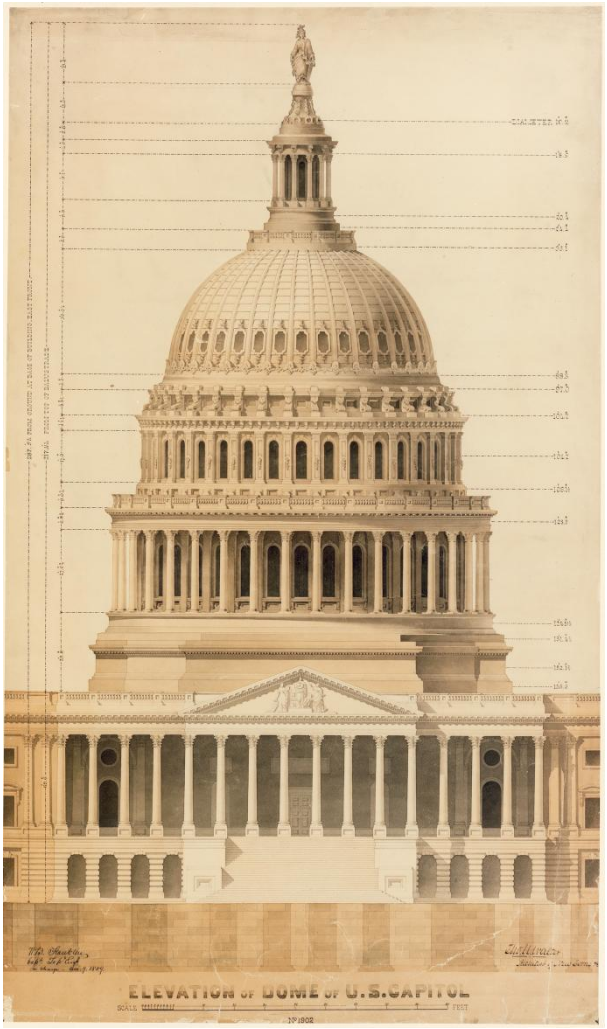
# REINVENTING GOVERNMENT

## *The Federal Budget*

### PART II

### 60 Recommendations to Reduce the Deficit by $2 Trillion over 10 Years





CONGRESSMAN MIKE QUIGLEY


May 2011

# Executive Summary

Government's mission matters. Our Constitution is unambiguous on this point—in 1787, we endowed our government with the power to "establish Justice, insure domestic Tranquility, provide for the common defence, promote the general Welfare, and secure the Blessings of Liberty."

Unfortunately, this vision is increasingly threatened by our government's unsustainable fiscal path. The Congressional Budget Office projects that by 2030, the federal government will be spending 30 percent of GDP but collecting only 20 percent in tax revenue. By 2050, the government will be collecting that same 20 percent, but spending 45 percent.

Deficit spending will also generate its own costs. Eventually, the accumulated costs of past deficits will be the drivers of new ones. The CBO projects that just 10 years from now, in 2021, the interest we will pay on previous borrowing will cost taxpayers $792 billion—accounting for all of 2021's projected $763 billion deficit and then some. These numbers speak for themselves.

The practical effect of these persistent deficits is that interest payments will eventually crowd out the essential work of government. When we fail to help the thousands of homeowners who have been wrongfully foreclosed on, there is no Justice. When we spend almost twice as much servicing our debt as we do educating our children, there is no general Welfare. When we have burdened future generations with a bill they did not choose and cannot pay, there is no Liberty.

Restoring our budget to a sustainable path will not be easy. We will have to make tough choices, sacrificing programs we care about to preserve programs that are essential. But there can be no sacred cows in this process—all options must be on the table and, while there can and must be genuine disagreement, all parties must negotiate in good faith.

In this report, we have tried to make some of these tough choices. On health care, rather than simply shifting costs to the private sector or ending entitlement programs altogether, we propose fundamentally reforming the way we deliver and pay for health care, emphasizing value over volume.

On defense, we suggest cutting outdated programs and consolidating duplicative ones, to keep our military as the strongest, most flexible fighting force in the world. We recommend cutting hundreds of billions of dollars in tax expenditures that hurt the environment and subsidize unproductive behavior, and also propose moving to an agricultural policy that uses market-based risk management tools.

On Social Security, we keep the basic benefit structure in place while putting the program on sounder financial footing. We also recommend that deficit reduction include reasonable cuts to non-defense discretionary spending. All told, our recommendations would save at least two trillion dollars over the next 10 years.

These are not arbitrary recommendations—our goal is not to cut spending simply for the sake of cutting it. On the contrary, we believe that deficit reduction must serve the greater purpose of government as envisioned by our founders. Fiscal sustainability is a means to an end, not an end in itself, and we have to be mindful of government's mission when we set about reforming it.

This is why the title of the report is "Reinventing Government". As we consider reforms to make our federal budget more fiscally sustainable, the seriousness of our problem demands that we do more than just nibble around the edges. Yet neither should we go overboard, eviscerating social safety nets and offloading all of the costs onto low-income individuals without the ability to pay.

Instead, we need to think about how we would design government if we were designing it from scratch. How can the federal government most effectively discharge its constitutional duties? How can it do so sustainably? These are the questions we are trying to answer.

We believe that the 60 recommendations detailed in this report can help answer these questions. We have tried to be attentive to our long-term fiscal challenges, but not dismissive of government's indispensable role in society. A more sustainable budget will enable us to responsibly invest in public goods like infrastructure, education, and health care.

