A Balanced Plan for Fiscal Stability and Economic Growth

American Enterprise Institute[1]

Joseph Antos, Andrew Biggs, Alex Brill, and Alan Viard

INTRODUCTION

The objective of this plan is to achieve long-term fiscal stability and promote economic growth. We cannot simply tax our way to fiscal stability without suffering the consequences of a sluggish economy and reduced prosperity. We also cannot simply cut spending without risking the loss of essential services for an aging population, undercutting our infrastructure on which economic growth builds, and reducing our ability to defend the country against its enemies.

Our proposals reduce the national debt from 105.8 percent to 62.7 percent of annual GDP in 2040. Ambitious cuts in federal spending are required to achieve that goal while minimizing tax burdens on the American people and the drag that high marginal tax rates impose on long-run economic growth. The plan emphasizes cuts in the major entitlement programs—Social Security, Medicare, Medicaid, and health insurance subsidies established by the Patient Protection and Affordable Care Act (PPACA).

Many of the policies will undoubtedly be politically unpopular, but some version of our proposal is necessary. None of the authors of this plan fully agree with every policy advanced here, but we have been able to reach the kind of compromise that is needed to address the long-run fiscal imbalance.

Health Care. Our proposed health reforms are intended to slow the growth of spending—both federal and system-wide—while maintaining access to high-quality health services. The reforms establish a clear understanding that there are binding resource constraints without imposing burdensome regulations that impose unnecessary restrictions on consumer choice. Incentives, rather than controls, promote greater efficiency and allow patients and their health care providers to make the best individual decisions within a responsible budget framework. That requires shifting away from the defined-benefit approach that characterizes Medicare and Medicaid today to a defined-contribution philosophy that places a limit on federal spending while recognizing the changing needs of the population. To develop an effective plan, it is necessary to repeal major sections of PPACA and replace them with a new set of policies based on market

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principles and budget realities. Nonetheless, the major objectives of that legislation (such as creating an organized marketplace for insurance, better information for consumers, and expanded federal insurance subsidies for those most in need) are reflected in new policies better able to achieve those goals.

Social Security. The Social Security reform is designed to make the program more effective in protecting low earners, simpler for individuals of all earnings levels to understand, more conducive to saving and longer work lives, and better aligned with the work and retirement conditions that will prevail in the coming decades. That will make Social Security solvent and sustainable over the long term while reducing program outlays to better accommodate rising costs for other priorities, including health care.

Taxes. The federal government raises most of its revenue from individual and corporate income taxes, which are biased against saving and investment. Our proposed tax reform replaces the income tax system and the estate and gift tax with a progressive consumption tax, thereby eliminating the tax penalty on saving and investment. To address environmental concerns in a more market-friendly manner, the proposal replaces an array of energy subsidies, tax credits, and regulations with a modest carbon tax.

Our proposal brings federal spending and revenue into closer alignment, thereby sparing future generations from the explosive growth of federal debt. At the same time, it promotes economic growth by emphasizing spending cuts rather than tax increases and by using an economically efficient consumption tax to raise the revenue that is needed. Real federal spending would continue to increase under the proposal, but at a significantly slower pace than under current law.

SPENDING

Medicare, Medicaid, and Other Federal Health Programs

Our proposal caps federal subsidies for insurance, promotes effective competition and innovation in the health sector, reduces regulatory burden, and develops better consumer information. Subsidies in all federal health programs would be made more progressive, helping those who most need the help. Such policies will provide strong incentives for the private sector to develop new ways to deliver care that improve efficiency and lower the cost per unit of service. Spending reductions are substantial, requiring beneficiaries to shoulder more of the cost of their health care. However, health system improvements are expected to maintain quality of care and access to essential services.

