MEMORANDUM

TO: The Administration and Congressional Leaders

FROM: Joseph Antos, Andrew Biggs, Alex Brill, James Capretta, and Alan Viard

DATE: June 11, 2019

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 one-half of annual GDP in 2049.

The plan emphasizes cuts in the major entitlement programs—Social Security, Medicare, Medicaid, and health insurance subsidies—while continuing to protect those less fortunate. The plan raises the same revenue (in present discounted value across the thirty-year horizon) as the current law baseline, resulting in a revenue level above historical averages, as a share of GDP. The plan reforms the income tax by broadening the base and reducing statutory rates to promote 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. The eligibility age would be gradually increased to 67.

Federal matching payments for Medicaid would be replaced with per capita allotments, enabling states to manage their Medicaid programs more efficiently and eliminating the incentive to draw more federal funds without necessarily providing more or better services. The tax exclusion for employer-provided health insurance would be capped and partially replaced by a refundable health insurance tax credit providing a fixed dollar subsidy.

Better Target Social Security

The current Social Security benefit formula would be replaced with a flat dollar benefit for all retirees and widow(er)s, 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 DI payroll tax, which would give employers the incentive to provide accommodations to workers with disabilities to keep them on the job.

Reform the Tax System

The tax system would be reformed to promote economic growth. Over the 2019–2049 period, revenue would be the same (in present discounted value) as under the current-law baseline.

The individual income tax provisions of the Tax Cuts and Jobs Act slated to expire at the end of 2025 would be permanently extended, with modifications. All individual income tax rates would be lowered by approximately 5 percent across the board from their TCJA values. The corporate income tax rate would be kept at 21 percent. The individual and corporate income tax bases would be broadened by reforming or eliminating ill-designed tax preferences, with transition relief for taxpayers who have relied on current tax laws. The municipal bond interest exclusion, the mortgage deduction, the remaining state and local tax deduction, the medical expense deduction, the pass-through business income deduction, and a variety of business tax preferences would be repealed.

The estate and gift tax would be repealed, but unrealized capital gains (above a threshold amount) would be taxed at death. The 3.8 percent net investment income tax would be repealed. A carbon tax would be adopted to replace the Clean Power Plan and other climate-related regulations. The gasoline tax would be increased.

ADDRESSING SHORTER-TERM ISSUES

Our plan addresses the major long-term fiscal policy challenges facing the country. Other issues should also be addressed, including the following:

- Discretionary caps. The 2011 Budget Control Act enacted nominal dollar caps on discretionary spending for FY 2013 to FY 2021. Congress raised the caps for FY 2013 through FY 2019. The caps do not apply to funding for Overseas Contingency Operations and certain other discretionary programs. Our plan assumes that discretionary spending will equal the levels in the current-law baseline, which assumes that the current caps remain in place through 2021 and that funding for programs not covered by the caps grows with inflation.
- Debt ceiling. The debt ceiling has failed to constrain federal spending and would be repealed.
- Expiration of tax cuts for individuals in the Tax Cuts and Jobs Act. As discussed above, the individual tax cuts would be permanently extended, with modifications that broaden the income tax base and reduce statutory rates.

- Exhaustion of the Highway and Hospital Insurance Trust Funds. The gasoline tax would be increased, which would extend the life of the Highway Trust Fund. Similarly, our health proposal would set Medicare on a sustainable fiscal path.

CONCLUSION

The health care proposal caps federal subsidies for insurance and makes them more progressive, promotes effective competition and innovation in the health sector, reduces regulatory burden, and develops better consumer information. 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. The tax proposal broadens the base and lowers statutory tax rates to provide a more neutral and growth-friendly tax system and replaces inefficient regulations with a carbon tax.

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.

A BALANCED PLAN FOR FISCAL STABILITY AND ECONOMIC GROWTH

American Enterprise Institute[1]

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

INTRODUCTION

The objective of our plan is to achieve long-term fiscal stability and promote economic growth. Under our plan, publicly-held federal debt is projected to equal 48 percent of annual GDP in the year 2049, one-third of the 147 percent of annual GDP projected under the current-law baseline. Achieving that goal requires ambitious reductions in the growth of federal spending (relative to the rapid increases under current law). The plan emphasizes cuts in the major entitlement programs—Social Security, Medicare, Medicaid, and the health insurance subsidies established by the Patient Protection and Affordable Care Act (PPACA). The plan reforms the tax code to reduce economic distortions and disincentives while raising the same revenue (in present discounted revenue across the thirty-year horizon) as the current law baseline.

