# United States Senate Committee on Finance Hearing
# "Confronting the Looming Fiscal Cliff"
# June 19, 2012

## Questions Submitted for the Record
## *Responses from Senator Pete V. Domenici and Alice M. Rivlin*

With respect for those questions that are directed to either Senator Domenici or Director Rivlin, all responses are endorsed by both Senator Domenici and Director Rivlin.

**Questions from Senator Hatch**

All questions are for both witnesses unless otherwise indicated.

**QUESTION 1**

*As I had mentioned during the hearing, the original 2010 version of the Domenici-Rivlin plan called for a Value Added Tax, which you called a Deficit Reduction Sales Tax. That national sales tax was intended to apply to around 75% of consumer expenditures and would apply to home sales, purchases of food, and purchases of clothing. According to your plan, the tax would have generated over $3 trillion between 2012 and 2020 and over $17 trillion between 2012 and 2040.*

*Subsequently, as I understand it, you have chosen to drop the VAT from your plan, citing likely lack of general support for a national sales tax in conjunction with an income tax. In place of the VAT, you have decided, again as I understand it, to increase the corporate tax rate from your initial proposed 27% to 28% and to increase the upper tax rate in your income tax schedule also from the initial proposed 27% to 28%. Yet I am not sure that your fiscal arithmetic adds up. I had expressed that I am not sure that those tax hikes would generate enough revenue to replace what your initial plan's national sales tax generated. During the hearing, you had expressed that the tax rate increases to 28% backfilled some of the lost revenue from dropping the VAT, but not all.*

*Could you tell me the amount of revenue that would have been collected according to projections of your plan that would not be recovered by increasing tax rates to 28%? And, have you also decided to make other changes to your plan in order to get more revenue?*

Three developments led us to remove the proposed Debt Reduction Sales Tax (DRST) from our package. First, we perceived that the DRST does not currently have very much traction, so much so that it actually reduced the willingness of some to consider our entire proposal with the seriousness which we believed it, and the nation's fiscal situation, deserved.

Second, subsequent economic and technical revisions of the baseline projections from the Congressional Budget Office indicated that our initial proposal actually overachieved our savings target.

And third, and over and above the previous point, we found that our initial savings target was more ambitious than other deficit-reduction proposals that were put forward. Accordingly, we revised our savings target to be more comparable to those of other proposals; we adjusted the income tax rates as you correctly describe in your question; and we made other changes to the parameters of our income tax proposal, because some low-income relief provisions that were intended to compensate for the DRST were of course no longer needed without the DRST. As a result of all of these changes, our revised proposal meets a reasonable deficit-reduction target and achieves the distributional goals that we originally set and maintain.

The current Domenici-Rivlin Task Force plan raises approximately $2.6 trillion in revenue to go along with roughly $3.2 trillion in spending cuts (approximately $1.2 trillion of which have been achieved through passage of the Budget Control Act and other legislation over the past two years.) Prior to removal of the DRST, the Domenici-Rivlin tax reform plan raised approximately $4 trillion in revenue.

**QUESTION 2**

*It seems that the Domenici-Rivlin plan contains reforms that end up treating charitable giving and mortgage interest in a peculiar way. According to your plan, the existing treatment of charitable deductions and mortgage interest deductions would be replaced with a new scheme that gives a 15% refundable tax credit. Those credits would be universal, so taxpayers would not have to file a tax return to claim them. Rather, according to your plan, the credits would not be reimbursed directly to the taxpayer but would go to the institutions.*

*You write the following in your plan: "Qualifying charities will apply to the Internal Revenue Service (IRS) for a matching grant to supplement contributions from taxpayers, so that for every $85 the taxpayer gives, the charity will receive another $15. Mortgage lenders will apply for a tax credit, which will be passed through to homeowners as a 15 percent reduction in their home mortgage interest payments."*

*Accordingly, synagogues and churches would have to file with the IRS to claim tax credits. And the federal government would be directly sending taxpayer resources to those synagogues and churches. Your plan assumes that mortgage lenders will obtain tax credits associated with mortgage interest payments and that competitive forces in real estate markets, including all of those large Wall Street firms, would simply pass those credits along to borrowers in the form of lower mortgage interest.*

*Has any other country attempted to use a similar scheme for treating charitable contributions and, if so, how have charities been affected? Are you confident that mortgage interest credits claimed by lenders would pass through dollar-for-dollar to lower interest payments for borrowers?*

The mechanism that we propose for charitable contributions is used in the United Kingdom, where it is known as "Gift Aid" (see http://www.direct.gov.uk/en/MoneyTaxAndBenefits/ManagingMoney/GivingMoneyToCharity/DG_078490). This system is fully transparent, and taxpayers can see (even more easily in our specific proposal for the United States than is the case in the United Kingdom) how much money their designated charities will receive, and how much money it will cost them. Americans are generous people, and there is no reason to expect that U.S. taxpayers will substantially change their willingness to support the charities about which they care because of this change in the mechanism of the tax subsidy. Concerns about the effect of the 1986 Tax Reform Act on giving to charities proved to be much overblown.

Similarly, there is no reason to believe that mortgage lenders will somehow determine to defraud their customers because of our proposed change to the delivery of the subsidy for mortgage interest. The amounts of money due to lenders are specifically defined by contract, and any lender who refuses to recognize payments, whether delivered directly from the borrower or from the tax authorities, will be in violation of the contract and will be subject to criminal or civil sanction.

**QUESTION 3:**

*Your plan calls for limiting the current-law charitable deduction because, you say, it "disproportionately subsidizes" upper-income taxpayers. This Committee held a hearing on the charitable deduction last year, and we heard evidence that reducing the value of the deduction will reduce charitable giving. Estimates vary as to how much charitable donations will drop. I have seen estimates that range all the way up to $10.8 billion per year. But all estimates point to a drop in donations, meaning less money for charity. The charitable sector has not yet recovered from the drop in donations following the 2008 market meltdown, yet demand for charitable services remains high. Therefore, the result of your charitable deduction proposal will be fewer resources for charities at a time when the need for charitable services is at the highest level in decades.*

*As I have said before, the charitable deduction is about the charities, not about the donors. The purpose of the deduction is to direct sufficient resources to charities so that they can move forward with the good work that our society desperately needs. And it makes perfect sense to provide larger tax incentives for giving to the donors with the largest capacity for giving. Upper-income donors, which are those in the high marginal tax brackets, are the very donors*

*who are in a position to give substantial amounts to charity and they ought to be encouraged to do so.*

*Of course, the current treatment of charitable giving provides what you call a "disproportionate" subsidy to upper-income households because those are the people who disproportionately pay federal income taxes. And the treatment of charitable giving in your plan will disproportionately hurt the poor and those most in need in our society. But it appears that what your plan takes away in terms of private charitable giving, it gives back, at least in part, by increases in federal government transfers to lower-income households.*

*How much so-called budgetary "savings" you get from altering the charitable deduction and how much you add to relatively inefficient federal government transfers to lower-income households and the elderly and disabled?*

As you note, the tax subsidy for charitable giving by upper-income individuals is "disproportionate" in the sense that it is a higher percentage of the gift than it is for giving by people of more modest means. Although some would argue that this "upside-down subsidy" has merit, we believe that it is difficult to justify. It also sends a signal to typical taxpayers that their contributions from their more-modest incomes are somehow of lesser social value **per dollar** than are the gifts of persons with far more income and wealth, and whose actual sacrifice in any meaningful sense may be less.

