produce large future budget deficits even if the economy fully recovers. The Bush tax cuts, for example, are a core reason that sizable structural deficits are projected if fiscal policy remains unchanged. Second, recent changes in tax policy have exacerbated income inequality, and tax progressivity must be restored to address the large rise in inequality of incomes in recent decades. Third, tax code complexity for both individuals and corporations is such that a tax bill can depend as much on the quality of one's accountant as the size of one's income. High-income households and corporations now often pay far less in taxes than what an optimal system would collect from them. Under our proposals, high-income earners and corporations would contribute more, while negative tax rates for low-income households would be expanded.

Individual income taxes

The Bush tax cuts were costly and ineffective, and the evidence of their failure to boost economic growth continues to mount. Our plan allows all of the Bush tax cuts to expire on schedule, to be replaced with more progressive refundable work and child credits targeted toward lower- and middle-income households. The work credit is set at 30% on the first \$20,300 of income per worker, while the child credit provides a refundable tax credit of \$1600 per dependent child under 18 (limit of 3 per household).

The tax code taxes income derived from wealth at a lower rate than income from work, which distorts economic behavior, creates opportunities to shelter wealth from taxation, and worsens inequality. Our plan closes the gap between the two rates by taxing dividends as ordinary income, taxing capital gains as ordinary income up to the revenue-maximizing rate of 36 percent, and repealing the step-up basis of capital gains at death. Our plan also adds additional individual income tax brackets to reflect that tax progressivity has fallen most sharply within the top 0.1 percent of households by income; this change would bring the top effective individual tax rate closer to the optimal top tax rate estimated by economists Peter Diamond and Emmanuel Saez in their 2011 paper *The Case for a Progressive Tax*.

Corporate income taxes

The corporate tax code is rife with inefficient and costly special-interest tax breaks. Our plan starts by adopting the administration’s proposals to eliminate fossil fuel tax subsidies, which are unnecessary and inhibit the transition to a more sustainable economy; and to reform the international tax system, close the tax gap, and modify the treatment of financial and insurance companies. Our plan also allows for the expiration of some of the more wasteful business tax preferences, such as bonus depreciation, the Subpart F active financing exception, the alcohol fuel tax credit, and the R&E (research and experimentation) credit (which is replaced with more efficient direct R&D investment in the National Labs and National Institutes of Health). Finally, our plan repeals some of the more egregious instances of corporate welfare in the tax code, but dedicates the savings to deficit reduction rather than using them to reward corporations with lower marginal rates.

Tax expenditures

As structured, many individual income tax expenditures are ineffective in promoting their purported goals and are skewed toward higher-income households. Our plan reforms tax expenditures by replacing the mortgage interest and charitable-giving deductions with 15 percent refundable credits (and limiting the value of tax-preferred mortgage debt to \$500,000). We also replace the tax exclusion on municipal bonds with a direct subsidy for the issuer, a more effective and progressive policy. We then cap value of remaining itemized deductions and other preferences, gradually reduced from a 28 percent cap in 2014 to 15 percent in 2017.

Other revenues

Our plan shifts the burden of taxation away from work and on to corrective taxes, seeking to minimize socially harmful outcomes and activities that act as “negative externalities” because their full social costs are unpaid. These include pollution, alcohol consumption, the diabetes epidemic and other adverse health effects, concentrated wealth, high degrees of financial leverage, and high-frequency financial trading. To help mitigate pollution and improve health, our plan prices carbon emissions (initially set at \$30 per metric ton) and recycles over half of the revenue back to low- and middle-income households through a refundable tax rebate. Our plan also phases in an increase in the motor fuel excise tax, raises alcohol excise taxes, and enacts a new sweetened-beverage tax. To reduce systemic financial risk, we adopt a leverage tax on “too big to fail” banks and a broad-based financial transaction tax. And to reduce the corrosive effects of concentrated wealth, our plan enacts a half-a-percentage-point annual surcharge on net wealth above \$10 million and reinstates the estate tax at a lower exemption (\$2 million) and higher top rate (50 percent).

V. Conclusion

Our blueprint navigates the impending headwinds by expanding effective job creation measures and reorienting tax policy to help lower- and middle-income families while letting the costly, inefficient, and regressive Bush tax cuts expire. Over the longer term, our plan reverses the decades-long erosion of public investment and declining tax code progressivity by boosting investments in future generations and financing these investments by asking more of those in society who can most afford it. Our plan preserves social insurance benefits and avoids cost-shifting measures that tend to exacerbate rather than address the underlying economic challenges.