Our plan supports economic growth by reducing transfer payments to the elderly, reforming the income tax system through rate reduction and base broadening, and replacing environmental subsidies and regulations with a carbon tax.

Our plan maintains economic opportunity by protecting core safety net provisions while adopting a more growth-friendly tax system that will provide future generations with higher living standards. The earned income tax credit for childless taxpayers will be doubled.

Many of the policies will undoubtedly be 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. Political opposition to the plan can be overcome by helping people across the ideological spectrum recognize that its balanced approach makes it superior to alternative plans that rely on extreme tax increases or extreme spending cuts. At least some aspects of the income tax base broadening and rate reduction have the potential to attract broad, bipartisan support, as those provisions have appeared in previous bipartisan deficit reduction plans.

1 The views expressed here are solely those of the authors and do not reflect the position of the American Enterprise Institute or any other organization.

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 unnecessarily restrict 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 principles and budget realities. The new policies offer better ways to achieve the major objectives of PPACA, such as creating an organized marketplace for insurance, providing better information to consumers, expanding federal insurance subsidies for those most in need, and preserving protections for persons with pre-existing conditions.

Social Security. Our proposed Social Security reforms are 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 upcoming decades. These changes 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. Our proposed tax reforms broaden the income tax base while lowering statutory tax rates, providing a more neutral and growth-friendly tax system. To address environmental concerns in a more market-oriented manner, the proposal replaces an array of energy subsidies, tax credits, and regulations with a carbon tax.

Our plan 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. 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 plan 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 in the greatest need. Such policies will provide strong incentives for the private sector to develop new ways to deliver care that improve efficiency and lower costs 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. Our cost estimate assumes growth in total Medicare spending would be 1.9 percentage points slower than under current law. Premium support is effective starting in 2022.

Other reforms would address longstanding problems in traditional Medicare. Medicare's eligibility age would be increased gradually to 67, consistent with Social Security. The basic premiums for Medicare Part B and Part D would increase from 25 percent to 40 percent of each program's cost, phased in over 10 years. Premiums would be based on enrollees' lifetime earnings rather than their current annual incomes. 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. 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 to 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 per-capita allotments eliminates this perverse incentive and permits states to manage their Medicaid programs more efficiently. Increased efficiency in the health sector would provide additional savings, but federal Medicaid costs would still grow about 20 percent faster than the economy

Federal subsidies to states would be restructured to encourage states to expand Medicaid eligibility to everyone up to 100 percent of the federal poverty level. 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 would be allowed to 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. As part of our revenue proposal, the tax exclusion would be capped and partially 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 risks. That change would eliminate the current system's incentive to purchase more expensive coverage and its favoritism toward higher-income purchasers. In addition, PPACA's subsidies would be restructured to compensate insurers for reducing cost-sharing requirements for low-income enrollees in exchange plans on the condition that premiums are reduced. That would reduce premium subsidies for eligible enrollees while leaving them no worse off. Some of the savings would be made available to states to promote more competitive insurance alternatives.

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 stifles 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

Our plan would 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 would 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 and widow(er)s, 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 long-run tax burdens. To give workers more time to plan for retirement, 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.

Our plan addresses 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 an incentive to provide accommodations to workers with disabilities 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.

Defense and Non-Defense Discretionary

Defense and nondefense discretionary spending would be maintained at their current-law baseline levels. The baseline already incorporates significant reductions in these spending categories as a share of GDP. Although further reductions would be welcome if they can be attained without endangering national security and other vital national objectives, we believe that it would be unwise to rely on such reductions. Instead, our plan emphasizes changes to mandatory spending and revenues, which drive the long-term fiscal imbalance.

Other Mandatory

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

REVENUES

Recognizing the costly health and welfare burdens imposed by an aging population, revenue would rise to 19.9 percent of GDP in 2049 under our plan. Over the 2019-2049 period, revenue would be equal (in present discounted value) to its level under the current-law baseline. Although revenue would be somewhat above the historical average, it would remain below the disturbingly high levels that would be necessary if current spending policies were left unchanged. We propose revenue-neutral tax reform to minimize the harm that the tax system imposes on long-run economic growth.

The provisions of the Tax Cuts and Jobs Act slated to expire at the end of 2025 would be permanently extended, with modifications. Tax changes would take effect in 2020 unless otherwise noted.