Of course, this report is only one set of recommendations and will not solve our deficit and long-term debt problems on its own. We will have to continue making tough choices so that our children and children's children are able to enjoy the same freedoms and liberties that we have enjoyed.

# *Reinventing Government: The Federal Budget (Part II)*

***60 Recommendations to Reduce the Deficit***

May 2011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# Introduction

This report reviews our recommendations for reducing the deficit and returning our budget to a sustainable fiscal path. In this introduction, we review our previous report, *Part One*, discuss the goals of this report, and explain why deficit reduction is important.

## Our Previous Report

In November 2010, we released *Part One* of our report series on reinventing the federal budget. That report reviewed our fiscal situation and offered 15 recommendations to reform our budget by making it more transparent and accountable to taxpayers. *Part One* can be found on our website at the following address:

**http://quigley.house.gov/reinventing**

Aside from its 15 recommendations, *Part One* made two broader arguments. First, even if we disagree on how to put our budget back on a sustainable path, we all need to acknowledge that a problem exists. Consider the Congressional Budget Office projection that by 2030, the federal government will be spending 30 percent of GDP but collecting only 20 percent in tax revenue. By 2050, the government will be collecting that same 20 percent, but spending 45 percent. Our deficits will only get worse from there.

Second, getting back on track is not just about pointing ourselves in the right direction, but is fundamentally about fixing the underlying problems that led us in the wrong direction in the first place. Budget reform should address the broken institutions that facilitated poor decision-making. It is difficult to find budgetary savings when our budget itself is so opaque. Effectively, we are flying blind. That has got to change.

## The Goal of this Report

This report, "Part Two", takes the next step. It discusses specific reforms to our federal budget that would directly result deficit reduction. This report, however, is not strictly comparable with the other deficit reduction reports that have come out in the last year.[1] While our ultimate goal is to put the budget on a sustainable path, we believe that the best way to go about this is through the lens of reinventing government. This does not mean that we have limited the scope of our recommendations to only efficiency reforms that would generate small

[1] These include reports from the National Commission on Fiscal Responsibility and Reform, the Committee for a Responsible Federal Budget & the Brookings Institute (Galston-MacGuineas), the Bipartisan Policy Center (Rivlin-Domenici), Esquire Magazine, Rep. Jan Schakowsky, Rep. Paul Ryan, EPI/Demos/Century Foundation, and others.
[2] Of course, our debt to GDP ratio needs to come down. In the short-term, then, that means we will probably need to

savings at the margin of bigger picture items. On the contrary, our vision for reducing the deficit is about reinventing the fundamental structure of government. Government's mission matters, and we believe that we can achieve that mission at a lower cost and with better overall results.

Consider the Department of Defense (DOD). When assessing the DOD budget, we find that many of our biggest defense costs are due to institutional inertia rather than necessity. Over the years, defense programs have appropriately been designed to combat the enemies of the time. Today, however, many of those enemies of years past no longer exist. During the Cold War, for example, when our adversary was the Soviet Union, it made sense to have thousands of nuclear weapons in our military arsenal. But today, when our primary enemy is a diffuse network of terrorists against whom nuclear deterrence is ineffective, expansion of our nuclear weapons program no longer makes sense. The point is that if we can realign our defense policy to match today's threats, potentially spending fewer dollars but spending them more wisely, we can make our country safer and our fiscal path more sustainable.

This report looks at six different areas of our budget—defense, health care, Social Security, tax expenditures, farm subsidies, and discretionary spending—and makes specific recommendations that would improve government's performance in those areas while at the same time reducing the federal budget deficit. Beyond these recommendations, we also present a "menu of options"—essentially, a list of other potential reforms that could save us billions of dollars. The distinction between "recommendations" and "options" is not just superficial, but is primarily meant to highlight those reforms that we are specifically recommending. Taken together, these 60 recommendations could save us hundreds of billions of dollars per year and go a long way toward putting our budget back on a sustainable path.

## How this Report is Organized

This report is organized into six sections, one each for the different parts of the budget that we are seeking to reform. Within these six sections, there is a list of reform recommendations, a cost savings estimate for each recommendation, and list of other reform options. Each of these items is discussed at greater length in the body of that section.

We also include an aggregate savings total for the each section. This "grand total" is expressed as a range rather than a specific number—this is to underscore the large margin for error in preparing this type of report. It also should not be interpreted as an "ideal" savings amount for each type of spending. In several cases, we believe that much more money could be saved. And in some cases, we believe that our recommendations would generate considerably more savings than they are given credit for.

However, we have always erred on the side of caution and only counted those savings which could be cited from respected sources.

- Health Care: $300-500 billion over 10 years
- Defense: $600-700 billion over 10 years
- Tax Expenditures: $700-800 over 10 years
- Social Security: 100 percent solvent
- Farm Subsidies: $50-60 billion over 10 years
- Non-Defense Discretionary: Depends on savings achieved in other budget areas

## Our Methodology

This report contains specific policy recommendations and options that, combined, add up to over two trillion dollars in savings over the next 10 years. Before moving on to the recommendations, we would like to make a few brief points about our methodology.

