BIPARTISAN POLICY CENTER

Bipartisan Policy Center
Domenici-Rivlin Debt Reduction Task Force Plan 2.0
Senator Pete Domenici and Dr. Alice Rivlin

INTRODUCTION

In 2010, the Bipartisan Policy Center (BPC) convened a Debt Reduction Task Force (DRTF) of 19 former elected officials and experienced citizens with diverse backgrounds from across the political spectrum. We co-chaired the task force with the goal of addressing the projected explosion of U.S. federal debt. As we released our report, the National Commission on Fiscal Responsibility and Reform, led by former Sen. Alan Simpson and former White House Chief of Staff Erskine Bowles, also delivered their plan.

These bipartisan groups came to similar conclusions: First, the present debt trajectory of the United States federal government cannot be sustained and poses grave dangers to the American economy; second, policymakers must make difficult decisions to get our fiscal house in order; and third, any realistic solution must include structural reforms to entitlements and fundamental tax reform that raises significant new revenue.

These bipartisan proposals have increased awareness of the nation's severe fiscal problems. Further, Congress has passed components of these plans into law – most notably, the caps on annually appropriated spending contained in the Budget Control Act of 2011. But much work remains and that is why we are updating our proposals and renewing our effort with the release of Domenici-Rivlin 2.0.

No debt reduction plan can be sustained without strong and steady economic growth. The financial crisis caused a protracted economic downturn, and unemployment remains unacceptably high. We continue to believe that the economy needs additional near-term support. To that end, we recommend an immediate, large income tax rebate, similar in structure to those used in 2001 and 2008, to spur economic activity by putting money into the pockets of those most likely to spend it. Importantly, while we believe lawmakers must agree to a debt reduction plan in 2013, many of the provisions ought to be phased in over time as employment and economic growth return to more typical levels.

FIVE PRIORITIES FOR THE 113TH CONGRESS AND THE PRESIDENT [1 page]

1. **Use Medicare's leadership to accelerate the transition from fee-for service reimbursement toward rewarding quality and positive health outcomes throughout the health care system.** We currently face immense budgetary pressures from the combination of rising per-capita health care spending and an aging cohort of baby boomers. To reduce the growing pressure on all budgets — federal, state/local, business, and household — we must control the growth of health care spending. Fee-for-service reimbursement, which dominates health care delivery, rewards volume of services rather than quality and effectiveness, and it leads to waste, duplication, and poor coordination of care. As the country's largest health care payers and spending drivers, Medicare and Medicaid urgently need reform and could help transform the whole health care system.

Our proposal for Medicare (described in more detail below) improves the cost effectiveness of traditional Medicare through innovations in reimbursements and other incentives while strengthening competition among comprehensive, integrated health plans. Increasing competition and reducing government overpayments – using Medicare Advantage (MA) as a vehicle (through the application of competitive bidding among traditional Medicare and private MA plans) – can produce savings, while simultaneously improving quality and preserving the Medicare guarantee.

2. **Reform the corporate and individual tax codes by eliminating or curbing nearly all tax expenditures, lowering marginal rates, and raising significant new revenues for deficit reduction, while maintaining progressivity.** Every plausible route to long-term fiscal sustainability includes substantial additional revenue. At the same time, however, we can reform the tax code to spur economic growth through a simpler system that stops picking winners and losers. The relevant Congressional committees should build broad, bipartisan support around such a reform.

3. **Promote short- and medium-term economic growth through an income tax rebate.** Long-term fiscal sustainability requires reforming and cutting government spending programs, raising additional revenues, and spurring the economy to create more jobs and increase investment. Near-term growth can be boosted through a wide array of policies, but few of them are likely to garner bipartisan support in the current polarized environment. We believe that an income tax rebate, similar in structure to those implemented in 2001 and 2008, could appeal to both parties and be effective. This one-time rebate, which should be similar in size to the expiring reduction in the payroll tax, will boost consumption and investment to accelerate the recovery. Of course, this and any other policies that add to the short-term deficit should be paired with a long-term debt reduction agreement rather than be enacted in isolation.

