BIPARTISAN POLICY CENTER

FRAMEWORK FOR A GRAND BARGAIN TO AVOID THE 'FISCAL CLIFF'

The 112th Congress can take clear action to avoid the "fiscal cliff" and establish a framework for achieving comprehensive spending and tax reform in 2013. The Bipartisan Policy Center (BPC) proposes enacting legislation in the lame duck session that has the four basic elements outlined below. This package is meant to serve as a starting point to be refined by Congress as it negotiates a final product. Therefore, we leave important elements unspecified, such as the ratio between spending cuts and revenue increases, the size of a "down payment" that might be necessary to pass this law in the **lame duck session of the 112th Congress**, and consideration of an increase to the federal debt limit.

The framework would essentially "codify" much of budget reconciliation, which is now part of the congressional budget process (the "regular order"), and set up a new **accelerated regular order.**

Elements of the Legislation:

1. Require the **committees of jurisdiction of the 113th Congress to produce a debt reduction package** containing policies that, if enacted, would reduce projected federal debt by $4 trillion over a decade relative to a current policy baseline.

2. Allow for such a package to move through Congress via **"accelerated regular order,"** which includes a threshold of a "simple majority of all members present and voting" to pass the debt reduction legislation. This comports with regular order reconciliation as it exists under the standard budget process.

3. Turn off the "fiscal cliff" (such as avoiding expiration of tax cuts, expansion of the Alternative Minimum Tax, imposition of an approximately 30-percent decrease in Medicare and Tricare payments to physicians, and cuts from the "sequestration" provisions of the Budget Control Act of 2011) and **impose a legislative "backstop" that would automatically become law** if the 113th Congress failed to act and pass the debt reduction legislation outlined above.

4. As part of the agreement, enact an initial package of tax and spending changes (a **"down payment")** in the lame duck to offset some of the fiscal cliff and that can be built upon to achieve a larger comprehensive debt reduction package in 2013.

Passage of such a framework in the **lame duck session of the 112th** Congress would eliminate the abrupt and chaotic austerity measures included in the fiscal cliff. It would provide much-needed assurance to the public and financial markets that federal debt reduction legislation will actually happen, even in the absence of action by the 113th Congress. And hopefully, the cooperation necessary to enact this framework will yield confidence in the ability of Congress to come to a broader agreement in 2013.

<u>How the Accelerated Regular Order Would Function</u>

In the lame duck session, the 112th Congress would pass a new bill that contains provisions for the 113th Congress as follows:

- directs the committees of jurisdiction in the Senate and House of Representatives to report legislative **language enacting reductions in mandatory and entitlement spending and increases in revenues that sum to $4 trillion over the next 10 years relative to a current policy baseline;**

- requires the directed committees to **report such legislation** to the House and Senate Budget Committees by October 15, 2013 and the Budget Committees to aggregate the various submissions into one bill;

- **for any committee that fails to achieve its goals**, allows the respective Budget Committee to produce legislation with spending cuts and revenue increases within the appropriate jurisdiction to fulfill the committee's target;

- requires the Budget Committees' packages to be reported out and brought to the floor for consideration by November 15, 2013;

- provides such legislation with **expedited House and Senate floor consideration** by providing privileged parliamentary status, which would allow a maximum 20 hours of debate in each body, including amendments (each of which will be limited to one hour of debate, equally divided);

- provides that at the **end of the 20-hour debate period**, no further amendments will be in order and the bill shall be voted upon with no intervening legislative action;

- requires only a **simple majority** of all members present and voting to pass the bill;

- requires that, within one week of passage of the legislation, **a conference committee be appointed and shall convene** to reconcile the House and Senate versions of the debt reduction package and report to their chambers a Conference Report within two calendar weeks;

- permits the Conference Report to have privileged parliamentary status, to be subject to only **10 hours of debate**, without amendment or intervening legislative action; and

- requires that at the end of 10 hours of debate, the report shall be brought to a **simple majority vote.**

Ensuring an Absolute Backstop

If Congress fails to enact the specified amount of debt reduction required under the new accelerated regular order framework, **an automatic backstop** would ensure that debt reduction is achieved.

