Tax and spending reform for fiscal stability and economic growth

By Joseph Antos, Andrew G. Biggs, Alex Brill, and Alan D. Viard

Recognizing the unsustainable fiscal outlook facing the United States, the authors present a plan to constrain the growth of federal spending and reform the tax system to promote economic growth. The plan replaces the income tax system with a progressive consumption tax, eliminating the bias against savings and investment. The plan revamps Social Security to provide a flat, universal benefit that would virtually eliminate poverty in old age, making the program more effective in protecting low earners, more conducive to saving and longer work lives, and better aligned with the work and retirement conditions that will prevail in the coming decades. Additionally, the plan adopts health reforms that are intended to slow the growth of spending while maintaining access to high-quality health services, by shifting away from the defined-benefit approach that characterizes Medicare and Medicaid today to a defined-contribution philosophy. The plan also brings federal spending and revenue into closer alignment, sparing future generations from the explosive growth of federal debt.

Absent major policy changes, growth in entitlement spending over the next 25 years is projected to push the federal debt as a share of GDP to more than 100 percent, an untenable fiscal prospect and one that will force undue burdens onto future generations. The objective of this plan is to achieve long-term fiscal stability and promote economic growth. We cannot simply tax our way to fiscal stability without suffering the consequences of a slower economy and reduced prosperity. Yet we also cannot address the imbalance simply by cutting spending without regard for the risks of eliminating essential services for an aging population, undercutting our infrastructure on which economic growth builds, and reducing our ability to defend the country against its enemies.

The tax proposals presented in this plan raise necessary revenues with the least possible impact on saving and economic growth. Our spending proposals make entitlement programs better targeted and more efficient. Our proposals would hold the national debt to 62.7 percent of annual gross domestic product (GDP) in 2040. Ambitious cuts in federal spending are required to achieve that goal while minimizing tax burdens on the American people and the drag that high marginal tax rates impose on long-run economic growth. The plan emphasizes reductions in the growth of the major

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2 The plan is a revision and update of the plan presented in Antos, Biggs, Brill, and Viard (2011).
entitlement programs—Social Security, Medicare, Medicaid, and health insurance subsidies established by the Patient Protection and Affordable Care Act (ACA).

Many of these policies will be politically unpopular, but some version of our proposal is necessary. None of the authors of this plan fully agrees with every policy advanced here, but we have been able to reach the kind of compromise that is needed to address the long-run fiscal imbalance. Our plan addresses three key areas.

**Taxes.** The federal government raises much of its revenue from individual and corporate income taxes, which penalize saving and investment. Our proposed tax reform eliminates these penalties by replacing the income tax system and the estate and gift tax with a progressive consumption tax. To address environmental concerns in a more market-friendly manner, the proposal replaces an array of energy subsidies, tax credits, and regulations with a modest carbon tax.

**Social Security.** The Social Security reforms we outline are designed to make the program more effective in protecting low earners, simpler for individuals at all earnings levels to understand and plan around, more conducive to saving and longer work lives, and better aligned with the work and retirement conditions that will prevail in the coming decades. The Social Security program will provide a flat, universal benefit that would virtually eliminate poverty in old age. This flat payment would increase benefits for the roughly one-third of retirees whose current Social Security benefit is less than the poverty threshold. But middle- and upper-income individuals will have to save more on their own for retirement, and this proposal facilitates that saving. Delayed retirement also would improve retirement income security, and this proposal provides clear incentives for individuals to extend their work lives. These changes will make Social Security solvent and sustainable in the long term while reducing program outlays to better accommodate rising costs for other priorities, including health care.

**Health Care.** Our proposed health reforms are intended to slow the growth of spending—both federal and system-wide—while maintaining access to high-quality health services. The reforms establish a clear understanding that binding resource constraints exist without imposing unnecessary restrictions on consumer choice. Incentives, rather than controls, promote greater efficiency and allow patients and their health care providers to make the best individual decisions within a responsible budget framework. That requires shifting away from the defined-benefit approach that characterizes Medicare and Medicaid today toward a defined-contribution philosophy that limits federal spending while recognizing the changing needs of the population.

To develop an effective plan, it is necessary to repeal major sections of the ACA and replace them with a new set of policies based on market principles and budget realities. Nonetheless, the major objectives of that legislation (such as creating an organized marketplace for insurance, better information for consumers, and expanded federal insurance subsidies for those most in need) are reflected in new policies better able to achieve those goals.

Our proposal brings federal spending and revenue into closer alignment, sparing future generations from the explosive growth of federal debt. At the same time, it promotes economic growth by emphasizing spending cuts rather than tax increases and by using an economically efficient consumption tax to raise the revenue.

**Table 1. Budgetary Effects of the Plan**

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<thead>
<tr>
<th></th>
<th>2026</th>
<th>2040</th>
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<tbody>
<tr>
<td><strong>Percentage of GDP</strong></td>
<td></td>
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</tr>
<tr>
<td>Revenues</td>
<td>19.3</td>
<td>21.2</td>
</tr>
<tr>
<td>Spending</td>
<td>21.8</td>
<td>22.5</td>
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<tr>
<td>Deficit</td>
<td>2.5</td>
<td>1.4</td>
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<tr>
<td>Debt Held by the Public</td>
<td>76.7</td>
<td>62.7</td>
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Source: Estimates by the authors and by the Urban-Brookings Tax Policy Center
needed. Real federal spending would continue to increase under the proposal, but at a significantly slower pace than under current law (table 1).

**Tax Policy**

The goal of our tax reform is to eliminate the income tax’s inherent bias against saving and investment and to reduce other tax distortions. To achieve this goal, the income tax system and the estate and gift taxes would be replaced by a progressive consumption tax, in the form of a Bradford X tax consisting of a household-level tax on labor income and a firm-level tax on business cash flow. To address environmental externalities in a more cost-effective and market-based manner, energy subsidies, tax credits, and regulations would be replaced by a modest carbon tax. The gasoline tax would be increased to cover highway-related costs.