4. **Pass a balanced package of policies that achieves sustainable Social Security solvency.** Social Security reform should not be approached from the vantage point of deficit reduction but rather with the goal of securing and strengthening a critical safety net for future generations. Without adjustments, the program will soon reach a point at which benefits must be slashed across the board or large transfers from general funds will be required. Accordingly, both parties in Congress should work with the president to adjust benefits and enhance revenues to set the program back on sound financial footing.

5. Improve the oversight and efficiency of federal expenditures by reforming the congressional budget and oversight process. Between mandatory or "entitlement" programs and tax expenditures – spending through the tax code – roughly three-quarters of all federal spending runs on autopilot with no periodic review. The budget process must establish a long-term spending trajectory for each such component and regularly evaluate whether actual spending exceeds those benchmarks. If it does, automatic adjustments should take effect unless Congress and the president enact legislation to replace them. Additionally, we recommend a regular, systematic analysis by Congress of each area of discretionary spending to identify those programs that deserve reauthorization and those that can be made more efficient. For example, analysts from across the political spectrum have called for reform of procurement within the Department of Defense. These periodic reviews will improve the effectiveness and accountability of government.

SPENDING

The only realistic way to close the gap between how much the federal government spends and how much it collects is to reduce outlays and increase revenues. On the spending side, in addition to structural reforms to the major health entitlement programs, this requires sensible adjustments to nearly all discretionary and mandatory spending programs. Although we recommend that policymakers enact these changes as soon as possible, they should not take effect until 2014 or later so as not to damage the fragile economic recovery.

Domestic Discretionary. The Budget Control Act of 2011 (BCA) already imposed ten years of caps on this category of spending – reductions that are roughly consistent with the restraint recommended by our original Task Force plan. We do not feel that any additional cuts to this area would be prudent.

Defense. Similarly, the BCA also established ten years of caps on defense spending similar to the DRTF proposal. Experts from across the political spectrum believe that the procurement and retirement components of the U.S. defense budget require major reforms. We agree on the need for these changes, and believe that they can produce some additional savings from the Department of Defense. We do not believe, however, that they will provide major additional deficit reduction.

Health Care. Most of the nation's long-term fiscal imbalance is the result of unsustainable growth in health care costs. The federal government must play a significant role in health system change, not only to reduce budget deficits, but to help restrain the growth in health care costs and improve health care quality system-wide.

The centerpiece of our Medicare reform proposals is the Domenici-Rivlin Protect Medicare Act, which would establish competition on the basis of quality and price between traditional Medicare and Medicare Advantage plans. Public and private plans would compete in a well-regulated Medicare Exchange where the cost and quality of all plans would be presented clearly to beneficiaries. The federal contribution would be based on the cost of the second-least expensive plan or traditional Medicare, whichever is less expensive, and the growth of the per-beneficiary federal support would be capped at GDP + 1%. (Under current law, however, CBO projects costs to grow, on average, more slowly than that rate for the next two decades, in which case the cap would not come into play. In fact, we are confident that competition will save more than the cap would in the long run, and that the cap therefore will never bind.) The competition among plans could be introduced as part of a reform of Medicare Advantage. Efficiency in the private sector will be encouraged by slowly phasing out the tax exclusion for employer-provided health benefits. This tax expenditure, in addition to being regressive, encourages expensive plans with inefficient cost-sharing, helping to drive unsustainable growth in health care costs.

We also propose a variety of reforms to Medicare, Medicaid, and other federal health programs to encourage greater efficiency, quality and consumer protections. In Medicare, we would modernize the benefit structure to have uniform cost-sharing and, for the first time, implement an out-of-pocket maximum to protect beneficiaries from catastrophic costs. We would end first-dollar supplemental coverage, increase Part B premiums over five years from 25% to 35% of total program costs, and use Medicare's buying power to reduce the program's drug costs. We would bundle Medicare payments for post-acute care to encourage care coordination and reward efficiency. In addition to deficit reduction, these cost savings could permanently replace the Sustainable Growth Rate (SGR) formula for Medicare physician payments.