Deficit reduction on its own will fail to boost living standards, opportunity, and security for current and future generations. To be successful, it must be paired with policies that push the labor market back to full employment and that lay the foundation for long-run economic growth.

Economic Policy Institute

Percent of GDP		
	2022	2037
Revenues	23.0	25.3
Spending	<u>25.3</u>	<u>26.3</u>
Deficit (-)	-2.3	-1.0
Debt held by the public	78.6	66.3

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

Alison Acosta Fraser, William W. Beach, and Stuart M. Butler, Ph.D.

INTRODUCTION

Since the Heritage plan, *Saving the American Dream*, was first published in April 2011, there has been almost no substantive progress on spending control. The only plausible exception was the flawed Budget Control Act (BCA), a product of a contentious debt limit debate. The complete failure of its bipartisan “Supercommittee” to reach agreement was a sad reflection on a Congress that is divided and unwilling to pass legislation necessary to rein in spending.

As a result, the nation is facing the looming sequester, which would gut the defense budget, jeopardizing one of the federal government’s core constitutional responsibilities. At the same time, it would leave entitlement programs virtually untouched, although they are the largest driver of spending today and in the future. Meanwhile, the prospect of a huge tax increase in January is already having a deleterious effect on the economy, though the effect is only a small portion of how the economy will ultimately be hit if the tax increase takes effect. A true way forward is seriously needed.

The Heritage plan reflects the need to rein in spending immediately and rethink major programs. Spending on the open-ended Social Security, Medicare, and Medicaid entitlements must be brought under control, and the core foundations of these programs should be strengthened. The following principles guided the policy solutions in *Saving the American Dream*:

- Total spending must be brought under control to balance the budget without raising taxes, ultimately holding revenues at their historical share of GDP.
- Entitlement programs should, unlike today, actually guarantee seniors economic security in retirement and be recast as *real* and sustainable insurance programs focused on those who really need them.
- Other spending must be curbed and the federal government restricted to its proper functions.
- Defense, as a core constitutional function of the federal government, should be fully funded and efficiently delivered.
- The tax system should be structurally reformed to foster growth by eliminating tax distortions of private economic decisions, especially with respect to saving and investment, and to make the system simpler and more transparent.

PRIORITIES FOR CONGRESS AND THE PRESIDENT

Fiscal 2012 closed on September 30 with the Congressional Budget Office (CBO) estimating spending of \$3.5 trillion and a deficit of \$1.1 trillion. Debt held by the public was \$11.3 trillion, or 73 percent of GDP. According to the CBO's Alternative Fiscal Scenario, by 2037, debt will explode to 199 percent of GDP, driven by growth in spending that will reach 36 percent of GDP. The major driver of spending is uncontroversially the major entitlement programs: Social Security, Medicare, and Medicaid. Of more immediate concern, unemployment remains stubbornly around 8 percent, job creation is tepid, and GDP growth is stuck in slow motion. The top priorities for Congress and the President are clear: Get control of spending, especially entitlement reform, and set a growth agenda through tax reform. After the fiscal cliff is averted, Congress and the President must turn their attention immediately to these pressing issues.

As noted, entitlements are the fastest-growing programs. Even if all other spending was eliminated, these programs would still cause large and unsustainable deficits in the future. Their growth is automatic, with auto-pilot spending built into the law and no serious budgetary constraints. Top priority must be to restructure entitlements and put a brake on their spending levels while strengthening and preserving them for future generations. Reform proposals for federal health programs are the most robustly developed in Congress and the ones for which the public is most open to change, so priority should be focused on Medicaid and especially Medicare. However, changes in Social Security should quickly follow, and the retiree programs in general should be more consistent. For example, increases in the normal eligibility age should proceed simultaneously for both Social Security and Medicare. Specific steps for Congress and the President include the following:

- The President should, as early in the year as practical, submit a budget that outlines strong, sweeping changes in entitlement programs that will reduce spending over the 10-year budget window and make significant improvements in the long-term trajectory of these programs.
- The President's budget should lay out specific goals for a pro-growth, revenue-neutral tax reform plan.
- Congress should repeal the Affordable Care Act (Obamacare) as soon as possible in 2013. This could be accomplished, for example, by passing a 2013 budget resolution with reconciliation instructions, but other legislative vehicles are possible.
- Congress and the President should include reforms in entitlement programs and further reductions in other spending areas in exchange for any increases in the debt limit. These should reflect lessons learned from the 2011 Budget Control Act such as avoiding high-stakes mechanisms like sequestration that are designed to fail.
- Congress should pass a joint budget resolution by the April 15 deadline that should include reconciliation instructions for entitlement and tax reform.
- The budget resolution should also require reforms for other spending programs to bring spending below the levels in the BCA for 2014 and beyond in their budgets.