Recognizing the health and welfare burdens imposed by an aging population, revenue would be modestly increased above its baseline path. The move to the X tax would allow additional revenue to be raised with less damage to economic growth.

**Replace Current Taxes with the Bradford X Tax**

The individual and corporate income taxes, including the alternative minimum tax and the estate and gift tax, would be repealed, as would the Unearned Income Medicare Contribution.

These taxes would be replaced by a Bradford X tax. Broadly, the tax would follow the principles of the Progressive Consumption Tax Plan discussed by the President’s Advisory Panel (2005, 182–90) and the proposal outlined by Carroll and Viard (2012). The X tax would consist of a 37 percent flat-rate firm-level tax on business cash flow and a graduated-rate household-level tax, with a top rate of 35 percent, on wages and fringe benefits. The new tax system would take effect on January 1, 2018.

Although the X tax has some administrative similarity to the income tax system, two features make it a consumption tax. First, the household tax applies only to labor income, not to capital income. Capital income faces no household-level tax. Second, the business tax applies to business cash flow, rather than to net business income, so business investment is immediately expensed rather than depreciated over time. The immediate tax savings from expensing a new investment fully offset (in expected present value) the taxes imposed on the investment’s subsequent cash flows. The firm-level tax collects revenue from business capital in place at the time of the reform (subject to transition relief, which we will describe) and from above-normal returns on new business investment but does not tax the normal returns on new investment. Because a marginal new investment faces no tax at either the firm or the household level, the X tax is, in economic terms, a consumption tax.

The X tax can be viewed as a value-added tax (VAT) that has been split into two components. Business firms are taxed on value added minus wages, or business cash flow, and households are taxed on wages. Splitting the tax base in this manner enables the X tax, unlike a conventional VAT, to be progressive. Wages are taxed at graduated rates, with higher-wage workers facing higher tax rates, and the lowest-wage workers receive tax credits. Business cash flow, which is generally earned by owners who are well off (owners of business capital in place at the time of the reform and investors who receive above-normal returns), is taxed at a flat rate approximately equal to the tax rate on the highest-wage workers.

**The move to the X tax would allow additional revenue to be raised with less damage to economic growth.**

**Household Tax.** For married couples in 2018, the first $80,000 of taxable income would be taxed at 15 percent, the next $160,000 of taxable income would be taxed at 25 percent, and taxable income above $240,000 would be taxed at 35 percent. The bracket ranges for unmarried taxpayers would be set at half of the values for married couples filing jointly. There would be no
head-of-household filing status. The bracket ranges would be indexed to the chain-weighted Consumer Price Index (CPI) after 2018.

Like cash wages, employer-provided health insurance and life insurance and employer contributions to defined-contribution plans would be deducted by firms and taxed to workers. Cafeteria plans, which allow participants to receive certain benefits on a pretax basis, would be abolished. Because it would be difficult to allocate employer contributions to defined-benefit plans among employees, employers would deduct 50 percent of contributions, and employees would not be taxed on the employer contributions. This treatment would effectively tax all employer contributions at a flat 18.5 percent rate (half of the 37 percent business tax rate).

In general, the household tax would apply only to labor income earned in the United States, with no tax on interest, dividends, capital gains, pensions, business income, and transfer payments. Most government benefits would not be taxed, including withdrawals from the new universal retirement accounts (created as part of the Social Security proposal we will discuss). Alimony income and gambling winnings would not be taxed, and alimony payments and gambling losses would not be deducted. However, Social Security and unemployment compensation benefits would be fully taxable, reflecting the fact that such benefits are partially or fully taxable under current law.

There would be no standard deduction, but the following deductions would be allowed against the household tax:

- Child and dependent care expenses could be deducted, subject to a ceiling of $9,000 for one dependent and $18,000 for two or more dependents in 2018. The ceilings, which approximate the real levels of the ceilings that applied to the child and dependent care credit when it was introduced in 1976, would be indexed to the chain-weighted CPI after 2018. The definitions of qualified dependents and qualified expenses, including the limitation based on the amount of labor income, would follow the definitions used for the current-law credit. Because child and dependent care expenses are costs of working, they should be deducted from taxable labor income.
- Employee business expenses could be deducted, subject to a floor of 2 percent of labor income. The definition of eligible expenses would follow the rules for the current-law itemized deduction for employee business expenses.

The following credits would be allowed against the household tax:

- A $1,000 nonrefundable credit for each adult taxpayer and a $500 nonrefundable credit for each child 17 or younger. There would be no income-based phaseout. The credit amounts would be indexed to the chain-weighted CPI after 2018.
- A 15 percent refundable credit for charitable contributions, in excess of an annual floor of $500. The $500 floor would be indexed to the chain-weighted CPI after 2018. The refundability of the credit would make it available to investors, who might not owe household tax, as well as to workers.
- A 15 percent refundable credit for mortgage interest, with a ceiling of $250,000 (not indexed for inflation) on the mortgage principal amount.
- A refundable credit for health insurance, created as part of the health proposal we will discuss.
- The current-law earned income tax credit (EITC), with three modifications: the EITC for childless workers would be doubled relative to current law; the maximum limit on investment income would be eliminated, but households with significant asset holdings would be disqualified from receiving the credit; and all dollar amounts would be indexed to the chain-weighted CPI rather than the Consumer Price Index for All Urban Consumers starting in 2018. The additional EITC for workers with three or more children, currently scheduled to expire at the end of 2017, would be permanently extended.
**Taxation of Business Firms.** Business cash flow would be taxed at a flat tax rate of 37 percent, approximately matching the combined X tax and Medicare payroll tax rate on wages of a worker in the top household tax bracket. Except as we will describe, the business tax would apply to all firms without regard to their legal form of organization, including sole proprietorships, partnerships, limited liability companies, and corporations.

Except for financial intermediaries, the business tax would apply to the firm’s cash flow from real operations in the United States and would disregard the firm’s financial activities. There would be no deduction for interest expense and no tax on a firm’s interest income or other financial income.

