AMERICAN ACTION FORUM

UNBALANCED

American Action Forum

Douglas Holtz-Eakin

Introduction

The American Action Forum (AAF) plan begins with the premise that time is quickly running out on the nation's capacity to forestall a potential debt crisis. Under successive administrations and Congresses, U.S. debt has grown such that its mere carrying costs will exceed defense spending—this year. To be sure, the nation's accumulation of debt has often been the result of unique crises or the combination of multiple challenges. That policymakers never do the hard work of fiscal consolidation when circumstances allow is the fundamental reason why the United States is at risk of failing to meet the challenges of the future.

The AAF plan reduces the debt relative to gross domestic product (GDP), permitting fiscal room to respond as needed and sending the message to global capital markets that the United States will be successful in managing its finances.

The AAF plan makes immediate and sweeping changes to the nation's major health and retirement programs. There is a cottage industry in Washington, D.C., dedicated to quibbling over which party, president, or Congress is more responsible for America's indebtedness. That question is irrelevant to this exercise, as the programs that will guarantee a future debt crisis are essentially the decades-old major entitlement programs. The political lesson of recent decades is that these programs are inviolate—but this consensus must be upended if the country is to meaningfully address its debt challenge.

A rapid fiscal consolidation can pose challenges for the economy. Accordingly, this plan focuses substantially on transfer payments and reorients the tax code to be more pro-growth. To the extent that what was once a long-term debt challenge has now become a near-term threat, meaningful fiscal consolidation should have positive effects on economic growth, especially compared to an alternative in which the nation's unsustainable debt challenge is left unaddressed. The consequences of a sovereign debt crisis would be catastrophic for global economic growth. The most vulnerable Americans would be disproportionally affected by the ensuing economic crisis and a fiscal consolidation imposed by circumstance. This plan recognizes that avoiding this future is not only critical to overall growth but reflects a need to spare the nation's vulnerable from such a scenario.

Spending

Medicare, Medicaid, and Other Federal Health Programs

In general, the AAF plan recognizes that the primary drivers of future debt accumulation are the nation's major health and retirement systems, and any meaningful fiscal consolidation must substantially and materially reform these programs. They simply cannot be sustained in their current form. According to the most recent report from the Trustees of the Medicare program, the Hospital Insurance (HI) Trust Fund will be exhausted in 2036 and unable to finance full benefits for seniors. Medicaid remains an open-ended budgetary commitment that fails patients and taxpayers.

The AAF plan focuses on cost containment to the federal government and slowing the growth of per-person health spending. This plan retains the Affordable Care Act's (ACA's) coverage provisions, but it incorporates substantial reforms to Medicaid. This plan would establish per-capita limits on the federal commitment to Medicaid. Market forces and competition are leveraged to reform the Medicare program and yield necessary and timely budgetary savings. Under the AAF plan, traditional fee-for-service (FFS) Medicare would be reformed and priced as a Medicare option with a market-based premium based on current Medicare FFS expenditures. This market-priced Medicare option would then compete with Medicare Advantage. The central tenet of Medicare market reform is that by introducing competition among private insurers, premiums may more accurately reflect costs and quality of care. To make this competition balanced, the plan establishes a quality metric in Medicare FFS comparable to the Medicare Advantage Stars program. In addition, the plan allows additional versions of market-priced Medicare FFS where Part D prescription drug coverage and Medigap supplemental coverage can be added. 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 shows that the financial outlook for Social Security will fail to meet its promises to future seniors in the absence of meaningful reform. The report estimates that the combined (retirement and disability) Social Security Trust Funds will be exhausted by 2035. The Trustees Report makes clear the program's structural imbalance puts the retirement benefits of millions of working Americans at risk.

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 the Chained Consumer Price Index (C-CPI-U).

Defense and Nondefense Discretionary

The overall trend of discretionary spending in the AAF plan hews to the discretionary baseline, which reflects the imposition of spending caps under the Fiscal Responsibility Act. The plan also provides additional defense funding to meet the growing challenges of the global security environment. For the first decade under the AAF plan, defense and related outlays rise commensurate with annual additional appropriations consistent with the security supplemental pending before Congress. In the latter two decades, this additional defense spending phases down to more modest additions. 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.

Other Mandatory

The AAF plan also includes limitations to spending on agriculture programs, as well as additional savings from federal student loan programs. Critically, the plan assumes a fundamental immigration reform. On net, such a reform would reduce the deficit and have a positive effect on economic growth. Conversely, enforcing existing immigration policies would have a detrimental budgetary and economic effect, requiring a substantial increase in federal spending on the order of half a trillion dollars to deport those unlawfully present and prevent future unlawful entry into the United States.

Revenues

Individual Income Taxes

Beginning in 2025, the AAF plan assumes a reversion of pre-Tax Cuts and Jobs Act (TCJA) income tax rates. All brackets are indexed by C-CPI-U, 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 $500 (indexed at C-CPI-U) 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 five years of ownership. The existing mortgage interest deduction would be phased out for existing mortgages over 10 years.

The plan would eliminate the alternative minimum tax, the additional Medicare tax, and the net investment income tax from the Affordable Care Act, and extend TCJA estate, gift, and generation-skipping tax provisions. The plan would implement carryover basis for bequests.

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 allow for the immediate expensing of all new investment. The plan would eliminate the new and unworkable corporate alternative minimum tax as well as the tax on stock buybacks enacted as part of the Inflation Reduction Act. One key challenge confronting the international tax landscape is the implementation of the Organisation for Economic Co-operation and Development's proposed Pillar 1 and Pillar 2 frameworks. The AAF plan assumes a diplomatically negotiated exit from these regimes.

Tax Expenditures

The AAF tax plan would replace the Section 199A deduction with 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 CO2 and would increase by C-CPI-U + 5 percent each year.

All tax proposals unless otherwise noted are assumed to occur in 2025.

Conclusion

The AAF proposal contains sweeping changes to both the outlay and revenue sides of the federal budget and accomplishes the feat of reducing debt relative to GDP. The success of these spending reforms combined with revenues—raised in a pro-growth fashion—that are two full percentage points of GDP higher permits essentially eliminating annual deficits and reducing the debt to the pre-pandemic range. The basic lesson of these results is that the current fiscal outlook for the United States is extraordinarily dangerous and requires dramatic action on both sides of the budget to be rectified.

Percentage of GDP	2024	2034	2054
Revenues	17.5	18.4	19.7
Spending	23.1	21.3	20.1
Deficit (-) or Surplus	-5.6	-2.9	-0.4
Debt Held by the Public	99.0	94.8	67.0