1. Writing this report, we have tried to maintain strict standards for what qualifies as a reliable savings estimate. Whenever possible, we have used savings estimates from official government organizations like the Congressional Budget Office, the Office of Management and Budget, the Congressional Research Service, the Joint Committee on Taxation, and the Social Security Administration. In some cases, we have also cited highly respected independent organizations like the Committee for a Responsible Federal Budget, the Center for American Progress, the Sustainable Defense Task Force, the National Commission on Fiscal Responsibility and Reform, and others. We have also used academic sources and, in some cases, news reports. However, some of our recommendations and associated cost savings figures depend on less authoritative sources. While we cannot entirely guarantee the accuracy of every savings estimate cited in this report, we have made every effort to properly cite these sources so that our readers may judge them for themselves. We have also left out some recommendations that we had hoped to include. Most often, this was because no reliable cost savings estimate could be found.

2. This report is the work of Congressman Quigley and his legislative staff, not professional economists. However, in order to effectively present cost savings estimates that were produced by a wide and diverse range of organizations, we have tried to normalize cost savings across a 10 year budget window (the standard for long-term budgeting in the federal government). What this means is that several five year savings estimates had to be converted to the 10 year window. In some cases this was not possible (for example, when the projected savings were from one-off cuts that would not have a multi-year budgetary effect). In those cases, we indicate the shorter time frame next to the savings estimate. On the other hand, some five year savings estimates could be properly

stretched over the full 10 years. When doing so, we have always erred on the side of caution, even when cost inflation suggests that the potential savings over the second five years would be greater than the savings projected over the first five years.

3. We have also used 10 year cost estimates across several different 10 year windows, most originating in the last five years. These 10 year windows are not strictly comparable and so we have indicated wherever appropriate any 10 year estimate that is not across 2011-2020 or 2012-2021.

4. Adding up each of the cost savings does not produce a meaningful grand total. This is because many of the recommendations, if implemented, would interact with each other and produce unexpected results. The "true" grand total might be larger or smaller than the precise sum of each of the recommendations contained in this report. This is why we have displayed each section's total as a range rather than as a specific dollar amount, and the grand total as around $2 trillion with significant margin for error.

5. Our savings numbers do not all make reference to the same baseline. In some cases, we use the current law baseline. In others, however, we estimate savings based on historical precedent (for example, when Congress has repeatedly renewed a deficit-increasing provision).

## What is Fiscal Sustainability?

Fiscal sustainability is the ability of the federal government to meet its fiscal obligations, now and in the future. This definition is in keeping with what we believe is an appropriate perspective on our government's role in society. We should reject the dogmatism of either extreme, one that would cut spending just for the sake of it and one that would raise revenues without considering the broader economic impact. Cutting spending and raising revenues may each be part of the solution, but they are not solutions on their own.

On the contrary, we believe achieving fiscal sustainability is about reinventing government. Government needs to be less wasteful, less intrusive, and more transparent—while at the same time delivering the vital services that society demands. But these goals are closely related. The long-term success of government services requires a well-managed government. The more tax dollars we squander on needless waste, the fewer we have to spend on health care or national defense or other priorities.

Fiscal sustainability should be measured by looking at both deficits and debt. Deficits can tell us about the annual performance of government while debt can tell us about the accumulated burden of past deficits. Neither of these measures makes sense as absolute numbers. After all, a $50 billion dollar deficit would be much more troubling for Luxembourg than it would be for the United States. Instead, they should be presented as percentages of GDP.

What deficit level is sustainable? Any deficit that does not increase our debt as a percent of GDP is probably acceptable.[2] What this means is that we should target reducing deficits to a share of GDP that is lower than the annual growth rate of our economy. This way we can avoid an out of proportion increase in outstanding debt.

This leads to a second question: what level of public debt is sustainable? This may seem like a strange question to those who believe that any debt is problematic, but a look at the historical record reveals that the U.S. government has carried debt on its books nearly every year since this country's founding, and at elevated levels since World War Two (see Figure 1).

The question, then, has less to do with the sustainability of public debt *per se* and more to do with what level of public debt is sustainable. Figure 1 shows that public debt as a percent of GDP only exceeded 100 percent for the few years during and after World War II. This sharply contrasts with the long-term CBO projections that show it rising to 250 percent of GDP by 2040 and to over 1000 percent of GDP by 2075. Of course this path is purely hypothetical: no one truly believes that our government could sustain such high levels of indebtedness, even if it briefly exceeded 100 percent during a period of national emergency some 65 years ago.

## Figure 1: Debt as a Percent of GDP 1940-2014[3]

[2] Of course, our debt to GDP ratio needs to come down. In the short-term, then, that means we will probably need to aim for annual surpluses.

[3] Congressional Budget Office, "The Long-Term Budget Outlook", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf> [accessed 22 November 2010]

Different groups have different ideas about what level of public debt is sustainable. One of the most prominent standards out there, put forward in the 2009 Pew-Peterson report *Red Ink Rising*, sets the sustainable debt to GDP level at 60 percent: "We believe that the 60 percent goal is the most ambitious yet realistic goal that can be achieved in [an eight year timeframe]. The 60 percent debt threshold is now an international standard—regularly identified by the European Union (EU) and the International Monetary Fund (IMF) as a reasonable debt target".[4] We believe that 60 percent should be the maximum debt to GDP level of a sustainable budget. While lower levels may be preferred, getting below 60 percent should be our target.

## Why is Deficit Reduction Important?

Deficit reduction is important because our current fiscal path is unsustainable. The Department of Treasury projects that our tax revenues, under current law, will remain relatively constant as a share of GDP at approximately 20 percent. Our spending outlays, however, are projected to jump from 25 percent of GDP in 2010 to 45 percent of GDP by 2050 and will surpass 70 percent of GDP by 2080. The main drivers of these deficits will be health care costs and net interest payments.

