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TO

THE JOINT SELECT COMMITTEE ON DEFICIT REDUCTION, U.S. CONGRESS

NOVEMBER 1, 2011

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Senator Murray, Representative Hensarling and Members of the Joint Select Committee on Deficit Reduction , thank you for inviting us to testify on the enormous fiscal and economic challenges confronting our nation.

The testimony we have submitted summarizes more than one and a half years of deliberation by nineteen former senior policy makers ranging from former Democratic mayors of large cities to former governors, to former members of presidential cabinets. The Task Force represented a very diverse cross-section of the nation's economic and political interests.

The United States faces two huge challenges: (1) accelerating growth and job creation and (2) reducing future deficits to stabilize the debt so that it is no longer growing faster than the economy. These objectives reinforce each other. Faster growth will reduce deficits, and stabilizing the debt will cut future interest rates, reduce uncertainty and enhance growth. This Committee, with its extraordinary powers, has both the opportunity and the obligation to address both challenges.

The Bipartisan Policy Center's Debt Reduction Task Force urges you put ideology aside, cooperate across partisan lines, and craft a Long term budget plan that will put the country on a path to sustainable prosperity and responsible budgeting. To achieve success, the Committee will have go well beyond the minimum charge of identifying at least $1.2-$1.5 trillion in savings over the next ten years, because even savings of this magnitude would still leave the debt rising faster than economic growth. We believe you should craft a grand bargain involving structural entitlement and tax reform that would save at least $4 trillion over ten years. In order to do so, the Committee should take full advantage of the authority given to it by the Budget Control Act (BCA) in Section 404, and write instructions to compel authorizing committees to produce fundamental tax and entitlement reform and provide for "fast-track" consideration of those reforms.

We believe that a grand bargain would have enormous economic benefits and would also reassure citizens and markets that our political process is functioning in the public interest, not stuck in partisan gridlock or overwhelmed by special interests. Failure to reach agreement (or even settling for the minimal $1.2 trillion savings) would increase the chances of continuing weakness in the economy, high joblessness, and deep distrust of the ability of elected leaders to govern.

The BPC recommends a three-step process in order to spur our economy, achieve savings and stabilize our debt:

- **Step 1** was passage of the BCA, which provided $900 billion in discretionary savings, similar to the amount recommended by the BPC's Task Force.

- **Step 2** – in progress – calls on the Committee to **identify a down-payment of $1.2-$1.5 trillion in net deficit reduction over ten years**, **which should be accompanied by a full payroll tax holiday to spur the economy**. The deficit reduction should utilize the many bipartisan plans that have been released, combining spending cuts from all parts of the budget with revenues. These savings also must be *real* – no budgetary gimmicks. Many of these policies will not be overly popular, but a comprehensive plan – one that addresses every aspect of the budget – is the most politically palatable approach.

- **Step 3** requires the Committee to take full advantage of Section 404 of the BCA and **instruct the relevant authorizing committees to legislate further reform**. The two primary areas of focus should be fundamental, pro-growth *tax reform that raises revenue*, and *structural Medicare reform* to ensure the future sustainability and efficiency of the program, as explained in the Domenici-Rivlin Protect Medicare Act.

Should the Committee fail to reach agreement on major reforms that will encourage growth and stabilize our fiscal situation, you will have missed an historic opportunity to set the country on the right track, and the consequences both to the economy and to public confidence could be dire. A sequester would produce mindless, possibly harmful cuts in spending, and even avoiding the sequester by finding $1.2 trillion would only kick the biggest part of the rising debt problem down the road. We urge you to seize the opportunity to get the job done.

The central elements of any grand bargain to stabilize our debt are clear:

1) Policies to promote growth and create jobs now;
2) Savings from discretionary accounts (which have already been enacted in the Budget Control Act);
3) Fundamental health care reform, especially Medicare; and
4) Fundamental tax reform that raises revenue.

The Bipartisan Policy Center's Debt Reduction Task Force, which we co-chaired, only was able to achieve consensus by addressing all four.

