BIPARTISAN POLICY CENTER

PUTTING AMERICA BACK ON TRACK: A BIPARTISAN APPROACH TO FISCAL POLICY SOLUTIONS

Bipartisan Policy Center

Bill Hoagland, Shai Akabas, Jason Fichtner, Tim Shaw, Jack Rametta

INTRODUCTION

The United States is at a fiscal tipping point. Total federal public debt outstanding has reached $22 trillion, greater than the nation's gross domestic product (GDP). Even excluding intragovernmental debt—that is, debt owed by the government to itself—federal debt is on track to exceed the size of the economy within 10 years and to be more than double the size of the economy by 2049 under realistic assumptions. Rising federal debt is fueled by rising annual deficits, reflecting a systematic imbalance between the government's spending and revenues. According to the Congressional Budget Office (CBO), $1 trillion deficits will return as soon as this year.

Mandatory spending programs—which make up the vast majority of the federal budget and include Social Security, Medicare, Medicaid, and others—largely run on autopilot and are consuming a growing share of federal revenues, crowding out needed public investments in important areas like education, science, and infrastructure. Interest payments on the federal debt, which provide little direct benefit to most taxpayers, are projected to approach $1 trillion by the end of the next decade, at which point they would far exceed total defense spending.

With the recent implementation of the 2017 Tax Cuts and Jobs Act (TCJA), CBO estimates that tax revenues will hover around 18 percent of GDP by the end of the decade, while spending will reach 23 percent of GDP and continue to climb thereafter. Thus, with each passing year, the deficit and the national debt will continue to increase.

The health of the U.S. economy will be severely damaged if we do not fundamentally alter the current trajectory of federal debt. Not only does public debt crowd out private investment that spurs economic growth, but at some point, bondholders may become concerned about the federal government's commitment and ability to repay all of its debts without devaluing the dollar. The only way to get our fiscal house in order is for federal policymakers to weigh competing priorities and make difficult decisions.

Further delaying the tough choices will only require much larger and more painful changes in the future. In fact, by ignoring past warnings to fix our fiscal problems, we have lost the opportunity to make small tweaks to mandatory spending and the tax code, that when combined with modest growth could have addressed this challenge.

The Bipartisan Policy Center has long been concerned with the unsustainable trajectory of our nation's debt, caused by a lack of action on both the spending and revenue sides of the budget equation. From the time BPC started the Domenici-Rivlin Debt Reduction Task Force in 2010, our stance has been clear: the United States finds itself on an unsustainable fiscal trajectory because the cost of our entitlement programs—especially health and Social Security—are not aligned with the revenue brought in by our tax code.

We believe the plan we offer here will course-correct the nation's fiscal path and bring spending and revenues more in line, while maintaining business competitiveness, creating a level and fair playing field for all Americans, and investing in critical areas that will grow the economy. It is a balanced plan that stabilizes debt as a share of the economy at around 85 percent of GDP, effectively bending down the debt curve over the next several decades to a sustainable level.

Any plan to address our nation's serious fiscal problems will have to be bipartisan. While policymakers may disagree with individual pieces of our plan, BPC believes that the hard choices of the type recommended here are the only path forward to ensuring our country continues to prosper well into the 21st century.

BPC's plan tackles the debt through three main avenues:

1. Tax reform and enhancements to revenue streams that cover spending in particular areas
2. Gradual changes to major social insurance programs, namely Social Security and Medicare
3. Other bipartisan reforms that restrain spending and grow the economy.

Specifically, BPC's plan would enhance economic growth by:

1. Streamlining the tax code
2. Increasing investments in domestic programs, such as infrastructure
3. Facilitating disaster recovery by bringing such spending "on budget"
4. Establishing a carbon tax to internalize the negative externalities associated with carbon and to spur innovation in sustainable green or renewable energy technologies.

SPENDING

Modernizing and Enhancing Social Security

Social Security is often described as the third rail of American politics. Touch it and you die. But contrary to this popular cliché, policymakers have no choice but to address the structural imbalance in Social Security's finances. If they refuse to do so soon, the consequences will surely be worse when the program's trust funds become depleted, potentially causing millions of retirees to face immediate benefit cuts. Luckily, reform is not only possible, but could even be popular, if action is taken soon. BPC's Social Security proposal includes a balanced set of policies to improve the program's benefit structure and reduce spending growth, described here, and to increase dedicated revenues, which are described in the Revenues section.