Our last report, *Part One*, examined these issues at greater detail. Nevertheless, it is worth reviewing some of the negative consequences of unsustainable deficits and the accumulating debt that results:

1. Large persistent deficits can increase interest payments for debt service.
2. Large persistent deficits can redirect American wealth overseas.
3. Large persistent deficits can crowd out private sector investment.
4. Large persistent deficits can cause a debt crisis.

The fundamental motivation behind making the recommendations contained in this report, Part Two, is to avoid the negative consequences of runaway deficits.

## "The First 10 Savings"

The next section, "The First 10 Savings", includes a diverse set of first step recommendations to reduce the deficit. While these recommendations could have been included in other sections of the report, we group them together here because we believe that they are helpful in illustrating the broader direction of this report. We also believe, as the section header suggests, that these recommendations are "low-hanging fruit" and ought to be among the first steps in achieving deficit reduction.

[4] Peterson-Pew Commission on Budget Reform, "Red Ink Rising", in *Peterson-Pew Commission on Budget Reform* <**http://budgetreform.org/sites/default/files/Red_Ink_Rising.pdf**> [accessed 22 April 2011]

# THE FIRST 10 SAVINGS

❶ **Reduce the federal travel and vehicle budget.**

❷ **Sell excess federal property.**

❸ **Cut the unnecessary Joint Strike Fighter second engine.**

❹ **Increase paperless transactions.**

❺ **Consolidate information technology infrastructure.**

❻ **Improve IRS tax enforcement.**

❼ **Cut farm subsidies for high-income individuals.**

❽ **Consolidate export-promotion agencies.**

❾ **Align premiums with risk on pension guarantees.**

❿ **Cut the tax subsidy for purchasing yachts.**

➲ ***Potential Savings: $75 billion over 10 years***[5, 6]

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[5] This calculation assumes annually consistent savings for several of the 10 recommendations in this section.

[6] Sources: 1-2 ( National Commission on Fiscal Responsibility and Reform, in *The Moment of Truth* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf> [accessed 22 April 2011]), 3-7 ( Office of Management and Budget, "Fiscal Year 2012 Terminations, Reductions, and Savings: Budget of the U.S. Government" <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/trs.pdf> [accessed 22 April 2011]), 8 ( John Podesta, Sarah Rosen Wartell and Jitinder Ko, "A Focus on Competitiveness", in *Center for American Progress*), 9 ( Congressional Budget Office, "Budget Options Volume 2", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf> [accessed 22 April 2011]), 10 ( Seth Hanlon and Michael Ettlinger, "Cut Spending in the Tax Code", in *American Progress* <http://www.americanprogress.org/issues/2011/03/pdf/tax_expenditures.pdf> [accessed 22 April 2011])

# Reinventing Health Care

## Our Twelve Key Recommendations

### Implement and Improve the Health Care Reform Law

- ***Recommendation 1: Follow through on cost-containment reforms.***
  - ***Potential Savings: $210 billion over 10 years***
- ***Recommendation 2: Strengthen the Independent Payment Advisory Board.***
  - ***Potential Savings: $50 billion over 10 years***
- ***Recommendation 3: Adopt delivery system reforms: pay for quality.***
  - ***Potential Savings: $23.3 billion over 10 years***
- ***Recommendation 4: Fully fund the CMS Innovation Center.***
  - ***Potential Savings: Variable***

### Expand Cost-Cutting Mechanisms

- ***Recommendation 5: Use comparative effectiveness research to set payment rates.***
  - ***Potential Savings: $0.9 billion over 10 years***
- ***Recommendation 6: Help CMS to combat Medicare waste, fraud, and abuse.***
  - ***Potential Savings: $9 billion over 10 years***
- ***Recommendation 7: Recoup incorrect payments to Medicare Advantage insurers.***
  - ***Potential Savings: $6.2 billion over 10 years***

### Reduce Drug Costs

- ***Recommendation 8: Shorten exclusivity period for brand name biologic drugs.***
  - ***Potential Savings: $2.3 billion over 10 years***
- ***Recommendation 9: Prohibit pay-for-delay agreements.***
  - ***Potential Savings: $8.8 billion over 10 years***
- ***Recommendation 10: Have Medicare require minimum rebates from drug companies.***
  - ***Potential Savings: $100 billion over 10 years***

### Improve Medicaid Efficiency.

- ***Recommendation 11: Eliminate double payment for Medicaid administrative costs.***
  - ***Potential Savings: $2.6 billion over 10 years***
- ***Recommendation 12: Allow enrollment of dual eligibles in Medicaid managed care.***
  - ***Potential Savings: $12 billion over 10 years***

## Recommended Minimum Potential Savings

## ➲ $300-500 billion over 10 years

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### ❍ Consider Other Options

► ***OPTION 1: Gradually raise the Medicare eligibility age to 67.***

➲***Potential Savings: $124.8 billion over 10 years***

► ***OPTION 2: Gradually increase all Medicare Part B premiums from 25 to 35 percent.***

➲***Potential Savings: $241.2 billion over 10 years***

► ***OPTION 3: Modernize Medicare cost-sharing.***

➲***Potential Savings: $26.4 billion over 10 years***

► ***OPTION 4: Require Medicare carriers to inform physicians about peer profiling.***

