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INVESTING IN AMERICA'S ECONOMY

AN OVERVIEW OF THE OFS PLAN'S ADAPTATION FOR THE PETER G. PETERSON FOUNDATION'S SOLUTIONS INITIATIVE

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Investing in America's Economy

An overview of the OFS plan's adaptation for the Peter G. Peterson Foundation Solutions Initiative

Last November, Our Fiscal Security (OFS), a partnership of Demos, the Economic Policy Institute, and The Century Foundation published *Investing in America's Economy: A Budget Blueprint for Economic Recovery and Fiscal Responsibility*. This budget blueprint offers a path for a sustainable federal budget policy that promotes strong job growth and strengthens the middle class.

Since publishing the OFS report, the Economic Policy Institute agreed to participate in the Peter G. Peterson Foundation's Solutions Initiative.

The Solutions Initiative solicited long-term budget proposals from six participating organizations in order to compare those proposals on an "apples-to-apples" basis.

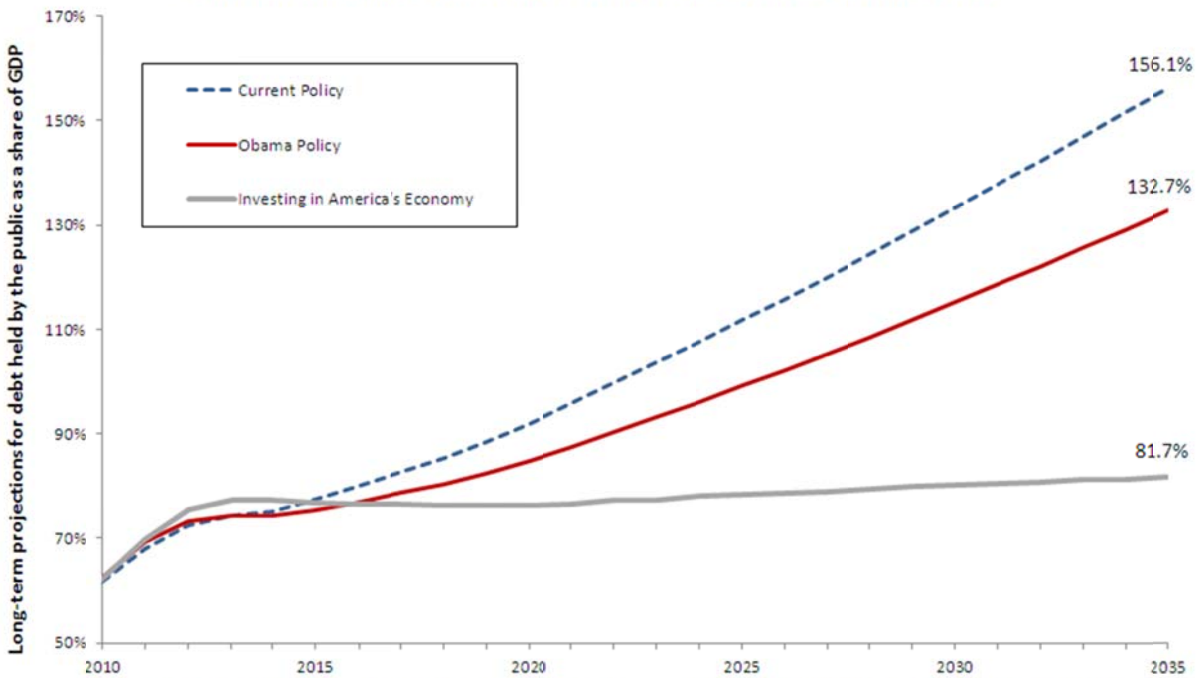
For this project, the Economic Policy Institute has adapted the OFS report, *Investing in America's Economy*, while leaving its guiding principles entirely unchanged. An overview of the plan produced for the Solutions Initiative[1] can be found at EPI.org.