Medicare Reform. Medicare is primarily a fee-for-service program that offers little incentive to patients or providers to hold down costs. It would be converted to a premium support plan, in which a subsidy would be provided to beneficiaries who would choose from among competing health plans. Larger subsidies would be paid to beneficiaries who are in greater financial need or who have higher health risks. Those selecting more expensive plans (including traditional Medicare, which would remain available but at a premium commensurate with its cost) would be responsible for any premium amount above the subsidy.

The annual growth in the premium subsidy would be determined by Congress in conjunction with decisions about other spending priorities. Growth in total Medicare spending would be 1.2 percentage points slower than under current law. This policy is effective starting in 2018. It would be desirable to phase premium support in over 10 or more years, allowing individuals and the health system time to adjust to placing Medicare on a budget. However, a phase-in period also delays the spending reductions needed to achieve our long-term fiscal goal.

Other reforms would address longstanding problems in traditional Medicare. Medicare's eligibility age would be increased gradually to 67, consistent with Social Security. Until premium support is effective, the basic premiums for Medicare Part B and Part D would increase from 25 percent to 40 percent of each program's cost. Traditional Medicare's cost-sharing arrangements would be simplified, replacing the current cost-sharing rules with a single deductible for Part A and Part B and 20 percent coinsurance for all covered services, and incentives to drop Medigap coverage would be offered to promote cost awareness.

Medicaid Reform. The federal government subsidizes state Medicaid programs through matching payments that cover about 62–64 percent of total costs on average, accounting for the higher match rates for newly eligible beneficiaries established by PPACA. States have developed complex financial arrangements that allow them to draw more federal funds without necessarily providing more or better services. Replacing matching payments with block grants eliminates this perverse incentive and permits states to manage their Medicaid programs more efficiently. Federal Medicaid costs would grow with the economy, allowing for some additional savings due to increased efficiency in the health sector.

States would be permitted to offer premium support for private insurance to Medicaid beneficiaries, on a voluntary basis. In addition, benefit payments for individuals who receive both Medicaid and Medicare benefits (the "dual eligibles") would be converted into fixed payments for insurance plus a contribution to a medical savings account. Dual eligibles may enroll in either a Medicaid or Medicare managed care plan, rather than drawing fee-for-service benefits from both programs.

Insurance Subsidy Reform. Workers currently are not taxed on contributions for health insurance made by their employers. That creates an open-ended and regressive subsidy that has promoted first-dollar coverage and rapid growth in health spending. The tax exclusion would be replaced by a refundable health insurance tax credit that provides a flat dollar subsidy, with higher payments to those with lower incomes and greater health risk. That eliminates the current system's incentive to purchase more expensive coverage and its favoritism toward higher-income purchasers. The health reform legislation establishes a new subsidy for individuals with incomes below 400 percent of poverty who buy insurance through the exchanges. Those subsidies would be converted to a block grant to underwrite state-level subsidy programs for private insurance that are coordinated with the state's Medicaid policies.

Other Reforms. Financing reforms must be accompanied by a host of other changes in the design and operation of the health system. Organized insurance markets, similar in concept to the exchanges but with less federal control that would stifle innovation and competition, are needed to foster effective consumerism. Better information on treatment options, including information on cost and provider performance, is necessary for patients to make informed decisions in conjunction with their doctors. Medical liability reforms are needed to reduce defensive medicine and to give all patients fairer recourse if medical errors occur.

Social Security

The proposal will reduce the growth rate of Social Security outlays in future years to keep the program solvent and to make room in the budget for the growth of other programs, particularly the health-related entitlements. Important changes will be made to the structure of Social Security benefits, to focus more heavily on providing a safety net against poverty for the aged, disabled, and survivors, while instituting new savings accounts outside of Social Security to buttress retirement preparation for middle- and high-earning individuals.