➲***Potential Savings: $1.7 billion over 10 years***

# Our Approach to Health Care Reform

Rising health care costs represent the single most significant threat to America's fiscal health. According to CBO projections, "projected growth in entitlement spending explains almost all of the projected growth in total non-interest spending—and the two big government health-care programs largely drive that increase."[7] While experts may disagree about how to reduce government spending, as Robert Greenstein of the Center on Budget and Policy Priorities points out, there is a striking consensus among budget experts, including the CBO, the Brookings Institute, the GAO, the Pew-Peterson Commission, and others, that the "continued rapid growth of per-person health care costs is the single biggest reason for the projected long-term increases in deficits and debt."[8] Medicare and Medicaid are responsible for "80 percent of the growth in spending on the three largest entitlements over the next 25 years and for 90 percent of that growth by 2080," according to the CBO.[9]

> ***"Continued rapid growth of per-person health care costs is the single biggest reason for the projected long-term increases in deficits and debt"***
> **- Robert Greenstein, Center on Budget and Policy Priorities**

Not only are these health care programs growing in cost, but they are also growing relative to federal spending. Each year they consume a bigger and bigger share of our resources. Under current policy, according to CBO budget projections, federal spending on Medicare and Medicaid will grow from 5.5 percent of GDP today to about 10 percent of GDP in 2035, and to more than 17 percent by 2080.[10]

Medicare and Medicaid costs that continue to outpace GDP growth cannot be sustained in the long-term. Cost cutting in these two entitlement programs must be part of any budget reform package. As Marc Labonte, a macroeconomic specialist for the Congressional Research Service, explains, "any policy changes to place the budget on a sustainable path must include reductions in the growth rate of government health spending."[11]

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[7] Congressional Budget Office, "The Long-Term Budget Outlook", in Congressional Budget Office <http://www.cbo.gov/ftpdocs/102xx/doc10297/06-25-LTBO.pdf> [accessed 22 April 2011]
[8] Robert Greenstein, "Perspectives on Long-Term Deficits", in Center on Budget and Policy Priorities <http://www.cbpp.org/files/1-21-10bud-test.pdf> [accessed 22 April 2011]
[9] Congressional Budget Office, "The Long-Term Budget Outlook", in Congressional Budget Office <http://www.cbo.gov/ftpdocs/102xx/doc10297/06-25-LTBO.pdf> [accessed 22 April 2011]
[10] Congressional Budget Office, "The Long-Term Budget Outlook", in Congressional Budget Office <http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf> [accessed 22 November 2010]
[11] Marc Labonte, "The Economic Implications of the Long-Term Federal Budget Outlook", in Congressional Research Service <http://aging.senate.gov/crs/medicare8.pdf> [accessed 22 April 2011]

There is also very little evidence that all this health care spending is actually improving health. In some cases, it may actually be making health care worse.[12] Additionally, research has shown that differences in health care spending show no corresponding differences in health outcome. Dartmouth University researchers have found, for example, that per-capita health-care spending—after adjusting for price, demographic, and illness level—varies by a factor of three across the U.S.[13] However, more is not always better, and Dartmouth research has shown that low-cost regions of the U.S. achieve equal or better health outcomes than high-cost regions.[14] These findings suggest that, by adopting the more efficient practices of the low-cost regions on a national scale, significant health care savings could be achieved without harming quality of care.

Health care cost trends are unsustainable but health quality is not keeping pace. However, by implementing the twelve reforms outlined below, we can curb cost growth and improve care at the same time.

[12] Dr. Elliott Fisher et al., "Health Care Spending, Quality, and Outcomes", in *The Darthmouth Institute for Health Policy & Clinical Practice* <http://www.dartmouthatlas.org/downloads/reports/Spending_Brief_022709.pdf> [accessed 22 April 2011]
[13] Dr. Elliott Fisher, "The Road to Reform", in *Dartmouth Medicine* <http://dartmed.dartmouth.edu/summer09/pdf/road_to_reform.pdf> [accessed 22 April 2011]
[14] Dr. Elliott Fisher, "The Road to Reform", in *Dartmouth Medicine* <http://dartmed.dartmouth.edu/summer09/pdf/road_to_reform.pdf> [accessed 22 April 2011]

# Our Twelve Key Recommendations

## Implement and Improve the Health Care Reform Law

The new health care reform law, also known as the Affordable Care Act (ACA), has laid a solid foundation for curbing skyrocketing health care costs. The CBO estimates that between 2012 and 2021, the ACA and health care provisions of the reconciliation act will reduce the deficit by $210 billion,[15] and by $1.3 trillion over the following decade.[16] The law also extends the solvency of the Medicare trust fund by twelve years, to 2029.[17]

Still, this important piece of legislation is merely the beginning. We still have to implement a number of ACA's more difficult reforms. Many of the cost-curbing mechanisms included in the bill will only bear fruit if Congress stands firm on unpopular reforms such as allowing Medicare payments to be reduced. Other reform provisions, such as the Independent Payment Advisory Board (IPAB) (which was designed to recommend Medicare payment reforms) must be strengthened. Further, other reform elements, such as the Centers for Medicare and Medicaid (CMS) Innovation Center, tasked with testing new payment systems to improve quality and lower costs, should be supported and expanded as soon as possible. Finally, several promising reform ideas were left out of the bill. They should now be considered by Congress.

Difficult as the passage of health care reform was, the full development, implementation, and execution of its provisions will be just as trying. Health care cost reduction and quality improvement are not guaranteed, but outlined below are twelve recommendations aimed at curbing costs, improving care, and strengthening our long-term fiscal outlook.