When the Social Security program—originally designed as old-age insurance—was first enacted, American society was different in a variety of ways. For instance, the majority of families were single-earner households, and there were several times as many workers paying into the program as beneficiaries drawing out. Today, things are quite different. Family structure has largely shifted to favor dual-earner households as women have entered the labor force, and life expectancy has significantly increased.[1] Other issues with the benefit structure are also apparent, such as the reduction in household income when one spouse passes away, and the diminishing work incentives as people near retirement age.

BPC's plan systematically addresses these challenges, and brings Social Security into the 21st century. We propose the following:

- Establish a Basic Minimum Benefit to enhance Social Security and replace Supplemental Security Income for beneficiaries with low incomes.
- Index the full retirement age to account for ongoing increases in longevity, gradually increasing the age over decades.
- Significantly enhance survivor's benefits by allowing surviving spouses to receive 75 percent of their deceased spouse's benefit in addition to their own.
- Base cost-of-living adjustments on the chained consumer price index, a better measure of inflation.
- Make the benefit formula more progressive, and in a similar vein, limit the spousal benefit (which provides outsized benefits to higher-earning, non-working spouses).
- Calculate benefits using annual, rather than averaged, income to incentivize work and reward longer careers by counting more years in the benefit formula.

These changes would improve Social Security's solvency while enhancing the adequacy of the program for those who rely on it most and improving equity and fairness in the system. The changes recommended here are adapted from the final report of BPC's Commission on Retirement Security and Personal Savings.[2] Pairing a Social Security package with changes to law that help millions of additional Americans save for retirement through their workplace would make the reforms more palatable and politically feasible.

Discretionary Spending

The levels of annually appropriated spending allowed under the Budget Control Act's sequester caps are too low. They do not allow the U.S. to adequately fund the readiness of its armed forces nor to make important investments in science, health, education, and infrastructure. Neither public investments nor national security should be sacrificed in the name of fiscal responsibility when the primary drivers of our debt are on the mandatory side of the budget. For these reasons, we propose to allow defense and nondefense discretionary spending to increase at the rate of inflation, rather than implementing further cuts in the coming years.

That said, there are plenty of necessary reforms to discretionary spending. For example, BPC proposes to eliminate the perpetual reliance on the Overseas Contingency Operations fund, which some have referred to as the "Pentagon slush fund." BPC also proposes several other defense reforms that would produce efficiencies and savings, including: a new round of Base Realignment and Closure; reforms to TRICARE to expand access and reduce costs; and modernizing the Department of Defense's civilian personnel systems and business practices. Importantly, BPC would put half of the resulting savings toward deficit reduction and reallocate the other half to other defense priorities. This approach retains savings but increases the political viability of these efficiencies.

1 Notwithstanding slight decreases in average life-expectancy over the last few years.

2 https://bipartisanpolicy.org/wp-content/uploads/2016/06/BPC-Retirement-Security-Report.pdf

On the nondefense side, BPC proposes a significant increase in spending to enhance the nation's crumbling transportation infrastructure. This new spending is paid for in BPC's plan by a one-time increase and indexing of the federal gas tax. Yet, with rising fuel efficiency and electric vehicle ownership, gas tax increases cannot sustainably meet expected long-term infrastructure needs. New, innovative funding mechanisms[3] are necessary to support these needs down the road.

Immigration Reform

BPC has long recognized that immigration reform in the United States is decades past due. Among the benefits of a modernized immigration system would be enhanced economic growth, an improved fiscal status for the federal government, and a policy approach that upholds both the integrity of the system and the dignity of the people in it. To reflect BPC's support for reform, our proposal includes the so-called "Gang of 8" immigration bill from 2013 in the package of recommendations. This plan represented a serious bipartisan effort to balance the need for comprehensive legal immigration reforms with legalization of the undocumented and enhanced border security. BPC's immigration project continues to develop policies that would achieve similar goals and meet the current political realities and challenges on the border.

Other Mandatory Spending

Disaster spending is likely to increase in the coming years and the federal government should be prepared. Ad hoc allocations for natural disasters have provided much-needed relief, but in the face of climate change, the government must plan more comprehensively for disaster spending. As such, BPC proposes bringing disaster spending "on budget" and using new revenue from a carbon tax, described in the Revenue section, to fund these relief and recovery efforts going forward.