The firm-level tax would be imposed on business cash flow. All investment, including equipment, structures, land, and inventories, would be immediately expensed. Firms would deduct their purchases from other firms and their wage and fringe benefit costs. The complicated current-law tax rules pertaining to capitalization, depreciation, amortization, and inventory accounting would be repealed.

The X tax treats wages workers receive more favorably than business cash flow the firm’s owners receive, taxing the former at graduated rates ranging up to 35 percent and the latter at a flat 37 percent tax rate. (As a partial offset, however, wages, but not business cash flow, are subject to payroll tax.) Rules are therefore required to classify payments received by an owner who works for a closely held firm; in economic terms, such payments are likely to comprise a mixture of wages for the owner’s work and cash flow received on the owner’s investment in the firm. We propose simple rules that allow favorable wage-tax treatment for any payments that include a significant amount of labor compensation.

Accordingly, a sole proprietor would be allowed to treat all of the proprietorship’s cash flow as wages. An owner of a firm other than a sole proprietorship who worked more than 500 hours during the year for the firm would also be allowed to treat payments from the firm as wages. An owner who worked for a firm other than a sole proprietorship for less than 500 hours during the year would receive wage-tax treatment only for payments equal to reasonable compensation for his or her labor; any payments from the firm above that amount would be subject to the 37 percent firm-level tax on business cash flow.

Firms would be allowed to carry negative cash flows back for five years and forward for an unlimited period, with interest paid on carryforwards at the one-year Treasury rate.

Business tax preferences, except a reformed and permanent research tax credit, would be abolished. The research tax credit would be a flat nonincremental credit. Qualified research would be limited to research undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field, along the lines specified in the (subsequently withdrawn) January 3, 2001, Treasury regulation (Viard 2011, 205–06). The credit rate would be set so that the cumulative revenue loss in fiscal years 2018 through 2040 would match the revenue loss from the research credit in the current-policy baseline. This credit, which would be more narrowly targeted than the prior-law credit, would address the positive externalities arising from some forms of research.

Transactions between financial intermediaries and household customers would be taxed on a cash flow method that integrates real and financial transactions, as Carroll and Viard (2012, 92–98) discuss. There would be no taxes on transactions between intermediaries and business customers unless the intermediary charged explicit fees or deemed fees to be charged, in which case the fees would be taxed to the intermediary and deducted by the business customer.

**International Transactions.** Because the X tax would not feature a border adjustment, under which taxes are imposed on imports and rebated on exports, it would be an origin-based tax. The firm-level tax would apply only to operations in the United States, and the household-level tax

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Because of ACA repeal (discussed as part of the health proposal below), the employee and employer Medicare payroll tax would each be 1.45 percent. If $100 is devoted to compensation of a top-bracket employee, the firm would pay $1.43 payroll tax and would disburse $98.57 wages, on which the employee would pay $1.43 payroll tax and $34.50 household X tax. The total tax rate would be 37.36 percent.
would apply only to labor income earned in the United States.4

The use of the origin basis would avoid complications under international trade agreements and would also prevent a large wealth transfer to foreign equity holders of US firms, as Carroll and Viard (2012, 109–11) discuss. To mitigate transfer-pricing problems, transactions between domestic firms and related foreign parties would be taxed using a cash flow method that integrates real and financial transactions, as proposed by Bradford (2004, 38–40).

There would be no credit for foreign income taxes. Withholding taxes on interest and dividends paid to nonresident aliens would continue to apply in the absence of treaty provisions, but reciprocal elimination of such taxes would be aggressively pursued in bilateral negotiations.

Nonbusiness Sector. There would be no tax on the cash flow of federal, state, local, and tribal governments and nonprofit institutions, including their commercial enterprises, such as universities and hospitals. Other firms would be taxed on their sales to, and deduct their purchases from, governments and nonprofits under the same terms as other sales and purchases. The wages and fringe benefits of employees of governments and nonprofits would be subject to the household tax on the same terms as wages and fringe benefits of other employees.

This treatment would exempt from taxes only the business cash flow of governments and nonprofits; the tax base would still include the full value added at earlier and later stages of production, as well as the payrolls of governments and nonprofits. As Carroll and Viard (2012, 147–48) explain, there would effectively be no tax on the existing capital of governments and nonprofits nor on their above-normal returns.

Transition. The research tax credit, bonus depreciation, and expanded section 179 expensing, which expired at the end of 2014, would be reinstated and extended for 2015, 2016, and 2017. The other tax provisions that expired at the end of 2014 would not be reinstated.

Investments made in 2017 would be expensed to ensure that firms did not delay investment in anticipation of expensing them under the X tax. For assets held on December 31, 2017, firms would be allowed to claim 85 percent of the depreciation, amortization, and cost-of-goods-sold deductions to which they would have been entitled under the schedule set forth in prior-law income-tax rules. The deductions would be decoupled from the underlying assets and claimed by the firm holding the assets on December 31, 2017, even if the assets were subsequently sold to other firms. All dispositions of business assets on or after January 1, 2018, would therefore be subject to X tax rules (expensing by the purchaser and full taxation of sale proceeds to the seller), with no impact on the transition deductions allowable to the December 31, 2017, holder.5

Interest on existing debt instruments, including home mortgages, would be taxed and could be deducted in accordance with prior law unless and until the interest rate was renegotiated. In each year, a household would be required to choose between this transitional mortgage interest deduction and the new 15 percent refundable mortgage interest credit. A number of other transition rules would apply.6

Households would not expense purchases of owner-occupied homes and consumer durables and would not pay tax on the imputed service

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4 The X tax would apply to the 50 states and the District of Columbia but not to Puerto Rico and the other four US territories. Because the territories are largely outside the current income tax system, they should remain outside of the X tax system.

