The Heritage Foundation
LEADERSHIP FOR AMERICA

Saving the AMERICAN DREAM

The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity

savingthedream.org

Saving the AMERICAN DREAM

The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity

About the Editors

- **Stuart M. Butler** is Distinguished Fellow and Director of the Center for Policy Innovation at The Heritage Foundation.

- **Alison Acosta Fraser** is Director of the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

- **William W. Beach** is Director of the Center for Data Analysis at The Heritage Foundation.

The editors are grateful to the team leaders who worked with policy experts throughout The Heritage Foundation to develop this report: **J. D. Foster, Ph.D.**, Norman B. Ture Senior Fellow in the Economics of Fiscal Policy; **Rea S. Hederman, Jr.**, Assistant Director and Research Fellow in the Center for Data Analysis; **David C. John**, Senior Research Fellow in Retirement Security and Financial Institutions; **Robert E. Moffit, Ph.D.**, Senior Fellow in the Center for Policy Innovation; **Nina Owcharenko**, Director of the Center for Health Policy Studies; and **Brian M. Riedl**, Grover M. Hermann Research Fellow in Federal Budgetary Affairs.

This plan was developed as part of the Solutions Initiative and funded by the Peter G. Peterson Foundation.

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

The spending and revenue estimates have been extensively reviewed by a team of independent scorekeepers, led by Barry Anderson and including William Menth and the staff of the Urban-Brookings Tax Policy Center. The Urban-Brookings Tax Policy Center assessed the revenue effects of each plan. The Urban Brookings Tax Policy Center and the other members of the scorekeeping team do not necessarily endorse any of the estimates made by the Participants of their own plans.

214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

FOREWORD

Fellow Americans:

WE HAVE COME TO A TIME OF DECISION. For far too long, Congress has been on an unsustainable binge of spending, taxing, and borrowing. Our nation is going broke, and we are passing the costs of these misguided policies to our children and their children.

Over time, our national government has become bloated, overextended and unrestrained, oblivious of its core functions, operating far beyond its means and vastly outside of its proper constitutional bounds. Unchecked, the course we are on now will cripple our economy, undermine our prosperity, and lead to fiscal insolvency. By robbing the future of opportunity and freedom, it will destroy the American Dream for future generations.

Already, we are living through the shame of being publicly lectured by our Communist Chinese creditors, who have contempt for our profligacy. The day it was announced that Standard & Poor's had lowered the outlook on our economy, a collective gasp went through the international community. If our elected leaders keep it up, we are certain to face financial crises like Greece or Portugal.

America is on the verge of becoming a country in decline—economically stagnant and permanently debt-bound, heavily regulated and bureaucratic, less self-governing and less free.

But this fate does not have to be our future. We can get spending under control, balance the budget, and shrink our debt. We can limit the size of government and set free once again the unlimited genius of Americans to create wealth and jobs. We can turn the tide and change our nation's course.

Saving the American Dream is our plan to fix the debt, cut spending and, above all, restore prosperity. It balances the nation's budget within a decade—and keeps it balanced. It reduces the debt and cuts government in half. It eliminates government-mandated health care and fully funds our national defense. In order to get our fiscal house in order, we must address Social Security, Medicare, and Medicaid, the three so-called entitlement programs which together account for 43 percent of federal spending today. Far too many seniors still lack enough help to avoid poverty. *Saving the American Dream* therefore does not end these programs; instead it focuses them on those who need them.

Our plan also encourages Americans to become more fiscally responsible themselves. It redesigns our entire tax system into an expenditure tax that will have a single flat rate. This is a structure that will promote savings, therefore benefiting individual Americans, our body politic, and the economy. Greater savings mean stronger capital formation and thus a more robust economy, which means real jobs for Americans.

This plan substantially reduces the size and scope of the federal government, fundamentally increases the role of the states in choosing their own practices, and brings decision-making closer to the people rather than unelected administrators. These are crucial steps that will get our nation on a path of fiscal, political, and constitutional responsibility. It is part of our larger effort to get our country back on track, reclaim its truths, conserve its liberating principles, and build an America where freedom, opportunity, prosperity, and civil society flourish.

At the end of the day our plan, while economic in nature, has a higher moral purpose. If entitlements are not reformed, the next generation and future ones will have to pay punitive tax rates that will end liberty as we have known it. Our proposal aims to preserve America's promise bequeathed to us by past generations.

Edmund Burke reminds us to think of our time on this earth not as an individual and temporary event, but rather as a partnership "between those who are living, those who are dead and those who are yet to be born." Keeping faith with this partnership is what we aim to do with *Saving the American Dream*.

We have been here before, and every time the American people have always risen to the occasion and seized the moment. In 1776 we were told that no upstart colonists could defeat the strongest nation in the world, and we decided to change the course of history. In 1860 we were told the Union could not hold and that America was over, and we brought forth a new birth of freedom. In 1980 we were told that the American century was at an end, and we launched a great economic expansion, rebuilt our military, and revived our national spirit.

Hard times demand tough choices. The future of our nation is at stake.

All that is required, as my hero Ronald Reagan once said, is "our best effort, and our willingness to believe in ourselves and to believe in our capacity to perform great deeds; to believe that together, with God's help, we can and will resolve the problems which now confront us."

Together, let us seize the moment, change our country's course, and save the American Dream.

–Edwin J. Feulner
President, The Heritage Foundation

INTRODUCTION

There Is Only One Choice

AMERICA MUST CHANGE COURSE. We face a staggering fiscal problem that threatens the very future of our nation. Not only will we continue to struggle with huge federal deficits into the near future, but the problem will become ever larger and ever deadlier in the decades to come. Unless we act wisely, massive government spending and surging public debt will destroy the foundations of our economy and darken the American Dream for our children and grandchildren.

But this is not inevitable. We can in fact preserve the American Dream. With bold and decisive action, we can reduce spending and solve our debt problem. We can safeguard our legacy of freedom, opportunity, and prosperity, and we can do it in such a way that shrinks the government to a manageable size, invigorates our economy, and ensures basic economic security to younger and older Americans alike. We can save ourselves from a sea of red ink while doing better for our seniors and the poor than the current programs that have gotten us into the present mess.

The Heritage Foundation has come up with such a plan.

The underlying problem that it addresses is simple: The government is doing things it should not be doing and spending far more than we can afford to pay or should be paying. It is time to start moving decisively toward a federal government that is limited and carries out its appropriate function. As a result of the government's doing far too much, spending since World War II is at record levels as a proportion of the U.S. economy (in terms of gross domestic product, or GDP[1]) and is growing. The federal government is borrowing 40 cents of every dollar that it spends. The accumulated national debt caused by this and past borrowing already stands at nearly 70 percent of the country's annual economic output and is set to climb to at least 100 percent by the end of this decade.

According to some international comparisons, the U.S. economy is already in worse shape than the stumbling economies of most European nations, and it is only a matter of time until our financial house collapses. We are living on borrowed time and risk an economic catastrophe unless somebody in government exercises real leadership to reduce spending and borrowing. We can and must do better.

What if we fail to act before domestic and foreign lenders lose confidence that America and Americans will ever act responsibly? What if a crisis engulfs us? To see our grim future, we need only look at countries like Greece that are experiencing stringent and disruptive austerity and sudden drops in living standards. Yet we can still avert such a catastrophe in America with real leadership and bold action. A growing number of states in America are confronting similar challenges with creative remedies to return to fiscal discipline.

However, if we do nothing, spending will continue to surge. Past Congresses made utterly unaffordable promises to Americans that are now coming due. These promises will continue to come due in the next decades. In particular, Washington promised

1. The gross domestic product is the measure of the value of the total output of goods and services within the United States in a year.

expensive Medicare and Social Security benefits to the baby-boom generation,[2] but the money to pay for these programs is running out.

These programs promise benefits for one set of Americans that are being paid through taxes and borrowing. The way this is done needs some explaining. Many Americans believe that the taxes and premiums they pay into Social Security and Medicare go into real trust funds where they will be used to cover promised future benefits. That's not the case. Instead, the money taken from one set of Americans today just goes out the door to pay for benefits for others. Any "surplus" is not kept in a fund either, but rather is spent immediately by the government for other purposes and replaced with an IOU that is nothing more than a tax lien that future taxpayers will be forced to repay. And that means obligations against the future incomes of unsuspecting Americans, many of whom have yet to be born.

Pay-as-you-go schemes can work only as long as enough people are paying into the system. Yet with the leading edge of the enormous baby-boom generation now reaching retirement, these programs are no longer cash cows covering other government spending. Instead, they are rapidly deepening seas of red ink. Fifty years ago, there were five workers paying the benefits of each retiree. Today, there are only three workers per retiree, and in 20 years, there will be just two. Simple math shows that this cannot continue.

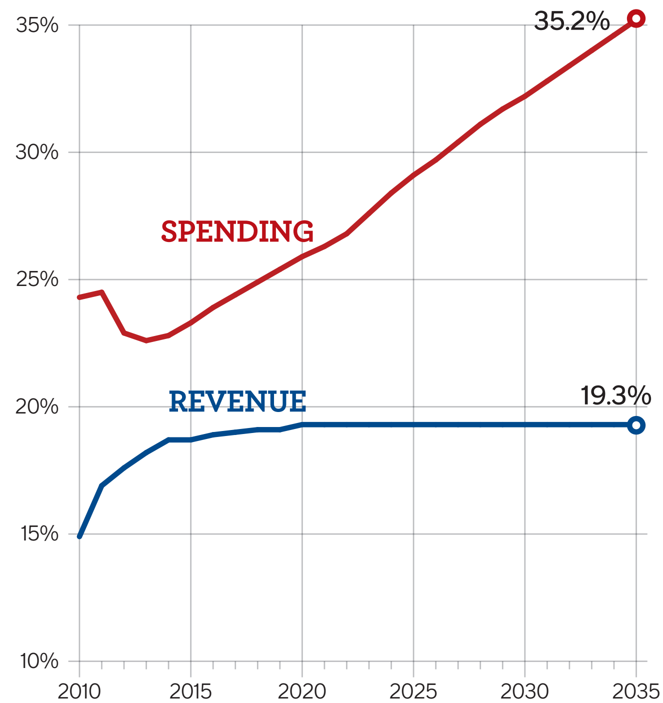
We are facing the consequences of generations of politicians from both political parties having promised millions of Americans certain services without regard to cost or how we will pay for them. The three major entitlements—Social Security, Medicare, and Medicaid—account for 43 percent of federal spending, or 10.3 percent of GDP. These three programs will surge from 10.3 percent of the economy to almost 20 percent in just 40 years. To pay these promised benefits in full for just Social Security and Medicare, the government would need to set aside

2. Baby-boom generation refers to people born in the years 1946 to 1964.

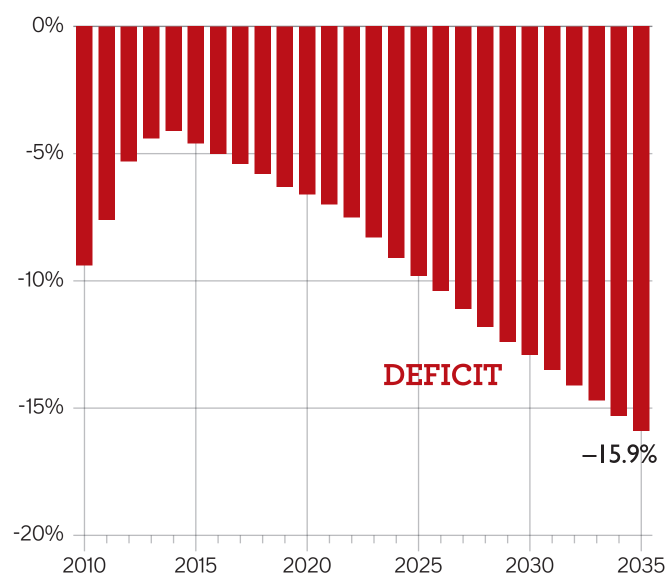
CHART 1

The Current and Future Crisis: Runaway Federal Spending Will Result in Huge Budget Deficits

Revenue and Spending as a Percentage of GDP



Surplus/Deficit as a Percentage of GDP



Source: Heritage Foundation calculations based on data from Congressional Budget Office, Alternative Fiscal Scenario.

and invest almost $40 *trillion* of our tax dollars today to cover this long-term shortfall.

With the baby-boom generation now reaching retirement, the finances of these programs are in dire crisis, and they are placing an increasing burden on Americans. These entitlement programs consume a large and rapidly growing proportion of the nation's economic output.

Politicians and policymakers have put forward three visions of how to respond to this, but only one of these choices would deal with the budget and economic threat while beginning to restore the federal government to its proper, limited role and not passing on a huge financial burden to our children and grandchildren.

Choice #1: Cross our fingers and hope for the best.

Many politicians either flinch from taking the necessary action or delude themselves into believing that somehow things will magically turn out okay. Others seem to believe that the federal government is somehow just "too big to fail"—something many Greeks once believed of their government—and that the Chinese and other lenders will trust in our ability to pay them back and thus never sell off their holdings of Treasury securities. But if they lose confidence, interest rates will skyrocket. The federal government would then need to make savage cuts to restore international confidence.

Even before such a crisis, growing concern among foreign and domestic lenders about our willingness to take the necessary long-term action will push up interest rates, hurting American businesses, investors, homebuyers, and borrowers. But even if this crisis never occurs, the only way we can continue to pay for the promised entitlements is to pass tens of trillions of dollars of debt onto our children and grandchildren. In this scenario, our children and grandchildren will pay the bill. And it is a huge bill: Each working American and each of his or her children now owes more than $200,000.

Perhaps the biggest danger is that when Washington sees this mounting debt, it will choose the most dangerous, "easy-way-out" strategy: printing money to pay the bills. This leads to rampant inflation. America and many other countries have experienced high inflation before. It devastates economies and perniciously eats away at the hard-earned savings of working and retired Americans.

This is not a real choice. Global capital markets will demand action at some point. Moreover, doing nothing is a choice that Americans emphatically rejected in the 2010 elections. They do not want an ever-growing federal government. They want the federal government to be limited and to operate in line with its constitutional functions. And they do not want Congress to continue spending and making promises that we cannot keep without undermining our prosperity and burdening future generations with debt.

Choice #2: Raise taxes.

Some argue that the proper approach is to continue our spending and entitlement binge and simply raise taxes until we balance the books. But if we did this, spending and taxes would rise over the next few decades to levels more like those endured in Europe than those we expect in America.

For instance, financing promised entitlement spending solely by raising tax rates would require doubling the marginal tax rates for *all* income brackets over the next 30 years, reaching a 66 percent federal income tax rate for many middle-income Americans, on top of payroll taxes or state and local income taxes. Corporate taxes—already among the highest in the industrial world—would also need to double. America cannot possibly compete economically at that level of spending and taxation.