Payroll Tax Holiday

To jumpstart the struggling economy, we recommend enacting a full Social Security payroll tax holiday for both employers and employees for one full year. This immediately will increase consumer spending and business hiring, thereby delivering economic growth and creating jobs. The tax cut will provide financial relief for roughly 160 million American workers, many of whom are having difficulty making ends meet in the aftermath of the worst recession in nearly

eighty years. A significant portion of the additional take-home pay will be spent quickly by consumers. Some of the money will undoubtedly go towards paying down debt, but household deleveraging is a necessary precondition for a return to low unemployment and sustained growth. A payroll tax holiday will help people get out of debt faster by adding roughly $3,000 to the average worker's paycheck.

Fundamental Health Care Reform

The fundamental problem to be addressed by this Committee is that federal spending is projected to rise faster than revenues for the foreseeable future leaving a widening gap to be financed by borrowing. The primary drivers of increased spending are the health care programs, including Medicare, Medicaid, and the subsidies to be provided by the Affordable Care Act (ACA). Huge projected increases in the number of older people, combined with persistent increases in health care spending per person account for this upward pressure on spending. Hence, reducing the rate of growth of these programs is essential to any long run debt stabilization plan. (See Chart)

Spending on mandatory healthcare programs is projected to increase from 23 percent of non-interest federal spending in 2011 to 34 percent by 2021.

Rising federal spending on health care is, of course, a part of the more general trend of increasing spending for health care in the economy as a whole. Over time, national health spending has grown about 2 percentage points per year faster than GDP and health care spending nationally is nearly 17 percent of GDP and rising. The objective of reforming federal health programs should not be to shift federal costs onto the private sector, but to use the federal programs to lead the way toward more effective and less wasteful delivery of health care, no matter how that care is paid for.

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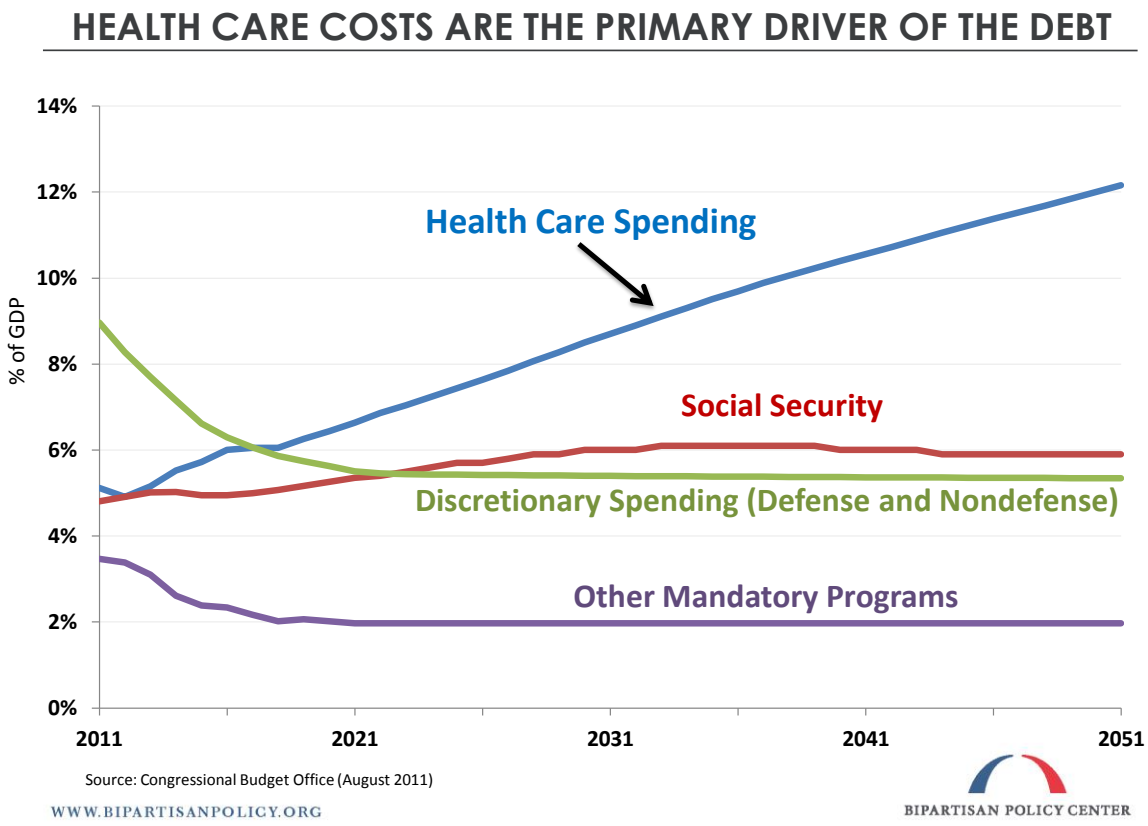

The Task Force plan includes both demand- and supply-side approaches to slowing the growth in overall health spending and federal spending specifically. Some aspects target the health system in general, while others focus specifically on Medicare and Medicaid.