Elements of a Backstop

The legislation passed in the lame duck session would provide specific instructions for the Office of Management and Budget (OMB) to **eliminate any shortfall** in the required amount of debt reduction compared to the current policy baseline – whether from the failure of the debt reduction bill to become law or from insufficient debt reduction contained therein.

The language in the law would specify that **half of savings to cover any shortfall are to come from reductions to all mandatory and entitlement programs (with the exception of Social Security) and half from reductions in all federal tax expenditures. OMB would not have the authority to pick and choose among savings from entitlements nor reductions in tax expenditures,** but would simply implement the required percentage cuts to meet the $4 trillion goal. The framework recognizes that the backstop of cuts in mandatory programs and tax expenditures would require flexible treatment – certainly, cutting an entitlement program involves different considerations than cutting a tax expenditure.

BPC believes, however, that such a backstop offers the most reasonable alternative for addressing both revenues and entitlements, which both debt commissions identified as essential components to any attempt to reduce federal deficits. It also provides a severe but workable failsafe to prompt Congress to act and pass a comprehensive debt reduction plan of its own. The constitutional lawyers with whom we have consulted are of the opinion that the Framework we suggest is not an improper delegation of powers between the Executive and Legislative Branches, and thus, would pass constitutional muster.

Providing for a Down Payment

As part of the lame duck agreement, the 112th Congress could agree to a "down payment," **comprised of revenue increases and spending cuts**, which would serve as a first step towards a more comprehensive debt reduction package.

Conclusion

All elements of any legislative framework enacted in the lame duck will be subject to intense negotiations within Congress and with the Executive Branch. BPC's Framework for a Grand Bargain ensures that debt reduction **will** be achieved, while maximizing flexibility for lawmakers to determine **how** it will be achieved. BPC believes that Congress must enact a pathway to a debt reduction package as outlined here before the end of 2012 to stave off the calamitous effects of the fiscal cliff and begin to stabilize our federal debt. An ambitious timeline for action has been laid out above, but investor and consumer reactions may drive policy if there is any further delay.

BPC Domenici-Rivlin Potential Down-Payment Package

We have assembled this sample down-payment package to illustrate potential ways to avoid the fiscal cliff and to serve as a stepping stone toward fundamental tax and entitlement reform in the next Congress.

We see many criteria for assembling such a package, including: easily understood; drafted easily into legislative language; spurring near-term economic growth while phasing in deficit reduction; and focusing on entitlements and revenues instead of the already-cut discretionary spending. If enacted, and when combined with spending cuts passed into law over the past two years, policymakers will have adopted nearly half of the deficit reduction called for by the Simpson-Bowles and Domenici-Rivlin commissions back in 2010.

SPENDING CUTS	**Rough Savings Estimate ($bn)**
Raise Medicare Part B premiums from 25% to 27.5% of program costs	$60
Transition to the chained CPI to index Social Security benefits and pensions for federal retirees	$135
Subtotal	**$195**
REVENUE CHANGES	
Growth Initiative: Implement an income tax rebate	- $120
Transition to the chained CPI to index tax brackets	$75
Tax carried interest as ordinary income	$20
Phase out certain deductions for high income taxpayers (PEP and Pease)	$163
Subtotal	**$138**
Debt service savings	**$40**
TOTAL DEFICIT REDUCTION	**$373 B**

Spending Cuts

Raise Medicare Part B premiums from 25 percent to 27.5 percent of program costs
This proposal will phase in a modest increase in Medicare Part B premiums, amounting to roughly $2 per month each year for five years. When fully phased in, seniors will pay Part B premiums that reflect 27.5 percent of program costs, instead of the current 25 percent. This will still be lower than the percentage covered by beneficiary premiums in the early 1990s, when seniors contributed over 31 percent of program costs.

