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## 10 Themes Emerging from the New Debt Reduction Plans November 23, 2010

It is gratifying to see the growing number of plans to address the federal debt. The recent proposal from the Co-Chairs of the President's National Commission on Fiscal Responsibility and Reform (Fiscal Commission), the Debt Reduction Task Force plan, Esquire's Commission to Balance the Federal Budget, Bill Galston and Maya MacGuineas' proposal, Rep. Paul Ryan's (R-WI) Roadmap, and the plan from Rep. Jan Schakowsky (D-IL) all dig deep into the budget to recommend ways to bring down future federal deficits and debt. Other approaches will also be released soon.

In this paper we provide a comparison of the various plans and point out a number of emerging themes.

### 1. Yes, the Deficit Does Matter

Policymakers have spent the past decade adding to, not cutting, the federal debt. After budget surpluses emerged in the late 1990s, the political narrative shifted from responsible budgeting to "Deficits Don't Matter." As a result, more than \$5.6 trillion has been added to the debt since 2000.

Public opinion polls and the results of the mid-term election indicate that the public's tolerance for all this borrowing has come to an end. It is encouraging to see the slew of serious debt reduction proposals that have been offered in recent months with politicians as diverse as Ryan (who was the first lawmaker courageous enough to get specific about how he would address the fiscal problems) and Schakowsky offering plans.

Importantly, the discussion has shifted from whether the mounting federal debt even matters, to how best to address it. In this new environment, it seems unlikely that legislation that includes programs whose costs are not offset—with the notable exception of extending some or all of the 2001/2003 tax cuts, which would add to the debt tremendously if not offset—will be able to win Congressional approval. So while there is plenty of disagreement about how best to reduce the deficit and debt, the broad-based agreement that we have to do something continues to grow.

