December 14, 2012

"I think that if we don’t get these politicians to come together, we face the most predictable economic crisis in history."
-ERSKINE BOWLES

In the wake of the US presidential election, it’s been interesting to listen to fellow Americans wax political on the issues facing our representatives in Washington. There are frequent references to the National Commission on Fiscal Responsibility and Reform (NCFRR) and its report "The Moment of Truth," or what’s more commonly known as the Simpson-Bowles Plan.

What’s unusual is that there seems to be bipartisan support for the much ballyhooed plan. Some left leaning supporters think taxes on the rich must go up and some right-leaning supporters appear to want major spending cuts immediately! This is not what the report they support calls for. Since this is a hot topic this season, I thought a summary of the exhaustive 64-page report may prove useful for EVA readers.

The report is incredibly detailed and makes solid, insightful arguments outlining how we can get to true reform. As it is today, both parties in Washington seem to have drawn clear lines in the sand on several issues. Whether its entitlement spending or taxes, everything should be on the table in order to reach a compromise. In this report, however, those partisan boundaries are crossed.

The report’s stated mission is made clear in the first paragraph: "Without regard to party, we have a patriotic duty to keep the promise of America to give our children and grandchildren a better life." The challenge that must be addressed is also very clear: "America cannot be great if we go broke."

This commission was established to address some of the biggest issues facing America so that future generations don’t have to inherit these problems. To summarize the entire Simpson-Bowles report in a single EVA, we are going to work under the assumption that most EVA readers are somewhat familiar with our nation’s current fiscal issues.

As a quick refresher, these issues include federal spending at 22.9% of GDP, coupled with revenues at only 16.3% of GDP. We also have an annual projected budget deficit of $1.1 trillion, or 7.3% of GDP, and a current debt-to-GDP ratio of over 100%. This massive debt load puts the US in some pretty rare company across the globe as there are only a handful of countries in the same perilous situation.

The NCFRR was founded on several guiding principles central to its end-goal of repairing fiscal neglect. The first was similar to the mission statement: "Make America better off tomorrow than it is today." The commission also highlighted the importance of treading lightly given the fragility of the US economy following the Great Recession. Among some of its main charges, the NCFRR seeks to invest in America, protect the disadvantaged, cut wasteful spending, demand effectiveness from Washington, simplify the tax code, and keep its promises. The commission also duly noted that the solution will be painful for both Republicans and Democrats as each will have to make significant concessions. The commission believes, however, that these sacrifices will help ensure the longevity of the United States.

Since Simpson-Bowles was written in December 2010, much of the data relating to cuts and the deficit need updating. Yet, the ideas are tangible and the plan could still be implemented to reach its original resolution.

At its core, the report aims to achieve six major objectives:

• Achieve $4 trillion in deficit reduction over eight years.
• Reduce the country is budget deficit to 2.3% in three years.
• Sharply reduce tax rates across the board for everyone, even the wealthiest Americans.
• Cap revenue and spending at 21% of GDP.
• Ensure lasting Social Security solvency.
• Stabilize debt in two years and reduce to 60% of GDP by 2023 and 40% by 2035.

The commission focused on six major areas within the budget where changes would be implemented to ensure that these projections are met. These topics should be very familiar to anyone who followed the election, as almost all of these issues were major topics of debate this past fall. Discretionary spending cuts, comprehensive tax reform, health care cost reform, mandatory spending and Social Security. Even the budget process in Washington were reviewed. The commission went over these areas with a fine-tooth comb, veritably leaving no stone unturned, yet remaining cognizant to operate within its guiding principles.

Discretionary Spending

The first partisan line to be crossed is a very popular debate on Capitol Hill: discretionary spending. In relation to this issue, the media seem quick to paint the Democrats as ambassadors to the underprivileged. Meanwhile, Republicans are often portrayed as unsympathetic to those less fortunate. Keep in mind, though, that the second guiding principle for the NCFRR was "protect the truly disadvantaged." Operating under that principle, the commission believed it could still cut $1.760 trillion in discretionary spending from 2012 through 2020.

The first move the NCFRR would make would be to cap discretionary spending through 2020. In 2012, this means reigning in spending to a greater degree than in 2011 and then limiting future spending growth to half the projected inflation rate through 2020. An endeavor heavily reliant on compromise, it will be imperative that Republicans view the plan’s proposed cuts to both non-security spending and security spending as fair game:

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Designed to help achieve its projections, the commission also outlined a series of rules. As stated in the plan, there are competing policies when considering security spending that need to be weighed. More specifically, spending restraints can't ignore security spending, but, at the same time, budget rules shouldn't determine war policy. As a result, the commission granted the president the authority to propose adjustments to the limits on spending relating to war policy. Even so, any spending above the cap is still subject to a 60 vote point of order.