The core element of the reform is a flat dollar benefit that would be paid to all retirees, disabled persons, and survivors, regardless of their earnings history or labor force attachment. The benefit would initially be set at the elderly poverty threshold, but would thereafter be indexed to wage growth rather than the Consumer Price Index. To supplement this flat benefit, workers would be automatically enrolled in employer-sponsored retirement plans with a default contribution of 3 percent of earnings, split evenly between the worker and employer. Assuming that accounts earn the Trust Fund bond rate of return, the combined benefits of the account and the flat benefit would roughly replicate the generosity and progressivity of Social Security under current law, but would provide significantly better poverty protection for low earners while reducing tax burdens. These reforms would be introduced gradually, taking full effect only when an individual entering the workforce today reaches retirement age.

The reforms also would encourage delayed retirement to ameliorate the effects of population aging. The early retirement age would gradually increase from 62 to 65, and the 12.4 percent Social Security payroll tax would be eliminated for all workers age 62 and older. The combined effect would enhance both individuals' retirement income and the economy.

The reforms address the Disability Insurance (DI) program by coupling policy reforms to reduce medium- and long-term costs with short-term borrowing between the Social Security retirement fund and the disability fund. The plan would institute "experience rating" for the employer share of the DI payroll tax, which would give employers the incentive to provide accommodations to workers with disabilities in order to keep them on the job. This policy is assumed to reduce the disability onset rate to halfway between the Social Security Trustees' intermediate and low-cost assumptions; disability recovery rates are assumed to remain unchanged.

Other Spending

Spending for other mandatory programs would be reduced by eliminating farm subsidies, reducing federal pensions, eliminating the refundable portion of the child tax credit, and other cuts. The proposal assumes that these programs would be reduced by 0.3 percent of GDP.

Defense spending levels should be based on the security needs of the country, rather than arbitrary budget targets. Productivity improvements and reductions in outdated, ineffective, and excessively expensive weapons systems can produce greater defense capability for less money and military personnel management and compensation policies can be modified to reduce costs. The proposal assumes that defense spending would rise to 3.8 percent of GDP by 2030 and remain at that level thereafter.

Nondefense discretionary programs would also face budget cuts to keep spending on the baseline path, which reflects implementation of the sequester. Deep reductions would be made in community and regional development, energy and agriculture spending, and other programs and all programs would enjoy cost savings from reductions in federal employee compensation.

REVENUES

Recognizing the costly health and welfare burdens imposed by an aging population, revenue would rise to 21.1 percent of GDP in 2040 under our plan. Although somewhat above the historical average, this level of revenue is below the disturbingly high levels that would result from leaving current policies in place. Holding revenues to this path will require the type of aggressive spending discipline outlined in this proposal. We propose fundamental tax reform to ensure that the additional revenue is raised without harming long-run economic growth.

Replacement of Income and Estate Taxes by Bradford X Tax

A Bradford X Tax would be instituted, along the lines of the Progressive Consumption Tax plan discussed, but not endorsed, by the 2005 Tax Reform Panel. The X tax consists of a flat-rate, firm-level tax on business cash flow and a graduated-rate, household-level tax on wages and fringe benefits. The X tax would replace the individual and corporate income taxes and the estate and gift tax on January 1, 2018, subject to transition rules.

The X tax is a consumption tax because it imposes no marginal tax on new saving and investment at either the firm or the household level. No household-level tax is collected on interest, dividends, capital gains, or other income from savings. Because firms immediately deduct business investments rather than depreciating them over time, there is no net firm-level tax on a marginal new investment; the tax savings from the immediate deduction fully offset the present value of the taxes on the investment's subsequent cash flows.

For married couples, the first $80,000 of earnings would be taxed at 15 percent, the next $160,000 of earnings would be taxed at 25 percent, and earnings above $240,000 would be taxed at 35 percent in 2018. The bracket ranges would be half as large for unmarried taxpayers. The bracket ranges would be adjusted for inflation, using the chained CPI, after 2018. There would be no standard deduction or personal exemptions, but households would be allowed a nonrefundable credit of $1,000 for each adult and $500 for each dependent. Households would be allowed a 15 percent refundable credit for charitable contributions above an annual floor of $500; the Earned Income Tax Credit computed largely under present-law rules, but with permanent extension of the 2009 increases and a doubling of the credit for childless workers; a refundable health insurance credit, as detailed above; a 15 percent credit for interest on a mortgage of up to $250,000; and deductions for child care costs and large employee business expenses.