The major demand-side strategy is to cap and then phase out the tax exclusion of employer-sponsored health insurance (ESI) benefits. This policy will result in more cost-conscious choices by purchasers of health insurance.

Also on the demand side is a proposal to modernize patient cost sharing in the Medicare program. The modernized benefit structure will include a combined annual deductible for Parts A and B, and will provide catastrophic coverage – a protection that is sorely lacking today – thereby more closely matching recent trends in private health care plans.

The key supply-side strategy is to reform provider payment incentives. Moving payment away from fee-for-service and toward broader payment units will incentivize providers to seek more efficient delivery systems. Health reform – i.e., the ACA – took some very important steps toward reforming provider payments in Medicare. The Task Force proposes to build on this by bundling payments for post-acute care into the payment for inpatient care. Many other options

for supply-side reform have received bipartisan support – this committee would be wise to select from some of those, as well.

For Medicaid, in the short term, the Task Force proposes to remove barriers to greater use of managed care for those dually eligible for Medicare and Medicaid. For the long term, significant changes to the program are needed – both narrowly-targeted and fundamental reform proposals should be given serious consideration.

Although each of these proposals will have beneficial effects for the national healthcare system help control federal costs, much of the long-run savings in the Task Force plan will come from transitioning Medicare from fee-for-service to a defined support option. This new system will marshal both demand- and supply-side leverage to transform the national healthcare infrastructure into a more efficient and effective vehicle. As such, this is the proposal that we primarily will focus on today:

Domenici-Rivlin Protect Medicare Act

Simply put, there can be no lasting solution to the U.S. debt crisis without structural changes in the Medicare program to slow its cost growth. This can be done through our proposal to transition Medicare to a "defined support" plan. Such a system will provide major incentives to increase the efficiency and effectiveness of health care delivery to seniors – without abolishing current Medicare, or forcing any beneficiary to move to a different system – and cap total Medicare spending while protecting low-income seniors.

The Domenici-Rivlin defined support proposal will preserve Medicare for future generations. It will allow beneficiaries who wish to stay in traditional Medicare to do so, but also control program costs by providing them the option of choosing among competing private plans that could save them money. It will restrain the growth in total Medicare spending, while protecting low-income beneficiaries from any increases in their cost. In short, the Domenici-Rivlin plan both will preserve Medicare as a choice and also save money by flattening the now-steeply-rising Medicare cost curve.

The Domenici-Rivlin proposal restructures Medicare to achieve fiscal soundness in three ways:

1) A new federally-run Medicare Exchange will provide beneficiaries with a truly competitive marketplace in which they can choose among private healthcare plans and traditional fee-for-service Medicare (FFS). The private plans will be required to cover at least the same services as FFS Medicare, and their government subsidy will be adjusted up (or down) if they attract patients whose illnesses are more (or less) expensive than

average. The Exchange will provide understandable information about the costs and health outcomes of plans so that beneficiaries can choose plans that are best for them, and will allow beneficiaries, if they are not satisfied, to change plans in an annual open season. This competition will incentivize healthcare plans to innovate in every facet of their operations and benefit designs to keep premiums down and quality of care up.

2) By using competitive bidding, this system will tie the federal contribution to the cost of the 2nd-cheapest approved plan or FFS Medicare in each area, whichever is cheaper. Thus, the government will no longer have to pay extra to private healthcare plans in areas where the public FFS plan provides cheaper coverage, nor will they have to overpay to provide FFS Medicare in areas where approved private plans offer the same care at lower cost.