### RECOMMENDATION 1 → $210 BILLION IN SAVINGS OVER 10 YEARS[18, 19]

### ►*Follow through on cost-containment reforms.*

The recently-enacted health care reform law has the potential to reduce the deficit by $210 billion[20] over the next decade, and by $1.3 trillion in the second decade, but only if Congress follows through on several key cost-containment provisions included in the law.

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[15] Douglas W Elmendorf, "CBO's Analysis of the Major Health Care Legislation", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/121xx/doc12119/03-30-HealthCareLegislation.pdf> [accessed 22 April 2011]
[16] Douglas W Elmendorf, "Letter to Speaker Nancy Pelosi", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/113xx/doc11379/AmendReconProp.pdf> [accessed 22 April 2011]
[17] Patricia A. Davis, "Medicare Primer", in *Congressional Research Service* <http://aging.senate.gov/crs/medicare1.pdf> [accessed 22 April 2011]
[18] Douglas W Elmendorf, "CBO's Analysis of the Major Health Care Legislation", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/121xx/doc12119/03-30-HealthCareLegislation.pdf> [accessed 22 April 2011]
[19] Provided reforms included in the Affordable Care Act (ACA) are executed, these saving will already be achieved. We include these savings estimates here to illustrate the importance of following through on the cost-containment provisions included in the ACA rather than repealing them, as has been proposed.

While the ACA includes dozens of cost-curbing mechanisms, certain provisions are estimated to be the most effective at cutting costs. Not surprisingly, the most effective cost-cutters are also the most controversial and may prove the most challenging to maintain. These key cost-curbing provisions include: (1) reductions in Medicare spending, (2) an excise tax on high-cost insurance plans tacked to inflation, and (3) a lower rate for subsidy growth.

The ACA calls for reductions in Medicare spending of approximately $500 billion over the next 10 years. Many of these savings will come from increasing efficiencies in Medicare and modifying the formulas used to determine payment rates to providers. Savings will also come from reducing overpayments to Medicare Advantage, which on average costs 14 percent more than traditional Medicare for the same services.

**"The most effective cost-cutters are also the most controversial and may prove the most challenging to maintain."**

Some critics have argued these savings are unrealistic because Congress has historically failed to authorize Medicare payment reductions (for example, by continually deferring reductions in Medicare payments to physicians, also known as the "doc fix"). While across-the-board payment reductions are not a solution to reducing long-term health care costs, providers must be fairly reimbursed for their services or they will be forced to reduce access to care, harming patients and shifting costs, the Medicare spending reductions in the ACA are reasonable and Congress must follow through on them if Medicare cost growth is to be contained.

The ACA includes two other important cost-curbing mechanisms. One is a new excise tax on high-cost insurance plans (those costing more than $27,500 annually for a family). The idea behind this provision is not that people will pay the tax, but that employers will choose insurance plans that more aggressively hold down costs in order to avoid the tax, thereby reducing costs. Importantly, the ACA also tacks the excise tax to inflation, rather than inflation plus one percentage point, which will apply downward pressure on the costs of more insurance plans more quickly. While this policy may need to be adjusted over time to ensure consumers are not adversely affected, Congress must resist the urge to significantly alter or repeal this important cost curbing mechanism.

The final bill also allows subsidies for low-income individuals to grow at a slower rate than originally proposed, ultimately reducing costs to the government. While we must ensure health care coverage is affordable for all, our focus should be on reducing the cost of health care for individuals rather than simply increasing subsidies to pay for it. Congress should allow health subsidies for low-income individuals to grow at the rate designated in ACA.

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[20] Douglas W Elmendorf, "CBO's Analysis of the Major Health Care Legislation", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/121xx/doc12119/03-30-HealthCareLegislation.pdf> [accessed 22 April 2011]

## RECOMMENDATION 2 → $50 BILLION IN SAVINGS OVER 10 YEARS[21, 22]

### ►*Strengthen the Independent Payment Advisory Board.*

Some experts, including Peter Orszag, former director of the OMB, argue that one of the most powerful cost containment mechanisms included in the ACA is the Independent Payment Advisory Board (IPAB). The CBO estimates that the IPAB will reduce Medicare spending by $28 billion between 2010 and 2019, with significant savings continuing beyond 2019.[23]

IPAB is a 15 person board of independent health experts appointed by the President, confirmed by the Senate, and tasked with developing reforms to reduce Medicare per capita spending if it exceeds GDP growth per capita plus one percent. The board will submit a package of reform proposals to Congress, which must hold an up or down vote on each. The package cannot be filibustered, and if Congress rejects the proposed package, it must find another way to save the same amount. Some have argued against such a board, claiming that it takes too much power away from Congress. However, this board has great potential to recommend innovative measures to curb costs while still allowing Congress to make the final decision on whether the reforms are actually enacted into law. Further, one might argue that Congress's record on cost containment suggests an independent board is necessary.

While the creation of this independent board is a huge step forward, the advisory board could be strengthened in several ways. IPAB doesn't go into effect until 2014, but this is too long to wait when health care costs are rising so quickly. The board should be convened immediately and should send Congress recommendations as soon as possible. Additionally, the Board is forbidden from making any recommendations regarding payments to hospitals, skilled nursing facilities, and other exempted providers until 2020. Hospital payments, which account for 28 percent of Medicare's budget, and other exempted providers should be included in IPAB's purview immediately.