Other changes seem to be very simple and obvious. For example, the commission proposed a disaster fund to literally budget for catastrophes. It also cited the abuse of "emergency spending," observing that all too often the serious distinction of "emergency" has been used too loosely. The commission plans to fund the transportation trust fund with a 15-cent-per-gallon tax on gasoline, a subsidy currently being provided by deficit spending. While such a charge will increase the cost of gas at the pump, and directly impact consumer spending, it will also crucially foot the bill for the roads and bridges on which we drive our vehicles.

The NCFRR also proposed creating a new government agency. However, unlike other agencies in government, this agency's job would be to find wasteful government spending and cut it wherever it is found. In addition, it also recommends creating a new cut-and-investment committee in Congress. This initiative calls for a $200 billion cut in discretionary spending and an investment of $100 billion in "high-priority" investments. There's even mention of leveraging private capital to develop an infrastructure bank. Sound familiar? One of Evergreen GaveKal's favorites, Woody Brock, has been championing that idea for some time.

Finally, the plan recommends several specific ideas that would reduce spending in 2015 by $50 billion. These include:

• Reducing the White House budget by 15% (proposal saves $800 million in 2015).
• Imposing a three-year pay freeze on Congress members' salary and that of federal and defense department civilians ($20.4 billion in savings in 2015).
• Reducing the size of the federal workforce through attrition (proposal would save $13.2 billionin 2015).
• Limiting federal travel, printing, and vehicle budgets (proposal would save $1.1 billion in 2015).
• Selling excess government-owned property.
• Eliminating all congressional earmarks (save $16 billion in 2015).

(It's worth noting that these are merely the committee's suggestions for areas where spending can be cut. There are also provisions stating that Congress can use other routes to find the $200 billion in reductions needed under the plan.)

Tax Reform

Simply put, the commission recommended lowering all tax rates. However, to pay for the tax cuts it would significantly reduce the spending that occurs in the tax code through "tax earmarks." These tax expenditures are most commonly seen in itemized deductions or subsidies. Simpson-Bowles states that "the code presents individuals and businesses with perverse economic incentives instead of playing on a level playing field." The commission attempted to level the playing field while still generating revenue in a fair manner. Ultimately, while the political left would have to agree to acquiesce to lower tax rates, those of the Republican persuasion would have to sign off on a dramatic reduction (or disappearance) of the currently substantial deductions available for mortgages and other subsidies.

Realizing that it's not possible to eliminate all of these tax expenditures, the commission outlined several possibilities, seen in the table below. While difficult to imagine, if all of the expenditures could be eliminated, tax rates could go as low as 8% for the bottom rate, 14% for the middle rate, and 23% for the top bracket.

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Keeping in mind that the proposal needs to be equitable to all, the committee proposed an illustrative plan with rates of 12%, 22%, and 28%. Such a structure would still provide support for low-income workers and families, mortgage interest deductions for a primary residence, and consideration of employer-provided health insurance, charitable giving, and retirement savings and pensions. Through additional revenue, the plan projected achieving $80 billion in deficit reductions in 2015 and $180 billion in 2020.

The changes to the tax code accompanied by the lower rates would include:

• Eliminating the alternative minimum tax and the personal exemption phase-out.

• Maintaining the current earned income tax credit and child tax credit.
• Keeping current standard deductions, but eliminating itemized deductions.
• Taxing all capital gains at ordinary income rates.
• Making mortgage interest deductible for interest on a primary residence up to a $500,000 mortgage.
• Excluding employer-provided health care, but capping it at the 75th percentile of premium levels in 2014, and freezing it in nominal terms through 2018 to be phased out by 2038.
• Allowing charitable giving a 12% non-refundable tax credit available to all taxpayers, available above a floor of 2% of adjusted gross income.
• Taxing newly issued municipal bonds at ordinary income rates with no future benefits from their tax-free status.
• Eliminating another 150 plus tax expenditures from the tax code.

The next big issue in tax reform obviously fell on the corporate side. The commission believes that the "U.S. corporate tax code is a patchwork of overly complex and inefficient provisions that creates perverse incentive for investment." Maybe not so coincidental, the recommendations are very similar to the ones made for the individual income tax code.

The commission again wants to lower the tax rate to 28%, but eliminate many of the subsidies that lead to an unlevel playing field. More than 30 business credits would be eliminated along with more than 75 other tax expenditures. This is sure to garner some stiff resistance from some powerful lobby groups in Washington that have battled for years to establish these beloved tax loopholes.

The commission also wants to move the US more in line with a territorial tax system. Today, most countries across the globe only tax income earned domestically. Foreign subsidiaries that earn income outside the US would only be taxed once at the specified tax rate in the country in which the income is earned.