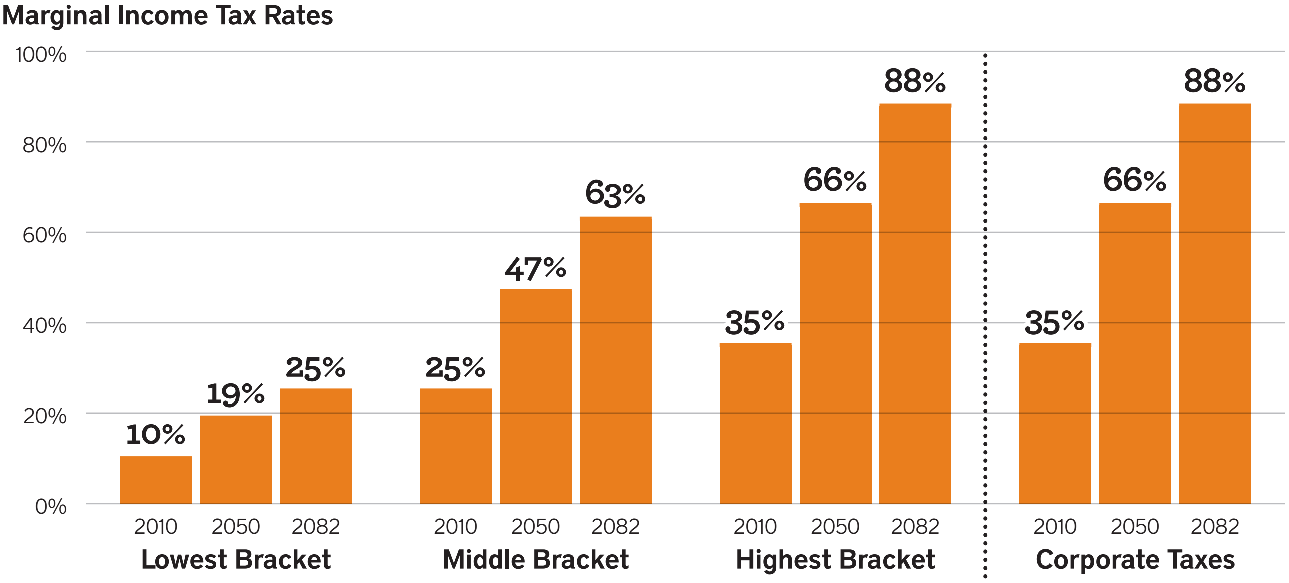
And who would pay the bulk of these taxes? Those in retirement or near retirement today would not, even if rates were raised immediately. The Americans who would pay the lion's share are those just starting out in life. They would bear this staggering tax burden for decades while still trying to provide for their own needs. Indeed, this second choice would simply substitute taxes on young Americans for borrowing on the same young Americans.

Some argue that even if spending commitments are trimmed, tax increases will still be needed because

CHART 2

Hiking Taxes to Pay for Entitlements Would Require Doubling Tax Rates

The cost of Medicare, Medicaid, and Social Security is rising substantially. Paying for this spending solely through federal income tax increases would require more than a twofold increase of current tax rates, even for the lowest tax bracket.



Source: Congressional Budget Office.

Americans are not willing to cut spending enough. Yet Americans have awakened to the spending problem. They are demanding spending cuts, not more taxes. They also realize from experience that if more of their money is sent to Washington to "deal with the deficit," Congress will likely spend it rather than use it to reduce the long-term debt. Moreover, raising taxes will hit younger generations longer and will still shift much of the burden onto the people who did not cause the problem.

This, too, is not a real choice. Imposing any new taxes or increasing current taxes—for example, by raising rates—would erode American competitiveness and discourage entrepreneurship and investment, slowing growth and job creation and dimming future prosperity. Even more important, it would lock in a vision of government that reflects the European tradition far more than it does the American tradition. It would fuel an ever-growing federal government that continues to engage in activities that should be handled by the states or the people themselves, with programs that are financially unsound and that cause more and more Americans to become dependent on government.

Choice #3: Actually fix the spending and debt problem and begin to restore the federal government to its proper functions.

The third choice is to recognize that the U.S. government has gone well beyond its proper functions. It has been living beyond the means of the American people, and Congress after Congress has made unwise and unaffordable promises. Americans must return to the basic truths and values of our vision of limited government and reshape our federal government accordingly.

To ensure prosperity and growth for ourselves and our children, we must reduce the federal government so that it is closer to its proper size and focus it on performing its core responsibilities. This will mean deep and sustained reductions in federal spending. We must also hold down taxes while reforming our needlessly complex, burdensome, and highly unfair tax system to sharpen incentives and reward saving if we want America to be prosperous once again. We must re-energize entrepreneurs and workers to restore America's prosperity powerhouse. We can best solve our spending and debt problem through the growth, opportunity, and prosperity that come with low tax rates and limited government.

This choice requires that we tackle the root of the spending problem by squarely addressing the unsustainable entitlement promises that are overwhelming us. If we act soon rather than waiting until the problem is too urgent and too big to fix prudently, we can fix the problems in ways that actually strengthen economic security.

To deal with entitlements, we must ask parents and grandparents to think not just of the promises past Congresses have made to them, but also of the consequences their children and grandchildren will suffer if these promised benefits remain untouched. To repeat, the money that Americans have paid into these programs has already been spent. It is no longer available to pay for all of the promised benefits. That is an indictment of Washington, but it is also a fact—and one that we must address.

Today, we must ask ourselves tough questions about how we can allocate public funds in the most effective way. We must acknowledge that everyone will need to pitch in to solve the problem.

The good news is that we can do this. We can guarantee economic security to middle-aged and older Americans even as we reduce the crippling debt that we have piled onto the shoulders of the young.

However, fixing these programs is only half of the economic equation. The other half is to foster the American spirit of self-reliance to flourish and to cast off the growing and dispiriting dependence on government that has characterized recent decades. Faster growth through greater economic freedom will enable more and more Americans to build both a solid and secure life and retirement for themselves and the means, as a community, to help those who worked hard but do not have the means to support themselves in retirement.

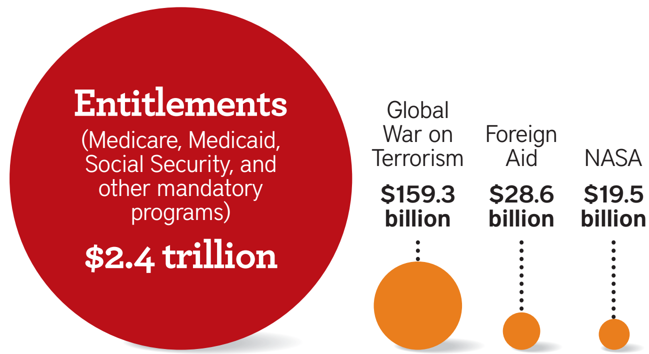
This third choice is the only one that upholds the vision of government shared by the vast majority of Americans. It is the only real choice. That is why The Heritage Foundation made this vision the basis of our plan to fix America's spending and debt crisis.

CHART 3

Discretionary Spending Cuts Alone Are Not an Adequate Substitute for Entitlement Reform

Annual spending on entitlement programs is massive compared to other federal spending priorities. Cutting discretionary spending is a necessary step, but cuts to foreign aid alone or pulling out of Afghanistan will not close the deficit. Entitlement spending must be reined in.

Spending in 2011



Note: Figure for entitlements includes net interest. Without net interest, the total is $2.2 trillion.

Source: White House Office of Management and Budget.

What the Heritage Plan Will Achieve

The Heritage plan will solve America's twin crises of debt and spending with reforms that are consistent with the principles of democratic governance and deeply held American values.

Our plan does this by cutting government down to size, re-energizing American enterprise through fundamental tax reform, and transforming entitlement programs to provide real economic security without passing a crushing financial burden onto younger generations.

Specifically, the Heritage plan:

- **Balances the federal budget within a decade and keeps it balanced forever at no more than 18.5 percent of GDP.** Americans have made very clear to Washington over many decades the limits of how much they are willing to pay for government. That historical average figure is approximately equal to 18.5 percent of GDP, so we balance spending and revenue at that level.

- **Reduces the debt to 30 percent of GDP within 25 years and puts it on track to continue falling thereafter.** Our national debt now is nearly 70 percent of GDP and on track to hit 185 percent within 25 years.[3] Lower debt will remove the threat of financial crisis and restore the confidence of investors and lenders. It will also sharply reduce the debt burden on future generations, relieve the pressure on interest rates, and help to secure our prosperity.

- **Cuts the size of the federal government by about half within 25 years.** By achieving balance at this level, we stop the federal government from growing to over one-third of the entire U.S. economy. Left unchecked, it would reach that size by the time a baby born today graduates from college.

- **Stops scheduled tax increases and replaces the complex and unfair tax code with a completely new tax system.** In addition to holding revenues at no more than their historical average, we replace the current Byzantine tax system with a much simpler system that minimizes tax distortions and perverse incentives.

3. Congressional Budget Office, "The Long-Term Budget Outlook," June 2010, at *http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf* (May 3, 2010).

TABLE 1

Heritage Plan Curbs Revenue, Spending, and Debt

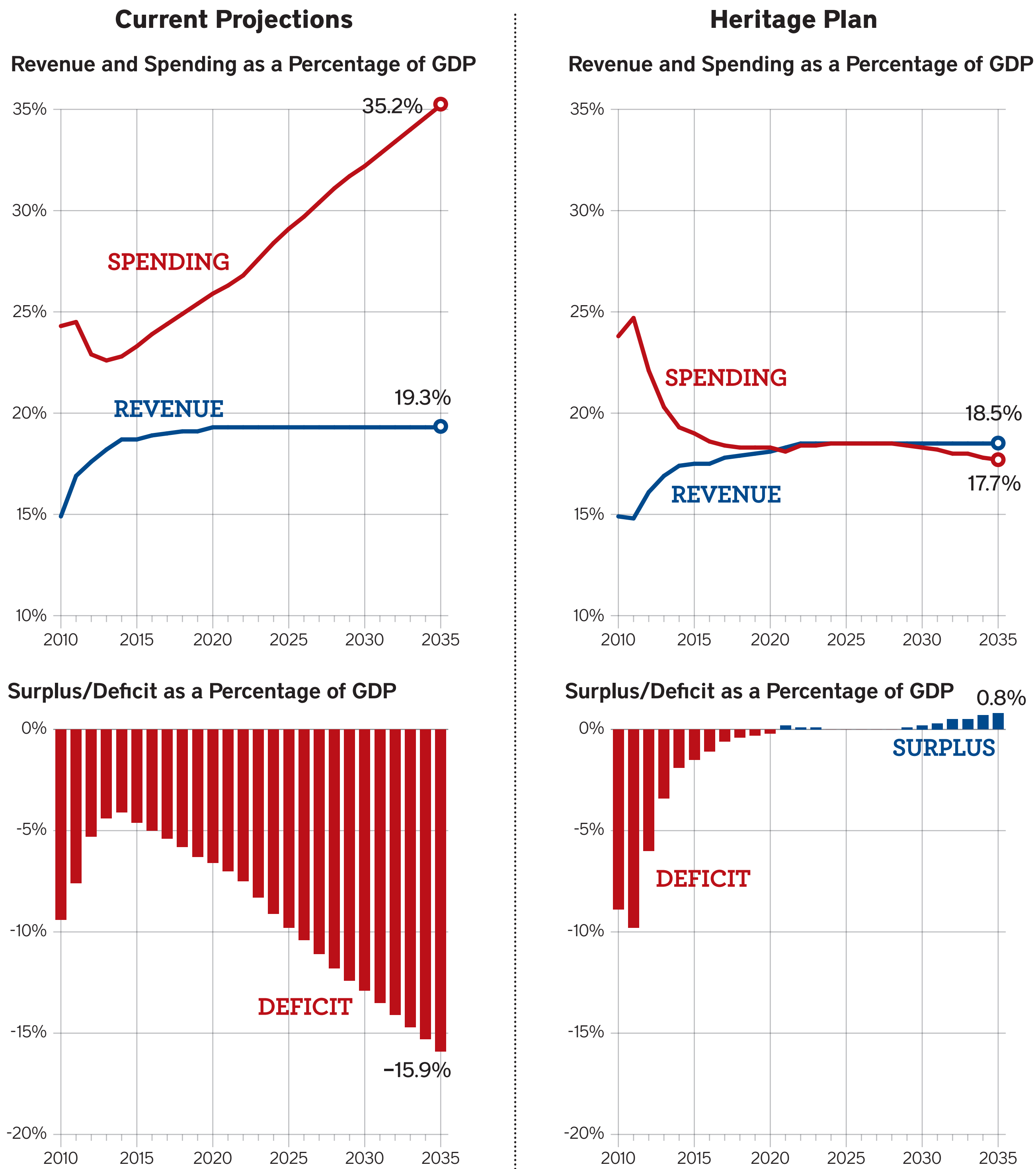
Figures are % of GDP	REVENUE AND SPENDING						PUBLICLY HELD DEBT	
	Heritage Plan			Current Projections			Heritage Plan	Current Projections
	Revenue	*Outlays*	*Surplus/ Deficit*	*Revenue*	*Outlays*	*Surplus/ Deficit*		
2011	14.8	24.7	−9.8	16.9	24.5	−7.6	69.4	67
2012	16.1	22.1	−6.0	17.6	22.9	−5.3	72.9	69
2021	18.3	18.1	0.2	19.3	26.3	−7.0	58.2	91
2035	18.5	17.7	0.8	19.3	35.2	−15.9	30.0	185

Sources: Current projections: Heritage Foundation calculations based on data from Congressional Budget Office, Alternative Fiscal Scenario. Heritage Plan: Calculations by the Center for Data Analysis, The Heritage Foundation, based on baseline data in the current projections, data provided by the Peter G. Peterson Foundation, and CDA policy models.

CHART 4

The Alternative—Saving the American Dream

By rapidly lowering total federal spending, the Heritage plan would balance the budget by 2021 and keep it there permanently, without raising taxes.



Sources: Current projections: Heritage Foundation calculations based on data from Congressional Budget Office, Alternative Fiscal Scenario. Heritage Plan: Calculations by the Center for Data Analysis, The Heritage Foundation, based on baseline data in the current projections, data provided by the Peter G. Peterson Foundation, and CDA policy models.

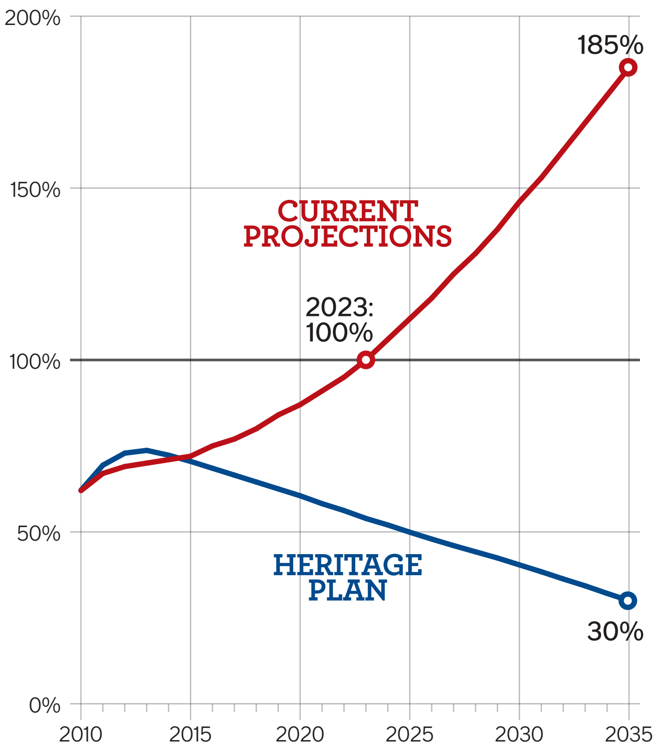
- **Protects America and its interests around the globe by ensuring full funding for national defense.** Defense is a core constitutional responsibility, a fundamental duty of the federal government, and essential to preserving American liberty and prosperity. Waste and inefficiency in defense spending should be rooted out, but we use the savings to meet defense needs.

CHART 5

The Heritage Plan Would Reverse Trajectory of Unsustainable Debt

Without significant spending reforms, the national debt is projected to reach 185 percent of GDP by 2035. Under the Heritage plan, federal spending would be reduced by about half, which would dramatically lower our debt to 30 percent.

Publicly Held Debt as a Percentage of GDP



Sources: Current projections: Heritage Foundation calculations based on data from Congressional Budget Office, Alternative Fiscal Scenario. Heritage Plan: Calculations by the Center for Data Analysis, The Heritage Foundation, based on baseline data in the current projections, data provided by the Peter G. Peterson Foundation, and CDA policy models.

- **Eliminates Obamacare and creates a health care system that is affordable both for the nation and for individuals and families.** This system fosters the individual choice, competition, and state-level innovation needed to control underlying health costs while assuring continuous and portable coverage. By overhauling subsidies and tax breaks for health care, we ensure that Americans can afford adequate coverage.