**Fig. 1: Summary Table of Fiscal Plans**

Major Areas of Each Plans	Fiscal Commission Co-Chair Proposal	Representative Paul Ryan's Roadmap	Galston-MacGuineas Plan	Esquire Commission	Debt Reduction Task Force	Representative Schakowsky's Plan
<b>Defense</b>	<ul style="list-style-type: none"> <li>Cap 2012 spending at 2010 levels, 1% cut from 2013-2015, then limit growth to inflation</li> </ul>		<ul style="list-style-type: none"> <li>Cut unneeded weapons</li> <li>Reform military pay and TRICARE</li> <li>Reform contracting</li> <li>Scale back R&amp;D</li> <li>Create War surtax after 2015</li> </ul>	<ul style="list-style-type: none"> <li>Enact President's cuts</li> <li>Reverse "Grow the Army" Initiative</li> <li>Restructure military on strategic lines</li> <li>Assumes war costs decline</li> </ul>	<ul style="list-style-type: none"> <li>5-year freeze, then limit growth to GDP</li> </ul>	<ul style="list-style-type: none"> <li>Cut various military projects</li> <li>Reduce military to pre-war levels</li> <li>Reduce contracting</li> <li>Reduce strategic nuclear arsenal</li> </ul>
<b>Domestic Discretionary</b>	<ul style="list-style-type: none"> <li>Cap 2012 spending at 2010 levels, 1% cut from 2013-2015, then limit growth to inflation</li> <li>Move the Transportation Trust Fund to mandatory</li> <li>Budget for disasters</li> </ul>	<ul style="list-style-type: none"> <li>Freeze non-defense, non-stimulus at 2009 levels until 2020</li> <li>Starting in 2020, spending growth assumed to be limited to CPI plus 0.7%</li> <li>Rescind all unused ARRA</li> </ul>	<ul style="list-style-type: none"> <li>Freeze for 3 years, then grow with inflation, starting in 2011</li> </ul>	<ul style="list-style-type: none"> <li>Delay some NASA missions</li> <li>Eliminate earmarks</li> <li>Limit discretionary growth to inflation</li> </ul>	<ul style="list-style-type: none"> <li>4-year freeze, then limit growth to GDP</li> </ul>	<ul style="list-style-type: none"> <li>Eliminate Overseas Private Investment Corporation</li> <li>Sell excess federal property</li> <li>Reduce unnecessary printing costs</li> <li>Reduce inefficient and improper payments by 5%</li> <li>Other efficiencies implemented</li> </ul>
<b>Social Security</b>	<ul style="list-style-type: none"> <li>Slow benefit growth for high and medium-income workers</li> <li>Increase early and normal retirement ages and index for longevity</li> <li>Index COLAs to chained CPI</li> <li>Include newly hired state and local workers after 2020</li> <li>Increase payroll tax cap</li> <li>Create new minimum and old-age benefits</li> </ul>	<ul style="list-style-type: none"> <li>Slow benefit growth for high and medium-income workers</li> <li>Increase full retirement age</li> <li>Create of optional personal accounts of 2% for the first \$10,000 and 1% of income between that and payroll tax cap (the percent would increase over time) for those under 55</li> <li>Use general revenue to replenish trust funds</li> <li>Create new minimum benefit</li> </ul>	<ul style="list-style-type: none"> <li>Slow benefit growth for high and medium-income workers</li> <li>Increase normal retirement age and index for longevity</li> <li>Index COLAs to chained CPI</li> <li>Include newly hired state and local workers</li> <li>Create new minimum and old-age benefits</li> <li>Create mandatory add-on accounts</li> <li>Reduce and make the payroll tax more progressive (replace revenues with some of the proceed from energy tax—see below)</li> </ul>	<ul style="list-style-type: none"> <li>Increase retirement age</li> <li>Index COLAs to chained CPI</li> <li>Increase years used to calculate benefits</li> <li>Include new state and local workers</li> </ul>	<ul style="list-style-type: none"> <li>Slow benefit growth for high-income workers</li> <li>Index benefits for longevity</li> <li>Fix CPI calculation</li> <li>Include newly hired state and local workers</li> <li>Increase cap to 90%</li> <li>Create new minimum benefit</li> </ul>	<ul style="list-style-type: none"> <li>Eliminate tax cap on employer side, raise to 90% on employee side</li> <li>Enact a 3-4% tax on all earnings above the tax cap</li> <li>Treat other salary reduction plans like 401(k)s</li> </ul>
<b>Health Care</b>	<ul style="list-style-type: none"> <li>Limit health care cost growth after 2020 to GDP +1%</li> <li>Tort reform</li> <li>Increase Medicare cost sharing</li> <li>Strengthen IPAB</li> <li>Identify an additional \$200 billion in savings</li> </ul>	<ul style="list-style-type: none"> <li>Allow interstate purchasing, small business pools, and state based exchanges</li> <li>Tort reform</li> <li>If 45% or more of Medicare funding is from general revenues, a 1% reduction in provider payments applies, starting in 2020</li> <li>Increase Medicare cost sharing</li> <li>Create a new system of vouchers to replace Medicare and Medicaid</li> <li>Current SCHIP population eligible for health care tax credit</li> </ul>	<ul style="list-style-type: none"> <li>Create a non-open-ended budget for health care</li> <li>Tort reform</li> <li>Increase Medicare cost sharing</li> <li>Reduce health subsidies for new health care subsidies</li> <li>Strengthen IPAB</li> <li>Index eligibility age for Medicare</li> </ul>	<ul style="list-style-type: none"> <li>Tort reform</li> <li>Assumes no Medicare payment patches</li> </ul>	<ul style="list-style-type: none"> <li>Tort reform</li> <li>Increase Medicare cost sharing</li> <li>Reduce payments to Rx companies</li> <li>New premium support (vouchers) program</li> <li>End Medicaid matching system</li> </ul>	<ul style="list-style-type: none"> <li>Establish a public option</li> <li>Require full drug rebates from manufacturers to full premium subsidy for eligible individuals in Medicare Part D</li> <li>Ban "Pay-for-Delay" patent settlements</li> <li>Require Medicare to negotiate for lower prescription drug prices</li> <li>Establishes Medicare-administered Part D program</li> </ul>
<b>Other Mandatory</b>	<ul style="list-style-type: none"> <li>Index programs to chained CPI</li> <li>Reduce farm subsidies</li> <li>Reform military and civil service retirement</li> <li>Reduce student loans</li> <li>Various others</li> </ul>	<ul style="list-style-type: none"> <li>Starting in 2020, spending growth is assumed to be limited to CPI plus 0.7%</li> <li>Improve job training</li> </ul>	<ul style="list-style-type: none"> <li>Reform military and civil service retirement</li> <li>Index federal salaries to private sector wage growth</li> <li>Reform farm subsidies</li> <li>Various others</li> </ul>	<ul style="list-style-type: none"> <li>Index federal and military pensions to chained CPI</li> <li>Cut federal workforce by 5%</li> <li>Reform farm subsidies</li> </ul>	<ul style="list-style-type: none"> <li>Reform military and civil service retirement</li> <li>Index programs to chained CPI</li> <li>Reform farm subsidies</li> <li>Various others</li> </ul>	<ul style="list-style-type: none"> <li>Cut farm subsidies in half and eliminate Market Access program</li> <li>New \$200 billion stimulus for job creation</li> </ul>

