

# AMERICAN ACTION FORUM

## *Balanced: 2028*

### American Action Forum

Douglas Holtz-Eakin and Gordon Gray

## INTRODUCTION

The United States currently faces two interrelated challenges: a precarious debt problem and the threat of persistently weak economic growth. Over the long term, dramatically tackling the U.S.'s fiscal challenges would remove an important impediment to growth and increased standards of living, while improved growth eases the difficulty of major fiscal policy changes. Weak economic growth damages the nation's bottom line by reducing revenues and prompting higher spending. Interest on the existing debt compounds these challenges. A pro-growth budget plan reflects these interdependencies and focuses budget savings where they are needed most, while pursuing additional policy goals to spur trend economic growth.

"Balanced: 2028" reflects the experience that the United States is served best by a contained, efficient government focused on core national security and domestic activities, including a durable social safety net. It is guided by the lesson of history that the best approach to simultaneous poor growth and explosive debt is to reform taxes to be more pro-growth, preserve core functions of government, and focus on streamlining transfer programs—entitlement programs in the United States—as the route to controlling debt. It enacts these reforms in a disciplined fashion that avoids precipitous cuts that would harm economic growth and the national well-being.

## SPENDING

### *Medicare, Medicaid, and Other Federal Health Programs*

This plan includes the repeal of the Affordable Care Act—on both the tax and spending sides of the federal ledger. The plan would restore provider reductions to Medicare and DSH payments to Medicaid while eliminating the planned expansions in Medicaid and the creation of new health subsidies. The plan also repeals the narrow, industry-level taxes, as well as the new Medicare investment tax and the health insurance surtax.

Instead, the plan would take the approach of beginning with "cost containment"—slowing the growth of

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

### *Social Security*

Avoiding sharp benefit reductions is the goal of any Social Security reform. Gradual reforms that *slow the growth* in promised benefits—not cut them outright—is the responsible approach to the challenge of an aging population and projected benefits that significantly exceed program income. This plan suggests a combination of policy changes that would address the structural imbalance in Social Security over the long term. Importantly, the plan would also address structural challenges in the Disability insurance program and place the program on a sounder structural footing. These reforms largely target future beneficiaries, and also contribute to the sustainability of the overall system.

### *Defense and Non-Defense Discretionary*

The plan restores funding to both defense and non-defense discretionary spending and averts the cuts to these programs arising from the reduced spending caps under current law. However, while overall discretionary funding levels are increased, the plan includes savings within these areas, including the implementation of reforms to constrain growth in civilian and military health costs. The discretionary component of the budget also includes reforms to better target Pell grants. Both defense and non-defense discretionary spending is fixed as a percentage of GDP at the end of the 10-year window, and, thus, grows at the same pace as GDP thereafter.

### *Other Mandatory*

Reform of these programs would see the major income and family support reappropriated to two principal assistance regimes: work support and family support. The Earned Income Tax Credit, SSI, and unemployment insurance would constitute work support programs. Real, per capita benefits would be maintained as under current law. The Earned Income Tax Credit would be repealed as a tax measure, but reinstated as a work incentive payment on a dollar-for-dollar basis. The same approach would be taken with major family assistance programs to include the Child Tax credit, which would be added to support a regime of family assistance programs, such as SNAP. Over ten years, these programs would see comparatively minor savings relative to aggregate program expenditures. Greater savings would accrue over the long term. The plan also includes limitations to mandatory agriculture program spending, as well as additional savings from federal student loan programs.

Additionally, the plan assumes a fundamental immigration reform. On net, such a reform would reduce the deficit and have a positive effect on economic growth—as much as a percentage point over the near term, which would translate into a per capita gain of \$1,500.<sup>2</sup> Conversely, enforcing existing immigration policies would have a detrimental budgetary and economic effect, requiring an increase in federal spending of

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

2 <http://americanactionforum.org/sites/default/files/Immigration%20and%20the%20Economy%20and%20Budget.pdf>

between roughly \$400 billion to \$600 billion to address the 11.2 million undocumented immigrants and prevent future unlawful entry into the United States. In turn, this would shrink the labor force by 11 million workers and reduce real GDP by \$1.6 trillion.<sup>3</sup>

## REVENUES

“Balanced: 2028” incorporates a fundamental tax reform that would move the U.S. to a progressive consumed-income tax code. This plan would be pro-growth and not penalize savings and investment. Research suggests that implementing a progressive consumed-income tax consistent with AAF’s tax plan would improve long-run economic growth by over 6 percent.<sup>4</sup>

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

On the individual side, tax rates for joint filers would be 15 percent on the first \$50,000; 25 percent on the next \$100,000; and 35 percent over \$150,000. Brackets for all unmarried taxpayers are half these amounts. All brackets are indexed after 2017 by chained CPI (CCPI)—consistent with other elements of reform on the spending side of the budget. We would provide an exemption for 100 percent of poverty up to a family of 2. This limit would grow at the rate of CCPI.

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

The only credits allowed would be: a new credit of 15 percent of charitable contributions in excess of \$500 (indexed by CCPI after 2017) and a new refundable credit for first-time homebuyers (as defined for the American Recovery and Reinvestment Act credit) of 15 percent of the value of the purchased home, claimed in five equal installments (i.e., 3 percent of the value) in each of the first 5 years of ownership. The existing mortgage interest deduction would be phased out for existing mortgages over 10 years.

The goal of this plan is to average 18.2 percent of GDP in revenue over the first ten years, which is equal to the current law revenue baseline. This is consistent with the goal of comprehensive revenue-neutral tax reform. Revenues would continue to rise as a percent of GDP in the future. This plan also assumes across-the-board rate reduction. To the extent revenue continues to increase and surpass outlays, additional rate reduction should be pursued.