- **Redesigns Social Security and Medicare as sustainable programs that truly protect seniors and will be around for our children and grandchildren.** The current system will soon be running massive deficits and unable to pay in full for all of its promised benefits. Accordingly, we redesign these defined-benefit entitlement programs as budgeted "real insurance" programs that focus on those who need them and are phased out by income for those who do not really need them. In contrast with those who argue for raising taxes on current and future Americans, the Heritage plan eliminates the need to raise taxes.

- **Provides powerful incentives for working Americans to save and invest so that they will be less dependent on these programs.** Our tax and Social Security reforms provide new ways for Americans to save for their future security and to create capital for enterprise.

SOCIAL SECURITY

Summary

SOCIAL SECURITY IS THE LARGEST SINGLE federal program, paying out about $700 billion per year to some 60 million Americans. It is a major source of retirement income for millions of Americans. Yet Social Security went into the red in 2010, paying out more in benefits than people paid in as payroll taxes. The Congressional Budget Office says that these deficits will continue for at least the next 75 years and probably indefinitely.

What Is Social Security?

Social Security, today's largest single federal program, provides (1) retirement income to workers and their spouses, (2) survivors benefits to the family members of deceased workers, and (3) disability benefits for workers who have been injured and are unable to work and to the families of those workers. The program is funded by a 12.4 percent payroll tax that is paid equally by both the worker (6.2 percent) and his or her employer (6.2 percent). Employers correctly see their contribution as a part of the employee's total compensation.

In 2009, the most recent year for which data are available, Social Security spent a total of $685.8 billion providing these benefits. That was also the last year that Social Security collected more in payroll taxes than it paid out in benefits. Starting in 2010, the program started to run cash-flow deficits that the Congressional Budget Office says are unlikely ever to end. The annual Social Security deficit will increase every year until about 2030, when it will reach about $350 billion annually in 2010 dollars (without including any inflation), and stay at approximately that level permanently.

Social Security does have a $2.5 trillion trust fund from the surpluses that it collected between 1983 and 2009—but that money isn't there. Rather than build up real assets in a real trust fund, Congress actually spent that money on everything from roads to corporate welfare. That trust fund is filled with special-issue Treasury bonds that the U.S. Treasury is required to finance when they are needed to fund Social Security's deficits. As they are bonds not backed by any real assets, the government will have to either borrow or raise taxes to pay for them.

In essence, then, these bonds are really a demand on future tax collections—a lien. In 2010, the Treasury started to redeem these bonds, or tax liens, by tapping into other tax sources in order to cover Social Security's deficits. Around 2037, even those special-issue bonds will run out. From that time on, under the provisions of current law, every retiree—no matter how wealthy or how poor—will have his or her Social Security benefits cut by about 22 percent.

Over the next 75 years, the program has promised to pay $7.8 trillion more in benefits than it will receive in payroll taxes. The only way that future retirees can collect all of the benefits promised to them is to make their children and grandchildren pay massive amounts of additional taxes.

Heritage proposes to solve these problems and strengthen the Social Security system by tightening its benefits and returning it to its original purpose: a guarantee that older Americans won't fall into poverty. Heritage proposes to make Social Security "real insurance" for Americans as they reach retirement.

This reform means that Social Security's promises in the future will change in several ways:

- Social Security will gradually be transformed from an "income replacement" system back to its original purpose of guaranteeing seniors freedom from fear of poverty and assuring a decent retirement income. This means that Social Security benefits will evolve over time into a flat payment to those who work more than 35 years—a flat payment that is sufficient to keep them out of poverty throughout their retirement.

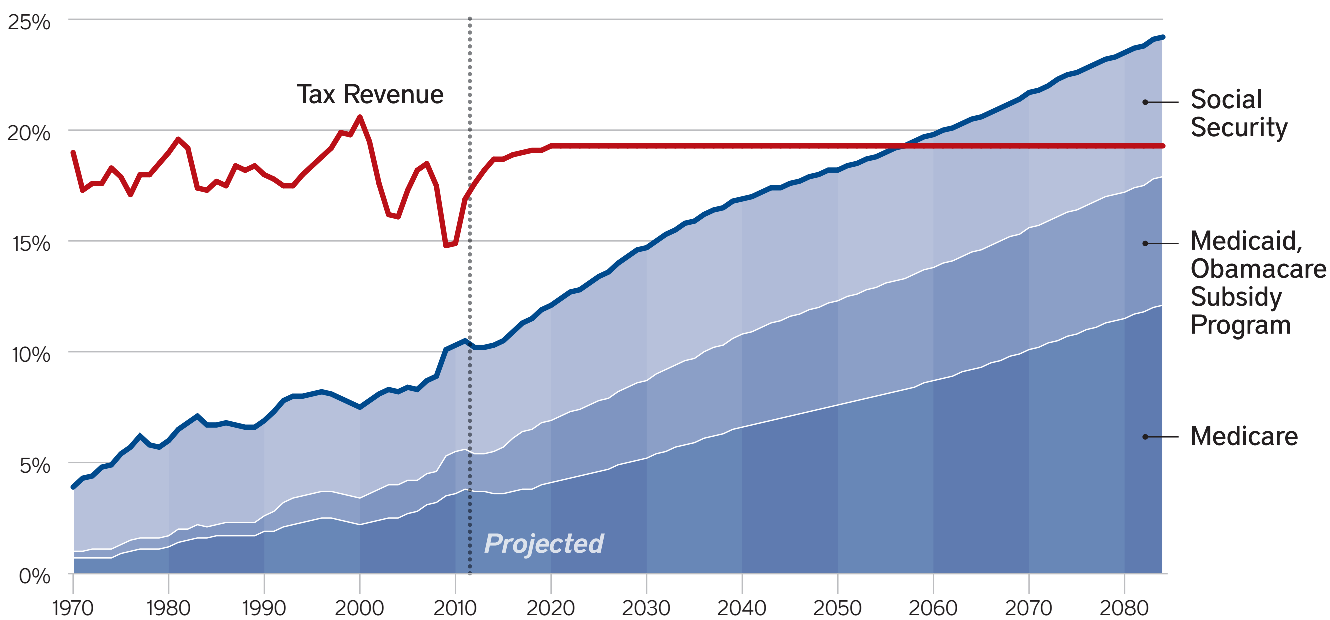
- Because the new Social Security is a real insurance system, designed to protect seniors from poverty, retirees with high incomes from sources other than Social Security will receive a smaller check, and very affluent seniors will receive no check. This transparent way of income-adjusting benefit checks will replace the method used today, whereby the checks of even modest-income seniors are taxed and thus reduced.

- To help make up the difference between the new Social Security benefit and what workers may desire for a more comfortable retirement, our plan will create greater incentives for workers of all income levels to save more for retirement. These savings will supplement their Social Security and create a more secure retirement.

CHART 6

Without Reforms, Entitlements Will Consume All Tax Revenues

Tax Revenue and Entitlement Spending as a Percentage of GDP



Source: Congressional Budget Office.

- Americans live much longer than they used to. While this is good news, it means that they are spending a much higher proportion of their lives in retirement. Regrettably, these longer retirements play a major role in Social Security's financial problems. For this reason, the Social Security retirement ages will be raised gradually and then indexed to life expectancy. This will create a more reasonable balance between the number of years a person works and the number of years one receives Social Security benefits.
- 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 during the period when they are not claiming benefits.

This new Social Security system is reasonable, predictable, and affordable. It focuses resources on those who need the most help while providing complete protection against poverty for all seniors who qualify for full benefits.

The Details

A Predictable Benefit That Provides Economic Security. The centerpiece of the new Social Security system involves a gradual transition to a flat benefit that pays retirees who qualify for a full Social Security check. This amount is well above the income level that the Census Bureau says an American over the age of 65 needs to avoid poverty.

Thus, the new system will guarantee that no retiree falls into poverty because of insufficient income. Under today's system, retirees can pay Social Security taxes for 35 years and still receive a benefit that is below the poverty level. Some of these seniors are forced to go on welfare. The new system corrects this serious flaw.

The flat benefit will be the equivalent of about $1,200 per month in 2010 dollars when the reform is complete. This is both higher than today's average Social Security retirement benefit payment ($1,164 per month) and well above the 2009 poverty level for a single adult over age 65 ($857 per month). To ensure that future retirees do not slip back into poverty, the flat benefit level will be indexed for wage growth.

Slow Transition to the New Flat Benefit. The new flat benefit will be phased in slowly. Current retirees and those who are close to retirement will see only a minimal change in the basic design of their benefits. Those with a significantly longer time before retirement, who have more flexibility in planning their future, will see larger changes in their benefits. Workers born after 1985 will come under the new flat Social Security benefit system when they retire.

Limiting Social Security to Those Who Actually Need It. In addition to moving to a flat benefit over time, the plan makes Social Security a properly financed, true insurance program. It starts to do that immediately. This means that the program will concentrate on protecting the economic security of retirees rather than following the current approach of promising unaffordable benefits to all without regard to need.

This new approach means that retirees with substantial non–Social Security retirement income will start receiving a lower benefit on a sliding scale that gradually reduces Social Security checks to zero for those with the highest non–Social Security incomes. This transparent mechanism will apply to benefits received by affluent Americans under both the current system and the flat-rate system. This transparent, sliding-scale approach is a major improvement on today's taxation of Social Security benefits.

Under the plan, income-adjusted benefits start in 2012 as individual retirees with non–Social Security incomes above $55,000 start to see a slight reduction in benefit payments. Those with higher non–Social

Security income will see larger reductions in their checks. Individuals with more than $110,000 in non–Social Security income will receive no Social Security payments. Married couples who file taxes jointly would be subject to higher thresholds, with benefits beginning to phase out at a joint non–Social Security income of $110,000 and ending when income reaches $165,000. Married couples can decide whether they want to qualify for benefits as individuals or jointly as a couple. The income thresholds will be indexed for inflation.

Income-adjusting benefits is not new. It occurs in today's Social Security system. But it is largely hidden today and hits lower-income seniors, not just the affluent. Seniors with as little as $15,000 in non–Social Security income, or even less in some cases, must pay tax on part of their benefits. Seniors with more income than that pay steadily higher rates of tax on more of their Social Security benefits. The Heritage approach, when fully phased in, would income-adjust benefits transparently and not tax the benefits a senior receives. It also would start income-adjusting at a much higher income. Today, about half of seniors have their checks eroded by taxation. Under the Heritage plan, only about 9 percent of seniors would see their checks reduced and only just over 3.5 percent of seniors would receive no check.

Real insurance also protects seniors from poverty if their financial situation changes. Retirees who suffer a sudden and permanent drop in non–Social Security income would find their benefits rapidly restored.

More Accurate Inflation Protection. The annual cost of living adjustment (COLA) for Social Security, which protects retirees against inflation, will be based on the Chained Consumer Price Index (C-CPI-U), a measure of inflation that is more accurate than the index used currently. The Bureau of Labor Statistics specifically designed this inflation measure to better reflect the way that consumers buy different items as the prices of various products fluctuate.

A More Reasonable Retirement Age. The plan adjusts the retirement ages to reflect increases in life expectancy and those anticipated in the future. Under the plan, these changes are phased in gradually. Those nearing retirement are affected only slightly. Over the next 10 years, the age for full benefits rises to 68 for workers born in or after 1959. Over the next 18 years, the early retirement age rises to 65 for workers born in or after 1964. After that, both early and normal retirement ages will be indexed to longevity, which will add about one month every two years according to current projections.

The plan recognizes that a small proportion of workers will be physically unable to work until these ages. It therefore includes an improved disability system to protect them. The reformed disability system ensures that those who are unable to work longer receive a quick and accurate decision on their benefit application rather than facing today's long delays, and improves today's often arbitrary decision-making process.

Incentives to Work Longer. Starting immediately, those who work past their full-benefit age receive a special annual tax deduction of $10,000, regardless of income level. For instance, once the new system is completely phased in, a worker earning $50,000 per year who delays Social Security payments will see a $200 per month increase in spendable income.

An Improved Savings Plan to Supplement Social Security. As Social Security is transformed into a real insurance system that focuses scarce resources on those who need them most, the plan also creates better ways for workers to build savings for retirement.

Beginning in 2014, a new savings plan will be introduced over two years. Under this plan, 6 percent of each worker's income is placed in a retirement savings plan that the worker owns and controls unless he or she explicitly declines to have such an account. (This approach is known as automatic enrollment.)

This new, additional retirement security system gives Americans another tool with which to secure their retirement standard of living. Savings are invested through an improved version of the IRA/401(k) employment-based retirement savings system already familiar to Americans. The money put into these savings accounts will not be double-taxed, unlike today's Social Security payments and many other savings mechanisms.

In addition to this new savings plan, workers have two other important ways to save for retirement.

First, under the reformed tax system detailed below, all savings (without limit) will no longer be double-taxed. Savings remain completely free of taxation until they are actually spent.

Second, as benefit reforms drive the costs of Social Security below the level of taxes collected, those savings will go into the workers' accounts.

The Bottom Line

The Heritage plan reforms Social Security to create a retirement security system that will be available for future generations. It will be one that provides a reasonable, predictable, and affordable benefit that ensures that no retiree who has worked for 35 years or more faces poverty or economic insecurity. At the same time, this new system protects our children and grandchildren from the massive tax increase that would be necessary to pay all of the Social Security benefits that Washington has irresponsibly promised.

MEDICARE

Summary

THE MEDICARE PROGRAM FACES A 75-year unfunded liability in excess of $30 trillion even as it is plagued by serious gaps in coverage, an increasing number of demoralized doctors refusing to accept new Medicare patients, a sluggish and outdated system of inflexible governance, and tens of billions of dollars in annual losses to waste, fraud, and abuse.

What Is Medicare?

Medicare is the federal government's health insurance program for all Americans age 65 and older and for the disabled. In 2010, the program covered 47 million enrollees. Almost half (47 percent) have annual incomes below 200 percent of the federal poverty level ($21,660 in 2010 dollars for individuals and $29,140 for couples). An estimated 45 percent have three or more chronic medical conditions, and 17 percent are non-elderly people with disabilities. Medicare is projected to spend $549 billion in 2011, increasing to $891 billion per year by 2019.

Medicare has four parts.

- **Part A** covers in-patient hospitalization, hospice care, and some home health care. It is funded by a 2.9 percent payroll tax, but projected spending will far exceed future tax revenue.

- **Part B** is voluntary and covers physician services, outpatient hospital services, preventive care, and some home health services. Beneficiary premiums cover just 25 percent of Part B costs. Taxpayers pay for the remaining 75 percent. Federal Insurance Contributions Act (FICA) payroll taxes contribute nothing to Part B. Premiums are income-related.

- **Part C,** the Medicare Advantage program, is also voluntary. It consists of private plans that already compete in the Medicare program. They are funded by a combination of enrollee premiums and taxpayer subsidies, including Part A funds.

- **Part D** is the voluntary Medicare prescription drug program. FICA payroll taxes do not fund this part of Medicare. Enrollees pay income-adjusted premiums, but the costs for all beneficiaries are subsidized by taxpayers, with greater subsidies for low-income enrollees. While beneficiary premiums account for approximately 10 percent of Part D financing, 82 percent comes from general federal revenues, and approximately 8 percent of the funding comes from states and other sources. As with Medicare Part B, wealthy retirees pay higher premiums, up to 80 percent of the costs of the drug benefit.

Medicare Part A and Part B together are sometimes referred to as traditional Medicare or Medicare fee-for-service (FFS). This means that doctors, hospitals, and other medical professionals are paid for the individual services that they provide to patients as opposed to being paid salaries or given "capitated" payments as payment for all of the care provided to a senior. The fees are governed by government fee schedules or payment formulas for specific medical services.

Medicare must be reformed to solve this huge financing problem, to improve access to quality care, and to ensure that health care will be available for younger Americans when they retire.