5 Taxpayers would similarly be allowed to claim 85 percent of the prior-law credit and loss carryforwards against their cash flow tax, subject to the prior-law limits on the carryforwards (with the general-business-credit limits applied to carryforwards of the foreign tax credit and the alternative minimum tax credit).

6 For example, existing traditional IRAs, 401(k)s, and other front-loaded tax-preferred savings accounts would be closed to new contributions. Withdrawals from such accounts would be subject to the household X tax, with no early-withdrawal penalties and no minimum distribution requirements. Employer defined-benefit pension funds would be closed to new contributions. Each firm’s contributions in and after 2018, which would be 50 percent deductible, would be made to a new fund. The firm would meet its pension obligations from the old fund until it was exhausted and would then draw upon the new fund; benefits paid from the old fund would be taxed to the recipient in accordance with current law. Existing Roth IRAs and other back-loaded tax-preferred savings accounts would be converted to ordinary savings accounts, with no early-withdrawal penalties and no restrictions on the purpose of the withdrawals.
flows. In economic terms, the purchase of such assets, rather than the subsequent service flows, would be treated as consumption. There would be no tax on resales of owner-occupied homes and consumer durables and no tax on the existing stock of those assets.7

**Payroll and Self-Employment Taxes**

All employer-provided fringe benefits subject to the household X tax would also be subject to payroll tax. Because employer contributions to defined-benefit plans would not be allocated to employees, they would not be subject to payroll tax. Payments to owners of closely held firms treated as labor income under the X tax system, as described, would be subject to payroll tax. There would be no separate self-employment tax.

Workers aged 62 or older would be exempt from payroll taxes, as discussed in the Social Security and health sections of this proposal. The 0.9 percent additional Medicare tax introduced by ACA would be eliminated.

**Replace Inefficient Subsidies and Regulations with Carbon Tax**

Subsidies for ethanol and other alternative fuels would be abolished, but basic research on renewable energy would be funded on the same stringent terms as other basic research. As we have discussed, business and household energy tax credits would be abolished. Regulations designed to lower greenhouse gas emissions would be repealed.

In place of these measures, a tax on greenhouse gas emissions (“carbon tax”) would be imposed. The tax would take effect in 2018 at a rate of $4 per metric ton of carbon dioxide equivalent. The tax would thereafter increase at the rate of increase of the chain-weighted CPI plus 2 percent per year. The tax rate is intended to approximate the domestic social cost of carbon. In the absence of a binding and operative international agreement to curtail emissions, the United States should curb only those emissions that can be eliminated at a cost below the domestic social cost of carbon, as Viard (2014) discussed. For this reason, the rate we propose is significantly lower than commonly proposed by others.

**Increase Gasoline Tax**

Under the proposal, federal highway taxes would be permanently extended beyond their September 30, 2016, scheduled expiration date. The gasoline tax would be increased from 18.4 to 24 cents per gallon, and the diesel fuel tax would be increased from 24.4 to 40 cents per gallon on January 1, 2016. Both tax rates would be indexed to the chain-weighted CPI after 2016. These tax increases would provide adequate financing for the highway trust fund without general-revenue transfers, ensuring that drivers pay for highway and related costs.8

**Impact on Revenue and Economic Growth**

Because of transition relief associated with the move to the X tax, our plan would initially reduce revenue and increase debt relative to current policies. Over time, tax revenue would gradually rise as a share of GDP because of real bracket creep and the expiration of transition relief. The upward path of tax revenue is necessary to finance the upward path of federal spending resulting from population aging and the rising relative price of medical care. The plan sets the debt-to-GDP ratio on a declining path.

The actual budgetary impact could be more favorable than the estimates in table 1 show because the estimates do not account for the increase in GDP likely to result from the plan. Economic simulations have repeatedly indicated that replacing the income tax system with a consumption tax can boost long-run GDP, although the magnitude of the gains depends on the design of the consumption tax and the assumptions that are made in the simulations. The President’s Advisory Panel on Federal Tax Reform (2005, 190) estimated that its Progressive Consumption Tax Plan would increase long-run output by “up to 6.0 percent.” Our proposal would also reduce transfer payments to the elderly, which should further increase private saving and long-run growth.

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7 Antiabuse rules would prevent tax-motivated sales of assets to governments and nonprofits and tax-motivated conversion of rental housing to owner-occupied use in anticipation of the reform. Antiabuse rules would also prevent inflated expensing of personal assets converted to business use, including owner-occupied housing converted to rental use, after the reform.

8 There would generally be no change to other federal excise taxes or customs duties. However, excise tax changes made by the ACA, such as the introduction of the tanning tax, would be removed as part of ACA repeal, as we discuss in the health proposal.
Social Security Policy

Since its inception in 1935, the Social Security program has had two broad goals: (1) to require that all workers save a portion of their earnings for retirement, and (2) to supplement benefits for individuals who could not provide a decent standard of living based on their own savings, such as the poor, the disabled, and survivors. Social Security has pursued these goals through a single, integrated program that is financed on a pay-as-you-go basis. In the future, however, we can best serve Social Security’s goals by changing the form and structure of how it is financed and how it pays benefits.

Social Security provides benefits in retirement, disability, and following the death of an eligible worker. Benefits are calculated as a progressive replacement of average lifetime earnings, meaning that the system is both earnings-based and redistributive. Higher earners receive larger absolute benefits but smaller benefits relative to their prior earnings or their contributions.

The proposed changes to the Social Security program follow two main paths:

1. Modernize the program to make it more effective in protecting low earners, simpler for individuals of all earnings levels to understand, more conducive to saving and longer work lives, and more generally better aligned with the work and retirement conditions of the mid-21st century rather than the early 20th century.

2. Make the program solvent and sustainable over the long term. Sustainable solvency is necessary, meaning that without it any other changes are undermined, but solvency alone is not a sufficient measure of a successful reform. Moreover, the reforms reduce program outlays to better accommodate rising costs for other government programs, in particular health-related entitlements. In other words, cost levels are chosen not in isolation, but in the context of the other fiscal burdens the government must bear in the coming decades.