3) These two cost-control features should flatten the cost curve. However, an additional element will ensure substantial savings. The growth in per-beneficiary federal support will be limited to one percentage point faster than the growth of the economy – "GDP+1%" – compared to the current projection of growth that is 1.7 percentage points faster. If costs rise faster than the established limit, Medicare beneficiaries will have to pay higher premiums. However, individuals whose Part B premiums are paid by Medicaid programs will not be affected. Additionally, to smooth the transition to the defined-support system, current beneficiaries with low incomes will be guaranteed access to traditional Medicare with no additional premiums. This subsidy will phase out at higher income levels.

How the Exchanges Work

In each regional market – be it a metropolitan area, or a large rural area where population density is low – all of the private healthcare plans and traditional FFS Medicare will submit bids (subject to strict quality and coverage standards) to provide the standard Medicare benefit package for Parts A and B to an average-risk beneficiary. The FFS "bid" will be based on average FFS costs for the same type of standardized beneficiary in the bidding area. The amount that the government contributes to premiums in that area will then be based on the 2nd-lowest private bid or FFS Medicare's bid, whichever is lower. This will be referred to as the "benchmark" bid.

Beneficiaries who choose to enroll in a plan that is more expensive than the benchmark – even if that plan is FFS Medicare – will be required to pay the incremental additional cost. A beneficiary who enrolls in the plan with the lowest bid will be rebated the full difference in cost from the benchmark

The Exchange will be federally run, presumably by the Centers for Medicare and Medicaid Services (CMS), require guaranteed issue (under which insurers may not decline any applicant), and enforce guidelines for the structure of the benefit package. CMS also will utilize risk adjustment by distributing the government subsidy among insurers according to the health status of those whom they enroll.

Why is this proposal an improvement over the current Medicare system?

Medicare Advantage already offers private plans to Medicare beneficiaries. However, if a private healthcare plan currently has lower costs than FFS Medicare in its area, it cannot offer a rebate to enrollees as an incentive to sign up. Instead, it must increase benefits – which in and of itself increases Medicare spending. Therefore, beneficiaries in areas with high FFS Medicare costs who enroll in private plans receive a host of free supplementary benefits, financed by the government. There is no policy justification for selectively offering free, government-financed supplementary benefits to beneficiaries in one geographic region but not another.

Instead, the new Medicare Exchange will provide strong incentives for plans to manage care-delivery efficiently and to offer the public evidence that their plans achieve quality outcomes at comparatively low cost – because low-bidding plans would be rewarded with increased enrollment.

The Domenici-Rivlin proposal also guarantees that the federal support per beneficiary will *not* grow faster than GDP+1%, thereby assuring the federal government of budgetary savings. The cap on the growth rate also should increase the pressure on plans to develop more efficient methods of care delivery, and might increase political support – by Medicare beneficiaries, their children, and those approaching Medicare eligibility – for federal policies that promote cost containment in health care. The Affordable Care Act already established a cap on the growth of Medicare; moving to a defined support model creates the incentives to make that cap stick.

In the event that Medicare spending per beneficiary rises at a faster rate, enrollees will have to pay higher premiums to cover the difference.[1] However, individuals whose Part B premiums are paid by Medicaid programs will not be affected. Additionally, to smooth the transition to the defined-support system, current beneficiaries with low incomes will be guaranteed access to traditional Medicare with no additional premiums. The new system also could be structured to provide a higher subsidy to those with lower incomes and a lower subsidy to those with higher incomes.

[1] To promote stability, the proposal calls for employing a five-year historical trend of per-capita GDP rather than measuring the change over a single year.

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Fundamental, Pro-growth Tax Reform

Unfortunately, even if we are able to significantly bend health care's cost curve through the Protect Medicare Act and rein in other spending, the aging of the population and retirement of the baby boom generation is not something that we can control. In order to stabilize the debt, therefore, we must raise more revenue. But, this can be achieved through fundamental tax reform that broadens the base, lowers tax rates, and promotes economic growth.

The Bipartisan Policy Center's Tax Reform Plan represents a radical simplification of the current tax code and raises $2.2 trillion more in revenue than current policy[2] (or, $1.7 trillion less than current law). In fact, to best explain it, forget what you know about the complexities of the current tax system, and start fresh. Outlined below are the core elements of the plan:

- A **two-bracket income tax with rates of 15% and 28%**. Because there is no standard deduction or personal exemptions, the 15% rate applies to your 1st dollar of income.[3]

- The **corporate tax rate will be set at 28%**, instead of the current 35% level.