Individual Income Taxes

The 10, 12, 22, 24, 32, 35, and 37 percent statutory rates set forth in the Tax Cuts and Jobs Act would be lowered by approximately 5 percent across the board. The new rates would be equal to 9.5, 11.4, 21.0, 22.9, 30.5, 33.4, and 35.3 percent. The individual alternative minimum tax would be repealed.

The standard deduction would be repealed; all allowable deductions would be above the line. Zero-bracket amounts would be established as follows, for 2020 (and inflation-indexed thereafter): $10,000 for singles, $15,000 for heads of households, and $20,000 for married couples, plus an additional $2,000 for a blind single or head of household taxpayer and an additional $1,500 for each married blind taxpayer. The child tax credit would be reduced to $1500 in 2020 and would be inflation-indexed thereafter. The credit would be refundable to the extent of 15 percent of the excess of the taxpayer's earned income over $2,500. There would be no income-based phase-out of the credit.

Tax relief would be provided for costs of earning income, including child care costs, moving expenses, and employee business expenses. The earned income tax credit for childless taxpayers would be doubled.

Corporate Income Taxes

The corporate income tax rate would remain at 21 percent to ensure that the United States remains an attractive investment location. The restrictions on loss deductions adopted by the TCJA would be repealed, removing penalties on risky investment. The mercantilist Foreign Derived Intangible Income provision and the arbitrary Base Erosion and Anti-Abuse Tax would be repealed, averting potential violations of tax and trade treaties.

Tax Expenditures

Individuals. The remaining deduction for nonbusiness state and local taxes would be repealed. The mortgage interest deduction would be repealed, with grandfathering for mortgages outstanding on June 11, 2019. The Lifetime Learning and American Opportunity tax credits would be repealed, but half of the resulting revenue gain would be used to increase Pell grant funding. The deduction for student loan interest would be repealed, with grandfathering for loans outstanding on June 11, 2019. All energy-related individual tax expenditures would be repealed. Charitable contributions would be deductible for all taxpayers to the extent that contributions exceed a floor of $500 ($1,000) for single (married couples) in 2020, with inflation indexation in subsequent years.

The exclusions of employer-provided transportation benefits, employer-provided life insurance, and employer-provided accident and disability insurance would be repealed. The excise tax ("Cadillac tax") imposed by the Affordable Care Act on high-cost health insurance offered by employers would be repealed, but the income and payroll tax exclusions for employment-based health insurance would be capped at the 50th percentile of premiums. The medical expense deduction would be repealed.

Social Security benefits would be fully taxable. The exclusion for interest on municipal bonds would be repealed; interest on bonds outstanding on June 11, 2019 would be grandfathered. All tax credit bonds would be eliminated, effective for bonds issued after June 11, 2019.

Businesses. For investments placed in service on or after June 11, 2019, 50 percent bonus depreciation would be allowed according to the bonus depreciation rules defined in TCJA.

The LIFO conformity rule would be repealed, allowing all businesses to use LIFO on their tax returns, regardless of their financial accounting decisions.

State and local employer payroll taxes would not be deductible. The work opportunity tax credit would be repealed. All business energy tax expenditures would be repealed, including percentage depletion. The exemption of credit union income and the special Blue Cross/Blue Shield deduction would be repealed. The rehabilitation tax credit would be repealed for projects started after June 11, 2019. There would be no new allocations of low income housing tax credits after June 11, 2019. The qualified opportunity zone provisions would be repealed, effective for contributions to qualified opportunity funds made after June 11, 2019.

The section 199A deduction for qualified business income would be repealed.

Other Sources

Employer-provided health insurance and other fringe benefits would be subject to 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.

Subsidies for ethanol and other alternative fuels would be abolished (except for 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 2020 at a level of $25 per metric ton of CO2 equivalent, increasing thereafter by inflation plus 2 percent per year.

The federal gasoline excise tax would be increased by 15 cents per gallon in 2020 and the tax rate would be indexed to infrastructure construction prices in subsequent years. Excise taxes adopted by the Affordable Care Act would be repealed.

Percentage of GDP	2019	2029	2049
Revenues	16.5	18.0	19.9
Spending	20.7	19.8	20.4
Deficit	-4.1	-1.7	-0.6
Debt Held by the Public	78.2	73.4	48.3

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-oriented tax code. Although these policies will require difficult choices, they will ensure a vibrant economy and fiscal stability, now and in the future.