In general, the largest changes to the Social Security benefit structure are introduced so that they would be fully implemented only as new entrants to the workforce today reach retirement. Thus, individuals would be given ample warning regarding changes to their benefits. However, improvements to the program’s benefit structure, such as a guaranteed minimum benefit for low-earning retirees and reductions in the payroll tax for older workers, are enacted immediately.

**Flatten the Basic Benefit**

For new entrants to the workforce, the benefit at retirement or disability would be a flat payment equal to the single individual over-65 poverty threshold (approximately $850 per month). The benefit would be granted to all individuals reaching retirement age, regardless of work history, and would assume the responsibilities of both the redistributive element of Social Security as well as the pure welfare approach of Supplemental Security Income (SSI). This minimum benefit would be indexed to wage growth and thus grow over time at a faster rate than the poverty threshold, which is indexed only to inflation.

The minimum benefit would be implemented immediately, increasing benefits for about one-third of retirees, while benefits for middle- and high-earning individuals would be scaled down to the wage-indexed poverty level between now and 2050. This flat benefit would effectively reduce the current elderly poverty rate of almost 10 percent to zero.

Because the benefit is a fixed value, it would be relatively more generous to lower-earning individuals. However, this flat benefit would come at the cost that middle- and high-earning individuals must save more for retirement, as they would receive lower benefits than under current law.

The flat benefit addresses several needs. First, Social Security leaves far more Americans in poverty than many might think. Despite spending more than $900 billion on the program each year, more than 9 percent of Americans over age 65 have incomes below the poverty line. We could provide a poverty-level benefit to every American retiree for about half that cost. The reasons Social Security leaves many retirees in poverty are that (1) the program has no true minimum benefit; (2) the program can pay different benefit to
households with the same lifetime earnings and contributions, based on differences in earnings between spouses and lengths of working careers; and (3) many retirees fail to meet the 10-year minimum work requirement to qualify for benefits. Although eligibility for Social Security benefits is almost universal for the richest four-fifths of Americans, more than 20 percent of the poorest one-fifth of Americans do not qualify for Social Security benefits in retirement (Biggs 2009b).

We can best serve Social Security’s goals by changing the form and structure of how it is financed and how it pays benefits.

Second, the Social Security benefit formula is so complex and confusing that many Americans have no idea what their benefit will be until the first check arrives. Almost one in four individuals on the verge of retirement cannot even hazard a guess as to their Social Security benefit level (Biggs 2009a). Of those who could make a prediction, guesses are close to accurate on average—but only on average. One-third of near-retirees overestimated their benefits by at least 10 percent, while one-quarter overestimated them by more than 28 percent. One in 10 retirees will receive a benefit less than half what they expected. If these individuals save or plan their retirement age based on what they thought they would receive from Social Security, their postretirement income would fall short of what they need. Similar numbers of people underestimate their future Social Security benefits and as a result may oversave while working. Neither outcome is desirable. A flat benefit for all retirees makes it easier for working-age Americans to know what they will receive and to plan how much additional income they will need to generate from work and saving.

Universal Retirement Savings Accounts
To supplement the basic benefit, middle- and upper-income individuals must increase the amount they save for retirement. To help do so, this proposal would institute a change in employer-sponsored retirement plans. In the past, most employer-sponsored pensions, such as 401(k) or 403(b) plans, have required that employees affirmatively choose to participate. As a result of this requirement, many employees failed to sign up and thus failed to save.

In recent years, however, a shift has been underway toward “auto-enrollment,” in which employees are automatically signed up for a retirement plan. Although employees may choose to withdraw, this approach has been shown to significantly increase employee participation and retirement saving. In 2013, 59 percent of employers used auto-enrollment for their 401(k) plans, but there is no reason that all employers should not utilize auto-enrollment.9

The Social Security policy outlined here would make auto-enrollment universal. As a condition of receiving a tax preference for retirement contributions, employers offering a pension would be required to follow the best practice of automatically enrolling eligible employees, with a minimum contribution of 2.5 percent of earnings matched at 2.5 percent. Where retirement plans are not offered, which is the case with many smaller employers, employees would be offered the chance to save through a federally run account program similar to the federal employee Thrift Savings Plan or the MyRA plan proposed by the Obama administration. Additional steps to encourage employer-sponsored pensions, such as legislation to facilitate so-called multiple employer defined contribution plans, are desirable.

If a worker’s combined contribution were invested in government bonds, the total benefit would approximately equal both the generosity and the progressivity of the current-law benefit formula. Thus, the plan is designed to produce similar total benefits to those promised under current law. However, the default investment portfolio could be a relatively conservative “lifecycle” portfolio that gradually shifts from stocks to bonds over time.

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Work and Retirement Incentives

The Earliest Eligibility Age (generally referred to as the early retirement age) would gradually be increased from 62 to 65 for those born in 1966 and retiring in the 2030s. The normal retirement age would not be affected. While individuals could in general not claim retirement benefits prior to 65, their benefits would be increased to account for the mandatory delay in claiming.

To assist those who cannot work longer, disability benefits would remain available and the age of eligibility for SSI-aged benefits would be reduced from 65 to 62, as Biggs (2010) discussed. The increase in the early retirement age would have little effect on Social Security solvency but would substantially increase average retirement incomes available to individuals when they do retire. Raising the early retirement age also would increase labor supply, boosting economic output by more than 1 percent, according to the Congressional Budget Office (2012).

Even as life expectancies have increased and work and health conditions have improved, Americans claim Social Security earlier today than they did in the 1950s (age 63 today versus age 68-plus). Claiming at 62 generates a 25–30 percent benefit reduction that lasts for life, leaving some individuals with too little to live on in old age. This is a particular danger given the substantial chance of living significantly longer than the average. For instance, a typical 65 year old survives to age 83, but 1 in 4 will survive to 90 and 1 in 10 to age 95. There is an almost 20 percent chance that at least one member of a retiree couple will live to age 95 and a 5 percent chance of one spouse surviving to 100 (Social Security Administration 2014).