We do not understand precisely your argument that "what your plan takes away in terms of private charitable giving, it gives back, at least in part, by increases in federal government transfers to lower-income households." Our report recommends substantial spending restraint. We do recommend an increase in and restructuring of the minimum benefit under Social Security, but not believe that would be a driver of the concern raised.

**QUESTION 4**

*Your plan includes reforms to the Social Security system, including a change in the price index used for Cost of Living Adjustments and changes in the benefit-calculation formula to effectively index benefits for increases in life expectancies over time.*

*The President has, unfortunately, refused to offer any plan to reform Social Security in order to put the system's finances on a sustainable path. We also have heard no plans for dealing with the Disability Insurance program, even though the Disability Insurance Trust fund will be exhausted in less than four years from now. What the President has offered is a set of vague and loose "guiding principles" for any plan to protect and strengthen Social Security, including the following which you can read on the White House website: "He believes that no current beneficiaries should see their basic benefits reduced and he will not accept an approach that slashes benefits for future generations."*

*Do you believe that your proposed Social Security reforms would abide by the President's guiding principles? That is, do your reforms reduce basic benefits of current beneficiaries and slash benefits for future generations?*

We can speak only for ourselves with respect to our proposals. We believe that our proposals are equitable. The only element of our package that would make adjustments to the benefits of current beneficiaries is the change to the price index used for the cost-of-living adjustment (COLA), which we believe would measure inflation more accurately, and whose effect would be modest. At the same time, we would increase the Social Security minimum benefit, which would mean that, on net, lower-income beneficiaries would receive a benefit increase, not a reduction. In return for these adjustments and other modest ones down the road, all current and future beneficiaries would receive the reassurance that the system will remain sound for the indefinite future.

**QUESTION 5**

*In the November 2010 version of your Restore America's Future plan, you state the following: "Nor can policymakers solve the [debt crisis] problem simply by raising taxes on wealthy Americans. Reducing deficits to manageable levels by the end of the decade through tax increases on the well-to-do Americans would require raising the top two bracket rates to 86 percent and 91 percent…"*

*Tax rates of 86 and 91 percent would, of course, stifle economic activity and not just hit what you characterize as the well-to-do; it would hit taxpayers who take income from flow-through businesses and subject it to personal tax rates. Those taxpayers run businesses, hire workers, invest in plants and equipment, and help our economy grow.*

*Dr. Rivlin, you are a regular student of federal budgets and seem to have a grasp of the numbers involved. You have identified, correctly in my view, that simply raising taxes on upper-income earners would not solve our fiscal crisis. In fact, I don't believe it would solve many of the problems that proponents of higher taxes think it would solve. For example, the President's budget for fiscal year 2013 states that the President "is proposing that the Buffett rule should replace the Alternative Minimum Tax." That is, he says that he wants to use his Buffett tax idea to replace the AMT.*

*One of the latest versions of the serial Buffett taxes that have been floated on the Senate floor was scored by the Joint Committee on Taxation, and we found out that it would generate around $47 billion over the period 2012 through 2022, while repeal of the individual AMT would cost around $840 billion over that period. So, the President's idea of replacing the AMT with his Buffett Tax just doesn't add up.*

*I have two questions. First, where do you believe it is more important to focus our energy in confronting the nation's fiscal challenges and moving to a sustainable fiscal course: raising taxes on upper-income earners or reining in growth of our entitlement spending? Second, do you believe that we can or should move to a sustainable fiscal course by relying on tax hikes on upper-income earners, including business owners, without also having plans to reform our entitlement promises embedded in Social Security, Medicare, and the like?*

We believe that the nation's budget problem has become so large that it cannot possibly be solved without both reduced expenditures and increased revenues, and that the latter can be achieved equitably only if done according to the ability to pay. We also sought to explain in our report that although the nation's long-term budget problem is caused in large measure by rising healthcare costs, it will take some time to restructure our entire healthcare system to achieve significant federal budget savings. In the meantime, the nation's debt already is too high, and in the very long run the predominant cause of our budget gap is actually interest on that debt, which will grow to be even larger than healthcare costs. Therefore, truly putting to rest the nation's budget problem requires a balanced approach of reduced spending and increased revenues, in both the near term and the long run. Savings in healthcare entitlements are an essential part of that package, but they will contribute mostly over the long run, not in the near term.

**QUESTION 6**

*Your plan calls for a lower corporate tax rate, equal to the upper rate in your proposed two-bracket personal income tax. However, the plan is somewhat vague about how the lower corporate rate would be financed and on whether you advocate a move to a territorial system. I wonder whether you can give me more details on how you propose to finance the lower corporate rate and whether you are proposing to move to a territorial system and, if so, how you propose to do so.*

In short, we "pay for" the lowering of the corporate tax rate to 28 percent by eliminating many tax expenditures, thereby broadening the tax base. We would call your attention to page 130, Appendix B, of our report, which contains a list of the current-law tax expenditures that we do **not** repeal or modify (we describe elsewhere the modifications, which mostly relate to the individual rather than the corporate income tax), and to footnote 89 on the same page, which explains that we do not advocate a territorial tax system.