This adjustment will help address the rising cost of the program through a reasonable beneficiary contribution since providers – in previous legislation – have already been dealt significant cuts in reimbursement rates and more responsibility for cost and quality outcomes. We estimate that this change will save approximately $60 billion over ten years.

Bending the health care cost curve will require fundamental reform of federal health programs. This proposal is a small step in the right direction that does not preclude broader policy changes next year.

Transition to the Chained CPI to Index Social Security Benefits, Pensions for Federal Retirees, and Various Provisions in the Tax Code[1]
The tax code and many federal programs rely on the consumer price index (CPI) for annual updates to account for inflation. Many economists believe that the CPI overstates inflation. The Bureau of Labor Statistics has developed a more advanced measure – referred to as the chained consumer price index ("chained CPI") – that accounts for situations in which consumers respond to pricing changes by purchasing different goods. For example, if cod prices increase, the old CPI assumes that buyers will pay the extra cost, when in reality some people will purchase haddock instead.

In this proposal, the chained CPI will be applied to indexing the tax code and calculating benefits for Social Security and federal retirement programs (including for federal civilian and military retirees and the railroad retirement program). By increasing the accuracy of inflation adjustments in the federal budget, this technical change will both increase revenue – as the thresholds for higher tax brackets will rise at a slower rate – and reduce spending – by modestly reducing the annual cost-of-living-adjustments to Social Security and retirement program beneficiaries. This adjustment will align the program benefit structures better with actual price increases in the economy, and importantly, will have no effect on the initial benefit for any beneficiaries.

This policy can be adopted for Social Security prior to a broader reform package for that program because this is an adjustment for accuracy that should be made throughout the

[1] Note: This proposal affects both spending and revenues

federal government.[2] All Social Security savings, however, should go to extending the life of the Trust Fund.

This chained CPI proposal was included in both the Bowles-Simpson and Domenici-Rivlin reports, and has the benefit of both producing substantial reductions to future entitlement costs (roughly $145 billion over 10 years) and raising revenues to reduce the deficit (roughly $75 billion over 10 years).

Revenue Changes

***Growth Initiative*: Implement an Income Tax Rebate**

There are many policies that could boost near-term growth, but few of them are likely to garner bipartisan support in the current polarized environment. An income tax rebate, similar in structure to that of 2008, could appeal to both parties and be effective and fast-acting. 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 enacted in isolation.

Tax Carried Interest as Ordinary Income

In general, the special low rates on capital gains (and the associated exemption from payroll taxes) are reserved for taxpayers who invest their own money in an asset that is sold for a profit. A controversial Internal Revenue Service ruling allowed managers of investment partnerships (including private equity funds) to pay the reduced capital gains rate on carried interest – i.e., earnings from the share of the fund that represents compensation for their management services. Many contend that this as an unfair tax preference because the profits that the fund managers earn were not from invested personal funds and therefore should be taxed as ordinary earned income.

This change will ensure that private equity and hedge fund managers pay ordinary income and payroll taxes on carried interest, bringing in approximately $20 billion in new revenues over the decade.

Phase Out Certain Deductions for High Income Taxpayers (PEP & Pease)

For many years, itemized deductions were limited and personal exemptions were completely phased out for taxpayers above certain income thresholds. These provisions were eliminated as part of the tax cuts enacted in 2001. This proposal will reinstitute them.

[2] A program such as Supplemental Security Income that utilizes the CPI to establish the *initial* benefit level for recipients, may require more specialized treatment, and we recommend that the change for this type of program be carefully crafted at a later date.

Taxpayers with incomes over $261,450 (joint filers) and $209,150 (single) would have their deductions reduced gradually over the next $122,500 of income. The personal exemption will phase out completely, whereas itemized deductions will be reduced by a maximum of 80 percent. For example, a married couple with income at or over $383,950 will be ineligible to receive personal exemptions and will receive only 20 percent of any itemized deductions that they claim.

This provision raises revenue from the wealthy (approximately $163 billion over 10 years) without increasing the top statutory tax rate, and allows for broader tax reform next year.