The Heritage plan accomplishes this by transforming Medicare from an open-ended and unsustainable defined-benefit entitlement into a properly budgeted program that focuses Medicare subsidies on those who need them most. The new Medicare program would look much more like the Federal Employees Health Benefits Program (FEHBP), the health care system for Members of Congress and federal employees.

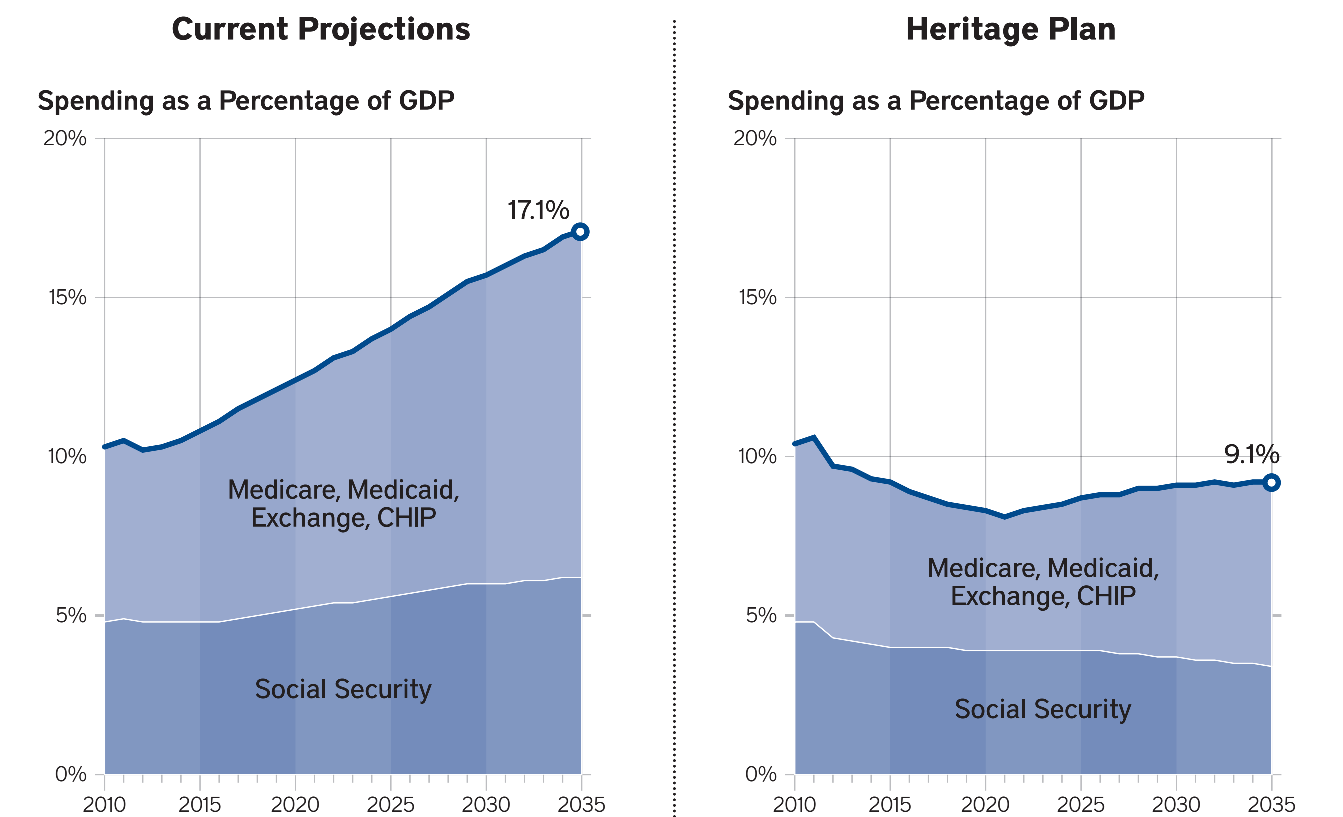
Over a five-year period, the plan transforms Medicare into a defined-contribution system, with stronger health security for the poor and less healthy, and guarantees new protections against catastrophic costs for all enrollees. Today's traditional fee-for-service Medicare program provides no such protections. Because of this gap, nine out of 10 seniors feel compelled to buy supplemental private health insurance, including Medigap, to cover themselves against the financial devastation of catastrophic illness. This means that seniors pay an extra set of premiums and often incur high out-of-pocket costs for both premium and non-premium medical expenses.

Finally, the plan establishes a true long-term budget for Medicare.

The Reformed System. When the changes are fully phased in, seniors will enroll in the health plans of their choice and receive a defined contribution (known as premium support) toward the cost of their

CHART 7

The Heritage Plan Would Rein in Mandatory Entitlement Spending



Sources: Current projections: Heritage Foundation calculations based on data from Congressional Budget Office, Alternative Fiscal Scenario. Heritage Plan: Calculations by the Center for Data Analysis, The Heritage Foundation, based on baseline data in the current projections, data provided by the Peter G. Peterson Foundation, and CDA policy models.

plans, much as Members of Congress and millions of federal employees and retirees do through the FEHBP. Unlike today, all plans will include catastrophic protection. Thanks to the structure and insurance rules in Medicare, the premium support will be sufficient for seniors to afford an adequate level of benefits, regardless of age or health care condition.

The range of choices in the transformed system includes Medicare premium-based fee-for-service insurance as well as other fee-for-service plans, Medicare Advantage plans, managed care plans, association plans, and Taft–Hartley Act and employer-based plans. Existing health savings accounts (HSAs) can also be carried into retirement.

Medicare's basic rules for insurance are retained, together with an improved risk-adjustment mechanism to offset the impact of any adverse selection. Under the reformed system, Medicare's Center for Drug and Health Plan Choice, whose mission today is to identify abuse and oversee marketing rules for Medicare Advantage and Medicare drug plans, carries out that function for all plans.

Beyond retaining the Medicare insurance rules, the reform provides for fiscal solvency and reserve requirements for all health plans to ensure that plans have the financial resources to pay insurance claims. It also provides marketing rules to protect consumers against fraud and a requirement that benefits be described in plain English without surprises or denials in fine print. By increasing choice and competition, the reformed Medicare program will deliver better care and provide true health care security for less money than under current projections.

The cash value of premium support is reduced for upper-income seniors and eventually phased out for those with the highest incomes. However, all seniors will have access to the same Medicare system with no need to buy a separate plan to cover catastrophic expenses. Poor seniors remain eligible for Medicaid assistance. Like the Social Security adjustments in retirement age, Medicare's eligibility age becomes 68 in 10 years and is indexed thereafter for increases in longevity.

During the five-year transition period, Medicare's traditional fee-for-service system also changes. Part A costs are offset by a new premium payment system for upper-income retirees. The premiums for Parts B and D rise according to income. The highest-income seniors pay an unsubsidized premium for Parts B and D during the transition.

The Details

A Defined Contribution Adjusted by Income. Five years after enactment, all new retirees receive a contribution (premium support) from the government, just as federal employees and retirees do today. They can use this contribution to choose Medicare's premium-based FFS plan or one of the other health plans. After one year of operation, Medicare enrollees in the traditional Medicare FFS program are free to join the new Medicare premium-support program. They can then choose a premium-based FFS plan or an alternative.

During the first five years of the premium-support program, the government's contribution is based on the weighted average premium of the regional bids of competing health plans. After the first five years, the government contribution is based on the lowest bid of competing plans in a region. The bidding system will be phased in and will include the bids of the competing managed care plans, other private plans, and the Medicare premium-based FFS plans offering an approved range and quality of services.

Under the Heritage plan, low-income enrollees receive the full Medicare defined contribution. The amount of the defined contribution starts to phase out for Medicare enrollees with annual non–Social Security incomes between $55,000 and $110,000 and couples with incomes between $110,000 and $165,000. Enrollees with incomes over $110,000 and couples with incomes over $165,000 receive no government contribution and pay full, unsubsidized premiums. As with Social Security, married couples can decide whether they want to qualify for benefits as individuals or jointly as a couple. The phaseout income levels will be inflation-indexed. However, Medicare remains a valuable program for higher-income seniors because they retain access to a guaranteed-issue and community-rated insurance program.

Under the Heritage plan over 90 percent of seniors would receive the full defined contribution. Only just over 3.5 percent have such high incomes that they would pay the entire premium without any contribution from the government.

This income-adjustment of Medicare is not new. Today, for instance, Medicare Part B and Part D premiums are changed significantly according to income. For single retirees, Part B premiums can range widely, from $96.40 per month to as much as $369.10 per month, depending on their income. Upper-income retirees can pay as much as $69.10 per month more for the same Part D coverage as a lower-income senior. What the Heritage plan does is rationalize the income adjustment of Medicare so that it fulfills the true insurance purpose of the program while assuring that the program will be available for future generations.

TABLE 2

Percent of Defined Benefit Contribution for Medicare Beneficiaries, by Income

SINGLES	% of Contribution
$0–$55,000	100%
$56,000–$57,000	98%
$75,000–$76,000	64%
$82,000–$83,000	49%
$100,000–$101,000	18%
$109,000–$110,000	2%
More than $110,000	0%
MARRIED COUPLES	**% of Contribution**
$0–$110,000	100%
$111,000–$112,000	98%
$130,000–$131,000	64%
$137,000–$138,000	49%
$155,000–$156,000	18%
$164,000–$165,000	2%
More than $165,000	0%

Sources: Calculations by the Center for Data Analysis, The Heritage Foundation.

A Medicare Budget and Financing System. During the first five years of the new Medicare program, the government's annual contributions to enrollees' plans are based on the weighted average premium of participating health plans' bids on a regional basis. The plans bid to provide Medicare benefits plus catastrophic coverage and, just like the FEHBP, are weighted on plan enrollment. Thereafter, the government contribution is based on the premium bid of the lowest-cost health plan that meets the required level of quality and provides an adequate range of benefits. In both cases, the per capita government contribution on the basis of the plan bidding is set at 88 percent of the bids. By comparison, the FEHBP contribution is set at 72 percent of the national average weighted premium, and the original Medicare Part B premium contribution was set at 50 percent in 1965.

The Heritage plan also caps total Medicare spending. The spending cap is indexed annually for inflation using the Consumer Price Index plus 1 percent and Medicare population growth. If Medicare spending exceeds the cap, the government's contribution declines from 88 percent to the percentage that complies with the Medicare spending cap, thereby pressuring the competing plans and providers to control costs more tightly.

Additional Assistance for Dual-Eligibles. Medicaid, the federal–state program for the poor and the indigent, provides supplemental coverage for about 8 million Medicare beneficiaries. These are poor people, and most qualify for full Medicaid benefits, including long-term care services in nursing homes. They receive subsidies for Medicare premiums and cost-sharing and for the Medicare Part D drug coverage.

Beginning five years after enactment, states have the option to "top up" the Medicare defined-contribution amount for dual-eligibles who choose to enroll in a private health plan. Dual-eligible enrollees who stay with the revamped Medicare FFS plan continue to receive Medicaid coverage as they do today.

Integrating Traditional Medicare into the System and Adding Catastrophic Cost Protection. Under the Heritage plan, all senior citizens have the option of keeping their current health plans or choosing better health plans. Five years after enactment, traditional Medicare FFS begins to compete directly with private plans on a level playing field. Seniors can remain in Medicare FFS if they wish. However, the previous organizational and benefit distinctions within Medicare FFS (Medicare Parts A, B, C, and D) disappear because Medicare becomes a single, unified program with a unified trust fund that is financed by a defined contribution.

A single stated premium incorporates today's multiple Medicare FFS premiums plus the cost of a new catastrophic benefit. Cost-sharing parameters are adjusted to ensure that the Medicare benefit package is actuarially equivalent to the package provided under current law. In the first year of competition with private health plans, the initial value of the catastrophic benefit will need to equal the average of such benefits currently provided in the Medicare Advantage program, but it may be adjusted thereafter by the Secretary of Health and Human Services.

Changes in Traditional Medicare FFS During the Transition

During the transition, the Heritage plan:

- **Reduces subsidies and phases them out for upper-income enrollees.** For upper-income seniors, the premium subsidies for Part B and Part D are phased out and a premium for Part A is phased in. For upper-income seniors, the subsidy implicit in their premiums is phased out over the same range as for Social Security ($55,000 to $110,000 for individuals and $110,000 to $165,000 for couples). Under the changes in traditional Medicare, these subsidy reductions and phaseouts also apply to government subsidies for those who are enrolled in Medicare Advantage plans.

  A new income-related Part A premium for retirees is phased in to cover the full cost of Part A services during the transition and to cover any deficit in the Hospital Insurance trust fund. The premiums are phased in for individuals with annual incomes between $55,000 and $110,000 and couples with annual incomes between $110,000 and $165,000. Individuals with an annual income of $110,000 and couples with an annual income of $165,000 pay full, unsubsidized premiums.

- **Changes co-payments.** Medicare Part A, which covers hospitalization, has a deductible. During the transition, the deductible is indexed annually to an average of the Consumer Price Index (CPI) and the Medical CPI. A co-payment of 10 percent is added for the total cost of each home health care episode (defined as 60 days of service). Today, there is no such co-payment in spite of heavy utilization of this costly benefit.

- **Raises the premiums for Part B and Part D.** The Part B and Part D premium percentage for most beneficiaries is gradually raised from 25 percent to 35 percent in increments of 2 percentage points per year over the five-year transition. The existing "hold harmless" provisions are retained for low-income seniors.

Other Key Changes in Medicare

The Heritage plan envisions other important changes and rules in the current Medicare program:

- **Eliminating restrictions on doctor–patient contracting.** Beginning immediately, the plan eliminates the statutory and regulatory restrictions on private contracting outside of Medicare that were enacted in the Balanced Budget Act of 1997. There were no such statutory restrictions before 1997. This means that Medicare enrollees can enter into private agreements for medical services with the physicians of their choice with no statutory or regulatory restrictions. For reasons of privacy, or *for whatever reasons seem good to them*, they can go outside of the Medicare program without being required to submit a claim to the Medicare bureaucracy for the physician's service. This restoration of the right of private contracting will also encourage the treatment of Medicare patients by more physicians who otherwise might not participate in the program.

- **Retaining Medicare savings for Medicare alone.** Beginning immediately, any savings in the Medicare program are prohibited from being credited to the cost of current or future "health care reform" provisions that fund Medicare benefits or subsidize those who are not enrolled in the program. Five years after enactment, any remaining savings from traditional Medicare are deposited into the new unified Medicare trust fund.

- **Enacting a permanent "doc fix" and making physician pricing fully transparent.** Beginning immediately, a permanent "doc fix" is implemented using any Medicare savings from legislation, including savings from this proposal. From this point forward, physician payments are adjusted for inflation, measured by the CPI (*not* the Medical CPI). However, the law is changed to permit balanced billing in combination with a price disclosure requirement for Medicare physicians' services.

  Thus, for traditional Medicare FFS during the transition, the government determines Medicare reimbursement, while physicians determine patient fees. This change will encourage doctors who otherwise might drop out of Medicare to continue to treat Medicare patients. Moreover, the required transparency in physician fees guarantees price competition in physician services, thus helping to lower Medicare costs.

- **Allowing new retirees to keep their existing plans.** Surveys show that the vast majority of working Americans are satisfied with and, if possible, want to keep their existing health plans. The Heritage plan expands the opportunities for Americans to keep their existing plans into retirement. Even before the five-year transition to a full premium-support program, Medicare provides a risk-adjusted defined contribution for any retirees who want to remain in their pre-existing health plan, including employer-based coverage. Subsidies will also be adjusted by the new income rules.

The Bottom Line

By moving to a premium-support program, Congress can introduce the powerful forces of consumer choice and competition into Medicare, forcing health plans and providers to deliver value for taxpayer and beneficiary dollars. Similar approaches to health care financing and delivery have been used in Medicare Part D and the FEHBP, the program that covers Members of Congress. The record shows that this approach can successfully control and slow the growth of health care costs while increasing patient satisfaction.