Health Care Costs

At almost any other time, reforming the cost of health care would be practically untouchable for politicians given its staunch importance to America’s most important voting group: seniors. However, if left unchanged, the NCFRR and most informed Americans agree that the current health care system will bankrupt this great country. Again, the commission ignored convention and put all the previously untouchable issues on the table and proposed reform.

To minimize health care costs, Simpson-Bowles proposes to reform both the formula for physician payments (known as the sustainable growth rate) and the Community Living Assistance Services and Support Act (or CLASS Act).

The commission highlighted several specific changes to Medicare:
• Reform Medicare cost-saving rules.
• Restrict first-dollar coverage in supplemental insurance.
• Extend Medicare drug rebates to dual eligibles.
• Reduce excess payments to hospitals for medical education.
• Cut Medicare payments for bad debt.
• Accelerate home health savings in the Affordable Care Act.
The commission also proposed savings from Medicaid:
• Eliminating state gaming of Medicaid tax.

• Placing dual eligibles in Medicaid managed care.
• Reducing funding for Medicaid administrative costs.

Fairly sweeping malpractice reform was also proposed that would modify the collateral source rule, impose a one- to three-year statute of limitations, replace joint and several liability with a fair-share rule, and create "health courts" that would institute safe haven rules for providers who follow the industry’s best practices.

The commission does believe it is possible to maintain these costs. Under the stipulations laid out by the NCFRR, health care costs would still grow at over 5% per year, a much more manageable rate than if left unabated.

Mandatory Spending

While mandatory spending programs are not huge drivers of deficits, the commission did find several areas for savings. About 20% of mandatory spending is currently devoted to income support programs for the most disadvantaged. The commission must weigh the goal of deficit reduction against the principle of protecting the truly disadvantaged. To that end, the commission proposed to reform federal workforce retirement programs over 10 years, reduce agricultural spending, eliminate in-school subsidies in federal student loan programs, allow the pension guarantee board to increase premiums, and continue to sell valuable spectrum and also mentioned some major reforms for the US Postal Service, including reducing days of operation.

Social Security

Social Security, as it is today, is destined to fail. However, the good news is that if we act now there are some fairly painless solutions that can get the program back on the right track. At the time Simpson-Bowles was published, one in four households received some form of Social Security benefits. The report pointed out that "when Franklin Roosevelt signed Social Security into law, average life expectancy was 64 and the earliest retirement age in Social Security was 65." This statistic has clearly changed now as the average retiree collects benefits for 17 years. In the 1950s, there were 16 workers per beneficiary; today there are 3 workers per beneficiary, and by 2025 there will be 2.3 workers.

To save Social Security, Simpson-Bowles proposes to adjust the retirement formula, in essence proposing that the wealthiest Americans pay more and receive fewer benefits. The NCFRR emphasizes care for the less fortunate and would provide a minimum benefit of 125% over poverty income for an individual with 25 years of work. The commission also proposed raising the retirement age and indexing it to life expectancy so that the age of retirement grows approximately one month every two years. The commission would increase the amount of income that is taxable for Social Security benefits to approximately $190,000 by 2050. In sum, the report stated that "the most fortunate will have to contribute the most, by taking lower benefits than scheduled and paying more in payroll taxes. Middle income earners who are able to work will need to do so a little longer. At the same time, Social Security must do more to reduce poverty among the very poor and very old who need help the most." Again, a compromise will be needed to address this issue.

Budget Process

The final area reviewed by the commission was the budget process itself. The commission presented several reforms that will help keep the US from getting into similar situations in future years. Specifically, it wants to establish a debt stabilization process to enforce deficit reduction to ensure that targets are met and stymie congressional or executive power by simply altering the deficit. It also included effective and automatic triggers for extended unemployment benefits so that these issues can't be used as negotiating pieces in the future.

The commission suggested that all budget concepts should be up for review and that "current scoring rules and definitions cause policy makers to undervalue some policies and overvalue others."

Conclusion

The end results of the plan are summed up in the following table:

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The Simpson Bowles plan is truly an example of sweeping and unprecedented political compromise. Unfortunately, such broad reform has little to no chance of being implemented anytime soon. It is very likely that we will raise rates on the wealthiest Americans, reduce spending in non-controversial areas, and avoid major changes to Social Security and Medicare. America needs to reform the tax code, reduce non-security and security spending, lower health care costs, fix Social Security, and reform our budget process. So, while it would be a lot easier to enact all of this reform now before we're in the middle of a crisis, that's unlikely to happen. As Winston Churchill eloquently put it, "You can always count on America to do the right thing – after they've tried everything else."

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