BPC also proposes to reform housing finance along the lines of the Housing Finance Reform and Taxpayer Protection Act of 2014. The act would completely overhaul government sponsored enterprises Fannie Mae and Freddie Mac, winding them down and then replacing them with a system of paid-for federal guarantees of the timely payment of principal and interest to investors in "eligible" mortgage-backed securities. Additionally, BPC's plan includes reductions to agriculture subsidies and reforms to the nation's crop insurance program.

Federal Health Programs

Federal health care programs are expected to grow faster than any other non-interest spending category over the next two decades. An aging population, rising utilization, and climbing health care prices have put Medicare's finances on an unsustainable path. Because Medicare is such a major player in the health care sector, changes to the program can encourage system-wide health care improvement. Thus, BPC's Future of Health Care Initiative is actively reviewing reforms to improve value and outcomes, and reduce costs, in the American health care system.

Reforms to Medicare could address several longstanding challenges and appeal across the political aisle. Some reforms under consideration by the Initiative, and included in this plan, include: implementing site-neutral payment policy; a reduction in Medicare's coverage of bad debt; prohibiting anti-competitive "pay-for-delay" drug agreements; reforms to reduce costs and improve coverage in Medicare Part D; and policies to address the ongoing obesity epidemic.

Further, there is interest in methods to combat market consolidation and promote competition in currently non-competitive insurance markets. Our plan suggests that the Federal Trade Commission use the

3 https://bipartisanpolicy.org/wp-content/uploads/2016/05/BPC-New-Infrastructure-Model.pdf#page=58

Herfindahl-Hirschmann Index—an existing measurement of market concentration—to encourage price competition and provide regulatory relief in highly consolidated markets. This model could spark business creativity, increasing value to consumers in the health care system overall.

We recognize that these changes alone would not be expansive enough to rein in health care costs, nor to cope with the myriad policy issues in the health care space. But reforms like these could be first steps toward broader, comprehensive reforms that partisans on both sides agree will be necessary in the coming years.

REVENUES

Under any realistic scenario, funding the federal government in the coming decades will require more revenue than is projected under current law. To the extent possible, however, new revenues should be tied to specific priorities, such as payroll taxes to shore up Social Security or a carbon tax to address climate change. BPC's tax plan also recommends several important changes to the tax code, and in total, would increase revenue from 16.6 percent to 20.0 percent of GDP by 2049.

The plan redesigns the federal income tax code to make it simpler, fairer, more progressive, and more efficient. We start by extending the individual tax provisions contained in the TCJA indefinitely, with some adjustments to marginal tax rates and bracket thresholds.

Further, we recognize that the statutory burden of a tax can be different from the economic burden, and that the corporate income tax is passed along to Americans either in the form of lower returns on capital, lower wages, or higher prices. However, to the extent that the distribution of the corporate income tax falls more heavily on owners of capital, who tend to have higher incomes, an increase in the corporate tax rate would be both simple to implement and be borne by those most likely to be able to withstand the burden of additional taxes. Therefore, BPC proposes a 4-percentage point increase in the corporate tax rate to 25 percent, near the average among developed countries. This increase would still represent a 10-percentage point reduction from the pre-TCJA baseline and allow U.S. companies to remain competitive in the global economy.

We propose to lower the exemption level for the estate tax from the current level of $11.4 million per individual to $2.5 million for singles and $5.0 million for couples. Marginal estate tax rates, including the top 40 percent rate, would remain unchanged. These changes would begin in 2020, and the exemption thresholds would be indexed to inflation thereafter.

To fund the nation's infrastructure investment needs, BPC proposes to increase the gasoline tax to $0.334 per gallon and the diesel tax to $0.394 per gallon beginning in 2020, with those rates indexed to inflation thereafter. Additionally, BPC proposes a new carbon tax. We would implement a tax on carbon, and all greenhouse gases, at $25 per ton in 2020 and then increase that levy at a real (inflation-adjusted) 2 percent per year. This tax serves the dual purpose of recognizing the real and growing threat of climate change and providing sufficient revenues to bring federal disaster spending "on-budget."