Major Areas of Each Plans	Fiscal Commission Co-Chair Proposal	Representative Paul Ryan's Roadmap	Galston-MacGuineas Plan	Esquire Commission	Debt Reduction Task Force	Representative Schakowsky's Plan
<b>Tax Expenditures</b>	<p><b>Option 1:</b></p> <ul style="list-style-type: none"> <li>Eliminate all tax expenditures as starting point</li> <li>Lower individual and corporate income tax rates (8%, 14%, and 23%, and 26% (corporate)) and increase rates if any tax expenditures are added back in</li> <li>Tax dividends and capital gains like normal income</li> <li>Eliminate AMT, Pease, and PEP</li> </ul> <p><b>Option 2:</b></p> <ul style="list-style-type: none"> <li>Eliminate some tax expenditures (S&amp;L deduction, cafeteria plans, others); limit others (mortgage deduction, charitable deductions, health exclusion, others)</li> <li>Lower income rates (15%, 25%, 35%, 26% (corporate))</li> <li>Triple standard deduction</li> <li>Eliminate AMT, Pease, and PEP</li> <li>Permanently extend R&amp;D tax credit</li> </ul> <p><b>Option 3:</b></p> <ul style="list-style-type: none"> <li>Enact tax reform by 2012 or impose gradually growing across-the-board haircut for certain tax expenditures</li> </ul>	<ul style="list-style-type: none"> <li>Eliminates health care exclusion with refundable credit as part of health reform</li> <li>Clear out nearly all of the existing tax deductions and credits</li> </ul>	<ul style="list-style-type: none"> <li>Reduce tax expenditure by 10%, index to inflation, divide proceeds between lower tax rates and deficit reduction</li> <li>Examples: <ul style="list-style-type: none"> <li>Reduce home mortgage deduction from \$1 million to \$500,000 and eliminate for vacation homes</li> <li>Repeal health care exclusion and replace with credit</li> <li>Phase out the deduction for state and local taxes</li> <li>Consolidate tax breaks for education</li> <li>Consolidate tax breaks for saving</li> </ul> </li> <li>Pay-Go for tax expenditures</li> </ul>	<ul style="list-style-type: none"> <li>Repeal health care exclusion and replace with credit</li> <li>Limit itemized deductions for high earners</li> <li>Curtail state and local tax deduction</li> <li>Eliminate subsidies for bio-fuels</li> </ul>	<ul style="list-style-type: none"> <li>Eliminates most tax expenditures</li> <li>Eliminate employer health exclusion</li> <li>Restructure tax benefits for low-income families and families with children</li> <li>Eliminate standard deduction and personal exemptions</li> </ul>	<ul style="list-style-type: none"> <li>Replace corporate interest deduction with a 25% credit</li> <li>Close active financing tax deferral for financial firms</li> <li>Repeal tax subsidy for corporate mergers and acquisitions</li> <li>Close dividend loophole for foreign source income</li> <li>Eliminate the deduction for business, meals, and entertainment expenses</li> </ul>
<b>Tax Reform</b>	<ul style="list-style-type: none"> <li>Increase gas tax by \$0.15 starting in 2013</li> <li>Index all of tax code to the Chained CPI</li> </ul>	<ul style="list-style-type: none"> <li>Cap total revenue at 19% GDP</li> <li>Offers individual taxpayers a choice - current tax system or new Simplified Tax: 10% rate for &lt;50k single &amp; 100k for joint or 25% rate for &gt;100k single and 200k joint</li> <li>Eliminate taxes on estates, dividends, capital gains</li> <li>Repeal AMT</li> <li>Increase standard deduction</li> <li>Eliminates corporate income tax and replaces it with a business consumption tax of 8.5% on goods and services</li> </ul>	<ul style="list-style-type: none"> <li>New carbon tax (some go to reduce payroll tax)</li> <li>Revenue neutral corporate tax reform to broaden base and lower rate</li> <li>Index all of tax code to the Chained CPI</li> </ul>	<ul style="list-style-type: none"> <li>Increase gas tax by \$1 per gallon</li> <li>Lower income tax rates for middle-income tax relief</li> <li>Reinstate AMT exemptions that expired in 2009</li> </ul>	<ul style="list-style-type: none"> <li>Payroll tax holiday</li> <li>Reduce income tax rates to 15%, 27% (top and corporate)</li> <li>Repeal AMT</li> <li>Index all of tax code to the Chained CPI</li> <li>Tax all capital gains and dividends as ordinary income (top rate of 27%), with \$1,000 exclusion for capital gains</li> <li>Introduce a 6.5% Debt Reduction Sales Tax</li> <li>Adjust excise tax on alcoholic beverages to \$0.25/oz</li> <li>New tax on manufacture and importation of sweetened beverages</li> </ul>	<ul style="list-style-type: none"> <li>Tax capital gains and dividends as ordinary income</li> <li>Estate tax at 2009 levels exemption with higher rates with additional brackets with higher rates</li> <li>Cap and trade with 50% rebated</li> <li>Auction off SO2 permits</li> <li>Limit royalty relief for offshore oil and gas production</li> <li>Auction radio spectrum licenses</li> </ul>
<b>Spending, % GDP in 2020*</b>	22%	22.5%	22%	21%	23.0%	N/A
<b>Revenue, % GDP in 2020*</b>	20.5%	18.5%	21.5%	21%	21.5%	N/A
<b>Debt, % GDP in 2020*</b>	65%	69%	60%	52%	60%	N/A