The Committee for a Responsible Federal Budget (CRFB) agrees that hospitals and other providers should be included in IPAB's purview and further recommends broadening its scope to allow it to expand the current payment reform demonstration projects if they appear to be working before their test periods have finished. CRFB also recommends allowing IPAB to make changes to cost-sharing and benefits design. However, any such changes to benefits would need to be carefully considered to ensure that they are promoting value and quality rather than

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[21] Committee for a Responsible Federal Budget, "Let's Get Specific: Health Care", in *Committee for a Responsible Federal Budget* <http://crfb.org/sites/default/files/Lets_Get_Specific_Health_Care.pdf> **[ac**cessed 25 April 2011]

[22] The original cost savings estimate was $10 billion per year beginning in 2017, which through the FY2012-2021 10 year budget window would add include five years of savings. We also err on the side of caution and ignore inflation.

[23] Douglas W Elmendorf, "Letter to Majority Leader Harry Reid", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/108xx/doc10868/12-19-Reid_Letter_Managers_Correction_Noted.pdf> [accessed 25 April 2011]

simply shifting costs or harming beneficiaries. CRFB estimates that increasing IPAB's authority could allow the board's cost-savings targets to be increased by $10 billion per year beginning in 2017.[24]

IPAB has the ability to significantly improve the fiscal health of the Medicare program and the federal budget as whole. However, fiscal health should not be achieved at the cost of access to quality care. History has shown us that across the board cuts to Medicare are not a long-term solution. This is why it is imperative that IPAB incorporate into its recommendations not simply cuts, but also reforms that improve quality and pay for value. To that end, the ACA calls for two Institute of Medicine studies to examine value-based purchasing that rewards quality over quantity. It also recommends how to incorporate "quality and value" metrics into Medicare payment systems. Such studies and the payment reforms that result should be fully supported by Congress, as such reforms offer the best opportunity to curb costs and improve care. The Mayo Clinic also recommends that IPAB serve as an unbiased national data aggregator, making performance and cost information publically available in order to identify best practices and high performers.[25]

**"Fiscal health should not be achieved at the cost of access to quality care."**

Several other critics of IPAB have also argued that the make-up of the board should be altered to ensure providers are properly represented and quality of care is emphasized along with cost-containment. To ensure providers are properly represented on the board, some have suggested requiring that health care providers comprise at least 50 percent of the board, and further that those providers be allowed to continue to practice, ensuring they are up-to-speed on the most current treatments and practices.

## RECOMMENDATION 3 → $23.3 BILLION IN SAVINGS OVER 10 YEARS[26]

### ►*Adopt delivery system reforms: pay for quality.*

A variety of measures have been designed to curb health care costs, but virtually all experts agree that the only way to truly "bend the cost curve" is to change the way we deliver and pay for health care. We must shift our current system from one that rewards quantity of care to one that rewards quality of care.

Researchers at Dartmouth College estimate that up to 30 percent of medical care—costing over $600 billion annually—goes to tests and procedures that do not actually improve health

[24] Committee for a Responsible Federal Budget, "Let's Get Specific: Health Care", in *Committee for a Responsible Federal Budget* <http://crfb.org/sites/default/files/Lets_Get_Specific_Health_Care.pdf> [accessed 25 April 2011]
[25] Mayo Clinic, "A Foundation for Health Care Reform Legislation", in *Mayo Clinic* <http://www.mayoclinic.org/healthpolicycenter/pdfs/viewpoint4.pdf> [accessed 25 April 2011]
[26] Congressional Budget Office, "Budget Options Volume 1: Health Care", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf> [accessed 25 April 2011]

outcomes.[27] This unnecessary care, a primary driver of cost growth, is the result of our fee-for-service system which pays for each individual test and procedure, thereby creating an incentive to deliver more services rather than better services.

Atul Gawande, a surgeon, Harvard University professor, and author of the now-famous *New Yorker* article, "The Cost Conundrum", uses two Texas towns of similar size, location, and make-up—McAllen and El Paso—to highlight the true drivers of health care costs. The cost per Medicare enrollee in McAllen is $14,946, almost twice as much as the $7,504 cost per enrollee in El Paso.[28] Yet despite these increased costs, the quality of care in McAllen is not "appreciably better, and by some measures, it is worse."[29] The primary reason for this incongruence is the "marked difference in the amount of care ordered for patients—patients in McAllen receive vastly more diagnostic tests, hospital admissions, operations, specialist visits, and nursing care than [patients] in El Paso."[30]

**"We have to start paying for value rather than volume."**

Gawande draws one very important conclusion from his research: the "the primary cause" of the U.S.'s high cost of health care is "very simply, the across-the-board overuse of medicine."[31] In other words, doctors prescribe too many expensive tests and surgeries that don't make patients appreciably healthier. In order to truly curb health care costs, for both private payers and the government, we have to change the way we pay providers and start paying for value and health outcomes rather than volume of care.