We propose two major changes to Medicaid federal-state financing. We would replace the current matching funds system, in which the federal and state governments split the cost of care for different beneficiaries at different rates, with a single, blended rate for each state that would automatically rise in times of recession and decline in times of growth. We would bar states from gaming the system to collect matching funds based on provider taxes, which are invariably returned to the providers after the states spend the federal matching dollars.

Our other proposals improve parts of the health system where costs are particularly high. To address public health and the rising costs of obesity, we would establish a two cents per ounce excise tax on sugary beverages. We would cap medical liability awards for noneconomic damages and launch large-scale tests, including safe harbors for following professional guidelines and administrative claims processing systems. We would accelerate savings in the Medicare home health program and reduce special Medicare payments that cover bad debts, graduate medical education, and rural hospitals, all of which will benefit from expanded coverage from the Affordable Care Act. We would increase TRICARE premiums and drug copayments. We would limit Medicaid reimbursement for durable medical equipment to Medicare rates. Finally, we would crack down on "pay for delay" agreements that restrict access to generic drugs and shorten the exclusivity period for brand name biologics.

Other Mandatory Spending. Many other programs run on autopilot, with no recurring oversight by Congress. We propose reforms listed below to constrain the growth of these programs and improve their effectiveness:
Implement a package of farm program reforms; adjust the age at which career military can retire to be consistent with federal civilian retirement; reform civilian retirement by calculating benefits based on a retiree's annual salary from his or her highest five years of government service, and increase employee contributions to the defined retirement benefit to be more consistent with the private sector; raise fees for aviation security; actuarially adjust flood insurance subsidies for risk; adopt a more accurate inflation measurement to calculate cost-of-living-adjustments (COLAs) for all federal programs; cease production of dollar bills and the one-cent piece, while increasing production of dollar coins; index mandatory user fees to inflation; restructure the power marketing administrations to charge market rates; sell non-hydropower Tennessee Valley Authority electric utility assets to private investors; gradually lower the conforming loan limits for Fannie Mae and Freddie Mac and increase the fees they charge; reform the Postal Service; and sell unneeded federal property.

Social Security. Our balanced package of policies achieves sustainable solvency, prevents the program from adding to the deficit in the coming decades, and, even more importantly, preserves and strengthens it for future generations. Changes include:
Gradually raise payroll taxes to cover 90 percent of all wages; use a more accurate calculation of annual COLAs (which applies to all indexed programs, including the tax code); implement modest additional means testing for high-income beneficiaries; increase the minimum benefit; index the benefit formula for increases in life expectancy; and cover newly-hired state and local workers under Social Security.

REVENUES

BPC's Tax Reform Plan radically simplifies the current tax code and raises approximately $1.6 trillion more than current policy (which is $2.9 trillion less than current law, with the expiration of all temporary tax cuts). To best explain it, forget what you know about the complex current tax system, and start fresh. Outlined below are the core elements of the plan. Unless otherwise indicated, all changes are implemented beginning in 2014.

- A **two-bracket income tax with rates of 15 percent and 28 percent**. Because there is no standard deduction or personal exemption, the 15-percent rate applies to the first dollar of income.[2]

- The **corporate tax rate will be a flat 28 percent**, instead of the current 35 percent top rate.

- Capital gains and dividends will be taxed **as ordinary income** (**with a top rate of 28 percent**), excluding the first $1,000 of realized net capital gains (or losses).[3]

- To replace the overly-complex Earned Income Tax Credit (EITC) and the personal exemptions, the standard deduction and the child credit, the BPC Plan will:
    - Establish a flat **refundable per child tax credit of $1,600** (higher than current law);
    - Retain the **child and dependent care credit**; and
    - Establish a **refundable earnings credit**[4] similar in structure to the recent Making Work Pay credit, but substantially larger.