Medicare today is less a traditional social insurance program, in which beneficiaries pay for their benefits, and is becoming more of an income transfer program. Today's enrollees are not, in fact, "paying for" their Medicare benefits, since it is really a "pay as you go" system with today's workers paying for today's beneficiaries. Even so, payroll taxes pay for just a portion of one part of Medicare, and the premiums that seniors pay for the other parts cover less than a quarter of those costs.

Taxpayer subsidies account for 85 percent of total Medicare program costs. If Medicare is left unreformed, our children and grandchildren will pay those higher taxes even as they work and save to provide for their own families.

By reducing the level of tax subsidies for seniors with higher incomes, the Heritage plan reduces both the burden on future taxpayers and dependence on government. By adding catastrophic protection against serious illness and targeting funding to those who are most in need, the plan strengthens Medicare as safety-net insurance for all Americans and guarantees them better health and economic security. Finally, by reducing the role of bureaucracy and red tape in the delivery of medical care, the Heritage plan makes the practice of medicine more attractive, thereby encouraging dedicated and talented individuals to join the health professions.

HEALTH CARE FOR FAMILIES

Summary

HEALTH CARE COSTS ARE RISING at an alarming rate, while individuals and families have less control over their health care dollars or decisions. Worse still, the recently enacted Patient Protection and Affordable Care Act (PPACA, or Obamacare) is accelerating these problems. In sharp contrast to the centralized government approach of the Obama legislation, the Heritage plan uses a consumer-centered, market-based approach to reduce health care costs and give patients and their families a greater say in health care spending and decisions that affect their lives.

This begins by repealing Obamacare.

The Heritage Foundation has already proposed major health care reform to create an affordable health care system in America. The reform is based on consumer choice and ownership of coverage, together with an infrastructure for competitive private plans and state-led innovation. The Heritage plan includes key budget and tax components of the overall Heritage health care reform, including reform of the tax treatment of health expenses and assistance for health insurance for lower-income families. Other features of the health care reform are developed in other studies and reports.

The Heritage Foundation health care proposal assumes numerous other policy initiatives that accompany the budget design elements in the Heritage plan. These include:

- **Removing** consumer barriers to the purchase of health insurance, such as existing limits on interstate purchase;
- **Developing** mechanisms, such as risk-adjustment and high-risk pools, to address access issues for the hard-to-insure;
- **Making available** new pooling arrangements, such as individual association plans; and
- **Supporting strong state-led initiatives** to promote innovation and experimentation with consumer-centered, market-based reforms.

These and other insurance reforms are intended to augment the Heritage plan, to promote competition, drive down cost, and advance stability, portability, and personal ownership.

In conjunction with the plan's tax reforms, the current individual tax exclusion for employer-sponsored health insurance and other tax mechanisms are replaced with a nonrefundable fixed tax credit for households to purchase health coverage. The credit is phased out as income rises and eliminated for upper-income households. The switch from the exclusion to the credit system is revenue-neutral to the federal government.

This change is needed because under today's system, the tax code provides unlimited tax breaks only to those workers who receive coverage through their employers. Workers cannot use this tax break if no plan is offered through their employers or if they simply prefer a plan other than their employer's. Moreover, while upper-income workers obtain a very large tax break, the exclusion provides little or no help to lower-income workers who are struggling to afford coverage for their families.

Through tax reform and other measures, the Heritage plan ensures that everyone, regardless of job situation, is eligible for a tax credit or other help in purchasing health insurance. This means that people can buy, own, and keep the health care plans of their choice.

For poor Americans, the plan provides assistance for coverage, paid with reductions in other federal spending. Under this reform, low-income able-bodied adults and their children who are currently on Medicaid would no longer participate in the costly and failing Medicaid program; instead, they would be able to enroll in private coverage.

In addition, under the Heritage plan, low-income individuals who are not currently eligible for Medicaid would receive financial assistance toward a plan. This ensures that everyone who needs assistance receives assistance in purchasing health insurance. Like those who receive the tax credit, individuals and families receiving assistance have the same health care plan choices as those with the tax credit and can buy, own, and keep their health insurance.

The Heritage plan transforms the remainder of today's Medicaid program—for the frail elderly and disabled—into a health care safety-net program rather than today's catch-all, patchwork program. In addition, the Heritage plan replaces the open-ended federal–state financing arrangement that is crippling state and federal budgets with a more consistent and sustainable capped allotment. In exchange for the capped allotment, states are given much more flexibility to redesign health services for the disabled and the elderly poor so that they can provide better and more integrated services at lower cost. This new arrangement enables states not only to provide better care for the neediest in our society, but also to keep to their budgets without cutting other state priorities or raising taxes.

The Details

A New Health Tax Credit. The Heritage plan ends the existing tax exclusion for employee compensation in the form of employer-sponsored health insurance. This means that the value of employer-paid health insurance premiums is included in the employee's total taxable compensation. Today's system excludes this compensation from income and payroll taxes, effectively giving upper-income workers in high-tax brackets a large tax benefit.

In return for ending this tax break, the plan introduces a new uniform, nonrefundable federal tax credit to assist families in their purchase of health insurance. Employers and employees could decide whether to have the employer continue to buy coverage or to cash out the existing coverage in the form of higher cash income. Either way, the tax break for coverage would change from an exclusion to a credit.

The net value of the credit is $2,000 for an individual and $3,500 for a couple or family. Under the Heritage plan, this credit can be used either to offset the cost of coverage offered through the workplace or to buy insurance outside the workplace. For most middle-income working families, the value of the credit is similar to the tax relief that they receive

TABLE 3

Health Care Credits and Subsidies

FAMILY OF FOUR

Income (% of Poverty Level)	*2011 Income*	*Credit*	*Enhanced Federal Subsidy*
0%–133%	Less than $29,727	$3,500	$5,500
134%–200%	$29,727–$44,700	$3,500	$2,750
201%–400%	$44,701–$89,400	$3,500	$0
401%–500%	$89,401–$111,750	$3,340	$0
501%–700%	$111,751–$156,450	$1,789	$0
701%–1,000%	$156,451–$223,500	$68	$0
1,001%+	$223,501+	$0	$0

SINGLE

Income (% of Poverty Level)	*2011 Income*	*Credit*
0%–133%	Less than $14,485	$2,000
134%–200%	$14,485–$21,780	$2,000
201%–400%	$21,781–$43,560	$2,000
401%–500%	$43,561–$54,450	$1,954
501%–700%	$54,451–$76,230	$1,231
701%–1,000%	$76,231–$108,900	$145
1,001%+	$108,901+	$0

Sources: Calculations by the Center for Data Analysis, The Heritage Foundation.

for health insurance today. For upper-income households, the new credit is typically less and is reduced as income rises. The phaseout begins at $50,000 for an individual and $100,000 for a family. The credit is fully phased out at $90,000 for an individual and $170,000 for a family.

The credit is advanceable, assignable, and available on a prorated basis. This means that the credit is available when premiums are due, enabling families to claim the credit for premiums already paid before the end of the tax year. An assignable credit allows a family to assign their tax credit to a health plan in return for a dollar-for-dollar lower premium, eliminating the need to claim it on their own tax forms.

It is important to note that health care benefits are a form of worker compensation directed by the employer and are not "paid for" in any charitable sense by the employers. Therefore, in the labor market, employers would likely adapt to the tax reform either by increasing the wages for their employees instead of offering health insurance or by continuing to offer coverage to their employees. Either way, we know from research that the employee's overall compensation should stay the same in most cases.

There is no mandate on individuals to obtain insurance, but if they did not obtain coverage, they would have to forgo the credit or assistance for insurance. Importantly, the Heritage plan envisions much wider use by employers of auto-enrollment mechanisms in the future, with employees automatically enrolled in a plan as the default option. Research suggests that such an auto-enrollment approach, combined with tax incentives or subsidies, is likely to result in high rates of enrollment under the credit system.

Assistance for Lower-Income Working Families. Financial assistance for purchasing insurance, equivalent to the tax credit, is made available to households with no tax liability and prorated to those households with a tax liability less than the value of the available credit. This money can be used only for purchasing health insurance and typically would be sent directly to the chosen plan in return for a dollar-for-dollar reduction in the premium to the family. This is like the way the government's contribution to a federal employee's FEHBP reduces the employee's premium.

Thus, if a family's tax liability is less than the value of the credit, the family receives assistance partly in the form of a credit (up to its tax liability) with the rest in the form of direct assistance for insurance. If this family's income rises in subsequent years, the amount it receives as assistance is phased out and the credit amount is phased in, maintaining the same full credit/assistance amount throughout the income change. In contrast to the current patchwork health care model, the Heritage plan streamlines federal assistance to ensure that no families fall through the cracks.

For very-low-income families with children earning less than 200 percent of the federal poverty level (FPL), the Heritage plan provides an additional federal subsidy worth $5,500. The full additional subsidy would be available to families up to 133 percent of the FPL and would gradually phase out between

133 percent and 200 percent of FPL. This enhanced subsidy is intended for the traditional, "mandatory" Medicaid populations—the groups that states are required by federal law to include in Medicaid—and the eligibility phaseout is designed to minimize work disincentives, unlike current law, in which Medicaid has a very sharp eligibility cutoff. In 2011, a family of three with an income below $37,000 would meet this threshold. Again, this is paid for with reductions in federal spending. Of course, states may provide additional assistance to low-income families and individuals.

Health Savings Accounts. Health savings accounts are replaced by the new Roth IRA savings system under the tax reform features of the Heritage plan. Existing HSAs are grandfathered, meaning that current HSA balances are not taxed when withdrawn, but account owners may make no further deposits in the accounts.

However, under the Heritage tax reform, money saved for future health care needs or for any other purpose is no longer double-taxed. In addition, any health credit or health assistance amount not used for premiums and any unused supplemental subsidies can be deposited into a Roth IRA–style savings account and can be used for out-of-pocket health care expenses, including deductibles, co-pays, and other medical expenses. Under the plan, withdrawals from these accounts are not taxed. (See the tax reform proposal.)

New Medicaid Safety-Net Program. In the Heritage plan, low-income nondisabled individuals and families currently on Medicaid, are covered through the credit/assistance. Low-income disabled and elderly continue to receive care and assistance through Medicaid.

For the Medicaid-eligible elderly and the disabled, federal Medicaid acute and long-term care spending is converted into a capped federal allotment to the state. Total federal Medicaid spending is set at its 2007 levels beginning in 2014, after the recovery is solid and unemployment at a normal level, and is adjusted for medical inflation thereafter.

In exchange for the capped federal allotment, states are granted considerable new flexibility to manage and administer the restructured Medicaid program to meet its mutual federal and state objectives. This means that states are granted broad discretion and authority to meet general objectives and outcome measures. States that wish to try very different approaches to better serve and improve health care quality for these key populations would have additional authority beyond the normal waiver process.

While states receive an allotment from the federal government, they still need to use their own funds to achieve agreed goals for providing care and services for the elderly and disabled on Medicaid. However, if states use innovative approaches that require less state spending than is now the case under the current Medicaid formula that determines the state share (known as FMAP), they can keep the savings and spend them on state priorities or provide tax breaks to their citizens.

The Bottom Line

Health care is a major cost for several important federal spending programs and for households and businesses. Thus, in addition to redesigning the programs, health care reform is needed to slow down rising costs in the public and private sectors. The Heritage approach to this challenge of rising health care costs and uncertainty over coverage is to transform the current government and employer-based models into a consumer-centered, market-based system in which individuals own and control health care dollars and decisions and the health industry competes for their business.

ADDITIONAL MAJOR SPENDING REFORMS

Summary

OVER THE PAST DECADE, Congresses and Presidents have undertaken a surge of spending that has accelerated America's speed along the road to economic ruin. Since 2000, non-defense discretionary outlays have expanded 50 percent faster than inflation. Antipoverty spending has risen 83 percent faster than inflation, and other programs have grown rapidly. Despite multiple government audits that have shown many programs to be duplicative or ineffective, no significant federal program has been eliminated in more than a decade. Government continues to grow, financed by taxes on Americans and an explosion of borrowing that is imposing huge additional burdens on future generations.

Thus, although the major entitlement programs are the primary driver of long-term spending and debt, Congress must take tough action on discretionary programs and smaller entitlement programs to reach a balanced budget and ensure that federal spending is smaller, more effective, and more efficient.

Under the Heritage plan, non-defense discretionary spending—appropriated programs such as foreign aid, K–12 education, transportation, health research, housing, community development, and veterans health care, which account for 4.5 percent of GDP—is reduced to 2.0 percent of GDP by 2021. These reforms will reduce the burden of government, thereby empowering families and entrepreneurs and promoting economic prosperity.

In addition, antipoverty spending is reformed. Obamacare is repealed, as noted earlier, and replaced with an alternative solution to uninsurance and high costs. Agriculture and education programs are structurally reformed. The central goal for defense is to guarantee national security as prudently and economically as possible. With improvements in efficiency, we estimate that defense needs will require spending approximately 4 percent of GDP for the foreseeable future.

Rather than across-the-board spending reductions, which would not set true priorities for government, the Heritage plan follows six guidelines in designing reforms:

- The federal government should focus on performing a limited number of appropriate governmental duties well while empowering state and local governments, which are closer to the people, to address local needs creatively in such areas as transportation, justice, job training, the environment, and economic development.

- Functions that the private sector can perform more efficiently should be transferred to the private sector.

- Duplicative programs should be consolidated both to save money and to improve government assistance.

- Federal programs should more precisely target those who are actually in need, which means reducing aid to large businesses and upper-income individuals who do not need taxpayer assistance and enforcing program eligibility rules better.

- Outdated and ineffective programs should be eliminated.

- Waste, fraud, and abuse should be cleaned up wherever found.

By following these six guidelines, the Heritage plan produces a more effective and efficient government and promotes stronger economic growth.

The Details

Returning Most Non-Defense Discretionary Spending to 2008 Levels. Non-defense discretionary spending has expanded 21 percent faster than inflation over the past three years. Returning to 2008 levels still leaves typical programs nearly one-third larger than they were in 2000 (adjusted for inflation). Freezing this spending at 2008 levels through 2015 and then capping subsequent growth at the inflation rate would save more than $2 trillion in the first decade and even more thereafter.

Many of these savings are achieved by reducing the size of the federal bureaucracy, overhauling the federal pay system, permanently eliminating many earmarked accounts, and consolidating duplicative functions. Yet not all programs are affected equally. For example, Coast Guard and other important security spending rises under the plan, while lower-priority spending, such as subsidies to public broadcasting, AmeriCorps, the National Endowment for the Arts, and the National Endowment for the Humanities, is left to the private sector.

Devolving or Privatizing Most Transportation Spending. Under the federal highway program, Washington collects the 18.3 cents-per-gallon gas tax from states, subtracts a large administrative fee, and returns the remaining funds to the states with numerous strings attached, including many requirements to spend the dollars on congressional earmarks and for specific uses that may not coincide with local needs. The Heritage plan reforms this inherently wasteful system by devolving the highway program and gas tax to the states, thereby eliminating the federal middleman and allowing states to retain the gas tax revenues and spend them on their own highway priorities, provided they maintain a minimum standard of interstate highway maintenance.

The Heritage plan ends federal funding for passenger rail, saving money on projects that invariably have ridership that is far below projections and costs that far exceed initial budgets. Amtrak subsidies are phased out over three years, the President's costly high-speed rail program is terminated, and subsidies to for-profit freight railroads are ended. This relieves states of the upkeep and maintenance burdens associated with rail programs that Washington is currently pressuring them to undertake. The private sector and state governments can either take over or terminate these rail programs as they see fit.

Finally, all non-safety functions of the Federal Aviation Administration (FAA) are transferred to the private sector, and most FAA fees are eliminated. The air traffic control system will be transferred to the private sector, where it belongs, and financed by flight ticket user fees. The airport improvement program is also terminated, with airlines, state government, and private investment taking the place of the federal taxpayer.