Firms' cash flow would be taxed at a flat rate of 37 percent, approximately matching the X tax plus Medicare payroll tax on the earnings of workers in the top bracket. Firms would expense all investment, including equipment, structures, land, and inventories. With minor exceptions, the tax would be real-based and disregard financial transactions. Business tax preferences, except a reformed and permanent research tax credit, would be abolished.

Changes to Payroll Taxes

Employer-provided health insurance and other fringe benefits would be subject to the payroll tax. Workers aged 62 or older would be exempt from payroll taxes. The 0.9-percentage-point increase in the Medicare payroll tax for high earners adopted by PPACA would be eliminated.

Replacement of Energy Subsidies by Carbon Tax; Gasoline Tax Increase

Subsidies for ethanol and other alternative fuels would be abolished (except for some basic research on renewable energy), along with energy tax credits and regulations intended to lower greenhouse gas emissions. A carbon tax would be imposed in 2018 at a level of $4 per metric ton of CO_2 equivalent, increasing thereafter by inflation (as measured by the chained CPI) plus 2 percent per year. The carbon tax rate is intended to match the *domestic* social cost of carbon. In the absence of an international agreement to curb carbon dioxide emissions, national wellbeing is advanced by basing the tax on the costs that climate change imposes on Americans.

The federal gasoline excise tax would be increased from 18.3 to 30 cents per gallon in 2016 and would be adjusted for inflation (as measured by the chained CPI) in subsequent years. The tax increase would restore solvency to the Highway Trust Fund.

CONCLUSION

Due to transition relief associated with the move to the X tax, our plan initially reduces revenue, and increases debt, relative to current policies, before setting the debt-to-GDP ratio on a declining path. The actual budgetary impact could be even more favorable than shown in the above estimates because they do not account for the increase in GDP likely to result from the move to consumption taxation and the reduction in transfer payments to the elderly.

There are no easy solutions to the country's fiscal crisis and further delay will only make the decisions harder. Fiscally sound policy will require greater self-reliance, but does not require us to turn our backs on the elderly and the less fortunate. Our proposal narrows the fiscal imbalance, limits the size of government, and adopts a more growth-friendly tax code. Although these policies will require difficult choices, they will ensure a vibrant economy and fiscal stability, now and in the future.

Percentage of GDP	2026	2040
Revenues	19.3	21.2
Spending	21.8	22.5
Deficit (-)/ Surplus (+)	-2.5	-1.4
Debt Held by the Public	76.7	62.7

MEMORANDUM

TO: The 45th President and 115th Congress

FROM: Joe Antos, Andrew Biggs, Alex Brill, and Alan Viard[1]

DATE: January 1, 2017

SUBJECT: A Balanced Plan for Fiscal Stability and Economic Growth

Introduction

Our plan seeks to achieve long-term fiscal stability and promote economic growth by aligning federal spending and revenue and pursuing market-based policy reforms. The plan limits the national debt to approximately two-thirds of annual GDP in 2040.

The plan emphasizes cuts in the major entitlement programs—Social Security, Medicare, Medicaid, and health insurance subsidies—but still ensures those less fortunate are protected. The plan increases revenue above its recent historical average share of GDP while switching to a consumption tax that allows additional revenue to be raised without hampering economic growth.

Top Three Policy Recommendations

Make Health Care Programs More Efficient

Incentives, rather than controls, would be used to promote greater efficiency while allowing patients and their health care providers to make the best individual decisions within a responsible budget framework. All subsidies would be reformulated to provide greater support to those with greater financial need or higher health risks.