Several factors necessitated revisions to the estimates and/or policy descriptions as originally presented in the OFS blueprint, including:

- The adapted plan was estimated on a different baseline (CBO current law vs. President Obama's FY2011 budget), thus the individual scores of various policies will differ from the OFS report.
- Since the publication of the plan, economic projections as well as economic policy have changed. For example, our initial report was completed prior to the December 2010 "compromise" that extended Bush-era tax changes, created a payroll tax holiday, and continued unemployment insurance benefits.
- OFS proposed tax policies were re-estimated by the Tax Policy Center using their micro-simulation model. This estimation is better able to give a complete picture of revenue impacts (including interaction terms) than individual scores of policies in isolation. The scoring of the tax provisions also necessitated a more specific articulation of the individual elements of the tax plan than what was included in the initial OFS blueprint.
- Based on the Tax Policy Center's revenue estimates and our scoring (as verified by the scorekeepers) the Solutions Initiative adaptation of *Investing in America's Economy* would decrease debt to 81.7% of GDP by 2035 (see **Figure A**).

[1] This plan was developed as part of the Solutions Initiative and funded by the Peter G. Peterson Foundation. The Peterson Foundation convened organizations with a variety of perspectives to develop plans addressing our nation's fiscal challenges. The American Enterprise Institute, Bipartisan Policy Center, Center for American Progress, Economic Policy Institute, The Heritage Foundation, and Roosevelt Institute Campus Network each received grants. All organizations had discretion and independence to develop their own goals and propose comprehensive solutions. The Peterson Foundation's involvement with this project does not represent endorsement of any plan. The final plans developed by all six organizations will be presented as part of the Peterson Foundation's second annual Fiscal Summit in May 2011.

FIGURE A
Long-term budget outlook for debt held by the public, 2010-35



Note: The Obama Policy and Current Policy baselines are from the *Investing in America's Economy* report published in November 2010 and were extrapolated from CBO's August 2010 baseline and President Obama's FY2011 budget. The Investing in America's Economy path reflects the Solutions Initiative adaptation.

Sources: Auerbach and Gale (2010), CBO (2010, 2011), Board of Trustees (2010), Peter G. Peterson Foundation, Tax Policy Center, and OFS calculations.

This Working Paper will outline scoring and policy differences between the OFS budget blueprint and the adaptation prepared for the Solutions Initiative.

Our bottom line remains clear: the first priority for national economic policy should be to create jobs and lay the foundation for long-run economic growth. Our proposal would increase national investments and protect vital economic security programs, while putting the nation on a sustainable budget path. We believe that only a path that fosters broadly shared economic growth and security will be viable in the long run.

Revisions to baseline projections

Since *Investing in America's Economy* was published in November 2010, the budget cycle and several legislative changes have forced basic revisions. December's tax deal extended all the Bush-era tax cuts through December 31, 2012, expanded several refundable tax credits, and replaced the Making Work Pay tax credit with a one-year payroll tax cut. The budget cycle also shifted from fiscal year 2011 to 2012. Some policies have been modified accordingly. Additional policy specifications were also made for independent scoring purposes, and tax policies have been independently scored by the Tax Policy Center and now account for interactions effects.

Lastly, the Solutions Initiative scored and built all six proposals from an extension of CBO's current law baseline. The OFS budget blueprint was scored and layered on top of the president's 2011 budget request; many policies not explicitly discussed were thus embedded in our budget proposal.

Public investments

The path for public investments has been altered slightly to reflect timing and budgeting for the current fiscal year. Our investment path was revised from $250 billion in 2011 to $125 billion to reflect the fact that we are now about halfway through the fiscal year (thus keeping the same level of annualized investment for the second half of this fiscal year). Funding levels of $250 billion and $200 billion for 2011 and 2012, respectively, were pushed back to 2012 and 2013 to maintain frontloaded job creation measures. Beyond 2013, this additional public investment funding is grown with nominal GDP through 2021 and then indexed for inflation and population growth. In the OFS report, public investments had been indexed to nominal GDP growth through 2045.

The baseline on top of which these investments are made is slightly changed. The OFS budget blueprint layered the investment path on top of the president's 2011 budget request, which included a three-year freeze of non-security discretionary spending and placeholders for near-term job creation. The *Investing in America's Economy* adaptation for the Solutions Initiative is layered on top of the extended CBO baseline, which is the baseline that was chosen and extrapolated by the independent scorekeepers and assumes discretionary spending is indexed for inflation.