**QUESTION 7**

*Your plan, I believe, claims to permanently end the sustainable growth rate mechanism—or SGR, otherwise known as the "doc fix"—in Medicare. Of course, the doc fix is a very costly and time-consuming thing to attend to each year. It is not clear to me, however, how you get rid of the doc fix in your plan. Buried in a footnote on page 46 of the 2010 version of your plan is a statement that your baseline assumes a permanent fix to the SGR and that a 10-year fix is reflected in your debt projections under your plan. It then says: "Specifically, the baseline*

*assumes that the SGR mechanism is replaced with annual updates based on the Medicare economic index (MEI), with a hold-harmless provision for Part B premiums."*

*I wonder whether you could elaborate on that footnote and clarify exactly how you eliminate the doc fix. It seems as though you are saying that you simply assume another mechanism of annual updates based on the MEI, which I am guessing would become a new law. In any case, could you provide additional clarity and also discuss whether you see any potential obstacles to the change that you are assuming?*

Perhaps this proposal will be easier to understand in the context of our overall budget objective. We began with a projection of the nation's debt as a percentage of the GDP, assuming a permanent "doc fix" in the baseline. We then sought savings relative to that projection that would reduce the debt to our target of 60 percent of the GDP by 2020. The sum of all of the savings from **all** of the policies that we specified – including those in the baseline – was sufficient to achieve that goal.

Those policies included, as we stated, "annual updates based on the Medicare economic index (MEI), with a hold-harmless provision for Part B premiums." In the updated version of our plan, however, our baseline includes a more "standard doc fix," where physician payments are frozen, at a cost of roughly $300 billion over the 10-year window. If this were to be passed, the need for the Groundhog Day process that you refer to with regard to the doc fix would be eliminated.

**QUESTION 8**

*Your plan calls for a change to the price index used to index Cost of Living Adjustments—or COLAs—for Social Security and to index income cutoffs in determining tax brackets. The idea, as I understand it, is that the current price index in use has been found by many to overstate the true cost of living and that the alternative index that you propose better measures living costs.*

*Of course, switching indexes as you propose will lead to slower growth of Social Security benefits through slower growth in the COLAs, which many seniors groups may not support. In addition, switching indexes for tax brackets in the tax code means that income cutoffs will rise more slowly. And, since nominal income tends to grow faster than the cost of living as measured by a consumer price index, slower growth in the tax-bracket income cutoffs means that we would have more bracket creep over time. Of course, that means that people are thrown into a higher tax bracket more quickly.*

*Why should we index tax-bracket income cutoffs using only a price index, given that it leads to bracket creep? Why wouldn't we index tax-bracket income cutoffs to growth in what is actually being taxed, which is nominal income—meaning price times real income? Isn't your idea to change the price index used for tax-bracket income cutoffs simply a stealth scheme to push people more quickly over time into higher tax rates?*

The General Explanation of the Economic Recovery Tax Act of 1981, prepared by the staff of the Joint Committee on Taxation at the time of the enactment of indexation, states that "The Congress believed that 'automatic' tax increases **resulting from the effects of inflation** were unfair to taxpayers" (emphasis added). In other words, the indexation provision was intended to compensate taxpayers **for inflation** and not for other factors. In 1981 and the years since, the Congress has enacted numerous tax cuts, including reductions of tax rates, creations and increases of tax credits, increases of exemptions and standard deductions, and the introductions and increases of numerous tax subsidies and incentives. Presumably, those many tax cuts were intended to respond to all changes in the economic environment other than inflation. Arguably, the mechanism for correction for inflation is an imperfect instrument for responding to all of those other economic influences, including real wage and other income growth.

**QUESTION 9**

*The Domenici-Rivlin plan includes a premium support mechanism for Medicare in an attempt to limit growth in per-beneficiary federal support. It also maintains traditional Medicare as a default, but with the potential for higher premiums if costs rise too fast. Or, people can decide to purchase a private plan. According to the initial plan of 2010, transitioning to premium support in 2018 would lead to over $2 trillion in budget savings over the period between 2012 and 2030 and over $7 trillion between 2012 and 2040.*

*Could discuss your ideas for Medicare reform and why you think that your premium support provision would generate trillions in budget savings in the longer run?*

We believe in markets, incentives, and consumer choice. We believe that if Medicare beneficiaries are allowed to choose among truly competing plans on the basis of quality and price, those Medicare beneficiaries will choose the plans that give them the care that they want at the best prices. Indeed, if competition is not the key element of ultimate control of healthcare costs, we are genuinely eager to hear what is.

Purely mechanically, in current Medicare markets where Medicare Advantage plans compete with traditional Medicare, the introduction of our proposal will achieve savings – because the system will no longer have to overpay either traditional Medicare or Medicare Advantage plans that cost more than the most efficient plans. However, we believe that the majority of the actual savings from our proposal will come from the force of competition – which cannot be scored. (The premium cap is not responsible for any of the scored savings over the first two decades and is included simply as a backstop to ensure that the Medicare savings actually occur.)

Because the original proposal was scored in conjunction with the entire Domenici-Rivlin debt reduction plan, the savings estimate listed in the 2010 report is not indicative of how much the proposal would save on its own. We explain the details further in the addendum to these

questions (see attached in addendum question #3), which provide supplemental answers to other questions from the "Confronting the Looming Fiscal Cliff" hearing, but our updated estimate of the budget savings is below:

| Estimated cumulative savings from CBO's Current Law baseline in billions of dollars, 2016 through: | | | |
|---|---|---|---|
| | **2022** | **2025** | **2032** |
| **Introduce the Protect Medicare Act in 2016** | $175 | $280 | $675 |

**QUESTION 10**

*Your plan calls for alterations in Social Security benefits as well as Medicare benefits. In a statement to the Joint Select Committee on Deficit Reduction, the AARP urged the so-called Super Committee "not to revisit proposals that would hurt the health and economic security of older Americans by cutting the Medicare and Social Security benefits they've earned."*

*With respect to Social Security, the AARP noted in regard to your proposal that "the last thing we should be targeting is the guaranteed, inflation-protected Social Security benefits that millions of Americans count on every day…" And with respect to Medicare, the AARP said that your plan "…called for changes to Medicare that would substantially shift health care costs to seniors…"*

*With those admonitions in mind, I wonder how the members of the Debt Reduction Task Force respond. The AARP seems to be saying that Social Security and Medicare should not be targets of reform, yet the Task Force's plan relies significantly on reforms to those programs. Dr. Rivlin and Senator Domenici, do you have any response to what the AARP is saying?*

First, please see our answer to question four, which specifically asked about the COLA provision for Social Security. We would state again that we can and seek to speak only for ourselves and our proposals.

We believe that current and future seniors will be most ill-served by Social Security and Medicare policies that yield unaffordable costs. For example, under current policies and projections, Social Security in only about 20 years will be forced to cut benefits across the board by approximately 25 percent – for **all** beneficiaries, not only new beneficiaries as of that date. Any policies that achieve equivalent savings at that point in time will be unthinkably draconian, and will have exceedingly painful effects on those seniors. We believe that addressing these issues sooner rather than later will be better for all seniors.