- Capital gains and dividends will be taxed **as ordinary income** (**with a top rate of 28%**), excluding the first $1,000 of realized net capital gains (or losses).[4]

- To replace the overly-complex Earned Income Tax Credit (EITC) and to help offset the elimination of personal exemptions, the standard deduction and the child credit, the BPC Plan will establish:
    - A flat **refundable per child tax credit of $1,600** (higher than current law); and
    - A **refundable earnings credit** similar in structure to the recent Making Work Pay credit, but substantially higher.

- Instead of the current system of itemized deductions, which disproportionately subsidizes the housing consumption and charitable giving of upper-income taxpayers, the BPC Plan will:
    - Provide a **flat 15% refundable tax credit for charitable contributions** and for up to $25,000 per year, not indexed, **mortgage interest on a primary residence**.
    - Eliminate the deduction for state and local taxes.

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[2] Current policy baseline assumes that all 2001/2003/2010 income and estate tax cuts are extended and that the AMT is indexed to inflation.
[3] The 27% rate applies approximately to income above $51,000 for single filers and $102,000 for couples.
[4] $500 for singles and heads of household

  - Provide a flat, **15% refundable tax credit** or a deduction (for those in the higher bracket) **for contributions to retirement saving accounts** up to 20% of earnings or a maximum of $20,000.

- Include 100% of Social Security benefits in taxable income, but:
  - Create a non-refundable credit for Social Security beneficiaries equal to 15% of the current standard deduction; and
  - Create a non-refundable credit equal to 15% of an individual's Social Security benefits.

- Allow deduction of medical expenses in excess of 10% of AGI (as in current law).

- Allow deduction of miscellaneous itemized deductions in excess of 5% of AGI.

The BPC Plan achieves a massive simplification of the tax code by **aligning the top individual, capital gains and dividend tax rates, significantly reducing the corporate tax rate, and eliminating the AMT**. Additionally, **most individuals will no longer have to file an annual tax return**[5] beyond an initial declaration of status because the most commonly taken deductions have either been turned into refundable credits, determined solely based on the number of children and earnings, or can only be deducted above a substantial floor. Despite a low top rate of 28%, the new tax system created under the BPC Plan will be **more progressive than the current system** and **raise the requisite revenue to achieve a sound debt-reduction goal**.

How the Joint Select Committee on Deficit Reduction can reach the grand bargain

To put our country's budget back on a sustainable path, these three elements are essential. However, time is short. With the deadline to report recommendations only three weeks away, writing legislation to fundamentally reform Medicare or the tax code is unrealistic. **Still, this Committee can achieve these objectives**.

Section 404 of the Budget Control Act (BCA) provides this Committee the power to draft legislation that must be voted on by the House and the Senate and, if approved, presented to the president for his signature. Significantly, such legislation could:

- Order the committees with jurisdiction over entitlements and revenues to report legislative language by a specific date next year (for example, April 15, 2012), after the

[5] According to Tax Policy Center projections, only 50% of tax units would be required to file tax returns, as opposed to 88% under the current tax system.

expiration of the Joint Select Committee (JSC) itself, to change their programs to reduce projected federal deficits by an amount certain.

- In that order, the JSC could specify explicitly not only the deficit reduction targets to be met, but also the nature of the structural program changes to be made – and by so doing, enforce what would be a true and binding agreement between the two political parties that had been negotiated within the JSC.

- The legislation developed by the instructed committees would be reported back to the House and Senate Rules Committees (or the Budget Committees) and combined into one bill, which would be scored by the Congressional Budget Office.
- The JSC, further, could order that the legislation reported back by the instructed committees receive "fast-track" treatment in the House and Senate, which could be similar to the fast-track treatment afforded to some other types of legislation, and would be determined by the recommendations of the JSC itself.

- Lastly, the JSC could draft the legislative language so that failure to produce the substantive legislation would trigger a sequestration, either conforming to the instructions given to the committees and in the amount of the deficit reduction targets required by the JSC, or in some new manner that could be specified by the JSC.

In sum, Section 404 of the BCA gives the JSC the power to do much more than just find savings of $1.2 trillion to $1.5 trillion; it also has the power to establish and enforce a process that uses existing congressional committees to change entitlement and tax policies.