SPENDING

Health Care: If there is one issue alone that must be fixed in 2013, it is the federal role in health care—the biggest driver of spending. The flawed Obamacare law should be replaced with a true patient-centered, market-based model, including reforms in Medicare, Medicaid, and the tax treatment of health insurance.

Medicare's finances must be brought under control. As a first step, the age of eligibility should be raised gradually from 65 to 68 and then indexed to life expectancy. In addition, there should be a gradual increase in premiums for Parts B and D, thus expanding the current policy for Medicare of adjusting the level of taxpayer subsidies to income, with the most affluent seniors receiving much smaller (or in some cases no) taxpayer subsidies for their health coverage. These steps should occur immediately, as they are easily achieved and less controversial and could be part of new debt limit legislation or even Obamacare repeal itself.

Within five years of these initial changes, patients should also be transitioned to a defined-contribution, or premium-support, model that would be income adjusted. Expanding competition in Medicare will restrain federal spending, slow health care costs, and promote greater innovation in the delivery of care. Federal spending on Medicaid should be put on a budget to bring greater fiscal certainty and stability. Federal Medicaid spending would follow the antipoverty spending caps by reverting to the 2007 spending levels when the economy approaches full employment and then be adjusted for medical inflation thereafter.

In lieu of traditional Medicaid, able-bodied individuals and families should receive direct federal government assistance in the form of tax credits or direct assistance to enable them to buy private insurance coverage, regardless of their employer or work status. For the disabled and frail elderly, Medicaid would remain a joint federal–state safety net program, but states would have additional flexibility to adopt more patient-centered models.

As a part of tax reform (see below), the employee tax break for employer-sponsored coverage would be converted to a non-refundable tax credit that individuals and families could use to purchase the health plan of their choice.

These larger reforms are best achieved through normal legislative order. This could include the legitimate use of reconciliation as part of a comprehensive budget plan. In any case, Congress should pass a concurrent budget resolution for FY2014, and conceivably FY2103 as well.

Social Security: Social Security is running permanent cash flow deficits, has severe programmatic flaws, and needs to be reformed. First, Social Security's eligibility age should be gradually increased in tandem with that for Medicare. For both, this change is straightforward and could be included in an initial, small reform package. Next, Social Security should return to its original purpose: guaranteeing that all older Americans are protected from poverty in retirement. As part of this insurance protection, benefits will evolve to an understandable, predictable flat benefit that is above the poverty level. As an insurance program, moderate-income retirees will receive a smaller check while affluent seniors will receive no check unless

their financial circumstances change. To encourage people to stay in the workforce longer, those who work beyond full retirement age will receive a higher level of after-tax income until they do retire.

Tax reform will support Social Security reforms by significantly increasing personal savings that seniors will take into retirement. There should be no limit on the amount of tax-deferred savings that can be taken into retirement. Thus, more retirement income is possible than under the current system. Social Security becomes a safety valve against economic reversals and a floor for income after the statutory retirement age.

Other Spending: Defense cuts are already reducing military readiness. Thus, the defense portion of the BCA cuts is dangerously flawed and must be reversed. The sequester for defense spending (including the 2013 cuts) is eliminated and more than offset with reforms in other spending and entitlements. Defense spending is brought slowly up to and held at 4 percent of GDP.

Non-defense discretionary spending is set for 2013 at the BCA sequester level and then reduced to 2 percent of GDP, after which it is indexed to inflation.

Spending in 2014 and beyond should include reforms in longstanding but growing and expensive programs such as farm subsidies and transportation. A program of privatization including federal asset sales could begin as early as 2015. Anti-poverty spending should be rolled back and capped when the economy approaches full employment, then consolidated into fewer programs reflecting strong incentives for work and marriage.

REVENUE

Tax Reform: The economy remains plagued by the uncertainty of expiring tax policy and an unwieldy and inefficient tax code. Beyond preventing Taxmageddon by extending all current tax policy by early 2013, Congress should pass broad substantive tax reform consistent with the New Flat Tax in *Saving the American Dream*. The emphasis for tax reform should be squarely on promoting economic growth by reducing tax rates and other tax distortions, along with simplification and improved transparency, revenue neutrality, and distributional neutrality.

The broad direction for tax reform already in play is fully consistent with the New Flat Tax, especially the bipartisan push for lower corporate income tax rates. Congress is likely to find the goal of lower corporate tax rates quickly pressing up against the consequent reality of the need to lower tax rates for non-corporate businesses as well. This occurs naturally under the New Flat Tax in which all businesses are taxed at the entity level on their domestic net cash flow at a single rate. Likewise, the growing support for a territorial tax system under which U.S. businesses are taxed solely on their domestic income is also fully consistent with the New Flat Tax, which levies tax solely on domestic income.