And specifically with respect to Medicare, we believe that our proposal will give beneficiaries an

array of choices that will provide them with the kind of quality care they want at lower cost for them and for their children – who will be paying the taxes to support the program, and who will themselves one day be seniors.

**QUESTION 11**

*Your testimony states that "the last time our budget was balanced, from 1998-2001, revenues averaged 20 percent of GDP…" A lazy interpretation of that statement would be that bringing revenues up to one-fifth of our entire economy somehow uniquely causes budget balance or economic growth.*

*Of course, the revenue boom during the period that you mention in your testimony corresponded with the buildup of the tech-bubble when, for example, the NASDAQ more than doubled, only to recede later when the bubble popped. Surely capital gains and taxes on them are reflected in your revenue figures, and those turned out not to be a very stable base for taxes. Moreover, what is often left out by proponents of higher taxes who invoke the magic of the 1990s is that federal outlays as a percentage of GDP were brought down from 21.4 percent in 1993 to 18.2 percent in 2000 and in 2001. Certainly reduced federal spending helped cause budgetary improvement.*

*According to the CBO, revenues as a share of GDP in their most recent so-called alternative fiscal scenario will rise to 18.5 percent by 2022, above the 18% average over the past 40 years. Therefore, I do not see revenue as the principle budgetary problem. However, the CBO also projects that spending will be almost 21 percent of GDP by 2022, rising to 26.1 percent by 2037. Therefore, spending is the principle problem.*

*And we know that growth in health care costs is the main culprit behind projected growth in federal spending in the future. The Domenici-Rivlin plan claims to tackle the problem of runaway health-care related spending by "bending the cost curve" on health care. Dr. Rivlin and Senator Domenici, I wonder if you could tell me what you believe are the critical features of your proposals that will bend the cost curve related to health spending and why you think that your solution will do the job. In your response, could you comment on how you view premium support as a cost control measure and could you also identify whether your plans rely on heavy-handed government bodies like an Independent Payment Advisory Board.*

With respect to the role of premium support in "bending the cost curve" on health care, please refer to our answer to your question number nine on the same subject. We propose to continue the current-law Independent Payment Advisory Board (IPAB), understanding that if competition works as we believe it will, the IPAB will not be required to submit recommendations.

**QUESTION 12**

*Last year, the Finance Committee held a hearing on retirement savings and considered proposals like the 15% tax credit idea and a 20% of income or $20,000 cap on savings. We heard evidence that reducing the value of retirement tax incentives will do severe harm to workers. Small businesses use the savings generated from retirement tax incentives to help pay for contributions required by the pension nondiscrimination rules. Reducing the incentives literally reduces the cash the small business owner has to work with, and will mean fewer plans or lower employer contributions for those plans remaining.*

*Most Americans save for retirement through employer-sponsored retirement plans. Over 70% of full-time employees making $30,000 to $50,000 contribute when covered by a plan at work. But less than 5 percent of workers at the same income levels save on their own in an IRA when there is no workplace plan. An analysis by the Employee Benefit Research Institute shows that the "20-20" cap proposal would result in lower account balances at retirement for all income groups, and younger workers in the lowest income quartile in a small employer plan could expect a 14% reduction in account balances at Social Security normal retirement age if this proposal became law.*

*Did you consider the evidence the Committee examined at our hearing last year before recommending the 15% tax credit and the "20-20" cap on retirement savings?*

Our Task Force's report was released in 2010, prior to the Committee's hearing last year on retirement savings. Thus, we were not able to consider the evidence as presented to the Committee.

That said, we believe that a so-called "20-20" plan would affect very few low-income people and would derive most of its savings from higher-income taxpayers. This proposal would by no means stop those taxpayers from accumulating sufficient retirement savings. It will, however, prevent individuals of great income and wealth from sheltering large amounts of money. This will limit public dollars from being spent on incentivizing savings that would take place anyway.

With regard to the non-discrimination rules: If a business owner in the highest tax-rate bracket (currently 35 percent) contributes an additional $1.00 to a retirement account on his or her own behalf, that business owner has $0.65 less – the $1.00 contribution, minus the $0.35 tax savings – to satisfy the nondiscrimination rules with respect to his or her employees. The fact that the contribution costs the business owner $0.65 rather than $1.00 does not mean that the business owner has more resources to satisfy nondiscrimination rules, only that the reduction of available resources is less. Our recommendation is based on a necessary calculation of the public value of additional tax-subsidy dollars to incentivize still larger pension-fund contributions on a high-tax-bracket taxpayer's own behalf. Obviously, that tax subsidy must be limited at some level, especially under fiscal stress such as the nation faces today.

**Questions from Senator Rockefeller**

To repeat, with respect for those questions that are directed to either Senator Domenici or Director Rivlin, all responses are endorsed by both Senator Domenici and Director Rivlin.

**QUESTION 1**

*Dr. Rivlin, you mentioned in your testimony that the Value Added Tax (VAT) in your original proposal was dropped because of political opposition and replaced with an increase in the top individual and corporate tax rates from 27 to 28 percent. This increase in rates does not make up for the lost revenue from eliminating the VAT. My question is, why did you stop at 28 percent?*

Please refer to our answer to question number one of Senator Hatch for additional background on our decisions regarding our proposed Debt Reduction Sales Tax (DRST). We concluded, given all of our policy changes including the elimination of the tax preferences for capital gains and dividends, that the 28-percent top-bracket rate yields sufficient revenues and a tax system that is more progressive than the current law, measured in terms of the distribution of after-tax income.

**QUESTION 2**

*This question is to both panelists. You have written about the dangers of allowing the proposed sequester to occur in early 2013. There are some in Congress who are proposing to do away with the sequester on the defense side only. What do you think of this idea of sparing the defense sector from these indiscriminate cuts while subjecting the discretionary side of the ledger to them?*

We would first observe that the prescribed levels of discretionary spending (both defense and non-defense) in the Budget Control Act – before any sequester is imposed – already roughly approximate the recommendations of our Debt Reduction Task Force. In addition, the manner and abruptness with which sequestration cuts occur, across-the-board and overnight, is particularly inefficient and anti-growth. Most of the consequences spelled out in the recently-issued Bipartisan Policy Center report on the sequester, Indefensible, apply similarly to both the defense and domestic reductions. As we have previously stated, both sides should be replaced with more a more logical deficit reduction policy or process that focuses on the long-term drivers of our debt: healthcare costs that are rising out of control and a broken tax system that raises insufficient revenue.

