

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

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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 uncontrovertibly 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.

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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