\* Rounded to nearest 0.5%. Estimates as reported by each plan.

## 2. A Credible Fiscal Plan Is a Necessary Part of an Economic Recovery Strategy

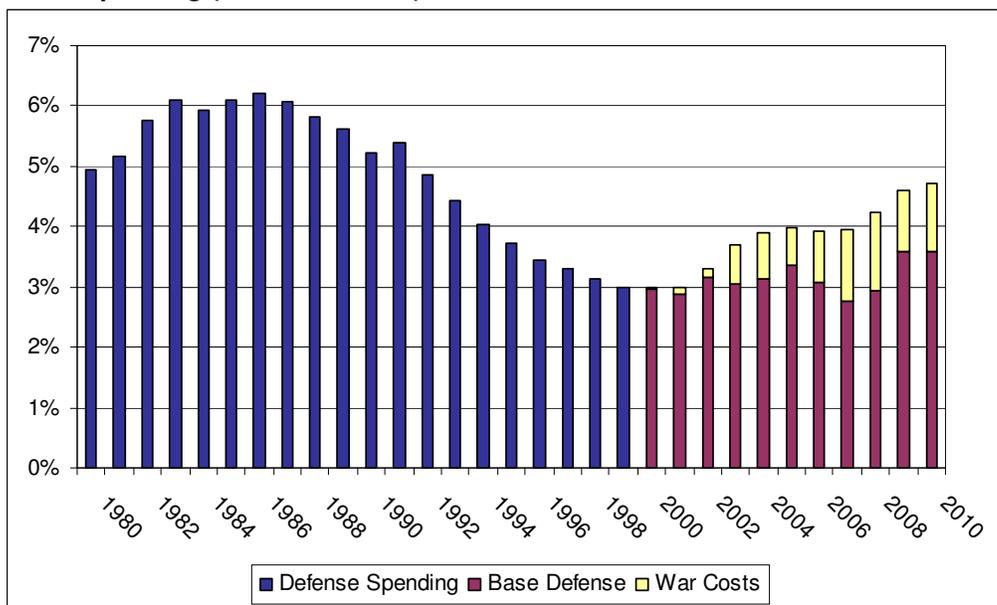
Arguments that reducing the deficit too much and too quickly would derail the nascent recovery are no excuse for getting our fiscal house in order. It is becoming better understood that putting a credible debt reduction plan in place is a *necessary* part of an economic recovery plan.<sup>1</sup> In the end, the most important thing for policymakers to do now is to put together a fiscal recovery program that puts the U.S. on a sustainable fiscal path over the next ten years. The U.S. must demonstrate that it can manage its fiscal affairs, and it is crucial for our credibility that we take steps in this direction sooner rather than later.