We believe that the budget crisis will be solved only through negotiation, compromise and concessions on the parts of all parties.

**QUESTION 3**

*This question is to both panelists. Your deficit reduction plan raises its revenue against a modified baseline as opposed to a current law baseline. While you state that it raises $2.6 trillion against a current policy baseline, it actually loses revenue against a current law baseline. Given the staggering amount of debt that our country owes, why did you choose to use a current policy baseline that masks the real costs of the choices we have to make?*

There are advantages and drawbacks to the current policy baseline as well as the current law baseline. For illustration, one reason that we utilized the former was to clearly demonstrate the magnitude of the problem that the country faces if it continues down the path of "business as usual."

That said, as your question properly points out, any baseline has "framing issues" and forces one to select a "default path." For this reason, in the deliberations, our Task Force members chose to focus on levels of revenues, spending, deficits and debt, rather than on changes relative to alternative baselines. The members concluded that this approach helped them to engage in their debate and decisions more constructively. They concluded that the levels of revenues (usually expressed as percentages of GDP) that were raised by the policies they chose made an appropriate contribution to the reduction of the budget deficit and the control of the debt.

**QUESTION 4**

*I have a question for you both regarding manufacturing promotion and the tax code. What does your plan do with regard to the existing R&D tax credit? Do you take any position on proposals such as the patent box? Given that many manufacturing companies currently pay an effective tax rate of less than 28%, I wonder if there are any additional manufacturing incentives that would be present in your tax code to avoid raising taxes on these job creators?*

Our proposal retains the expensing for research and experimentation expenditures, but eliminates the R&D tax credit. We concluded that the reduction of the statutory corporate tax rate was the most important incentive that we could provide for all productive business activities.

**QUESTION 5**

*Dr. Rivlin, you mentioned in your testimony that we should protect low-income beneficiaries. However, I am concerned that proposals to restructure patient cost sharing in the Medicare program, while they may protect the very sickest beneficiaries, can place the majority of people with Medicare at risk of increased costs. This is because, despite including a catastrophic coverage provision, such proposals subject most Medicare beneficiaries to higher cost-sharing before they reach the catastrophic cap.*

*Please explain how your proposal to restructure patient cost sharing in the Medicare program would indeed protect the lowest-income beneficiaries from increased cost-sharing, while still reducing the federal deficit.*

First, on net, beneficiaries do not face higher out-of-pocket costs. The budget savings from the proposal come from reduced utilization due to new cost-sensitivities created by more uniform cost-sharing.

As an insurance program, in order for Medicare to protect those with the highest out-of-pocket costs – a cohort that any senior can find themselves in without warning – other beneficiaries have to pay a little more. According to a study undertaken by the Kaiser Family Foundation, while nearly three quarters of individuals would see their out-of-pocket costs go up – by about $15 per person per month on average – the small portion of the population with the highest costs would see an average reduction of $130 per person per month.

Additionally, with regard to your question in particular, almost all of those with the lowest incomes who qualify dually for Medicare and Medicaid will continue to have their cost-sharing covered in full, and thus will not see any increased out-of-pocket costs.

If desired, it is also possible to accompany this policy with increased support for low-income beneficiaries who do not qualify for Medicaid assistance, while still gaining the benefit that comes from getting some beneficiary skin in the game.

**QUESTION 6**

*Senator Domenici and Dr. Rivlin, your plan calls for eliminating barriers to greater use of managed care for those dually eligible for Medicare and Medicaid as a way to reduce the deficit. Specifically, your plan calls for creating a "fast-track" for waivers to expand managed care programs for dual eligibles. However, managed care is as yet a largely untested and unproven model for dually eligible beneficiaries, particularly for specific subpopulations of this extremely heterogeneous group of beneficiaries. Only 10 percent of individuals dually eligible for Medicare and Medicaid were enrolled in Medicaid comprehensive risk-based plans in FY2009 (MACPAC), and MedPAC has raised a number of questions about Medicare and Medicaid managed care plan readiness to care for the full continuum of care for dually eligible beneficiaries, including long-term services and supports. While in my opinion, cost savings should <u>not</u> be the primary goal of efforts to integrate care for dually eligible beneficiaries, significant questions remain about the ability of most managed care plans to save money caring for dual eligibles while maintaining or improving quality. Furthermore, in its June 2012 report to the Department of Health and Human Services, the Measures Application Partnership of the National Quality Forum identified significant gaps in measuring quality of care for dually eligible beneficiaries.*

*Please provide a detailed outline of the research studies or other analysis that you used in estimating cost savings from managed care for dual eligibles. Please also provide evidence of*

*whether or not quality of care for the beneficiaries in those studies was maintained or improved.*

Providing the best care for dual eligibles is a challenging problem for which much more research must still be undertaken. Don Moran of The Moran Company (and formerly of The Lewin Group) performed the research on this policy proposal.

Some of the studies used were: Menges, J. et al. Medicaid Managed Care Cost Savings – a Synthesis of 24 Studies (Falls Church, VA: The Lewin Group) July 2004, updated March 2009 and data from Kaiser Commission on Medicaid & The Uninsured, Medicaid & Managed Care: Key Data, Trends & Issues. (Palo Alto: Kaiser Family Foundation), February 2010.

**QUESTION 7**

*This question is for both witnesses. In your testimony, you note that the key supply-side strategy for containing health care cost growth is to reform provider payment incentives and that the health reform law took important steps towards reforming provider payments in Medicare. One of those steps was the creation of the Independent Payment Advisory Board, which is designed to slow excess cost growth through targeted, expert recommendations. As you know, IPAB explicitly protects Medicare beneficiaries from increased premiums or cost sharing, and from reduced benefits. Your Protect Medicare Act appears to depend on IPAB as a mechanism to contain excess Medicare cost growth, yet contemplates that if IPAB's reforms are "inadequate", Congress should increase premiums for Medicare beneficiaries who make more than 150 percent of the federal poverty level, which translates to $16,755 for an individual and $22,695 for a couple (in 2012 dollars).*

*Please provide your recommendations for ensuring the success of the Independent Payment Advisory Board in reforming provider payments in order to ensure the sustainability of the Medicare program and avoid shifting costs to Medicare beneficiaries.*

We believe that the best way to avoid shifting costs to Medicare beneficiaries – and in fact to prevent the Independent Payment Advisory Board (IPAB) from ever being required to issue recommendations in the first place – is to subject all insurance plans and providers, including providers who serve under traditional Medicare, to competition and beneficiary choice on the basis of quality and cost. When beneficiaries are empowered to leave their plans and providers if they provide poor care and are inefficient (and therefore, too costly), plans and providers will work actively to improve quality and hold costs down.