## CONCLUSION

This approach seeks to address the top domestic policy goals—the need for stronger economic growth and long-term debt reduction—without harming near-term growth. The plan achieves balance by 2028—reflecting the need for significant debt reduction that begins immediately and accrues over time. A central part of the plan is a fundamental restructuring of the tax code—a restructuring that would significantly broaden tax collection to a more economically efficient consumption base, increase simplicity, and generate

<sup>3</sup> <http://americanactionforum.org/research/the-budgetary-and-economic-costs-of-addressing-unauthorized-immigration-alt>

<sup>4</sup> David Altig, Alan J. Auerbach, Laurence J. Kotlikoff, Kent A. Smetters, and Jan Walliser, “Simulating Fundamental Tax Reform in the United States,” *American Economic Review*, 91(3), June 2001, pp. 574-595.

economic growth. The plan relies heavily on reforms to major health entitlement programs, which are the principle drivers of our long-term fiscal challenge. The plan would propose modest reforms to Social Security that would ultimately balance the program over the long term. The plan also imposes modest savings on “other mandatory” programs through reforms that would seek to sustain real per capita benefits for eligible participants. The plan *increases* both defense and non-defense discretionary spending, albeit modestly, compared to current law, while implementing reforms to constrain growth in civilian and military health costs.

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

Percentage of GDP	2026	2040
Revenues	19.1	22.3
Spending	20.9	17.8
Deficit (-)/ Surplus (+)	-1.8	4.5
Debt Held by the Public	69.4	15.9

# AMERICAN ACTION FORUM

## MEMORANDUM

TO: The 45th President and 115th Congress

FROM: Douglas Holtz-Eakin and Gordon Gray

DATE: January 1, 2017

SUBJECT: Balanced: 2028

## Introduction

The debt currently stands at over \$14 trillion and is growing, while the economy is on track to grow at a rate of only about two percent per year. Left unchanged, these trends endanger the future prosperity of the nation. The debt is no longer an abstract, distant challenge, but rather a headwind to economic growth that must be addressed now. Persistently sluggish economic growth will bequeath to the next generation a standard of living unworthy of the American Experiment. Both of these challenges threaten to break the nation's social compact that successive generations bequeath to the next a brighter future. But this is only one possible future. An alternative can promise declining debt through a balanced budget and future surpluses and a policy environment to support higher economic growth.

## Top Three Policy Recommendations

A brighter future is achievable by focusing on what is driving the structural budgetary challenges confronting the nation, and where federal policy is failing the economy. Addressing the nation's broken tax code, the rapid growth of health, retirement, and other entitlement programs, and the U.S.'s irrational immigration system will improve both the nation's fiscal and economic outlook and should be the top three priorities of the administration.

### *Tax Reform*

Fundamental modernization and simplification of the tax system has been an elusive dream for Congresses and administrations over the past 30 years. Indeed, over the 100-year history of the U.S. income tax system, only a handful of meaningful simplification efforts have seen success. This administration should defy history and enact comprehensive tax reform. This effort should be even more ambitious than the 1986 Tax Reform Act. Instead, this administration should pursue a wholesale rewrite of the tax code, one that moves to a

consumption-based system that, while retaining progressivity, spurs savings and investment and imposes taxes on commerce in the least harmful way.

“Balanced: 2028” would eliminate the current individual and corporate tax code. Businesses would be taxed on cash flows, with businesses able to deduct purchases and employee compensation, at a flat rate initially set at the same top rate as the household portion of tax.

Individuals above an exemption would be taxed progressively up to a top rate of 35 percent. The plan would raise adequate revenue to fund the nation’s priorities, but do so in a manner that is far more efficient, and therefore more conducive to economic growth, than the current system—indeed such a reform could boost long-term economic growth by 6 percent.

### *Entitlement Reform*

The primary causes for our growing debts have been largely untouched by past deficit reduction efforts. Discretionary spending, reduced by the Budget Control Act, and tax revenue, recently hiked, are not driving debt. Mandatory spending and interest payments are. Mandatory spending has been growing as the nation ages, health costs grow, and policy-makers create new entitlements and expand old ones. In 1974, mandatory spending was 41 percent of the budget. By 2025, it will be 64 percent. Meanwhile, interest payments on the debt will continue to crowd out the budget as the debt portfolio remains outsized, and interest rates normalize.

These pressures reflect legacy costs—past promises—crowding out investment in the future in the form of infrastructure, basic research, and education. This budget pressure strains the capacity to adequately fund what should be the first priority of the federal government: national defense. Absent restraint on entitlement programs, the United States will be unable to budget for these priorities.

### *Immigration Reform*

The demography of the nation is graying. Low U.S. birth rates are falling short of the aging of the population. As the baby-boom generation continues to reach retirement age, the U.S. labor force will face additional downward pressure, and with it, the economy as a whole. A rational immigration system that refocuses on economic goals could help reverse this trend by raising population and labor force growth, and thus economic growth as a whole.

In addition to the mere mechanics of raising the U.S. population, immigrants have displayed entrepreneurial rates above that of the native-born population. New entrepreneurial vigor embodied in new capital and consumer goods can raise the standard of living.

## **Conclusion**

In the absence of fundamental reforms to every major federal policy area and on both sides of the nation’s ledger book, the U.S. faces the threat of debt-driven financial crisis and stagnant trend economic growth. “Balanced: 2028” proposes overhauls of the nation’s tax code, and reform to every major area of federal spending—reducing growth in spending over time and reaching balance by 2028. These reforms target the drivers of the nation’s budget challenges and the policy impediments to economic growth. While the incoming administration should pursue each of the elements of this blueprint—it should start with the three most important: tax, entitlement, and immigration. If pursued successfully, the administration will have 4 more years to implement the rest of the plan.

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