Regardless of whether lawmakers inject the economy with more short-term stimulus and/or future Federal Reserve actions, the economy will not return to sustained growth if excessive borrowing continues, as it would under current policy. Growing levels of debt would crowd out private investment once the economy returns to full capacity, squeeze all areas of the budget through growing interest payments, create high levels of consumer and business uncertainty, and leave open the possibility of a fiscal crisis from a credit market revolt. No economic recovery will be sustained if we do not change course, and this is the driving force behind a number of the fiscal plans.

## 3. There Is Plenty of Room for Defense Cuts without Compromising National Security

During times of war, the defense budget, including the parts not related to the war effort, often grows relative to the economy, as lawmakers find it harder to say no to any defense spending.

**Fig. 2: Defense Spending (Percent of GDP)**



<sup>1</sup> See IMF, *IMF Direct*, November 4, 2010 (<http://blog-imfdirect.imf.org/2010/11/04/how-to-bake-a-credible-medium-term-fiscal-pie/>) and IMF *Staff Position Note*, September 1, 2010 (<http://www.imf.org/external/pubs/ft/spn/2010/spn1013.pdf>).

But there is now a newfound commitment by many on the political left and right to find savings within the defense budget. Nearly all of the proposed fiscal plans specifically target the defense budget as a source of potential savings. In addition, a growing amount of work has been done by experts to suggest areas of the defense budget—from weapon systems, to procurement and R&D, to compensation—which could be reduced without compromising security interests.

#### **4. Health Care Needs a Budget**

In the long-term, growing health care costs still remain the single largest problem in the budget, despite the recently passed health\_reform legislation. The federal commitment to health spending cannot remain open-ended. Addressing this growth in health care spending must be a part of any budget plan, and there are a number of different approaches to doing so.

Many of the recently released plans create new ways for budgeting for health care. The Paul Ryan proposal and the Debt Reduction Task Force plans would change Medicare to a voucher or premium support system in which the government subsidizes individuals to purchase private insurance. (An additional bipartisan proposal for how to do this recently has been released by Paul Ryan and Alice Rivlin.) The Fiscal Commission and the Galston-MacGuineas plans both recommend limiting growth of federally financed health care and creating a new budget for the various programs. Furthermore, the Schakowsky plan would create a public option to help control costs.

There also are common elements in many of the plans that could be useful in reducing costs in the medium-term while longer-term structural changes are phased in, including tort reform, increased cost sharing, and limiting or eliminating the exclusion for employer-provided health care.

#### **5. Domestic Discretionary Freezes—or Cuts—Are on the Way**

Since entitlement reforms (the most important aspect of controlling government spending) are generally phased in more slowly, discretionary spending controls will be critical in the medium-term. Many of the plans suggest spending freezes—or cuts—and strict spending caps. While the plans have different caps and different time frames for when the cap is applied, the idea of freezing or cutting domestic discretionary spending and allowing policymakers time to find specific areas for savings is a common theme in many of the plans.

Other countries, chiefly those in Europe, also have targeted all types of spending in order to gain control of deficits. The British government recently unveiled a large package of deficit reduction proposals, as have the Greek and Irish governments. While many particulars of the U.S. situation are different, the actions of the Europeans probably raise the bar for what constitutes credible fiscal management. In addition to tackling current challenges, the United States, like the European nations, needs to create more fiscal room to maneuver in preparation for the Baby Boom generation's retirement. Looking at what the British and other European

governments recently have proposed suggests that the U.S. should consider going beyond freezes to significant nominal dollar cuts in some areas.

## **6. Social Security Needs a Lasting Fix**

The Social Security Trustees have been warning for years that changes must be made to the program, and that the sooner they are made the better. Since Social Security is the nation's largest program and is unsustainable on its current course, no credible comprehensive deficit reduction plan can omit Social Security reforms.