Scaling Back K–12 Education Spending and Reforming Higher Education Spending. Federal spending on K–12 education has grown 192 percent faster than inflation since 2000, yet this sharply increased federal spending and federal micromanagement of school districts has not improved student performance. Under the Heritage plan, total federal K–12 spending is reduced to 2000 levels (adjusted for inflation), in part by eliminating many of the numerous small education programs that Washington uses to micromanage school districts. This will allow states and school districts to manage and meet the needs of their students more effectively.

Higher education reforms, including the new deduction for college tuition in the Heritage tax reform, ensure that students receive enough financial assistance to attend college. Shifting from grants to student loans ensures that most college costs will be financed by the college graduates themselves, who benefit the most from their degrees, and not by other Americans.

However, thanks to a key provision in the Heritage plan's tax reform, higher education costs are partially defrayed through the simplified and generous tax deduction for higher education tuition. Families whose incomes are too low for them to benefit fully from this tax deduction are eligible for a Pell Grant with a value up to the tax deduction. The direct student loan program is retained with loan limits high enough to guarantee college access but with rates set to ensure that there are no budgetary costs, including the costs associated with deferred repayment until graduation as well as the costs of loan forgiveness programs.

Thus, all Americans will have access to financial aid in attending college, but it will not be a free ride at the taxpayers' expense.

Making Public Health Service Spending More Efficient. Public health service spending has grown 56 percent faster than inflation since 2000. While health research is vital, the Heritage plan eliminates waste and inefficiencies that have accumulated. For example, by consolidating redundant facilities and laboratories, the Heritage plan saves the National Institutes of Health $1 billion annually. States take over the financing and operation of health centers, health professions programs, and the substance abuse block grant. The Centers for Disease Control and Prevention sees savings over $2 billion annually by reducing travel, ending questionable public campaigns, and focusing its role on interstate coordination. Finally, converting Indian Health Service aid into a premium-support system (where possible) and reforming the Food and Drug Administration save a combined $1 billion annually.

Funding an Adequate Defense. The most important core function of the federal government is ensuring America's national security, but it needs to be accomplished as economically and efficiently as possible. The Defense Department will focus on identifying and addressing its significant levels of wasteful spending and initiating significant reforms and efficiencies in logistics and acquisition processes so that those funds can be reprioritized into the most important uses to protect America and our allies by maintaining a strong, modern, and effective military.

The war on terrorism has increased defense spending to approximately 5 percent of GDP, yet it remains well below the 9 percent spent during in the 1960s and the 6 percent spent during the 1980s. While the Heritage plan recognizes that predicting precise funding requirements for overseas contingency operations is impossible, it is reasonable to expect that the phasedown in those efforts will permit reducing defense spending to approximately 4 percent of GDP and maintaining it at that level. Ultimately, of course, defense spending will have to be whatever it takes to protect America and its interests around the globe.

While this proposal for maintaining sufficient levels of defense spending assumes that future military personnel will be brought under the broader proposals for health care and retirement reform outlined in this report, it also provides for tailored transition options for current military personnel and retirees. Importantly, reforms in compensation and benefits must maintain effective recruitment and retention of, and honor reasonable commitments to, members of the armed forces.

Repealing Obamacare. If fully implemented, Obamacare will add trillions of dollars in long-term government spending to a health care system that is already unaffordable. It also increases federal controls and mandates and will impose heavy costs on states, businesses, and households. As noted earlier, the Heritage plan repeals Obamacare and replaces it with the improved, consumer-centered health care system.

Replacing Farm Subsidies with Farmer Savings Accounts. Intended to remedy low crop prices and farmer poverty, the current farm subsidy system does neither. Farm subsidies encourage overplanting, which drives prices down further, necessitating even more subsidies. Moreover, rather than focusing on low-income farmers, most farm subsidies go to commercial farmers who report an average annual income of nearly $200,000. Claims that the agriculture industry could not survive without large subsidies are contradicted by the fact that nearly all subsidies go to growers of just five crops (wheat, cotton, corn, soybeans, and rice), while fruit, vegetable, livestock, and poultry operations thrive with almost no government aid.

The real problem—yearly income fluctuations due to crop and weather unpredictability—can be solved inexpensively with farmer savings accounts. Under the Heritage plan, growers of all crops, not just the "big five," can save money during boom years in tax-deductible IRA-style accounts and withdraw those funds during bust years as taxable income, thus smoothing out their yearly income fluctuations. An improved no-net-cost crop insurance system will assist when major disasters deplete most farmers' accounts. All farmers can participate in the new system regardless of income or crop grown and at a fraction of the current cost to taxpayers.

Capping and Reforming Antipoverty Spending. Since 1990, federal antipoverty spending, including Medicaid, has expanded 236 percent faster than inflation, from $190 billion to $639 billion (an increase of 2.2 percent of GDP). Antipoverty spending has grown as much as Social Security, Medicare, defense, and education spending *combined*. Overall, the federal government spends approximately $28,000 per family with children in the bottom third of the income table without encouraging independence. Many of the programs do not include enforced work requirements and continue to reward illegitimacy and other destructive behaviors that block the road to independence.

Once the unemployment rate drops back to normal levels (projected in 2014), the Heritage plan returns total federal antipoverty spending to its 2007 level (adjusted for inflation) and then caps total spending growth at the inflation rate (using the medical inflation rate for the health care portion). Congress or states could shift spending among antipoverty programs to increase effectiveness as long as total spending does not exceed the cap. This cap and flexibility will force lawmakers at all levels to reexamine the size and goals of the welfare state and tailor assistance more efficiently to help families escape poverty and dependence and achieve independence.

Other Spending Reforms. Multiple federal programs should be returned to the state or local levels. For instance, there is no compelling reason for Washington to finance local job training, justice, environmental, or community and economic development programs. Therefore, the plan eliminates these federal grant programs with the expectation that state and local governments will determine whether to address these local issues with local funds and be held accountable by local voters. Energy research and development spending that is commercial in nature is moved to the private sector. Lawmakers are also expected to pare $15 billion in costs associated with the estimated $125 billion in annual federal payment errors.

Asset Sales. The federal government currently owns and controls vast assets, including huge swaths of commercial land, especially in the West; power generation facilities; valuable portions of the electromagnetic spectrum; underutilized buildings; and financial assets. Given the federal government's huge debt, it makes sense to sell at least a portion of these assets, especially those that are currently generating revenue below market levels (in which case the sale value would be above the present value of the current income on the assets). Sales of assets would immediately reduce the government's operating deficit and debt, reducing future interest costs.

The Heritage plan includes a program of asset sales totaling approximately $260 billion over 15 years. This includes partial sales of federal properties, real estate, mineral rights, the electromagnetic spectrum, and energy-generation facilities.

Reforming the Federal Budget Process. When Congress established its current budget process in 1974, the United States was in debt by about a half-trillion dollars; it is now in debt over $14 trillion. Regrettably, for any proposal to deal with the nation's fiscal problems, the budget process does little to help and in many ways impedes good and bold policy. For one thing, its focus on just 10 years diverts lawmakers from dealing with the mounting long-term challenges, such as retirement programs. For another, the lack of firm budget controls and enforcement procedures makes fiscal discipline very difficult. Reforming the budget process is therefore an implicit part of reforming the budget itself.

In the Heritage plan, we change the budget process to impose enforceable caps to reduce total federal spending to 18.5 percent of GDP by 2021 (including entitlement programs) and then keep spending at that level. Within those overall caps we also cap non-defense discretionary spending at 2.0 percent of GDP. Anti-poverty spending is also capped, as described above. These statutory restrictions on future spending are to be no higher than the modern historical level of federal revenues.

We also propose amending existing federal laws that provide permanent or indefinite appropriations for federal agencies or programs (including and especially entitlement programs), or that allow agencies or programs to spend funds they receive from fees or other sources, rather than depositing them in the U.S. Treasury, so as to retrieve congressional control of spending for those agencies and programs. Within our specific reforms for Medicare and Medicaid we also include a fixed budget amount for each program.

To make the budget process more visible, understandable, and accountable to the American people, we require Congress to estimate and publish the projected cost over 75 years of any proposed policy or funding level for each significant federal program. Any major policy change should also be scored over this long-term horizon.

Finally, in addition to calculating the costs of proposed congressional actions without regard to the response of the economy to those actions (known as "static" scoring), we require a parallel calculation that takes account of that response (known as "dynamic" scoring) so as to make more practical and useful cost information available to Congress when it decides whether to pursue the actions.

The Bottom Line

Runaway federal spending threatens to drown the nation in taxes and debt for generations to come. Promoting economic prosperity requires streamlining government, cutting spending, and empowering families and entrepreneurs.

The Heritage plan achieves those objectives by focusing Washington on performing a limited number of appropriate duties well rather than a wider range of questionable duties poorly. It transfers more power to state and local governments, which are closer and more responsive to the people; transfers functions to the private sector that the market can perform better; targets federal spending more precisely to those in need; and eliminates wasteful, unnecessary, and duplicative spending.

These steps will unleash the power of the private sector to meet market demands, create jobs, and raise living standards. Taking these steps, combined with entitlement and tax reform, means that Americans can look forward to opportunity and prosperity rather than a future of debt and economic decline.

TAX REFORM

Summary

THE EXISTING TAX SYSTEM IS MANIFESTLY INDEFENSIBLE, especially in its complexity and its drain on economic vitality. The complexity of the tax system plagues taxpayers in all walks of life. Low-income citizens must navigate the enormously complex Earned Income Credit. Those who save must sort through multiple tax rates and tax regimes for different kinds of returns on those savings, and there is a multitude of phase-outs of various credits, exemptions, and deductions. As if this were not bad enough, Congress created a parallel income tax called the Alternative Minimum Tax, so millions of taxpayers must figure their taxes two different ways before they can know what to pay. Yet these difficulties suffered by taxpayers are relatively minor compared to some of the tortuous rules and exceptions inflicted on businesses large and small.

The drain inflicted on economic vitality is even worse than the tax code's complexity. High marginal rates discourage all manner of productive activity. The U.S. corporate income tax rate is the highest in the industrialized world and much higher than the average tax rate of our international competitors.

The current tax system actively discourages citizens from saving enough for retirement, emergencies, or the large purchases in life, thus driving them toward consumer debt. In turn, it artificially depresses the level of national savings and makes domestic investment more dependent on foreign investment.

For decades, Congresses have tweaked and twisted a fundamentally flawed system into knots, each time creating two new problems while attempting to solve one old one. The income tax was a poor choice from the outset, and Congress after Congress has consistently made it worse. The federal tax system need not be so complex or damaging to our economy, nor should it be.

A stronger economy means higher wages for American workers and better returns for America's savers. A stronger economy means better opportunities for college graduates and better economic security for families. It means that American companies and workers can compete more effectively in the global economy. And a stronger economy is a more resilient economy, able to withstand and overcome the inevitable economic shocks of tomorrow.

A stronger economy also plays a vital role in improving federal finances. It means sustained, normal levels of tax revenues and a lower level of spending to meet the needs of those who are temporarily distressed because of unemployment. A stronger economy offering better wages and better job opportunities is also the most powerful antidote to persistent poverty, and less poverty reduces the demands for anti-poverty spending.

Without a stronger economy, we will not solve our long-term problems of federal overspending and overborrowing. Thus, tax reform to spur economic growth is a critical component of the Heritage plan.

In broad terms, to promote growth, the federal tax system must be:

- **A single, low rate** system to collect needed revenues without unnecessarily distorting economic decision making.

- **Simpler and far more transparent.** A simple, transparent tax is needed so that taxpayers can anticipate and plan for the tax consequences of their actions and easily understand the full extent of their tax burden. It also provides greater confidence that other taxpayers are not exploiting tax complexities to underpay their taxes.

- **Neutral between savings and investment.** Unlike the current system, it must not impose multiple levels of taxation on saved income. Treating savings neutrally gives individuals greater control of their economic futures while ensuring that the economy has the raw financial material to grow and encourages Americans to invest their savings in the most productive ventures.

- **Levied in a way that minimizes tax distortions and perverse incentives.** This allows prices and market forces—not intentional or inadvertent government meddling—to decide how best to grow the economy. It also helps to keep the tax system simple.

- **Capable of collecting revenues equivalent to 18.5 percent of the economy.** The modern average of tax revenue under normal economic conditions is approximately 18.5 percent of GDP. This is the upper limit that Americans have over many decades indicated to politicians they are prepared to accept. Thus, the tax system should be capped at collecting no more than this amount both to ensure a strong economy and to restrain the growth of government.

Using these essential elements, the Heritage plan will transform the current tax system into a modern flat tax that taxes individual income only once and replaces all federal income taxes, all payroll taxes, the death tax, and virtually all excises. Specifically, for individuals, the current system will be replaced with a new flat-rate tax applied to income after deducting all savings. Taxable income will be reduced by the net amount contributed to savings, and savings will be taxable only when spent. This eliminates the current-law bias against saving and ensures that individuals pay taxes only on what they withdraw from the economy and not on savings that they make available for investment in the economy by others.

Today's business tax code will be replaced by a flat business tax on domestic sales of goods and services with deductions for labor costs and purchases from other businesses, including expensing of capital purchases. All business activity, including corporate, will be taxed under the new flat business tax.

The Details

A Unified Single Tax Rate. The Heritage tax reform plan is far more comprehensive than previous well-known tax reform proposals. Typical of many tax reform proposals, our plan replaces today's individual and corporate income tax systems and eliminates the death tax. In lieu of the current motley collection of taxes, this plan institutes a simple, single-rate tax on individuals and businesses. It also folds today's federal payroll taxes financing Social Security and Medicare into the new system, establishing a single tax rate for all taxpayers. In addition, it replaces all federal excise taxes except those dedicated to specific trust funds, such as the gasoline tax, which would be retained until that tax and its associated highway program are devolved to the states.

Tax Rate. The tax system is designed to raise a permanent revenue stream of up to 18.5 percent of the economy as measured by GDP. With the design characteristics of this new tax system, we estimate that the statutory individual and business tax rates will likely eventually be between 25 percent and about 28 percent under traditional scoring methods. This is comparable to or significantly below the typical rate facing an individual or family today. Most working families today are subject to a 15.3 percent payroll tax rate on wages and salaries plus a 10 percent, 15 percent, 25 percent, or 28 percent individual income tax rate for a combined rate of 25.3 percent, 30.3 percent, 40.3 percent, or 43.3 percent.

A Simplified System. The basic structure of this tax plan is simple. With its single rate, it taxes uniformly all income sources that are spent on consumption. This means that taxable income includes all labor compensation and all net borrowings. The net amount put aside in savings is then subtracted to determine net taxable income. Thus, the more individuals or families save, the lower their taxes; they pay tax on savings only when savings are used to pay for goods and services.

However, the new tax system does not tax government transfers explicitly associated with low-income citizens, such as welfare, health care assistance, and similar programs. Ultimately, when the Social Security and Medicare programs are fully reformed, the Social Security checks and premium support that seniors receive will not be taxed either. In the Social Security and Medicare transition periods, a portion of the benefits of some seniors will be taxed if their income is above a certain amount, just as many seniors' Social Security is taxed today.

Thus, the new tax system offers individuals and families a comparable or lower tax rate and vastly improves their savings incentives to build wealth and ensure their own financial security. It simultaneously improves the ability of the economy to raise wages and provide more job opportunities. And filling out tax forms will be a lot simpler.

An Alternative Option for Savings. For some purposes, many taxpayers today prefer to save after-tax dollars as permitted through the current-law Roth IRA rather than paying tax when funds are withdrawn as under today's traditional IRA. This Roth-style alternative maintains the principle of a single incidence of taxation but may result in further increased saving by giving savers an additional option. To allow such accounts for those who feel they need them, the plan permits taxpayers to contribute after-tax dollars to an account, contributing as they choose until the account balance reaches $100,000, with a limit of one account per adult taxpayer. The income earned on the account is tax-free, and disbursements from the account are tax-free for any purpose.