BPC would replace the standard deduction, the Earned Income Tax Credit, and the child tax credit with a refundable per-child tax credit of $1,750 and a refundable earnings credit worth 17.5 percent of the first $21,900 of earnings (adjusted for inflation in future years). Such a reform would make the tax system fairer, simpler, more efficient, and less burdensome for taxpayers and easier for the IRS to administer. This reform would also significantly increase wage subsidies for childless moderate-income workers, who are largely excluded from the existing constellation of tax expenditures. Further, BPC proposes to convert both the home mortgage interest deduction and the deduction for charitable contributions into a 20 percent nonrefundable credit, phased down to 15 percent over five years. Both of these credits would be capped at $25,000 per year, adjusted for inflation. BPC also suggests allowing individuals to deduct miscellaneous itemized expenses, but only if they are in excess of 5 percent of adjusted gross income (AGI), rather than the previous 2 percent threshold, and medical expenses in excess of 10 percent of AGI, compared to the 7.5 percent threshold today.

Under current law, employer-sponsored health insurance premiums are excluded from the taxable income of employees. The Affordable Care Act's "Cadillac tax" effectively limits this exclusion by imposing an excise tax of 40 percent on plans that exceed certain costs, but this tax has never been allowed to take effect. Our plan includes a repeal of the Cadillac tax, replacing it with a limit on the income-tax exclusion for employer-provided health benefits.

To improve the finances of the Social Security system, BPC proposes several policies to increase revenues. First, we would raise the payroll tax rate by 1 percentage point (to 13.4 percent) over the course of 10 years (by 0.1 percentage points per year) beginning in 2020. Additionally, BPC proposes to increase the taxable maximum wages covered by Social Security to $210,000 over three years (reaching that amount in 2022), and then indexed to the average wage index plus 0.5 percentage points thereafter to maintain the tax base in the face of growing wage inequality.

Lastly, for the highest-income beneficiaries, we propose subjecting all Social Security benefits to taxation. Beginning in 2022, single/head-of-household/married filing-separately taxpayers with AGI of more than $250,000 and joint filers with AGI of more than $500,000, would have 100 percent of Social Security benefits included in taxable income, up from 85 percent currently. In subsequent years, these thresholds would be updated for growth in wages.

The tax code is also an important instrument to support and encourage people to save for retirement. Thus, for younger workers, we recommend replacing the Saver's Credit with a Starter Saver's Match that would match contributions to an individual retirement arrangement (IRA) or workplace retirement plan on a dollar-for-dollar basis up to a maximum of $500 per year ($1,000 for joint filers). The match would phase out between $25,000 and $30,000 of AGI for single filers and between $50,000 and $60,000 of AGI for joint filers. The existing Saver's Credit would continue to be available for workers aged 36 and older. Unlike the Saver's Credit, the Starter Saver's Match would be fully refundable.

Finally, our plan also focuses on administration and implementation of the tax system, an issue that is too often overlooked in discussions of tax policy. For example, Congress has chronically underfunded the IRS, reducing its budget in real terms by more than 15 percent since 2010. The lack of staff and resources hinders the agency's customer service and enforcement abilities alike. For example, underfunding has resulted in longer telephone wait times for taxpayers seeking assistance and only 0.5 percent of all returns audited in 2016. BPC therefore recommends additional funding for the IRS to adequately support customer service initiatives and properly administer the tax system to reduce the tax gap and ensure compliance with the tax code, as well as several changes to the tax administration system to improve efficiency.

CONCLUSION

Without action soon, the risk of a fiscal crisis will rise dramatically. We can no longer ignore the nation's debt problem and punt the tough fiscal decisions to the next generation.

BPC's plan tackles the fiscal challenge head on, establishing a sound and responsible fiscal policy by increasing revenues, constraining spending growth, addressing the unsustainable and rising costs of the nation's health care and retirement programs, and increasing targeted investments to boost economic growth. Our proposals would do all of this while lifting the most vulnerable members of society by targeting them for increased support.

BPC's reforms reflect important priorities of both political parties—including equity, competitiveness, investment, and fiscal responsibility—and represent achievable changes to the policies in place today.

Percentage of GDP	2019	2029	2049
Revenues	16.6	18.7	20.0
Spending	20.6	22.0	24.2
Deficit	-4.0	-3.2	-4.3
Debt Held by the Public	78.2	84.4	86.4