American Action Forum
“Balanced”
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INTRODUCTION

Unless Congress and the Administration act, in January of 2013, a fiscal contraction in excess of $600 billion will occur. This so-called “fiscal cliff” stems primarily from the expiration of current tax policies and scheduled across the board spending reductions. Given the large federal debt levels and their even more daunting projected increases, some find such an automatic contraction appealing.

Unfortunately, these scheduled tax increases and spending reductions are so large and sudden that the combined effect would likely spell recession for the United States economy. The simplest approach to avoiding the economic distress would be to simply extend all expiring tax relief measures, and forestall all spending reductions.

Unfortunately, the United States faces a dual challenge. Avoiding the fiscal cliff does dodge a recession, but the fiscal challenge confronting the United States is daunting and failure to address it in a credible way would likely generate alternative negative economic effects through higher interest rates. Indeed, the Congressional Budget Office has noted this compound challenge in addressing the fiscal cliff: “eliminating or reducing the fiscal restraint scheduled to occur next year without *imposing comparable restraint in future years* would reduce output and income in the longer run relative to what would occur if the scheduled fiscal restraint remained in place.” It is therefore necessary to pair any mitigation of the fiscal cliff with meaningful budget restraint in future years.

FIVE PRIORITIES FOR CONGRESS AND THE PRESIDENT

1. **Moving Beyond the Current Tax Debate**

The scheduled expiration of the 2010 tax extension will bring tax policy into immediate focus for the next Congress. Looking past the current tax code, there is wide agreement that the U.S. corporate tax is an international outlier and in need of reform. However, the proliferation of pass-through businesses suggests that a corporate tax reform approached in isolation of the broader tax code may be too narrow in scope, and possibility induce further distortion.

There is broad consensus that the corporate rate is too high – that consensus does not persist in a discussion of the individual rates. To the extent that coordinating the individual and corporate tax policy debate is necessary, a progressive consumption tax would afford that opportunity while retaining the progressivity that has animated that president’s approach to existing tax policy. A wholesale reform could be approached beyond the sclerosis of any tax policy debate that is a zero-sum game for certain constituencies, induce needed pro-growth reforms, while addressing revenue considerations as part of a larger budget reform. This effort would necessarily include transition relief.

2. **Sequestration: Reprioritizing Federal Spending**

As in the first priority related to tax reform, the second priority for the next congress is a permanent replacement of the scheduled sequesters. The sequester has been widely acknowledged as poor policy – a failed "stick" to induce more substantive reforms that the "Super-Committee" ultimately failed to deliver. The sequester is heavily biased towards discretionary cuts, and further still towards defense reductions that, following initial defense cuts, would materially damage U.S. readiness. Across the board reductions in domestic discretionary spending are poorly conceived.

3. **Revisiting the Affordable Care Act**

As noted above, the looming fiscal cliff requires immediate attention to addressing expiring tax law and scheduled, largely discretionary spending cuts. Addressing those priorities narrowly is not feasible in light of other budgetary challenges, and must therefore be addressed in concert with other elements of the federal budget. No area of federal expenditure is in greater need of reform than the nation's health programs.

Changes to health programs face steep political hurdles, which is why they remain sufficiently unreformed as to remain on perilous financial trajectories. However, no meaningful approach to at once address the fiscal cliff and fiscal sustainability can be successful without such changes.

4. **Addressing Retirement**

It has been nearly 30 years since the last major Social Security Reform. Social Security is now running perpetual cash-flow deficits. As such, despite claims to the contrary, Social Security is currently contributing to federal budget deficits and has done so since 2010. The Combined Trust Funds will exhaust in 2033, 3 years earlier than last year's projection. More daunting, the 21 years until Fund exhaustion is the shortest since 1982, when the programs were facing immediate solvency challenges. Absent reform, Social Security revenue will fund only 75 percent of promised benefits in 2033.

5. **Reorienting the Social Safety Net**

This plan reaffirms the need for a social safety net – a series of federal assistance programs to support and encourage productive enterprise, and provide assistance to needy families. These programs are not the primary causes of the nation's fiscal challenges. However, that should not preclude needed reforms to better rationalize and target federal assistance programs.

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, 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. In terms of budgetary effects of specific policy changes, this repeal is effectively a wash. $95 billion of the estimated $107 billion in increased deficits associated with a repeal are the result of off-budget effects entirely unrelated to health programs.

Instead, the plan would take the approach of beginning with cost containment. 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 health care 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).[1] 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 should introduce additional cost savings throughout the health sector. 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. It would not achieve this balance within the ten-year budget window, nor even by 2037. To do so would require higher payroll taxes that run afoul of other competing policy objectives or benefit reductions incompatible with the stated objective of Social Security reform.

Defense and Non-Defense Discretionary

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. 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 grown at GDP thereafter.

Other Mandatory

Reform of these programs would see the major income and family support reapportioned 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

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

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.

REVENUES

The plan includes a progressive consumption tax in the style of David Bradford's X-tax and built on a recent proposal 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 noncorporate. 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 first $50,000; 25 percent on next $100,000; and 35 percent over $150,000. Brackets for all unmarried taxpayers are half these amounts. All brackets indexed after 2013 by chained CPI – 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 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 for: a new credit of 15 percent of charitable contributions in excess of $500 (indexed by CCPI after 2013) and a new refundable credit for first-time homebuyers (as defined for the ARRA 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.

We would also provide for an increase in the gas tax to cover projected shortfalls in the Highway Trust and Fund.

The goal of this plan is to average 18.9 percent over the first ten years– or about the average amount of revenue recouped in the year the U.S. last ran a surplus and the preceding 4 years. Revenues would continue to rise as a percent of GDP in the future. This plan incorporates a five percent, across the board rate reduction beginning in 2023. To the extent revenue continues to increase and surpass outlays, additional rate reduction should be pursued.

CONCLUSION

This approach seeks to address conflicting policy goals – the need for near-term aversion of the fiscal cliff coupled with long-term debt stabilization. Relative to current law – which assumes the fiscal cliff will occur – this plan will *increase* deficits in the near-term by precluding scheduled major tax increases and spending reductions. However, over the long term, through a combination of reforms, deficits are reduced to below one percent of GDP, well below the necessary threshold to diminish debt as a share of the economy. 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 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 gradual 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.

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Percent of GDP	2022	2037
Revenues	19.4	21.2
Spending	21.8	18.8
Deficit (-)	-2.4	2.4
Debt held by the public	71.7	40.1