Over the 2012-20 period, we earmark roughly $100 billion worth of general investments to health IT and comparative effectiveness research (booked as health care spending). The budget still finances $2.5 trillion worth of public investments (including these health efficiency investments) over a 10-year horizon, which is now 2012-21.

Health care

Health care proposals in the *Investing in America's Economy* adaptation for the Solutions Initiative maintain the framework of building upon health care reform to slow economy-wide health care cost growth and improve access to affordable, quality health care. Many of the policy proposals are unchanged but the scoring is somewhat different. Specific policies include adding a public insurance option, bundling provider payments, and investing in comparative effectiveness research and health IT. As noted earlier, we invest roughly $100 billion upfront in health care efficiency programs, notably health IT and comparative effectiveness research. Additionally, the *Investing in America's Economy* adaptation for the Solutions Initiative includes specific proposals for negotiating prescription drug prices for Medicare Part D and a handful of Centers for Medicare and Medicaid Services program integrity savings that were included in the president's 2012 budget request.

In the OFS report, no health care savings were assumed until 2025, when upfront investments, payment reforms, and the public option were expected to start reducing excess health care cost growth. For the Solutions Initiative adaptation, we still expect investments and reforms to incentive structures to slow economy-wide health care cost growth, but given the high degree of uncertainty in health care cost growth, we do not count any additional spending reductions. Instead, we include a revenue trigger for the contingency that federal health spending exceeds projected levels in 2025 and we assume the trigger is activated. The revenue trigger would instruct Congress to limit the deductibility of corporate debt interest, a revenue policy suggested in the OFS report.

Department of Defense

Both versions of *Investing in America's Economy* phase-in $960 billion in Sustainable Defense Task Force savings over the 2011-20 period. The OFS budget blueprint budgeted for the overseas contingency operations in the president's 2011 budget request, and the *Investing in America's Economy* adaptation for the Solutions Initiative has been adjusted to reflect overseas contingency operations in the president's 2012 budget request, down from higher inflation-adjusted costs assumed in the CBO baseline. Spending by the Department of Defense is frozen in real terms (adjusted for inflation) beyond 2021 in the *Investing in America's Economy* adaptation for the Solutions Initiative, whereas spending by the Department of Defense was frozen as a share of GDP beyond the 10-year budget window in the OFS report.

Social Security

The *Investing in America's Economy* adaptation for the Solutions Initiative adopts the same policy for strengthening Social Security endorsed in the OFS budget blueprint. The taxable earnings threshold on the employee-side would be gradually increased to 90% of total earnings over the 2013-22 period and the taxable maximum on the employer-side would be eliminated in 2013.

Other mandatory outlays

The *Investing in America's Economy* adaptation for the Solutions Initiative explicitly proposes reforming and reducing farm subsidies, particularly reducing payments to wealthy farms and reforming crop insurance. A smaller reduction in farm subsidies was implicitly included in the OFS budget blueprint, as the president's 2011 budget proposed limiting commodity payments to wealthy farmers.

Additionally, the Tax Policy Center was able to model interacted outlay effects for all refundable tax credits, which were included as "other mandatory" outlays. Many similar outlay effects were implicitly included in the OFS blueprint in the Obama policy baseline. The refundable climate rebate was scored as a revenue rather than an outlay effect, however, in the OFS report.

Revenue

In the OFS report we endorsed a number of tax reforms and ways to modernize the tax code with new revenue sources that were intended to more than meet set revenue targets. In the *Investing in America's Economy* adaptation for the Solutions Initiative, revenue policies have been scored collectively with interaction effects by the Tax Policy Center. As noted earlier, passage of December's tax deal also required additional adjustments to several policies.

Individual income taxes

In the OFS budget blueprint we proposed ending the Bush-era tax cuts for individuals earning more than $250,000—upper-income tax cuts that were extended in December's tax deal. Consequently, the adaptation for the Solutions Initiative proposes immediately rescinding those tax cuts and making permanent the remaining middle-class tax cuts after December 31, 2012. The adaptation for the Solutions Initiative also adds a 5.4% millionaire surcharge (replacing the investment income and payroll tax surcharges included in health care reform), as endorsed in the OFS report.