Few Deductions or Credits. Under the Heritage tax plan, the individual income tax has only three deductions instead of the legion of deductions under current law:

- **Higher education.** Recognizing the role of higher education as a form of saving and investment in human capital, a deduction is allowed for tuition and expenses for higher education up to the average annual cost at a four-year public college or university.

- **Charitable donations and other gifts.** Since the tax is levied on consumption, gifts are not taxable until they are spent by the recipient. Thus, per current law, gifts to nonprofit organizations are tax deductible if the organization is recognized as tax-exempt for tax purposes. Gifts to individuals and transfers through inheritance are deductible and become taxable to the recipient only when spent on consumption. And there is no death tax.

- **Mortgage interest.** As under current law, homeowners can deduct mortgage interest while the lender continues to be taxed on mortgage interest income. Homeowners are also given the option of forgoing the deduction, in which case the lender is not taxed on mortgage interest income and market pressure would encourage the lender to offer a lower mortgage interest rate.

Protections for Low-Income Working Households. Current law hits low-income workers and others with the full weight of today's payroll taxes, whatever their wage and salary income may be. The Heritage tax plan folds all payroll taxes—or FICA—into the single tax system. It then eliminates all income tax on low-income workers through the health insurance tax credit described above (a $3,500 nonrefundable tax credit for families and $2,000 credit for individuals). In addition, the Earned Income Credit is retained as part of the overall system of financial support for low-income Americans. Further, the calculation of taxable income excludes all other cash and noncash benefits provided by the federal government through its anti-poverty programs, such as food stamps. The net effect is that, compared to current law, this plan provides substantial tax relief to low-income workers and families.

Protecting Low-Income Seniors. For Medicare-eligible senior citizens, the measure of taxable income is modified to ensure that the flat benefit amounts for Social Security and the Medicare defined contribution are tax-free. Thus, lower-income seniors will not be pushed back into poverty by the tax system after Social Security and Medicare have lifted them out of poverty. As noted earlier, during the lengthy transition period for the Heritage plan's Social Security reform, some seniors above certain incomes with relatively high benefits will pay tax on part of those benefits, but they will pay less than many do today.

Thus, this tax plan includes three important senior-specific features:

- During the transition to the new Social Security and Medicare systems, all seniors have a "senior's standard exclusion" amount equal to the sum of the flat Social Security benefit amount plus the value of the Medicare defined contribution. This exemption amount will be approximately $22,500 per senior in 2015. This provision ensures that seniors protected from poverty by the Social Security and Medicare reforms are not again placed at risk by losing some benefits through taxation. As explained earlier, when the benefits reforms are fully implemented, the amount received by a senior will not be taxed.

- Encouraging seniors to stay in the workforce longer is important both for their own financial security and for the health of the economy. To achieve this, the first $10,000 of a senior's wages and salary is excluded from tax. This provision is especially important for low-income and middle-income seniors.

- Because they are on Medicare and have the seniors' standard exclusion to protect low-income seniors from tax, seniors do not qualify for the health insurance tax credit described above.

Protection for the Social Security and Medicare Trust Funds. The tax system leaves in place the existing wage income reporting systems. Even though the existing payroll taxes are eliminated, the revenues they would have raised are credited appropriately to the Social Security and Medicare trust funds as per current law.

Taxation of Businesses. The tax on businesses is a simple levy on domestic net cash flow so that all compensation provided to employees and all purchases from other businesses are deducted from gross domestic receipts. In addition to its great simplification compared to the current income tax, this means that businesses can immediately deduct purchases of new productive equipment, thus eliminating a tax bias against business investment.

All other special provisions and credits in existing law are repealed except for the Alternative

Simplified R&D tax credit, which is retained in its current form.

Family businesses in particular are able to grow without the uncertainty or burden of dealing with the death tax, which is repealed.

After a brief transition period, the tax rate on businesses matches the rate for individuals. During the transition period, the tax rate on businesses declines from current law, 35 percent, by a percentage point per year until the business rate matches the individual rate. From that point forward, individual and business rates will be the same.

The business tax base includes only income generated by domestic sales of goods and services. It excludes all foreign-source income, which is taxed in the foreign jurisdictions according to their laws and systems. The tax is also border-adjustable, which means that the federal taxation of exports and imports is adjusted to level the playing field between foreign and domestically produced goods and services. Specifically, the domestic tax is lifted from exports and levied on imports, normalizing tax levels between countries much as a series of locks on a canal raises or lowers boats so they can travel from point to point.

Transition Arrangements. Special care is needed in transitioning taxpayers from the old tax system to this Heritage tax plan. For example, it is important that taxpayers are not subject to an extra tax burden solely because of the transition. This would amount to retroactive taxation because the higher tax burden would arise from actions taken before tax reform. Thus, all current-law accrued tax "assets"—such as interest on pre–tax reform debt, including existing home mortgages, depreciation, and accrued tax credits—are applicable to taxable income or tax liability under the new tax system until the tax assets are exhausted. As noted above, there will be a period over which the business tax rate declines until it matches the individual rate.

The shift to taxing only what businesses earn domestically is an important simplification and an important step toward improving international competitiveness. However, many businesses have accrued foreign tax credits under current law that would be inapplicable under the new tax system. To provide adequate time to adjust, businesses will have the option of being taxed under the current system of worldwide taxation for up to 10 years after the enactment of tax reform.

It is important to avoid retroactive taxation, but it is equally important to avoid creating tax windfalls caused merely by transitioning from one tax system to another. This would occur especially with respect to savings prior to tax reform ("old savings"), which are invested in various assets generating income streams and capital gains that are subject to immediate taxation at current rates. These tax windfalls, which would be similar to winning a tax lottery, would tend to benefit the wealthiest taxpayers and erode the tax base, thus necessitating a higher tax rate. Thus, a transition system is provided to prevent tax windfalls by ensuring that old savings remain subject to current levels of taxation.

In the transition to the new tax system, employers will furnish their employees with a statement on how they will handle that part of the employee's compensation that currently takes the form of the "employer's share" of payroll taxes paid to the Treasury. The options in the statement could include, among others, an adjustment in the employee's cash compensation, a contribution to the employee's savings or retirement account, or an allocation of the money to the employee's income tax withholdings. The Department of Labor would make template forms available on its Web site for employers to use. After the transition, when compensation and tax withholdings are fully adjusted, no further statements would be necessary.

The Bottom Line

Economic growth is one of the fundamental underpinnings of fixing America's budget problems, so any changes in the tax system must ensure that growth is a primary objective.

The Heritage tax plan fixes the labyrinth of complexities and inequities that taxpayers must endure in today's system by replacing it with a new system that is flat, simple, and transparent. It encourages far greater economic growth by lowering rates and removing multiple layers of taxation on the same income. One low rate replaces today's array of income and payroll tax rates, treats all businesses the same, and allows them to compete better globally. We end today's disincentives to build savings—whether for retirement or for buying a house—by taxing only income that is spent on consumption, so Americans can build better economic security for themselves and their families. And we do all this without raising taxes by injecting every dollar saved back into lower rates, not so-called deficit reduction.

The Heritage plan will raise no more than the level of taxes Americans historically have been willing to pay: 18.5 percent of the economy. Under our tax plan, Americans will have far greater economic freedom, more opportunities, more jobs, and higher wages.

ECONOMIC AND FISCAL RESULTS

Scoring Fiscal Plans

The Heritage plan produces strong economic growth by reducing burdens on taxpayers and businesses, reducing the government debt, increasing investment, and encouraging competition. It also brings federal spending into balance and maintains revenues over the next decade at the average historical level of 18.5 percent of GDP, which as noted earlier is the upper limit that Americans have indicated a willingness to pay. The economy typically has grown quite well under this average level of taxation. Taxes above this level often have had a negative impact on the economy.

With the expansion of the federal government not just slowed but reversed, the economy grows swiftly, creating new jobs and raising incomes for Americans. A stronger economy strengthens the tax base and helps to achieve the plan's revenue targets. When combined with sharp reductions in spending, the Heritage plan's revenues are sufficient to reduce deficits and, thus, the debt.

As a part of its Solutions Initiative,[4] the Peter G. Peterson Foundation asked Heritage and the five other organizations to prepare their own solutions to the long-term budget crisis and to score their plans using the same baseline. Thus, The Heritage Foundation's Center for Data Analysis (CDA) modeled the Heritage plan using a "static" scoring against a close approximation of the Congressional Budget Office's (CBO) extended baseline that was developed by the Peterson Foundation.[5]

A static score assumes some behavioral changes by individuals and markets, but leaves the overall economy unchanged. A dynamic model assesses the economic effects of policy changes, and the CDA will separately publish a dynamic scoring of the Heritage plan, using the CBO's alternative fiscal scenario as the baseline.[6] This alternative scenario, widely used in budget discussions and comparisons, assumes that Congress will continue its current policy and thus practices, such as adjusting the unindexed Alternative Minimum Tax (AMT) threshold, suspending payment reductions to Medicare physicians (the "doc fix"), and extending the 2001 and 2003 tax relief.

When available, the CDA used and updated reform proposals analyzed by the CBO, such as the effect of some policy changes to Medicare. For analysis of the impact of tax changes, the CDA used its tax and health care models.

A number of important insights into the fiscal effects of the Heritage plan can be obtained by examining the static, or conventional, changes in federal

4. In addition to The Heritage Foundation, five other organizations are participating in the Peter G. Peterson Foundation's Solutions Initiative. Peter G. Peterson Foundation, "Peter G. Peterson Foundation Announces Grants to Six Institutions to Develop Solutions to America's Fiscal Challenges," January 20, 2011, at *http://www.pgpf.org/Issues/Fiscal-Outlook/2011/01/20/PGPF-Announces-Grants-to-Six-Institutions-to-Develop-Solutions-to-Americas-Fiscal-Challenges.aspx* (May 2, 2011).

5. The extended baseline is based on current law extended beyond the normal 10-year CBO window to 2035. The exact extended baseline used by the CDA was created by analysts at the Peterson Foundation. This CBO baseline builds on the CBO's 10-year current law forecast published in January of this year

6. For a description of the Alternative Fiscal Scenario, see Congressional Budget Office, "The Long-Term Budget Outlook," June 2010, at *http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf* (April 29, 2011).

revenues and outlays resulting from fully implementing the Heritage plan under this Peterson/CBO baseline. However, the methodology for static scoring does not account for macroeconomic changes that result from changes such as higher tax rates or lower spending. These economic changes can significantly affect fiscal items, including revenue, because in reality more economic growth will increase the tax base. Thus, policies that create more economic growth also generate more tax revenue than a static model would indicate. To show the full benefits of the Heritage plan, the CDA will publish a separate dynamic analysis of the plan to supplement the static analysis presented in this report.

The Bottom Line: Static Analysis and CBO Current Law Baseline

On the revenue side,[7] the Heritage plan reforms the tax code as described in the Tax Reform section by creating a new labor and business tax system. The static estimates of tax changes were developed by introducing these changes into the CDA tax models. The resulting estimates show revenues reaching approximately 16.9 percent of GDP in 2013 and increasing to 18.5 percent in 2022, where they remain throughout the remaining forecast period. The Peterson/CBO baseline, on the other hand, shows revenues rising from 18.8 percent of GDP in 2013 to 23.3 percent in 2035.

On the outlay side, changes to nearly every major spending category sharply reduce the spending estimates under the Heritage plan. The plan starts with spending at 22.1 percent of GDP in 2012—roughly $188 billion lower than the baseline—by assuming some cuts in discretionary spending. Outlays drop significantly thereafter. By 2021, spending stands at 18.1 percent of GDP and ends the forecast period in 2035 at 17.7 percent of GDP. In contrast, the baseline projects outlays at 24 percent of GDP in 2021 and 28.3 percent in 2035.

Given this much lower spending path and steady revenue growth, the Heritage plan achieves low deficits and then fiscal balance during the forecast period. A balanced budget appears in 2021 and 2022 and the budget remains balanced in each subsequent year through the simulation. The baseline shows worsening deficits throughout the forecast period. By 2035, the fiscal deficit stands at a 5 percent of GDP in the current law baseline.

7. Estimates reported in the section have been taken from the Peter G. Peterson Foundation, "PGPF Fiscal Solutions Reporting Template," March 18, 2011.

Taxes. Under the Heritage plan, the tax system is reformed, and revenue is capped at its historical level of 18.5 percent of GDP. The plan replaces the current six tax brackets and payroll taxes with one simple flat rate that applies to all corporate, small business, and personal income, excluding savings and a few other deductions, and produces that needed level of revenue (18.5 percent of GDP).

The Heritage tax model estimates that these reforms will save taxpayers an average of almost $280 billion annually over the next 10 years compared with the current law baseline. By 2021, total tax savings will exceed $3.1 trillion. Many taxpayers will immediately see a significant reduction in their tax burden. For example, those with small business income will see an average tax reduction of about $8,000 in 2012, rising to $11,000 by 2014. By 2014, households filing jointly will see an average tax reduction of about $4,000, while college students will see an average reduction of about $3,000. In 2014, seniors with Social Security income will on average owe about half what they currently owe ($5,500 down from $11,000).

Many tax provisions have strong effects on other elements of the budget. For example, health care benefits are no longer excluded from taxation, but are replaced by a health care tax credit. This change will make total compensation more transparent and in most cases quickly lead employers to provide more compensation in the form of cash, which will encourage employees to make more efficient purchases of health insurance. The credit is available to all taxpayers, regardless of insurance offering by their place of work, therefore promoting tax equity and limiting "job lock."[8]

Health Care. Heritage's plan makes important changes at all levels of the health care system. The Heritage plan encourages consumer choice and increased competition to reduce health care costs. Significantly, some of the key Heritage reforms alter the price of health care, which will affect consumer decisions. This demand side reform will reduce some health care spending by encouraging consumers to make more efficient choices on plans and services, thereby reducing health care outlays across the board. Some of the health care proposals, such as the Medicare reforms, will also shift the cost curve of health care.

The Heritage plan will also affect the supplier side of health care providers. With increased competition, suppliers will be encouraged to improve their business models and reduce their costs to consumers. When highly regulated markets are more free and subject to competitive pressures, costs can drop quickly and substantially. For example, the deregulation of the airline industry reduced airfares by more than 20 percent in only 20 years.[9] Regulatory policy changes and increased competition have prompted sharp price reductions in other industries, such as communications.

This fundamental downward shift in the cost curve of health care is anticipated, but not modeled in this static analysis of the Heritage plan. We expect the prices of certain health care goods and services to fall. These effects will be included in the dynamic analyses, but our static score modeling of the proposal, including the Medicare reforms, does not model a scenario in which the change in prices would fundamentally change the growth path of the cost curve. Instead, we model the price changes as a change in the level of spending. Some of the price changes will likely spill over into the non-Medicare market, but modeling those effects were outside the scope of the analysis because the cost of the health care tax credit and Medicaid are not tied to the price of health care.

Health Care for the Working-Age Population. The Heritage plan fundamentally reforms the American health care system beginning with a critical change in the tax treatment of health insurance. The plan replaces the current tax exclusion for employer-sponsored health insurance with premium assistance for most American households. This policy change eliminates the current inequity in which only individuals with access to employer-sponsored insurance receive favorable tax treatment and the additional inequity generated by the subsidies in PPACA. This will reduce labor market distortions, such as "job lock," and remove the incentive created in the PPACA for individuals to stop working to qualify for a generous subsidy for health insurance. The Heritage premium support model will reduce the dominance of employers in selecting one or two plans for their workers and allow individuals greater freedom to shop for an insurance plan that will provide the best health care at the best value for their families.