Preventing individuals from claiming early retirement would generate an average 17 percent increase in Social Security benefits. As individuals also would spend more time in the workforce building personal savings, total annual retirement income would rise by around $5,000 for retirees in the 2050s.

The 12.4 percent Social Security payroll tax would be eliminated for all individuals aged 62 and older, beginning in 2017. Eliminating the payroll tax would encourage individuals to remain in the workforce and make older workers more attractive to employers. Individuals would continue to accrue benefits as under current law, although such accruals would be small. Although this provision would reduce revenues to the Social Security program, higher labor supply from older workers would increase revenues from federal income taxes, Medicare taxes, and state income taxes.

Social Security pays extremely low returns to continued work at older ages because of the 35-year wage averaging period and the benefit formula for spouses. On average, a near-retiree who works an additional year receives only about three cents in additional benefits for each dollar of additional taxes they pay (Reznik, Weaver, and Biggs 2009). Eliminating the payroll tax at an older age restores actuarial fairness and eliminates a significant disincentive to extended work lives.

The Social Security Retirement Earnings Test (RET) would be eliminated under this plan. The RET reduces benefits for early retirees who continue to work and earn more than $14,160 in a given year. Benefits are reduced by 50 cents for each dollar of earnings above the threshold. At the normal retirement age, the RET is stopped and benefits are adjusted upward to compensate for any RET-related reductions in early retirement. Over the course of a typical retirement, total benefits are the same with or without the RET (Biggs 2008).

The Social Security Administration and financial advisers historically have done a poor job of informing Americans that, while the RET reduces benefits for early retirees who work, benefits are increased at the normal retirement age to compensate for losses due to the RET in early retirement. Individuals tend to treat the RET as a 50 percent marginal tax rate on work, over and above the income and payroll taxes they already pay. As a result, many individuals work up to the RET earnings but not beyond. This hurts individual retirement security, the economy, and the federal budget. Given the confusion, and the fact that the RET would apply only to ages 65–67 once the early retirement age was raised to 65, eliminating the RET is probably more conducive to overall retirement security.
Accurate Inflation Adjustment to Postretirement Benefits

Beginning in 2020, annual cost-of-living adjustments (COLA) payments would be reduced by 0.11 percentage points to approximate the effects of using a chain-weighted version of the CPI based on the purchasing habits of the elderly.

Currently, Social Security benefits are adjusted each year based on changes in the Consumer Price Index for Urban Wage Earners (CPI-W). There are two potential problems with the use of the CPI-W for Social Security COLAs. First, most economists have concluded that the conventional CPI measures tend to overstate the true rate of inflation because they do not account for how individuals alter their purchasing habits as the relative prices of goods change. The “chain-weighted” CPI is designed to better account for this so-called “substitution bias.” The chain-weighted CPI generally reports inflation around 0.3 percentage points lower than that of the CPI-W.

Second, however, the CPI-W is based on the purchasing habits of working-age Americans, which may differ from those of Social Security beneficiaries. Specifically, Social Security beneficiaries may spend a greater share of their incomes on health care, for which prices have risen faster than other goods or services. The experimental CPI-E tracks prices changes based on purchases made by individuals over age 65 and tends to show inflation rates around 0.2 percentage points higher than the CPI-W. A more accurate COLA for Social Security beneficiaries would be generated from a chain-weighted CPI based on the purchasing habits of Social Security beneficiaries and would tend to show inflation approximately 0.11 percentage points lower than the CPI-W.

Reform Disability Insurance Benefits

This component adopts reform proposals that have been discussed by experts on disability insurance reform as a means to slow the growth of the number of beneficiaries. This provision would provide for experience rating of Social Security disability taxes paid by employers based on the propensity of their employees to claim Disability Insurance (DI) benefits.

The growth of costs for the DI program has exceeded that of the Old Age and Survivors component of Social Security, and the DI trust fund is projected to be insolvent in late 2016. Compiled census data show that the share of working-age individuals who report a disability that limits or prevents them from working has remained roughly stable over the past three decades. Self-reported health status has improved, according to the National Center for Health Statistics National Health Interview Survey: fewer workers hold physically demanding jobs, according to the Urban Institute (Johnson, Spiro, and Steuerle 1999); and Bureau of Labor Statistics data show that the rate of occupational injuries has fallen. The major change is that far fewer individuals with disabilities are working: in 1990, 28 percent of individuals with self-reported disabilities were employed. Today, just 14 percent of individuals in that category are working. Congress played a role in this; in 1984, it loosened eligibility standards, paving the way for increased applications based on more-difficult-to-assess mental conditions, like depression, and musculoskeletal disorders, like back pain.

This step, similar to the way that taxes for unemployment insurance and workers’ compensation are levied, would give employers the incentive to offer rehabilitation, retraining, and other accommodations to keep workers on the job. Experience rating was a core component of the Dutch disability reforms passed in the late 1990s and early 2000s, which reduced the inflow of disability beneficiaries by 60 percent. While the effects of these policies are difficult to estimate, it seems reasonable that they could reduce the disability incidence rate to a level halfway between the Social Security trustees’ intermediate and low-cost projections. This provision also would indirectly benefit Medicare, as DI beneficiaries become eligible for Medicare benefits after two years on the rolls.

10 See http://www.cdc.gov/nchs/nhis.htm
12 Author’s calculations from Current Population Survey data.
Health Care Policy

The goal of proposed changes to Medicare, Medicaid, and other federal health programs is to slow the growth of spending (both federal and system-wide spending) while maintaining and improving access to high-quality health services. Although that was a stated objective of the ACA when it was enacted in March 2009, it failed to address the structural problems in Medicare and Medicaid that have led to an unsustainable trend in spending.

