

# AMERICAN ACTION FORUM

## MEMORANDUM

TO: The Administration and Congressional Leaders

FROM: Douglas Holtz-Eakin and Gordon Gray

DATE: June 11, 2019

SUBJECT: Balanced

## INTRODUCTION

The debt currently stands at nearly 80 percent of the economy and is projected to grow inexorably, promising a future debt crisis at worst or an economic millstone at best. The economy has seen substantial improvement in the last two years, but its long-term health remains unsure. Meanwhile, policymakers must come to grips with the reality of growing security threats from near-peers, while existing threats from international terrorism and other quarters persist. Addressing any one of these challenges would be a signal policy accomplishment, but the hard reality that all policymakers must recognize is that each of these challenges must be met. The nation's fiscal problem threatens the standard of living of future generations, while an unsure economic outlook undermines a sustainable fiscal trajectory. Global security threats must also be confronted, as the risks of inaction can vastly outstrip the pecuniary costs of resourcing this challenge. Our budget plan seeks to balance these needs and challenges.

## TOP THREE POLICY RECOMMENDATIONS

### *Tax Reform*

The Tax Cuts and Jobs Act (TCJA) marked a substantial improvement in the U.S. tax code, but tax reform remains unfinished. The reconciliation process used to enact the TCJA left a number of important tax provisions as temporary, while the 10-year budgetary cost worsened an already poor fiscal outlook. A lasting reform would build on the best elements of the TCJA and reform those that could be improved. Specifically, our plan would reinstate the income tax rates that prevailed prior to the enactment of the TCJA but retain other key elements of the individual tax reforms.

The business tax outlook would be substantially improved under this plan, with the current provision for expensing of equipment expanded and made permanent. The corporate rate would be further reduced

to 20 percent. Most substantially, the plan would reform the current patchwork of base-erosion and other international tax provisions to a destination-based cash flow tax. This reform would obviate the complex international tax regime that adds needless complexity and harms U.S. competitiveness.

### **Entitlement Reform**

The primary causes of our growing debts have been largely untouched by past deficit-reduction efforts. Discretionary spending, reduced by the Budget Control Act, and tax revenue are not driving debt. Mandatory spending and interest payments are driving debt. Mandatory spending has been growing as the nation ages, health costs grow, and policymakers create new entitlements and expand old ones. In 1974, mandatory spending was 41 percent of the budget. By 2029, it will be 65 percent. Meanwhile, interest payment on the debt will continue to crowd out the budget as the debt portfolio remains oversized 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.

### **Addressing Global Threats**

Commenting on the collision of budgetary constraints and national security risks, former Secretary of Defense Robert Gates once observed that “math [is] not strategy.” Nothing has changed in the interim. To the extent that the United States has achieved deficit reduction in recent years, it has largely been borne by defense and non-defense discretionary spending cuts. These cuts have come while the United States has needed to improve its defense posture against high-end threats from near-peer nations with a force that has been grappling with two major and long-term counterinsurgency campaigns. The nation’s military forces require recapitalization to meet these new challenges while addressing existing threats.

## **ADDRESS SHORTER-TERM ISSUES**

This budget plan will eliminate the “sequester” and remove the biannual threat of across the board spending cuts on discretionary funding. It assumes the debt limit is routinely raised to accommodate borrowing needs. The plan will substantially improve the outlook for Medicare, affording the opportunity to continue to finance benefits under a reformed system. Critically, our plan substantially reduces the debt, providing fiscal “space” for countercyclical policies and geopolitical crises. Our plan also assumes that outlays under the Highway Trust Fund are allowed to keep pace with the Congressional Budget Office’s current-law projections.

## **CONCLUSION**

The United States must address three key policy changes: a poor budget outlook, an unsure economic outlook, and growing security threats. These challenges are interrelated, and over the long term the solutions are complimentary. The combined policies in our plan are politically challenging, but they offer significant fiscal consolidation that is broadly pro-growth and afford the capacity to address a challenging national security environment.

# AMERICAN ACTION FORUM

## BALANCED

### American Action Forum

Douglas Holtz-Eakin and Gordon Gray

## INTRODUCTION

The United States currently faces three substantial challenges: unsustainable debt, a modest growth trajectory, and a difficult global security environment. Over the long term, addressing the debt challenge will remove a significant future risk to the economic outlook. The magnitude of the fiscal consolidation needed to place the federal budget on a sustainable course, however, will involve policy choices that are difficult and, all else being equal, may impose costs to the economy. The goal of the American Action Forum plan is to impose these policies efficiently, while recognizing that the scope and scale of the budgetary challenge requires enacting policies that would not have been considered even just a few years ago. Against this backdrop, the United States must also contend with new and varied security threats that will require a significant investment in new capabilities while maintaining the capacity to resource existing missions.

This plan 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 also recognizes the practical reality that the Affordable Care Act (ACA) is the law of the land but can still be improved. 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 significantly improves long-term economic growth.