Unlike health care where it is less clear what will work in controlling costs, the list of potential Social Security changes is well known. Some combination of benefit reductions, retirement age increases, and new revenues—either from the payroll tax or other revenues—will be needed. The sooner changes are made, the more time participants will have to adjust and the more people over which the changes can be spread. There is no reason to delay.

Additionally, there appears to be a growing consensus that those who depend on the program for a large part of their retirement income should be protected from excessive benefit reductions, and in many cases, reform plans would increase their benefits.

## **7. Tax Expenditures—Spending through the Tax Code—Are Desperately in Need of Reform**

The government loses more than a trillion dollars a year in revenues because of tax expenditures—the multitude of exclusions, exemptions, deductions, and credits that permeate the tax code. These programs are more similar to spending than tax cuts, and often are inefficient and regressive efforts by the government to control how private resources are directed. Reducing these “tax earmarks” is a critical first step in fundamental tax reform since it would broaden the tax base and permit lower rates. All plans focus heavily on tax expenditure reform.

## **8. The Gap Is Too Large to Keep Revenues off of the Table – Changes Should Be Part of Fundamental Reform**

Spending as a percent of the economy is set to significantly grow over the next few decades, and is the central driver of future deficits. Considering the aging population and the growing demand for health care, it is very difficult to close the entire fiscal gap without touching revenues. While there are serious differences between the existing plans, most tend to reduce spending and increase revenues in the medium-term, with more of the savings coming from spending reductions over time. Studies have found that an emphasis on spending reductions in

fiscal consolidation plans can be beneficial, but few—if any—countries have successfully engaged in a fiscal turnaround without a revenues component.<sup>2</sup>

A variety of approaches to taxation have been proposed. The Deficit Reduction Task Force proposes a “Debt-Reduction Sales Tax” and taxes on sweetened beverages, while Galston and MacGuineas include a carbon tax, and Schakowsky, the Fiscal Commission co-chairs, and the Esquire Commission all call for an increase in the gas tax.

While spending is the problem, revenues will have to be part of the solution. The challenge is to reform taxes in a way that is fair and damages the economy the least.

## **9. In the Longer-Term, It Is All about Entitlement Reform**

Any plan that achieves a reasonable fiscal goal without reforming the major entitlements (Social Security, Medicare, and Medicaid) will quickly fall back out of balance because of the untenable growth in those programs. Therefore, while medium-term efforts may focus more on defense, domestic discretionary spending, and revenues, in the long term, entitlement reform will have to be the centerpiece of reform plans.

## **10. Fiscal Goals: 60 Is the New 40**

Any plan will have to have a fiscal goal. Historically, the public debt in this country has averaged below 40 percent of GDP. Today, it is over 60 percent and is on a path to reach almost 100 percent by the end of the decade. Many plans aim to bring the debt-to-GDP ratio back down to 60 percent in the medium-term. While the time frames differ, it seems likely that a credible plan should reach this level in roughly a decade.

As stated in the Peterson-Pew Commission on Budget Reform’s *Red Ink Rising*, “The 60 percent debt threshold is now an internationally recognized standard. In the EU, under the requirements of the Maastricht Treaty and the Growth and Stability Act, EU countries must satisfy a benchmark target of 60 percent of GDP for debt...Likewise, the IMF has singled out the 60 percent debt target as a reasonable benchmark.”

Over the longer-term, policymakers should aim to get back down to the more sustainable 40 percent level.

## **Conclusion**

It is extremely encouraging to see the flurry of new ideas replacing the “do nothing” approach to dealing with our fiscal challenges that has dominated the past decade. The next step will be for all actors—including policymakers and the public—to accept that compromises must be

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<sup>2</sup> See IMF *Staff Position Note*, September 1, 2010 (<http://www.imf.org/external/pubs/ft/spn/2010/spn1013.pdf>) and IMF *World Economic Outlook*, October 2010 (<http://www.imf.org/external/pubs/ft/weo/2010/02/pdf/c3.pdf>).

made. It would be far better for policymakers to adopt changes themselves, rather than waiting for the financial markets to force changes. Having others force changes would be more difficult and painful. It is encouraging to see the number of people who accept that notion. Progress on fiscal issues looks more possible than it has in years.