To best preserve public funds, the Heritage plan begins phasing out the tax credit at $100,000 in income for a family and $50,000 for an individual. The tax credit is completely phased out at $170,000

8. "Job lock" refers to a common difficulty that workers face when thinking about changing jobs or starting a business. If workers believe that changing jobs might mean losing their health insurance, they are less likely to make the change. Thus, employer-provided health insurance has the effect of locking workers into their current jobs. This job lock clearly is economically inefficient. It frequently traps workers in jobs where their talents are not applied in the best way. It discourages the formation of new businesses, reducing entrepreneurship and innovation. Reductions in innovative activities slow economic growth below its potential.
9. Steven A. Morrison and Winston Clifford, "The Remaining Role for Government Policy in the Deregulated Airline Industry," in Sam Peltzman and Clifford Winston, eds., *Deregulation of Network Industries: What's Next?* (Washington, D.C.: American Enterprise Institute Press, 2000).

for a family and $90,000 for an individual. The current Medicaid eligibility structure as well as the subsidy cliff in the PPACA discourages people near the upper income limit from pursuing better job opportunities for fear of losing Medicaid coverage for themselves or their children. Importantly, the Heritage plan alleviates this disincentive for upward mobility. The tax credit is also available to individuals well into the middle class. For instance, individuals and families earning well over 400 percent of the federal poverty line (about $90,000 for a family of four), the level at which the health insurance subsidies in PPACA phase out, will be eligible for a tax credit.

Families with children and incomes below 200 percent of the federal poverty line qualify for an additional subsidy under the plan. This subsidy can be used to pay insurance premiums or other health-related expenses. The additional subsidies phase out slowly to prevent effective marginal tax rates from being too high for eligible low-income workers.

Medicare. The Heritage plan changes Medicare by moving to a defined contribution premium-support system subject to competitive bidding. The CDA projects that the Heritage plan will save almost $1.6 trillion by 2021 compared with the current law baseline and $9.4 trillion by 2035. Overall, federal health care spending is 40 percent less under the Heritage plan.

Premium support and competitive bidding are not new ideas and have been analyzed before. In December 2006, the CBO estimated that a premium-support program with competitive bidding could reduce Medicare expenditures by 8 percent to 11 percent, although it would not significantly affect underlying spending growth.[10] Another study on the benefits of consumer choice through such approaches found that Medicare spending would fall by 8 percent as a result of choice and competition.[11]

10. Congressional Budget Office "Designing a Premium Support for Medicare," December 2006.

11. Robert F. Coulam, Roger Feldman, and Bryan E. Dowd, *Bring Market Prices to Medicare* (Washington, D.C.: American Enterprise Institute Press, 2009).

The CDA assumes that, when the Heritage plan is fully implemented, Medicare spending will fall by 5 percent annually because of the budgeted defined contribution and competitive bidding. However, there are reasons to believe that Medicare cost growth would fall by much more as seniors are given a reason to be cost-conscious consumers of health care. Therefore, the 5 percent decrease that we estimate from the competition reform is likely a lower bound.

Wealthier seniors contribute more toward their health care under the Heritage plan. The CDA used the Current Population Survey to estimate how many seniors have adjusted gross income in excess of the phaseout thresholds. Under the plan the value of the premium contribution is reduced by 1.82 percent for each $1,000 in excess of the phaseout level. The CDA estimates that just over 9 percent of seniors have income in excess of the phaseout threshold.

Other changes in Medicare include increasing the eligibility age and requiring higher Part B premiums for those continuing to participate in the traditional Medicare fee-for-service program. The CDA scoring of these changes closely matches CBO scoring estimates of various budget options.[12]

Medicaid and the Working-Age Population. The Medicaid reforms in the Heritage plan will significantly strengthen the economy by slowing down health care costs and federal spending on health care, reducing barriers to economic mobility, and encouraging work and savings.

The Heritage plan makes several reforms to Medicaid, reshaping the program to focus on the disabled and elderly with very low incomes and providing able-bodied adults and their families with assistance to buy private insurance instead of Medicaid. This is an especially important component

12. Congressional Budget Office, *Budget Options*, Vol. 1, Health Care, December 2008, at *http://www.cbo.gov/doc.cfm?index=9925* (April 29, 2011).

of the plan because it will reduce barriers for many non-disabled adults to return to work. Today, many lose coverage if they take a job with an employer that does not offer insurance. By introducing stricter eligibility requirements for the program (with the alternative assistance for certain current enrollees) and capping spending growth, the Heritage plan will bring Medicaid spending and its growth path under control, saving taxpayers $1.1 trillion compared with the baseline in the first 10 years and $8.2 trillion by 2035.

The Heritage plan replaces Medicaid coverage for non-disabled adults and children with a tax credit and voucher for purchasing health insurance in the private market.

Social Security Modernization. The Heritage plan works to protect seniors from poverty, but also transparently reduces checks to more affluent seniors. Today, the benefits of more affluent seniors are taxed, and the taxes reduce checks at much lower income levels than the phasedown threshold in the Heritage plan. The Heritage plan also adjusts the retirement age to take into account increased life expectancy.

With modeling assistance from the American Enterprise Institute, the CDA estimates that the Heritage reforms will reduce federal spending by $1.7 trillion from 2012 to 2021 and $10.9 trillion cumulative by 2035. This is a reduction of almost 4 percent in annual Social Security outlays by 2035 while ensuring that no eligible senior falls below the poverty line.

Achieving Fiscal Balance

The Heritage plan achieves fiscal balance by ensuring that tax receipts will match government expenditures. If no action is taken, the deficit in the current law baseline is 3.2 percent of GDP in 2021 and 5 percent in 2035. The Heritage plan balances the federal budget by 2021, with spending and revenues each reaching 18.5 percent of GDP. The budget stays balanced without exceeding those levels through the entire time frame. This leads to a sharp reduction in debt as a percentage of GDP. In the extended baseline scenario, debt climbs to 91.5 percent of GDP by 2035. The Heritage plan reduces the debt by two-thirds to 30 percent of GDP. A smaller national debt results in savings to taxpayers as interest payments fall sharply from an annual share of 4.6 percent of GDP to 1.7 percent in the Heritage plan, a savings of more than $1 trillion each year. Reduced interest payments on the national debt account for almost one-third of the reduced government spending, which is a result of the strong budget reforms contained in the Heritage plan.

TABLE 4

Comparing the Heritage Plan to Current Projections

Figures are in Percentages of GDP

	REVENUE AND SPENDING						PUBLICLY HELD DEBT	
	Heritage Plan			Current Projections			Heritage Plan	Current Projections
	Revenue	*Outlays*	*Surplus/ Deficit*	*Revenue*	*Outlays*	*Surplus/ Deficit*		
2010	14.9	23.8	−8.9	14.9	24.3	−9.4	62.1	62
2011	14.8	24.7	−9.8	16.9	24.5	−7.6	69.4	67
2012	16.1	22.1	−6.0	17.6	22.9	−5.3	72.9	69
2013	16.9	20.3	−3.4	18.2	22.6	−4.4	73.7	70
2014	17.4	19.3	−1.9	18.7	22.8	−4.1	72.3	71
2015	17.5	19.0	−1.5	18.7	23.3	−4.6	70.5	72
2016	17.5	18.6	−1.1	18.9	23.9	−5.0	68.5	75
2017	17.8	18.4	−0.6	19.0	24.4	−5.4	66.5	77
2018	17.9	18.3	−0.4	19.1	24.9	−5.8	64.5	80
2019	18.0	18.3	−0.3	19.1	25.4	−6.3	62.5	84
2020	18.1	18.3	−0.2	19.3	25.9	−6.6	60.5	87
2021	18.3	18.1	0.2	19.3	26.3	−7.0	58.2	91
2022	18.5	18.4	0.1	19.3	26.8	−7.5	56.2	95
2023	18.5	18.4	0.1	19.3	27.6	−8.3	53.9	100
2024	18.5	18.5	0.0	19.3	28.4	−9.1	52.0	106
2025	18.5	18.5	0.0	19.3	29.1	−9.8	49.9	112
2026	18.5	18.5	0.0	19.3	29.7	−10.4	47.9	118
2027	18.5	18.5	0.0	19.3	30.4	−11.1	46.0	125
2028	18.5	18.5	0.0	19.3	31.1	−11.8	44.2	131
2029	18.5	18.4	0.1	19.3	31.7	−12.4	42.4	138
2030	18.5	18.3	0.2	19.3	32.2	−12.9	40.4	146
2031	18.5	18.2	0.3	19.3	32.8	−13.5	38.4	153
2032	18.5	18.0	0.5	19.3	33.4	−14.1	36.3	161
2033	18.5	18.0	0.5	19.3	34.0	−14.7	34.3	169
2034	18.5	17.8	0.7	19.3	34.6	−15.3	32.1	177
2035	18.5	17.7	0.8	19.3	35.2	−15.9	30.0	185

Sources: Current projections: Heritage Foundation calculations based on data from Congressional Budget Office, Alternative Fiscal Scenario. Heritage Plan: Calculations by the Center for Data Analysis, The Heritage Foundation, based on baseline data in the current projections, data provided by the Peter G. Peterson Foundation, and CDA policy models.

TABLE 5

Federal Spending by Category Under the Heritage Plan

Figures are in Percentages of GDP

	Social Security	Medicare, Medicaid, Exchange Subsidies, and CHIP	Other Mandatory	Defense	Non-Defense Discretionary	Net Interest	Total
2010	4.8	5.6	2.8	4.7	4.5	1.4	23.8
2011	4.8	5.8	3.4	4.7	4.4	1.5	24.7
2012	4.3	5.4	2.5	4.8	3.6	1.6	22.1
2013	4.2	5.4	2.1	4.3	2.9	1.4	20.3
2014	4.1	5.2	1.4	4.1	2.5	1.9	19.3
2015	4.0	5.2	1.3	4.1	2.2	2.2	19.0
2016	4.0	4.9	0.9	4.1	2.2	2.5	18.6
2017	4.0	4.7	1.0	4.0	2.1	2.6	18.4
2018	4.0	4.5	1.0	4.0	2.1	2.6	18.3
2019	3.9	4.5	1.3	4.0	2.0	2.6	18.3
2020	3.9	4.4	1.4	4.0	2.0	2.6	18.3
2021	3.9	4.2	1.5	4.0	1.9	2.5	18.1
2022	3.9	4.4	1.5	4.0	1.9	2.7	18.4
2023	3.9	4.5	1.4	4.0	1.9	2.7	18.4
2024	3.9	4.6	1.4	4.0	1.9	2.6	18.5
2025	3.9	4.8	1.4	4.0	1.9	2.6	18.5
2026	3.9	4.9	1.4	4.0	1.8	2.5	18.5
2027	3.8	5.0	1.3	4.0	1.8	2.5	18.5
2028	3.8	5.2	1.3	4.0	1.8	2.4	18.5
2029	3.7	5.3	1.3	4.0	1.8	2.3	18.4
2030	3.7	5.4	1.3	4.0	1.7	2.3	18.3
2031	3.6	5.5	1.2	4.0	1.7	2.1	18.2
2032	3.6	5.6	1.2	4.0	1.7	2.0	18.0
2033	3.5	5.6	1.2	4.0	1.7	1.9	18.0
2034	3.5	5.7	1.2	4.0	1.6	1.8	17.8
2035	3.4	5.8	1.2	4.0	1.6	1.7	17.7

Sources: Calculations by the Center for Data Analysis, The Heritage Foundation, based on data provided by the Peter G. Peterson Foundation, and CDA policy models. Totals may not sum to 100 percent due to rounding.

TABLE 6

Federal Spending Comparison: The Heritage Plan and Current Projections

Figures are in Percentages of GDP

	THE HERITAGE PLAN					CURRENT PROJECTIONS				
	Social Security	Medicare, Medicaid, Exchange Subsidies, CHIP	Other Spending	Net Interest	Total	Social Security	Medicare, Medicaid, Exchange Subsidies, CHIP	Other Programs	Net Interest	Total
2010	4.8	5.6	12.0	1.4	23.8	4.8	5.5	12.5	1.4	24.3
2011	4.8	5.8	12.5	1.5	24.7	4.9	5.6	12.4	1.6	24.5
2012	4.3	5.4	10.9	1.6	22.1	4.8	5.4	10.9	1.8	22.9
2013	4.2	5.4	9.3	1.4	20.3	4.8	5.5	10.2	2.1	22.6
2014	4.1	5.2	8.0	1.9	19.3	4.8	5.7	10.0	2.4	22.8
2015	4.0	5.2	7.6	2.2	19.0	4.8	6.0	9.9	2.7	23.3
2016	4.0	4.9	7.2	2.5	18.6	4.8	6.3	9.9	2.9	23.9
2017	4.0	4.7	7.1	2.6	18.4	4.9	6.6	9.9	3.1	24.4
2018	4.0	4.5	7.1	2.6	18.3	5.0	6.8	9.8	3.3	24.9
2019	3.9	4.5	7.3	2.6	18.3	5.1	7.0	9.8	3.6	25.4
2020	3.9	4.4	7.4	2.6	18.3	5.2	7.2	9.7	3.8	25.9
2021	3.9	4.2	7.4	2.5	18.1	5.3	7.4	9.7	3.9	26.3
2022	3.9	4.4	7.4	2.7	18.4	5.4	7.7	9.7	4.1	26.8
2023	3.9	4.5	7.3	2.7	18.4	5.4	7.9	9.7	4.6	27.6
2024	3.9	4.6	7.3	2.6	18.5	5.5	8.2	9.6	5.1	28.4
2025	3.9	4.8	7.2	2.6	18.5	5.6	8.4	9.6	5.4	29.1
2026	3.9	4.9	7.2	2.5	18.5	5.7	8.7	9.6	5.7	29.7
2027	3.8	5.0	7.2	2.5	18.5	5.8	8.9	9.5	6.1	30.4
2028	3.8	5.2	7.1	2.4	18.5	5.9	9.2	9.5	6.4	31.1
2029	3.7	5.3	7.1	2.3	18.4	6.0	9.5	9.5	6.7	31.7
2030	3.7	5.4	7.0	2.3	18.3	6.0	9.7	9.5	7.0	32.2
2031	3.6	5.5	7.0	2.1	18.2	6.0	10.0	9.4	7.3	32.8
2032	3.6	5.6	6.9	2.0	18.0	6.1	10.2	9.4	7.6	33.4
2033	3.5	5.6	6.9	1.9	18.0	6.1	10.4	9.4	8.0	34.0
2034	3.5	5.7	6.8	1.8	17.8	6.2	10.7	9.4	8.3	34.6
2035	3.4	5.8	6.8	1.7	17.7	6.2	10.9	9.3	8.7	35.2

Sources: Current projections: Heritage Foundation calculations based on data from Congressional Budget Office, Alternative Fiscal Scenario. Heritage Plan: Calculations by the Center for Data Analysis, The Heritage Foundation, based on data provided by the Peter G. Peterson Foundation, and CDA policy models. Totals may not sum to 100 percent due to rounding.

The Heritage Foundation
LEADERSHIP FOR AMERICA

The Heritage Foundation is a research and educational institution—a think tank—whose mission is to formulate and promote conservative public policies based on the principles of free enterprise, limited government, individual freedom, traditional American values, and a strong national defense.

Our vision is to build an America where freedom, opportunity, prosperity, and civil society flourish. As conservatives, we believe the values and ideas that motivated our Founding Fathers are worth conserving. As policy entrepreneurs, we believe the most effective solutions are consistent with those ideas and values.

Leadership *for* America Ten Transformational Initiatives

This special report is part of the **Entitlements** and **Health Care Initiatives**, two of 10 Transformational Initiatives making up The Heritage Foundation's Leadership for America campaign. For more products and information related to these Initiatives or to learn more about the Leadership for American campaign, please visit *heritage.org*.

American Leadership
Education
Energy & Environment
Enterprise & Free Markets
Entitlements
Family & Religion
First Principles
Health Care
Protect America
Rule of Law

214 Massachusetts Ave. NE ▪ Washington, D.C. 20002 ▪ (202) 546-4400 ▪ heritage.org

savingthedream.org