## SPENDING

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

In general, the plan focuses on cost containment to the federal government and slowing the growth of per-person health spending while raising the value of healthcare and recognizing that the basic architecture ACA is here to stay. This plan retains the ACA's coverage provisions, but it incorporates substantial reforms

to Medicaid and reinstates the cost-sharing reduction and reinsurance regime that ceased under the current administration.

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 ACA). 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, among other more modest changes to federal health programs, should also further constrain cost growth.

### **Social Security**

In its most recent report, the board of Trustees that oversees the Social Security program confirmed that the nation's primary safety net for retirees, survivors, and the disabled remains in financial distress. The report proves that, absent reform, the program will fail to meet its promises to future seniors. The report estimated that the combined (retirement and disability) Social Security Trust Funds will be bankrupt by 2035, at which point retirees would see their benefits reduced by 20 percent.

Avoiding these sharp benefit reductions is an essential element of any meaningful Social Security reform. This plan assumes a combination of policy changes that would address the structural imbalance in Social Security over the long term. Specifically, the plan would move to price indexing in the calculation of benefits, means-test benefits for higher-earning beneficiaries, and incorporate chained CPI. The plan would also reform the Disability Insurance benefit formula for the calculation of work history and place the program on a more sound structural footing.

### **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. The plan also provides additional defense funding to meet the growing challenges of the global security environment. 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.

### **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, Supplemental Security Income, 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 the Supplemental Nutrition Assistance Program. Over 10 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. Conversely, enforcing existing immigration policies

would have a detrimental budgetary and economic effect, requiring an increase in federal spending of 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 enforcement would shrink the labor force by 11 million workers and reduce real gross domestic product by \$1.6 trillion.

## REVENUES

### *Individual Income Taxes*

Beginning in 2020, this plan assumes a reversion of pre-Tax Cuts and Jobs Act (TCJA) income tax rates. All brackets are indexed by chained CPI (CCPI)—consistent with other elements of reform on the spending side of the budget and current law. The tax plan preserves the current-law structure of the standard deduction, and the elimination of personal exemptions and other tax preferences.

The only credits allowed would be: a new credit of 15 percent of charitable contributions in excess of \$500, indexed at CCPI, 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 plan would eliminate the AMT and the HI and NIIT taxes from the ACA, and extend TCJA estate, gift, and GST provisions. The plan would implement carryover basis for bequests after 12-31-2019.

### *Corporate Income Taxes*

The plan would eliminate the newly imposed international tax regime and implement a destination-based cash-flow tax consistent with the House Blueprint for Tax Reform. The plan would also reduce the statutory corporate tax rate from 21 percent to 20 percent. The plan would allow for the immediate expensing of all new investment. The plan would eliminate all excise taxes, fees and penalties from the ACA, except for the excise tax on high-cost health insurance plans, which would be allowed to enter into force.

### *Tax Expenditures*

The AAF tax plan would replace the 199A deduction with a 25 percent rate cap on active business income and enforce the 70/30 rule consistent with the House Blueprint for Tax Reform.

The AAF tax plan would eliminate the deduction of net interest expense for new loans.

### *Other Sources*

The AAF plan would make two other important tax changes: It would increase the payroll-tax cap to capture 90 percent of earnings and would implement a carbon tax. The carbon tax would impose a \$20 per metric ton tax on CO<sub>2</sub> and would increase by C-CPI-U + 5 percent each year.

All tax proposals unless otherwise noted are assumed to occur in 2020.

## CONCLUSION

The AAF plan seeks to address the nation's policy priorities—substantial fiscal consolidation, robust economic growth, and a strong national defense. It achieves balance by 2036—reflecting the difficulty in balancing the need for significant debt reduction, while ensuring there is an adequate safety net in place. It begins deficit reduction immediately but relies on the gradual accrual of savings in mandatory spending programs to achieve most of the savings proposed under this budget. The plan continues the reform

effort begun with the TCJA to make the tax code a more efficient means of collecting sufficient revenue to fund the nation’s priorities. The tax changes in this plan, including the repeal of certain elements of the TCJA, a new carbon tax, and an increase in the payroll tax cap, would increase revenues above current law. These changes, all else equal, would have a negative effect on economic growth. The scope and scale of the nation’s fiscal, demographic, and national security challenges, however, are such that some additional revenue will be required to balance these priorities. The plan relies heavily on reforms to major health entitlement programs, which are the principal drivers of our long-term fiscal challenge. The plan proposes significant reforms to Social Security to ensure it is in place for future generations. It 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 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 and improve long-term economic growth. According to estimates from the Tax Policy Center, this plan would increase annual GDP growth on average by almost four-tenths of a percentage point over the budget window—over three decades of meaningfully higher growth. This budget represents a practical approach to constraining the growth in government that also recognizes that the nation’s competing policy priorities will require difficult tradeoffs.

Percentage of GDP	2019	2029	2049
Revenues	16.9	19.0	20.6
Spending	20.8	20.6	18.9
Deficit (-)/Surplus	-3.8	-1.5	1.7
Debt Held by the Public	78.1	72.5	24.2