Moreover, the ACA created a new entitlement and expanded Medicaid, relying on tax increases and Medicare payment cuts to cover the cost. Those Medicare cuts have failed to control program spending in the past, and they are unlikely to be implemented by future Congresses. To develop an effective fiscal plan, it is necessary to assume that significant ACA provisions are repealed and replaced with a new set of policies based on market principles and budget realities. Nonetheless, the major objectives of the ACA (such as creating an organized marketplace for insurance and expanding federal insurance subsidies for those most in need) would be reflected in new policies better able to achieve those goals.

Although the budget reductions from the baseline are large, quality of care and access to essential services may improve over the long term.

In general terms, the proposal caps federal subsidies for insurance, promotes effective competition and innovation in the health sector, reduces the regulatory burden, develops better consumer information, and lowers unrealistic expectations on the part of everyone. Subsidies in all federal health programs would be made more progressive, helping those who most need it. We anticipate that such policies will provide strong incentives for the private sector to develop new ways to deliver care that will improve efficiency and lower the cost per unit of service. Thus, although the budget reductions from the baseline are large, quality of care and access to essential services may improve over the long term.

Medicare Reform

Medicare provides health benefits to all Americans age 65 or older and some disabled persons. Beneficiaries may enroll in the traditional fee-for-service program or in Medicare Advantage, which provides a choice of private health plans. The traditional program covers inpatient and other services under Part A, physician and most outpatient services under Part B, and prescription drug coverage that beneficiaries may purchase under Part D. Traditional Medicare pays doctors, hospitals, and other providers for individual services. In contrast, Medicare Advantage plans are paid a fixed payment for all covered services provided to enrollees.

Our proposed Medicare reform restructures the traditional Medicare program, creates level competition for all Medicare plans (including the traditional program), and replaces the open-ended entitlement with a defined-contribution system called premium support. Traditional Medicare is not eliminated, but its benefit structure is modernized and it competes with private Medicare plans under premium-support rules.

In addition, Medicare’s eligibility age would be increased gradually, consistent with a similar policy in Social Security. This reflects the increasing longevity among the elderly and greater opportunity for individuals to extend their work lives, thanks to better health and the shift towards less physically demanding employment. The eligibility age is increased two months each year starting in 2017 until it reaches 67 in 2028. Subsequently, the Medicare eligibility age would conform to the Social Security full retirement age.

Restructure Traditional Medicare. The benefit structure in traditional Medicare is unlike that of comprehensive health insurance plans offered to people under age 65. Private insurance typically requires enrollees to meet a deductible (often amounting to $1,000 or more) before a benefit is paid. After the deductible is satisfied for the year, enrollees are usually required to pay
either a fixed-dollar amount or a percentage of the cost of covered services.

Traditional Medicare requires beneficiaries to pay a sizable deductible—$1,260 in 2015—for each inpatient hospital stay during the year (with some limitations) and a more modest annual deductible—$147 in 2015—for outpatient services. It also has a complex set of coinsurance requirements that vary depending on the medical service, and it places a lifetime limit on the number of days a beneficiary is covered for inpatient hospital care. Traditional Medicare does not provide protection against catastrophic health care costs; beneficiaries are potentially at risk for unlimited costs even though they are covered by Medicare.

Most beneficiaries in traditional Medicare are protected from the confusion and financial risk of this structure through supplemental insurance—Medigap, retiree coverage, or Medicaid. As a result, most beneficiaries pay little or nothing out of pocket for their care. The patient’s lack of cost awareness coupled with fee-for-service incentives for the provider has contributed to the rapid growth of Medicare spending.

Our proposal corrects these problems. Medicare cost-sharing requirements are simplified, with a single deductible for inpatient and outpatient services and a 20 percent coinsurance rate for all services. Instead of maintaining separate programs under Medicare Parts A, B, and D, traditional Medicare would offer a comprehensive set of benefits, including coverage for prescription drugs and catastrophic costs.

The policy, recently adopted by the Medicare Access and CHIP Reauthorization Act (Public Law 114-10, enacted April 16, 2015), that prohibits Medigap plans from covering the Part B deductible beginning in 2020 for new Medicare enrollees would be strengthened. Enrollees with supplemental coverage would be required to pay the first $700 out of their own pockets rather than having that cost covered by insurance. In addition, half of the next $6,300 in Medicare-covered service costs would also be paid out of pocket rather than through supplemental coverage.

Until traditional Medicare is restructured and the premium-support system becomes effective, premiums for Medicare Parts B and D would be increased from 25 percent to 40 percent of each program’s costs, on average. Premiums would continue to be income-related, with beneficiaries with higher incomes paying higher premiums.

Shift to Market Pricing in Traditional Medicare. Traditional Medicare uses various methods to establish the prices for individual medical services. Except in limited circumstances when competitive bidding has been tried, traditional Medicare is the price setter, and prices do not adjust readily to changes in market conditions. Prices tend to be set above the market-clearing level, both to ensure beneficiary access to services and because those who may have been paid too much are unlikely to complain to Congress.

In the Medicare Access and CHIP Reauthorization Act, Congress recently replaced the sustainable growth rate (SGR) formula with an alternative mechanism to limit the growth of Medicare physician payments. The SGR has called for double-digit reductions in Medicare’s payment rates, which Congress has consistently overturned. The new approach continues to limit the annual payment update, initially setting annual increases at 0.5 percent per year. In later years, updates depend on whether a physician has become part of an alternative payment model (such as an accountable care organization) or has remained in the more traditional fee-for-service system. Our proposal sets physician payment updates equal to 0.5 percent per year through 2017 and then converts the Medicare program to a premium support model, which we will discuss.

Our proposal stabilizes physician payment rates and allows them to increase with general inflation. To introduce an element of market pricing, restrictions on “balance billing” would be lifted. Physicians would be permitted to charge any amount over the Medicare payment for their services (subject to their ability to command higher prices in the market), as long as they disclose their prices in advance. In addition, restrictions on physicians’ ability to provide services to Medicare beneficiaries outside of program rules (referred to as “private contracting”) would be lifted.