**QUESTION 8**

*I'd like to ask you both about Social Security. How much did the recent economic downturn and the resulting high unemployment affect the Social Security Trust Funds?*

This question could be approached in multiple ways. Although not perfect, the way that makes the most sense to us, given what we can attempt, is to compare the measures of the solvency of Social Security as of 2007, before the financial crisis, with those same measures this year. The April 2012 annual report showed a 75-year actuarial deficit of 2.67 percent of taxable payroll, and trust-fund exhaustion for the OASDI programs was expected in 2033. As of the 2007 annual report, the 75-year actuarial deficit was 1.95 percent of taxable payroll, and trust-fund exhaustion for the OASDI programs was expected in 2041. Again, this simple comparison does not perfectly isolate the effects of the economic downturn. The actuarial deficit would change simply because of the passage of time relative to the irregular age profile of our population, and the Office of the Actuary has made some methodological changes in the interim. We would defer to the Office of the Actuary should you seek a more precise accounting of the effects of the economic downturn.

**QUESTION 9**

*Dr. Rivlin, during previous debates on Social Security reforms and solvency, it was discussed by some that the payroll tax cap should be 90% of wages, but the cap was set instead at a specific number indexed to inflation rather than 90% of wages. How far has the current payroll tax cap slipped below 90% and is this growing gap due to the growing income disparities in our country?*

*If the Social Security payroll tax had been linked to 90% of wages instead of an income level in previous reforms, what would such a policy have meant for the Social Security Trust Funds today, and would the short falls there be less than they are at present if the 90% link had been implemented? What would the payroll income cap be?*

In recent years, the percentage of earnings covered by the payroll tax has slipped below 85 percent. If that percentage had been held firm at 90 percent, you are correct that a significant chunk of the current shortfall would not have materialized. In current earnings, the 90-percent level would be roughly $180,000 of income.

The slippage of the share of wages that is subject to the payroll tax is to some degree caused by growing wage disparity. An associated, but indirectly linked, factor is the growing share of compensation that is paid in the form of fringe benefits, especially employee health-insurance premiums. Because health-insurance premiums on average increase less than in proportion at higher levels of total compensation, their growth over time removes from the tax base more of cash wages paid below the tax cap than of cash wages paid above the tax cap.

**Addendum: Supplemental Answers to Questions from the "Confronting the Looming Fiscal Cliff" hearing**

**QUESTION 1**

*How does your plan prevent cherry-picking / adverse selection?*

The Domenici-Rivlin Protect Medicare Act includes substantial barriers to adverse selection. For starters, the exchanges would be federally run (either by the Centers for Medicare and Medicaid Services (CMS) or a separate entity), require insurers to offer coverage to every beneficiary in the geographic area for the same price, regardless of age, gender, or health status, and enforce guidelines for the structure of the benefit package.

The structure of this exchange system significantly mitigates the risk of cherry-picking. Most importantly, the Medicare beneficiary does not apply to the insurance company, but rather to the exchanges, and the insurance company cannot interfere. With beneficiaries being presented with a clear, apples-to-apples comparison of plans, the adverse selection that derives from misleading marketing at the point of purchase will disappear.

Another risk is that a health plan could try to create a reputation of not doing well by persons with expensive conditions, potentially by under-investing in treating those conditions. There are multiple strategies that can be employed to head this off. First, Medicare Advantage (MA) already uses a quality rating system that deters plans from making themselves unattractive to sick people because they will receive low ratings. Also, plans that get four or five stars can continue to receive higher payments than others. These practices can be continued and improved upon. Additionally, the final backstop included in the Domenici-Rivlin plan is to give the regulator the power to remove plans from the exchange if they misbehave. We must acknowledge the need for intelligent regulation – which is true of many markets beyond insurance, but is true of all insurance.

To further mitigate adverse selection by private plans, the Domenici-Rivlin proposal requires all plans on an exchange to offer a specific core set of benefits and have an actuarial value at least as high as traditional Medicare's – similar to the requirements in the Patient Protection and Affordable Care Act (PPACA), where competing plans at each grade (bronze, silver, gold, platinum) must have the same actuarial value. This would preclude the possibility of "bare-bones" plans attracting healthier people in ways not fully offset by the risk adjustment mechanism.

Moreover, the exchange would be able to block benefit designs (even those of comparable actuarial value) that are deemed likely to disproportionately attract healthy people – just as the Office of Personnel Management (OPM) does for the Federal Employees Health Benefits

(FEHB) program. The federal government would also enforce rules on plans' accuracy of promotional materials and network adequacy.

The last line of defense would be risk adjustment, such that an insurer that does wind up with a population of lesser risks also winds up with less premium revenue (and vice versa). Methods used in MA would be a starting point. Efforts to risk adjust more effectively are ongoing.

It is important to note that the concern applies only to plans that seek out healthy people. With a good risk adjustment system, some plans will specialize in good treatment of chronic diseases, and will seek out such patients. In fact, the plans that are most effective can be the best at efficiently treating enrollees with serious chronic conditions. CareMore, for example, has been successful by enrolling people with chronic diseases and treating those conditions very aggressively. They have shown that with risk adjustment, providing additional services to manage chronic conditions leads to lower costs, higher quality, and a better business model. Rewarding insurance plans that raise quality and reduce costs is the best and perhaps the only way to truly bend the cost curve.

**QUESTION 2**

*How do private plans make money if they have to offer the same benefits as traditional Medicare?*

In short, private plans can make money offering the same benefits as traditional Medicare in the same way that firms in other lines of work make money providing the same product or service as other firms: They become more efficient and demonstrate their quality.

In many counties across the United States, this is already done in Medicare Advantage. MA plans currently have to offer essentially the same benefit package as traditional Medicare, and they often do it more efficiently.

Despite assertions to the contrary, according to data from the Medicare Payment Advisory Commission (MEDPAC), the private plans serving Medicare patients, on average, already provide the same benefits and services for less cost than the traditional program. Furthermore, the HMOs participating in MA, which represent the majority of MA enrollment, provide Medicare benefits for 95 percent of the cost of the traditional program. (http://www.medpac.gov/documents/Jun12DataBookEntireReport.pdf, p. 146, Chart 9-6) In fact, analyzing CMS data, Robert Coulam, Roger Feldman, and Bryan Dowd found that 88 percent of Medicare beneficiaries live in counties where the price of the private plan at the 25$^{th}$ percentile is lower than that of traditional Medicare.