In the OFS budget blueprint we proposed making permanent the refundable Making Work Pay tax credit, which was replaced with a 2% payroll tax cut in December. For the adaptation for the Solutions Initiative we left the payroll tax cut in place for tax year 2011 but permanently replaced it with the Making Work Pay credit in tax year 2012. In the adaptation for the Solutions Initiative we also explicitly propose extending the American Opportunity Tax Credit (partially refundable tuition tax credit extended in the December tax deal), which had been built into the Obama policy baseline but was not explicitly mentioned.

Lastly, the Tax Policy Center was able to model indirect revenue effects of health savings (increasing individual income tax revenue) that were not calculated in the OFS report.

Corporate income tax

The adaptation for the Solutions Initiative proposes eliminating fossil fuel tax preferences and reforms to close the tax gap as proposed in the president's 2012 budget rather than 2011 budget request. The Solutions Initiative adaptation also proposes taxing U.S. Corporate foreign income as it is earned rather than waiting until it is repatriated, which essentially combines two proposals in the OFS report: closing the dividend loophole for foreign source income and closing the "active financing" tax deferral loophole.

The adaptation for the Solutions Initiative also permanently extends a research and experimentation (R&E) tax credit (modified in a revenue-neutral manner), which had been assumed in the Obama policy baseline but was never explicitly mentioned in the OFS report.

As noted earlier, the limitation on corporate debt interest payments was used as a health care trigger in the Solutions Initiative adaptation, and is assumed to be activated in 2025 and beyond, although we would expect savings of a similar magnitude to come in the form of decreased health care expenditure instead of increased revenue.

Tax expenditures

In the OFS report we proposed taxing all capital gains and qualified dividends as ordinary income. The adaptation for the Solutions Initiative taxes capital gains and dividends as ordinary income, up to a top rate of 28% on capital gains. Millionaires subject to the surcharge would pay a higher 33.4% rate on capital gains.

Like the OFS report, the adaptation for the Solutions Initiative converts deductions for charitable giving and mortgage interest to refundable tax credits available to non-itemizers. The charitable giving credit would refund 25% of qualified giving. The mortgage interest credit would refund 15% of interest on up to $500,000 of mortgage debt for a primary residence. The rate at which all remaining itemized deductions reduce tax liability would be capped at 15%.

Other revenues

The OFS budget blueprint proposed pricing carbon to address the societal cost of greenhouse gas emissions and rebating half of revenue to consumers. The adaptation for the Solutions Initiative uses a TPC revenue estimate based on an initial price of $40 per metric ton of $C0_2$ emissions in 2013. TPC also modeled a refundable climate dividend of $161 for one person and $49.50 per additional person in the tax unit. The credits are phased out between $70,000 and $110,000 for joint filers and between $30,000 and $50,000 for non-joint filers (earnings or AGI, whichever is higher) and rebates approximately 55.5% of net carbon revenues.

The OFS report proposed a progressive estate tax designed around Senator Sanders' "Responsible Estate Tax," which generated revenue relative to the Obama policy baseline. The adaptation for the Solutions Initiative instead maintains current law revenue from estate and gift taxes and instructs Congress to design a revenue-neutral progressive estate tax reform with graduated rates. The adaptation for the Solutions Initiative would also repeal the estate tax provisions in December's tax deal.

The financial transactions tax base and rates were specified to tax stock transactions at 0.25%, bond transactions at 0.004%, option premiums at 0.25% per year to maturity, foreign exchange transactions at 0.004%, and futures and swaps at 0.01%, which the Tax Policy Center estimated would raise $821 billion over the 2012-21 period. The parameters of the financial crisis responsibility fee are unchanged.

Like the OFS report, the adaptation for the Solutions Initiative would increase the motor fuel excise tax, phasing-in an increase of 15 cents by 2019 and an additional 10 cents by 2024.