Medicare Premium Support. Medicare would be placed on a budget through premium
support, in which a subsidy would be provided to beneficiaries choosing from among competing health plans. Larger subsidies would be paid to beneficiaries who are in greater financial need or who have higher health risks. Those selecting more expensive plans (including traditional Medicare, which would remain available but at a premium commensurate with its cost) would be responsible for any premium amount above the subsidy.

This mechanism eliminates traditional Medicare’s open-ended subsidy and places all plans into competition with one another. Within limits, competing health plans could adjust their benefits, provider networks, cost-sharing requirements, and premiums to attract enrollees. Since seniors live on limited incomes, plans will be motivated to find more efficient ways to deliver services that cut costs without unduly burdening patients. They cannot simply order more tests or procedures to increase their profits, as in a fee-for-service world, because the total payment for an enrollee is limited. That provides a strong incentive to seek ways to deliver care that are both more efficient and attractive to consumers.

To compete, traditional Medicare would be granted new authority to manage its benefit. That could mean giving Medicare the power to adjust cost sharing or offer services through provider networks at a reduced cost to consumers (as an optional alternative to the virtually unlimited provider network now available).

As part of Medicare premium support, the bidding process for Medicare Advantage would be changed. Traditional Medicare would bid along with private plans in each market area, and the federal subsidy for premiums would be determined relative to those bids. Employer plans could participate in this bid process if they opened enrollment to all comers; otherwise, they would remain closed to anyone not otherwise eligible for the plan and accept the premium-support payment determined through the bidding process.

Congress would determine the annual growth in the premium subsidy in conjunction with decisions about other spending priorities. Total Medicare spending would average growth of about 1.2 percentage points slower than under current law. This policy is effective starting in 2018. It would be desirable to phase premium support in over 10 or more years, allowing individuals and the health care system time to adjust to placing Medicare on a budget. However, a phase-in period also delays the spending reductions needed to achieve our long-term fiscal goal.

Medicaid Reform
The federal government subsidizes state Medicaid programs through matching payments that cover about 62 to 64 percent of total costs, on average. States have developed complex financial arrangements that allow them to draw more federal funds without necessarily providing more or better services. Replacing matching payments with block grants eliminates this perverse incentive and permits states to manage their Medicaid programs more efficiently. Federal Medicaid cost would grow with the economy, allowing for some additional savings because of increased efficiency in the health sector.

In exchange for this cap on federal payments, states would be granted new flexibility to manage their Medicaid programs. If states find more efficient ways to deliver services, their federal payment is not reduced as it would be under the current matching-grant approach.

States would be permitted to offer premium support for private insurance to Medicaid beneficiaries on a voluntary basis. In addition, benefit payments for individuals who receive both Medicaid and Medicare benefits (the “dual eligibles”) would be converted to fixed payments for insurance plus a contribution to a medical savings account. Dual eligibles may enroll in either a Medicaid or Medicare managed care plan, rather than drawing fee-for-service benefits from both programs.

Insurance Reform
Workers currently are not taxed on contributions for health insurance made by their employers. That creates an open-ended and regressive subsidy that has promoted first-dollar coverage and rapid growth in health spending. The tax exclusion would be replaced by a refundable health insurance tax credit that provides a flat dollar subsidy, with higher payments to those with lower incomes and greater health risk. That
eliminates the current system’s incentive to purchase more expensive coverage and its favoritism toward higher-income purchasers.

The ACA establishes a new subsidy for individuals with incomes below 400 percent of poverty who buy insurance through the exchanges. Those subsidies would be converted to a block grant to underwrite state-level subsidy programs for private insurance that are coordinated with the state’s Medicaid policies.

Financing reforms must be accompanied by a host of other changes in the design and operation of the health system. Organized insurance markets, similar in concept to the exchanges but with less federal control that can stifle innovation and competition, are needed to foster effective consumerism. Limits on the use of health savings accounts coupled with high-deductible insurance would be lifted. Interstate insurance sales would be permitted to encourage states to drop unnecessary regulations. Better information on treatment options, including information on cost and provider performance, is necessary for patients to make informed decisions in conjunction with their doctors. Medical liability reforms are needed to reduce defensive medicine and give all patients fairer recourse if medical errors occur.

### Other Federal Spending Programs

In the remainder of the budget, we propose to restrain the growth of other mandatory programs and nondefense discretionary spending while ensuring adequate funding for national defense.

We assume that outlays for mandatory programs, other than Social Security and health programs, would be cut, relative to the current-law baseline, by a constant 0.3 percent of GDP. Some of the cuts would be achieved by phasing out farm subsidies and reducing federal pensions and other programs.

We assume that nondefense discretionary spending would follow its current-law path, which reflects spending caps and the sequester. That path imposes significant reductions on such spending as a share of the economy.

It is important to maintain adequate capacity to protect US and allied interests. Future defense spending needs are uncertain and will depend on geopolitical developments. For planning purposes, we assume that defense spending would rise to 3.8 percent of GDP by fiscal year 2030 and would remain at that level thereafter.

### Conclusion

No easy solutions to the country’s fiscal crisis exist, and further delay will only make the decisions harder. Fiscally sound policy will require greater self-reliance but does not require us to turn our backs on the elderly and the less fortunate.

Our proposal narrows the fiscal imbalance, limits the size of government, and adopts a more growth-friendly tax code. Although these policies will require difficult choices, they will ensure a vibrant economy and fiscal stability, now and in the future.

### About the Authors

Joseph Antos ([jantos@aei.org](mailto:jantos@aei.org)) is the Wilson H. Taylor Scholar in Health Care and Retirement Policy, Andrew G. Biggs ([andrew.biggs@aei.org](mailto:andrew.biggs@aei.org)) is a resident scholar, Alex Brill ([alex.brill@aei.org](mailto:alex.brill@aei.org)) is a research fellow, and Alan D. Viard ([aviard@aei.org](mailto:aviard@aei.org)) is a resident scholar, all at the American Enterprise Institute.

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