The primary tool that private healthcare plans can use to increase their efficiency compared to fee-for-service (FFS) is care coordination. Private plans have the ability to be more selective with their provider networks. The plans are also not subject to the artificial division within Medicare between Parts A, B, and D, and can utilize flexibility in cost-sharing and innovative strategies for disease management and care delivery (such as identifying enrollees that can be helped by a case manager).

Some claim that FFS must be more efficient than private plans due to its low administrative costs. However, it is unclear that the low level of FFS' administrative costs is optimal. Experts frequently bemoan the lack of administrative resources devoted to fraud prevention and care coordination in FFS. An efficient health plan should be willing to spend a dollar on administration if doing so saves more than a dollar or increases quality commensurately.

**QUESTION 3**

*How did BPC calculate the savings generated by the Domenici-Rivlin Protect Medicare Act?*

| Estimated cumulative savings from CBO's Current Law baseline in billions of dollars, 2016 through: | | | |
|---|---|---|---|
| | **2022** | **2025** | **2032** |
| **Introduce the Protect Medicare Act in 2016** | $175 | $280 | $675 |

***One hundred percent*** of the proposal's projected budget savings over the first two decades would come from the switch to competitive pricing, and ***zero*** would accrue due to the cap on per beneficiary spending growth. The federal government's contribution in each region would be set to the cost of the second-least-expensive health plan or fee-for-service (FFS) Medicare, whichever is less expensive, as opposed to the current system of administratively basing the government contribution on the cost of FFS in each region. This shift would not, in any way, prevent beneficiaries from receiving the same quality care that FFS offers today at the same cost – rather, all of the competitive pricing savings are achieved by preventing overpayments to health plans that do not provide care efficiently.

In particular, these savings would accrue in two ways:

a. In regions where traditional Medicare is one of the two least expensive plans, currently the government pays private plans more than the cost of FFS to enroll beneficiaries. The

Protect Medicare Act would eliminate these overpayments, and thus produce budget savings.

b. In regions where two private plans provide the same benefits as FFS for less money, currently the government pays at least the cost of FFS for each beneficiary. Under this system of competitive pricing, however, the government would only contribute the cost of the second-least-expensive private plan, which would produce budget savings.

To calculate the amount of savings from the switch to competitive pricing, we utilized analysis of CMS data from Robert Coulam, Roger Feldman, and Bryan Dowd,[1] and then factored in our own estimates for the cost of proposed additional subsidies to lower-income beneficiaries.

In projecting the budget savings from this proposal, we used a method comparable to what the Congressional Budget Office (CBO) would employ. Accordingly, we have not assumed savings resulting from efficiency improvements that stem from increased competition, because CBO's scoring would not include them.

**QUESTION 4**

*Would higher capital gains rates actually generate more revenue?*

All of the members of BPC's Debt Reduction Task Force concluded that both increased revenues and spending cuts will be necessary to contain the nation's rising public debt. For that reason, we spent considerable time developing a fundamental tax reform package that we believe would meet three essential criteria: increase revenue, stimulate economic growth, and distribute the additional burden according to the ability to pay. To achieve all three goals, we determined that it would be essential to eliminate the current preferential tax treatment of capital gains.

Fortunately, we have a precedent for our recommendation. The Tax Reform Act of 1986, passed by a Republican Senate and a Democratic House and signed by President Ronald Reagan, eliminated the tax preference for capital gains and reduced the top-bracket individual income tax rate to 28 percent. The Task Force proposal is quite similar.

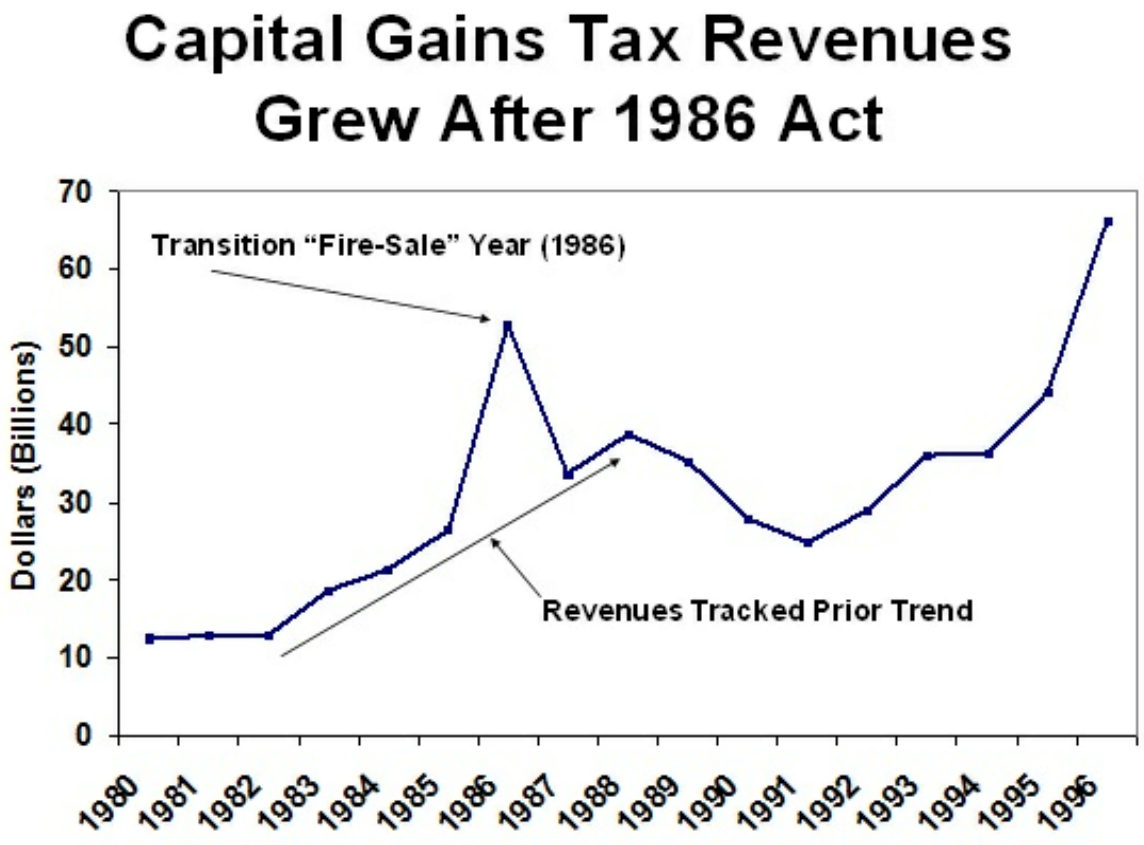
Below, we discuss our proposal with respect to capital gains in the context of all three criteria.