- Instead of the current system of itemized deductions, which disproportionately subsidizes the housing and charitable giving of upper-income taxpayers, the BPC Plan will:
    - Provide a **flat 15-percent refundable tax credit for charitable contributions** and for up to $25,000 per year (not indexed) **mortgage interest on a primary residence**. (These refundable credits would begin at 20 percent in 2014, and then phase down to 15 percent over five years.)
    - Eliminate the deduction for state and local taxes.

[2] The 28% rate applies approximately to income above $51,000 for single filers and $102,000 for couples.
[3] $500 for singles and heads of household
[4] The refundable earnings credit is equal to 17.5% of the first $20,000 of earnings.

- Provide a flat, **15-percent refundable tax credit** or a deduction (for those in the higher bracket) **for contributions to retirement savings accounts** up to 20 percent of earnings or a maximum of $20,000.

- Include 100 percent of Social Security benefits in taxable income, but:
  - Create a non-refundable credit for Social Security beneficiaries equal to 15 percent of the current standard deduction; and
  - Create a non-refundable credit equal to 15 percent of an individual's Social Security benefits.

- Effective in 2015, cap and then phase out over 10 years the tax exclusion for employer-sponsored health insurance benefits.

- Limit the deduction for medical expenses to the amount exceeding 10 percent of adjusted gross income (AGI) (unchanged from current law).

- Limit miscellaneous itemized deductions to the amount exceeding 5 percent of AGI (increased from 2 percent in current law).

- Increase the gas tax by 15 cents and index it to inflation, dedicating the revenue to the highway trust fund.

- Increase taxes on cigarettes and alcohol.

The BPC Tax Reform Plan enormously simplifies the tax code by **aligning the top individual, capital gains and dividend tax rates with the significantly-reduced corporate tax rate, while eliminating the Alternative Minimum Tax**. Additionally, **most individuals will no longer have to file an annual tax return**[5] beyond an initial declaration of status because the most commonly taken deductions are either converted into refundable credits, determined solely based on the number of children and earnings, or can be deducted only above a substantial floor. Despite a low top rate of 28 percent, the BPC tax system will increase progressivity and will **raise the requisite revenue to achieve our debt-reduction goal.**

CONCLUSION

This updated BPC Domenici-Rivlin deficit reduction plan addresses the nation's fiscal problem in a balanced and workable way. Our plan shows that the challenge can be met if lawmakers demonstrate leadership and put everything on the table. The changes we suggest are not easy, but they improve the quality and efficiency of government and strengthen the economy for all Americans.

[5] According to Tax Policy Center projections, only 50% of tax units would be required to file tax returns, as opposed to 88% under the current tax system.

The experience of BPC fellows and staff – former elected officials, cabinet secretaries, business leaders, senior congressional staff members, and senior executive branch officials – informs our recommendations, which also benefit from the work of the Congressional Budget Office and other experts. But despite literally millions of words deployed on analysis, legislative proposals, and recommendations, the policy changes to achieve fiscal sustainability and strengthen the American economy have not yet been made.

The nation needs substantial fiscal reforms no later than the first session of the 113th Congress. BPC has proposed a legislative framework to be enacted this year to facilitate a 2013 agreement, which could be similar to the Domenici-Rivlin proposal. To provide the time lawmakers need to reach a comprehensive agreement, the fiscal cliff (automatic spending cuts and tax increases scheduled to take effect in January 2013) should be replaced with a more realistic backstop that would guarantee $4 trillion in deficit reduction if Congress fails to act by the end of 2013. The framework limits procedural delays and removes supermajority requirements that could prevent an agreement. To show good faith, Congress should add to the framework a combination of initial spending cuts and revenue increases that offset part of the cost of addressing the fiscal cliff.

Time is running out. The election is over. The options are clear. Now our leaders must show the courage to take risks and make hard decisions, and the American people should support those who do. We stand ready to help.

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Percent of GDP	2022	2037
Revenues	20.9	22.6
Spending	22.3	25.0
Deficit (-)	-1.5	-2.4
Debt held by the public	67.2	64.2