Medicare would be converted to a premium support plan, providing a subsidy to beneficiaries who would choose from among competing health plans. Those selecting more expensive plans (including traditional Medicare) would be responsible for any premium amount above the subsidy.

Federal matching payments for Medicaid would be replaced with block grants, enabling states to manage their Medicaid programs more efficiently and eliminating the incentive to draw more federal funds without

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necessarily providing more or better services. The tax exclusion for employer-provided health insurance would be replaced by a refundable health insurance tax credit providing a fixed dollar subsidy. Subsidies for lower-income individuals who buy insurance through the exchanges would be converted to a block grant to underwrite state-level subsidy programs for private insurance.

Better Target Social Security

The current Social Security benefit formula would be replaced with a flat dollar benefit for all retirees, disabled persons, and survivors, regardless of their earnings history or labor force attachment. The benefit would initially be set at the elderly poverty threshold, but would thereafter be indexed to wage growth. To supplement this flat benefit, workers would be automatically enrolled in employer-sponsored retirement plans with a default contribution of 3 percent of earnings, split evenly between the worker and employer.

The early retirement age would gradually increase from 62 to 65 and the 12.4 percent Social Security payroll tax would be eliminated for all workers age 62 and older. "Experience rating" would be instituted for the employer share of the disability insurance (DI) payroll tax, which would give employers the incentive to provide accommodations to workers with disabilities in order to keep them on the job.

Switch to a Growth-Friendly Consumption Tax

The individual and corporate income taxes and the estate and gift tax would be replaced by the Bradford X Tax, a progressive consumption tax. The X tax consists of a flat-rate, firm-level tax on business cash flow and a graduated-rate household-level tax on wages and fringe benefits.

For married couples, the first $80,000 of taxable earnings would be taxed at 15 percent, the next $160,000 of earnings would be taxed at 25 percent, and earnings above $240,000 would be taxed at 35 percent (bracket ranges would be half as large for unmarried taxpayers). Households would be allowed a nonrefundable credit of $1,000 for each adult and $500 for each dependent. There would be no standard deduction or personal exemptions. An earned income tax credit and credits for charitable contributions, health insurance, mortgage interest payments (on mortgages of up to $250,000), and deductions for child care costs and large employee business expenses would be permitted.

Business firms' cash flow would be taxed at a flat rate of 37 percent. Firms would immediately expense (rather than depreciate over a period of years) all investment, including equipment, structures, land, and inventories. Business tax preferences, except a reformed and permanent research tax credit, would be abolished.

Conclusion

The health care proposal caps federal subsidies for insurance, promotes effective competition and innovation in the health sector, reduces regulatory burden, and develops better consumer information. Subsidies in all federal health programs would be made more progressive, helping those who most need the help. Such policies will provide strong incentives for the private sector to develop new ways to deliver care that improve efficiency and lower the cost per unit of service. Spending reductions are substantial, requiring beneficiaries to shoulder more of the cost of their health care. However, health system improvements are expected to maintain quality of care and access to essential services.

The Social Security proposal protects low earners, is more conducive to saving and longer work lives, and better aligns the work and retirement conditions that will prevail in the coming decades. That will make Social Security solvent and sustainable while reducing program outlays to better accommodate rising costs for other priorities.

The tax proposal increases saving and promotes long-run economic growth by removing the marginal tax penalty on new saving and investment. Because no household-level tax is collected on interest, dividends, capital gains, or other income from savings, there is no household-level penalty on saving. And there is no net business-level tax on a marginal new investment because the tax savings that firms receive from immediately deducting investment costs fully offsets the present value of the taxes on the investment's subsequent cash flows.

Fiscally sound policy will require greater self-reliance, but does not require us to turn our backs on the elderly and the less fortunate. Our proposal narrows the fiscal imbalance, limits the size of government and adopts a more growth-friendly tax code. Although these policies will require difficult choices, they will ensure a vibrant economy and fiscal stability, now and in the future.

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