The adaptation for the Solutions Initiative added a tax on sweetened beverages as a Pigouvian tax to encourage better health outcomes and complement health reforms, a policy not explicitly recommended in the OFS report, but consistent with our cost-savings approach to health care reform.

Lastly, the adaptation for the Solutions Initiative also indexed all tax parameters to chained CPI rather than CPI-U. The involvement of the Tax Policy Center allowed us to obtain a precise estimate of the budgetary impact that was not available for the OFS report.

Baselines and budget window

The Solutions Initiative adaptation is built on and scored relative to the Congressional Budget Office's March 2011 current law baseline, extrapolated through 2035 by the Peterson Foundation's independent scorekeepers. The OFS report was, on the other hand, built on and scored relative to the president's budget request for fiscal year 2011 and compared with Obama policy and current policy baselines. Both the Obama policy and current policy baselines for 2011-20 were compiled by Alan Auerbach and William Gale, taken from "The Federal Budget Outlook, Chapter 11,"[2] and based on the CBO August 2010 baseline and revised Medicare and Social Security Trustee reports (reflecting passage of health care reform). Auerbach and Gale regularly compile these administration and current policy baselines, and the most recent projections can be found in "Tempting Fate: The Federal Budget Outlook."[3]

The current policy baseline assumes extensions of the estate and gift tax repeal, a permanent 15% rate on capital gains and dividends, other extensions of the Bush-era tax cuts, indexation of the AMT exemption for inflation, and an interaction effect for indexing the AMT. On the spending side, non-defense discretionary spending is adjusted for both inflation and population growth (CBO adjusts only for inflation), defense discretionary spending is assumed to follow the path in the president's budget (resulting in a decrease from CBO projections), and the scheduled reduction in Medicare physician payment rates is assumed not to occur (i.e., the so-called "doc fix" continues). We extrapolated both the Obama policy and current policy baselines through 2045 using economic and budgetary assumptions in the CBO's June 2010 Long-Term Budget Outlook and the 2010 Social Security and Medicare Boards of Trustees Report. For more detail, see Appendix A in *Investing in America's Economy*.

Based on the Tax Policy Center's revenue estimates and our scoring (as verified by the scorekeepers),[4] the Solutions Initiative adaptation of *Investing in America's Economy* would decrease debt to 81.7% of GDP by 2035

[2] Alan J. Auerbach and Gale, William G. 2010. "The Federal Budget Outlook, Chapter 11." Washington, D.C.: Urban-Brookings Tax Policy Center, September 15. http://www.taxpolicycenter.org/UploadedPDF/1001450_chapter11.pdf

[3] Alan J. Auerbach and Gale, William G. 2011. "Tempting Fate: The Federal Budget Outlook." Washington, D.C.: Urban-Brookings Tax Policy Center, February 8. http://www.urban.org/uploadedpdf/1001497-Auerbach-Gale-Tempting-Fate.pdf

[4] The spending and revenue estimates have been extensively reviewed by a team of independent scorekeepers, led by Barry Anderson and including William Menth and the staff of the Urban-Brookings Tax Policy Center. The Urban-Brookings Tax Policy Center assessed the revenue effects of each plan. The Urban Brookings Tax Policy

(see Figure A above). The baselines for the OFS report show, in stark contrast, debt at 156.1% of GDP under current policy and 132.7% of GDP under Obama policy. These baselines would look slightly different if remodeled and extrapolated from the most recent Auerbach and Gale (2011) current policy projections and the president's 2012 budget request. The Solutions Initiative adaptation of *Investing in America's Economy* shows a smaller improvement relative to CBO's March 2011 current law baseline, but this baseline ignores current policy for Medicare physician payment rates (i.e., the "doc fix"), the alternative minimum tax patch, and the Bush-era tax changes. *Investing in America's Economy,* by contrast, maintains Medicare physician payment rates at 2011 levels, indexes the AMT for inflation, and extends the Bush-era tax changes for all tax filers earning less than $200,000 ($250,000 for joint-filers).

Center and the other members of the scorekeeping team do not necessarily endorse any of the estimates made by the Participants of their own plans.