A BALANCED PLAN FOR FISCAL STABILITY AND ECONOMIC GROWTH

American Enterprise Institute[1]

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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 85 percent of GDP in 2054, a substantial reduction from the projected 166 percent of GDP 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 savings 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 30-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. We provide additional funds to maintain and strengthen the country's defense capabilities in light of growing threats to peace around the world.

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.

Many of the policies will undoubtedly be politically challenging, 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 such an approach has 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.

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 healthcare. However, health system improvements are expected to maintain quality of care and access to essential services.

Medicare reform. Despite strong enrollment growth in comprehensive private health plans under Medicare Advantage, nearly half of all Medicare beneficiaries receive care under a traditional fee-for-service program that offers little incentive to patients or providers to hold down costs. Medicare 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.

Other reforms address longstanding problems in traditional Medicare. Medicare's eligibility age would be increased gradually to 67, consistent with Social Security. Medicare's benefits under Part A, Part B, and Part D would be combined and traditional Medicare's cost-sharing arrangements would be simplified. An annual out-of-pocket limit of $8,500 would apply to covered services. Incentives for Medicare beneficiaries to drop those Medigap plans that eliminate nearly all cost-sharing would be offered to promote cost awareness.

Medicare premiums currently cover 25 percent of the cost of Part B and Part D and require higher premiums from enrollees with higher incomes. The reform increases premiums to cover 30 percent of the cost of all Medicare-covered services (including Part A). The premium structure would be progressive, with premiums based on enrollees' lifetime earnings rather than their current annual incomes.

These reforms would permanently ensure solvency of the Hospital Insurance Trust Fund.

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.

Federal subsidies to states would be restructured to encourage them 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.

Enhanced premium subsidies for PPACA exchange plans would lapse in 2025 and not renewed.

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. 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 universal enrollment in workplace retirement plans. Workers whose employers did not offer a retirement plan at work would be enrolled in a defined contribution retirement plan similar to the Thrift Savings Plan offered to federal employees.

The core element of the reform is a means-tested benefit that would be paid to all retirees and widow(er)s, regardless of their earnings history or labor force attachment. The benefit would equal 28 percent of the national average wage for single retirees and 41 percent of the average wage for couples.[2] The benefit would be adjusted to provide greater support for lower-income retirees. To supplement this basic benefit, workers would be automatically enrolled in employer-sponsored retirement plans with a default contribution initially set at 3 percent of earnings, split evenly between the worker and employer. The default contribution would gradually rise to 10 percent of wages. Assuming savings earn the Trust Fund bond rate of return, these accounts would provide a retirement income equal to roughly half of the employee's final earnings, which would be supplemented by the minimum benefit. 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.

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.

To maintain Social Security solvency without increases in tax rates or additional reductions in Social Security benefits, we allow the trust funds to borrow from the general fund during years when they would otherwise be depleted, and then to repay the borrowed funds in future years when the reforms included in this plan produce more savings. A variety of research concludes that the tax preference does little to increase total retirement

2 The couples' benefit is less than twice the benefit for a single retiree because of economies of scale from two people living together.

savings, with the benefits of the tax preference accruing principally to higher-income households that are at little risk of inadequate incomes in old age.

The OASDI trust fund balance would deteriorate for several years, but eventually would become permanently solvent. The figures presented here assume that, during any years in which the trust funds are exhausted, general revenues are borrowed to pay benefits as scheduled under the Social Security reforms outlined herein.

Defense and Nondefense Discretionary

Given increased threat levels, defense discretionary spending is increased above current-law baseline levels in the near term. Nondefense discretionary spending is maintained at baseline levels. Note that the baseline incorporates significant reductions in these spending categories as a share of GDP, which may prove to be unattainable. Our plan emphasizes changes to mandatory spending and revenues, which drive the long-term fiscal imbalance.

Revenues

Recognizing the costly health and welfare burdens imposed by an aging population, revenue would rise to 18.8 percent of GDP in 2054 under our plan. Over the 2024–2054 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, relative to current law, to minimize the harm that the tax system imposes on long-run economic growth.

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

Individual Income Taxes

The 10, 12, 22, 24, 32, 35, and 37 percent statutory rates set forth in the TCJA would be reduced to four brackets and the rates set to 10, 20, 30 and 35. The individual alternative minimum tax would be repealed.

Interest income would be taxed like dividends and capital gains, zero percent for those in the first two tax brackets and 20 percent for those in the 30 or 35 percent bracket. The 3.8 percent tax on net investment income would be repealed. Tax-preferred savings accounts would be simplified and consolidated in a revenue-neutral manner.

The standard deduction would be repealed and replaced with a credit, $1,500 for singles and $3,000 for married filing jointly; all allowable deductions would be above the line.

Charitable contributions would be deductible for all taxpayers to the extent that contributions exceed a floor of $500 for single filers and $1,000 for married couples filing jointly, with inflation indexation of the floor in subsequent years.

The child tax credit would be set to $1,500 and would be inflation-indexed. The $2,500 income threshold would be eliminated, thereby increasing the generosity of the credit for low-income households. There would be no income-based phase-out of the credit. The Earned Income Tax Credit for childless taxpayers would be doubled. The maximum Child and Dependent Care Credit would be expanded to $6,000 for one child and $12,000 for two or more children while the credit rate would be reduced to 15 percent and made refundable.

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 May 13, 2024. 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 May 13, 2024. All energy-related individual tax expenditures would be repealed.

The exclusions of employer-provided health insurance, transportation benefits, employer-provided life insurance, and employer-provided accident and disability insurance would be repealed. 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 May 13, 2024, would be grandfathered. All tax credit bonds would be eliminated, effective for bonds issued after May 13, 2024.

Corporate Income Taxes

The corporate income tax rate would be reduced from 21 percent to 20 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.

Businesses. For investments placed in service on or after May 13, 2024, 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. Net interest expense would be limited to 50 percent of such costs and the current limitations on interest deductibility would be repealed.

Amortization of research and development costs will be repealed, thereby permitting immediate expensing of these costs, as was the law prior to the TCJA. The Foreign Derived Intangible Income provision and the Base Erosion and Anti-Abuse Tax would be repealed.

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 Rehabilitation Tax Credit would be repealed for projects starting after May 13, 2024. There would be no new allocations of low-income housing tax credits after May 13, 2024. The qualified opportunity zone provisions would be repealed, effective for contributions to qualified opportunity funds made after May 13, 2024.

Other

The estate and gift tax, including the generation-skipping tax, would be repealed, for gifts made, and decedents dying, on or after January 1, 2025. However, capital gains would be realized at death, subject to an exemption amount of $2 million (indexed for inflation), payable over time with interest.

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

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 2025 at a level of $25 per metric ton of CO_2 equivalent, increasing thereafter by inflation plus 2 percent per year.

The federal gasoline excise tax would be increased by 15 cents per gallon in 2025 and the tax rate would be indexed to infrastructure construction prices in subsequent years.

Conclusion

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.

Percentage of GDP	2024	2034	2054
Revenues	17.5	17.9	18.8
Spending	23.1	22.3	19.4
Deficit (-) or Surplus	-5.6	-4.4	-0.6
Debt Held by the Public	99.0	105.6	84.6