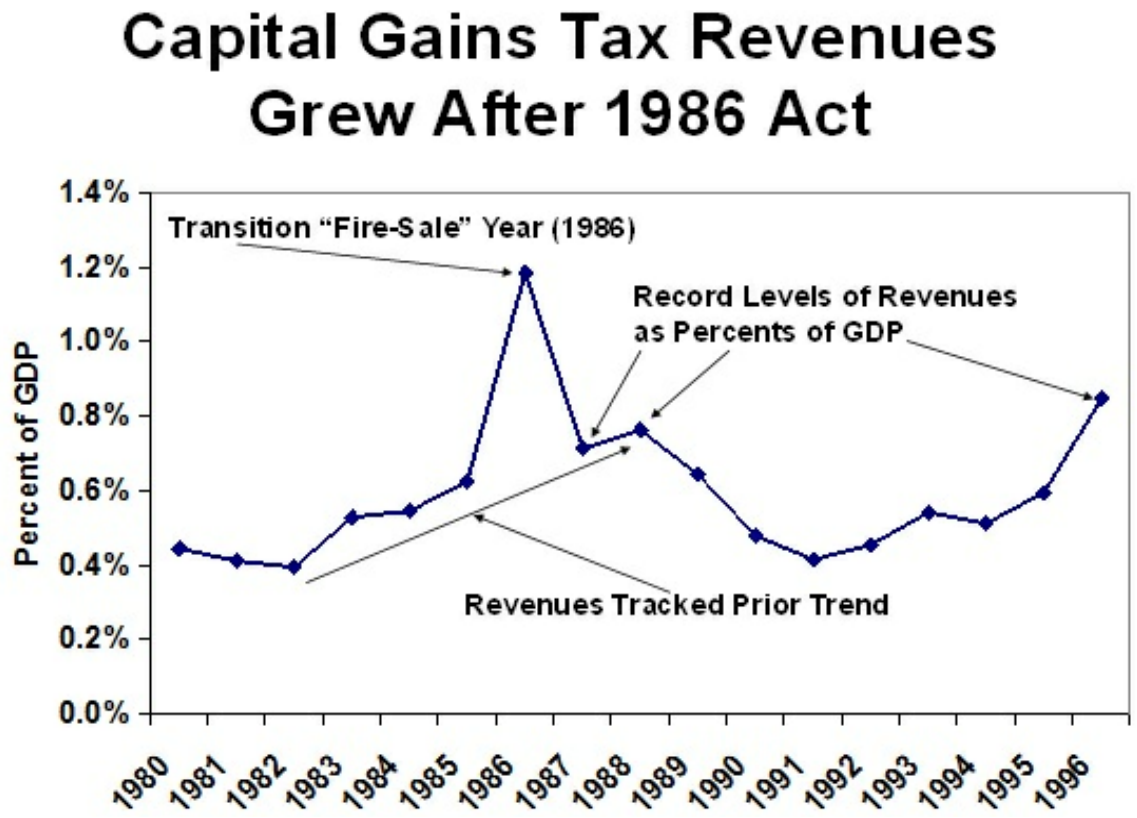
**Increasing Revenue**

[1] http://www.aei.org/outlook/health/healthcare-reform/competitive-bidding-can-help-solve-medicares-fiscal-crisis/

The evidence shows that the elimination of the capital gains exclusion in the 1986 Act increased tax revenue, as expected, and did not significantly reduce sales of assets. In fact, tax revenues on capital gains reached their highest level ever (setting aside the transition year of 1986) as a percentage of the economy in 1987, and then surpassed that level in 1988. Capital gains tax revenue exceeded that record level in 1996, the final year in which the tax treatment of capital gains remained virtually unchanged from the 1986 law.

Comparisons of subsequent revenues to the transition year of 1986 are misleading. The Tax Reform Act eliminated the capital gains preference with a prospective effective date of 1987, to allow taxpayers who were contemplating sales to do so under the prior law. This created a "fire sale" opportunity which was not representative of a normal year. The remarkable result is that even after that "fire sale," tax revenues continued along their prior trend until the recession intervened.






Currently, the reward for legal manipulation that re-characterizes ordinary income as capital gain, or capital loss as ordinary loss, loses the federal government significant revenue. Ending that manipulation by equalizing the rates will allow the government to tax ordinary income at a lower rate, thereby increasing the incentive to work by bringing down marginal tax rates for all working Americans.

**Increasing Economic Growth**

Capital gains tax preferences are much more a bonus for the already-wealthy portfolio investor than an incentive for the budding entrepreneur. The preference is irrelevant for the many entrepreneurs who hope to build and run successful businesses and earn salaries from them. Even for such entrepreneurs who look forward eventually to selling their businesses upon retirement, the tax on any resulting capital gains is years away, and its impact on their ultimate outcomes will be overwhelmed by the degree of their success in running their businesses.

Even with the higher capital gains tax rates under the 1986 Act, the economy in 1996 had recovered from the 1990-1991 recession, economic growth was robust, and a full-fledged investment boom was underway.

In sum, we believe that the Task Force tax proposal would on net be more conducive to economic growth than the current system – by substantially reducing rates on individual and corporate income to 28 percent – while also reducing the deficit directly.

**Establishing Fairness**

The capital gains preference is a key reason why many people of extraordinary wealth can pay lower tax rates on their income than people of far more modest means who simply work for a living. For the wealthy who make over $1 million annually, capital gains make up 39 percent of their income. In stark contrast, only 5.2 percent of people in the median income group ($30,000 to $40,000) have *any* tax-preferred capital gains, and those constitute only 0.9 percent of their total income.

These statistics demonstrate that the special treatment of capital gains overwhelmingly benefits the wealthiest taxpayers. Any capital gains preference implicitly forces higher tax rates on ordinary income, thereby transferring income from people who work – including many job-creating entrepreneurs – to people who already have accumulated wealth.

**Conclusion**

In an uncertain world with complex issues at play, the tax reform proposal of BPC's Debt Reduction Task Force provides the best balance that we have found among the nation's revenue needs, the imperative of economic growth, and society's need for a foundation of fairness of contribution according to ability to pay.