Under the New Flat Tax, the individual income tax and the payroll tax are rolled into one system with the same tax rate as is imposed on business income. Also, nearly all other federal levies are repealed, leaving a simple system for both individuals and businesses. Under the New Flat Tax as it applies to individuals, only income used for consumption is taxed, thus eliminating the existing tax bias against saving. In addition, all distorting credits, exemptions, and deductions are eliminated, with two exceptions.

The first exception is the tax credit for health insurance (mentioned above). This tax credit is less distortive of economic decisions than is current law, but it remains a clear subsidy for the purchase of health insurance. It is necessary because the current-law tax bias favoring health insurance is so powerful and so entrenched that simply eliminating the tax advantage altogether is impracticable.

The second tax distortion carried over from current law is the earned income credit (EIC). The EIC is in need of reform in its own right, but it is also the largest income-support component of the overall federal anti-poverty program and one of its most effective elements. Changes in the EIC should then be considered as part of the proposed budget for anti-poverty programs. The New Flat Tax, the tax reform plan, is implemented effective January 1, 2014.

The Heritage Foundation

Percent of GDP		
	2022	2037
Revenues	18.5	18.5
Spending	<u>17.6</u>	<u>18.3</u>
Deficit (-)	0.9	0.2
Debt held by the public	54.5	28.0

A Note about Scorekeeping

The Peter G. Peterson Foundation's Fiscal Solutions Initiative required the five organizations who accepted grants to develop comprehensive plans that met the following criteria:

- Proposed solutions should be sufficiently detailed to allow them to be scored by an independent group against the June 2012 CBO baseline, extended through FY2037.
- Each finished budget plan should represent a comprehensive package of specific policy proposals to address the projected long-term fiscal gap. Although the Foundation did not stipulate a required goal or target for these plans, each plan will be evaluated on its impact on projected debt-to-GDP ratios, how it proposed to accept, reject or otherwise change the elements of the fiscal cliff, and other related measures over the FY2013-FY2037 time period.
- Each of the comprehensive budget plans should be accompanied by a detailed spreadsheet that provides estimates of each plan's projected budgetary impact.

To allow for fair and objective comparisons of the plans, the Foundation engaged independent scorekeepers to review the estimates and analyses for each plan. This scorekeeping effort was led by Barry Anderson, former Acting Director at CBO and senior career civil servant at OMB. Eric Toder and Jim Nunns of the Tax Policy Center, a joint venture of the Urban Institute and the Brookings Institution, led the review of the plans revenue proposals. Bill Menth, former OMB senior analyst, tracked each of the plans specific proposals and performed aggregate comparisons of the plans. Other current and former budget analysts helped review the plans specific proposals, particularly in the health, Social Security, and defense areas. The scorekeeping team carefully reviewed each of the spending and revenue proposals submitted by the five organizations. In particular, the scorekeeping team reviewed:

- the sources cited by the organizations to support their estimates;
- the baseline assumptions used by the organizations in measuring the budgetary impact of their proposals;
- estimates produced by existing models developed to score similar proposals;
- comparisons with estimates of similar proposals made by other organizations;
- and,
- comparisons of similar proposals made by one or more of the other organizations who developed plans in response to the Foundation's Fiscal Solutions Initiative.

Many of the organizations relied on the scoring of similar proposals produced by CBO, OMB, the Joint Committee on Taxation, and other organizations that have extensive experience in scoring proposals, and this reliance greatly facilitated the review of the scoring of the proposals. For the past three months, the scorekeeping team has had extensive discussions with each of the organizations. Some of the organizations' original proposals were modified as a result of these discussions. The scorekeeping team recognized that estimating over a 25-year period the year-by-year budgetary impact of proposals—many of which were innovative with few similar proposals having been made previously—is inherently difficult. Nevertheless, despite these difficulties, all of the organizations sought to make their estimates as accurate and consistent with objective scorekeeping principles as possible. As a result of these efforts, the scorekeeping

team is satisfied that the organizations' plans can be fairly and objectively compared with each other.

This is not to say that the Foundation, the scorekeeping team or its members, or any of the organizations to which members of the scorekeeping team belong, should be cited as sources of the estimates. The sources of the estimates are the five organizations that made the proposals. However, the scorekeeping team believes that because of the actions taken by each of the organizations in trying to achieve common, comparable estimates of the budgetary impact of their proposals, a fair and objective comparison of the five plans can be made.