The great news is that health care providers across the country are already moving away from the broken fee-for-service system and are paying providers for quality. The renowned Mayo Clinic in Rochester, Minnesota delivers some of the highest quality care in the world and costs the government 17 percent less than the national average for treatment of Medicare patients with major chronic diseases, according to a Dartmouth study.[32] Intermountain Healthcare in Utah is another good example, offering high quality care for chronically ill Medicare patients at a cost of nearly one-third less than the national average. And the Geisinger Medical Home in

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[27] Fisher S Eliot et al., "The Implications of Regional Variations in Medicare Spending. Part 1:The Content, Quality, and Accessibility of Care", in *Annals of Internal Medicine* <http://www.annals.org/content/138/4/273.full.pdf+html> [accessed 25 April 2011]

[28] Atul Gawande, "The Cost Conundrum" <http://www.newyorker.com/reporting/2009/06/01/090601fa_fact_gawande> [accessed 25 April 2011]

[29] Atul Gawande, "The Cost Conundrum Redux" <http://www.newyorker.com/online/blogs/newsdesk/2009/06/atul-gawande-the-cost-conundrum-redux.html> [accessed 25 April 2011]

[30] Atul Gawande, "The Cost Conundrum Redux" <http://www.newyorker.com/online/blogs/newsdesk/2009/06/atul-gawande-the-cost-conundrum-redux.html> [accessed 25 April 2011]

[31] Atul Gawande, "The Cost Conundrum Redux" <http://www.newyorker.com/online/blogs/newsdesk/2009/06/atul-gawande-the-cost-conundrum-redux.html> [accessed 25 April 2011]

[32] Dartmouth Institute for Health Policy and Clinical Practice, "Tracking the Care of Patients with Severe Chronic Illness", in *The Dartmouth Atlas of Healthcare* <http://www.dartmouthatlas.org/downloads/atlases/2008_Chronic_Care_Atlas.pdf> [accessed 26 April 2011]

Pennsylvania treats 2.5 million patients who are typically sicker, older, and poorer than patients nationally, but has been able to reduce medical costs by seven percent, largely due to a 29 percent reduction in emergency room visits and a 20 percent reduction in hospital admissions.[33] Finally, the Cleveland Clinic provided the most cost-efficient care during the last two years of life at a cost of $31,252, almost 50 percent less than the most expensive.[34]

What do all of these outstanding health providers have in common? They have all implemented what health experts refer to as "delivery system reforms." They have changed their incentive structures and have begun to reward quality over quantity.

While the private sector has lead the way on many of these reforms, the federal government has also begun a number of delivery system reforms. The ACA establishes pilot programs to evaluate (1) accountable care organizations (which integrate a group of physicians, hospitals, and other providers and hold them accountable for the whole of a patient's care), and (2) bundled payments (where providers are paid a set fee for certain services, rather than paying for each individual test and procedure, thereby incentivizing providers to avoid complications and readmissions). Additionally, the ACA puts in place a new policy which calls for reduced payments to hospitals for preventable readmissions and certain hospital-acquired conditions.

These programs are an excellent start, but we must ensure that the successful ones are adopted and implemented on a wide scale as soon as possible, and that no amount of pressure from physicians, hospitals, or other providers prevents their full implementation. These reforms have often been overlooked in the debate on health care reform because their benefits are not easily quantifiable and usually do not score as savings. But these reforms target the root of our health care cost growth problem. While we do not have cost-savings estimates for all delivery system reforms, the CBO has estimated that just two of these reforms—accountable care organizations and bundling payments for hospital and post-acute care—could save $23.3 billion over 10 years.[35]

Further, converting our broken fee-for-service system to one that pays for quality will ultimately address the problem of the sustainable growth rate (SGR), or "doc fix." The SGR is a poorly designed formula that was originally created to slow the growth of physician payments, but ended up as a blunt instrument that required harsh, unrealistic payment cuts. As highlighted by the Fiscal Commission, there is no quick fix to the SGR. Rather, a new formula

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[33] Ellen-Marie Whelan and Lesley Russell, "Better Health Care at Lower Costs", in *Center for American Progress* <http://www.americanprogress.org/issues/2010/03/pdf/health_delivery.pdf> [accessed 28 April 2011]
[34] John E Wennberg, "Tracking the Care of Patients with Severe Chronic Illness Executive Summary", in *The Darmouth Institute for Health Policy and Clinical Practice* <http://www.dartmouthatlas.org/downloads/atlases/2008_Atlas_Exec_Summ.pdf> [accessed 26 April 2011]
[35] Congressional Budget Office, "Budget Options Volume 1: Health Care", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf> [accessed 25 April 2011]

needs to be created that "pays doctors based on quality instead of quantity of services."[36] The only way to pay doctors for quality rather than quantity is to pursue and adopt delivery system and payment reforms.

## RECOMMENDATION 4 → VARIABLE SAVINGS[37]

### ►*Fully fund the CMS Innovation Center.*

The federal government needs to support, study, and adopt delivery system and payment reforms in order to achieve cost savings and quality improvements. The health care law includes a vital but overlooked provision designed to do just that.

The ACA creates an innovation center which will test, evaluate, and expand different delivery systems designed to pay health care providers for quality rather than quantity.[38] The center, dubbed the Center for Medicare and Medicaid Innovation (CMMI), or the "Innovation Center", is tasked with developing and testing innovative payment models that will slow the rate of cost growth and improve the quality of care. Health care providers from around the country, many of whom (like Mayo and Geisinger) are already running successful reform models, will apply to participate in the Innovation Center's pilot programs. These programs found to be most successful will be expanded nationwide. The Innovation Center will allow government programs like Medicare and Medicaid to learn from private providers and vice versa.

The ACA includes $5 million in 2010 for the design, implementation, and evaluation of models, and $10 billion for pilot programs between 2011 and 2019. However, a number of Members of Congress have already voiced opposition to the Innovation Center and have pledged to completely eliminate its funding. Cutting funding to the Innovation Center or hampering its operations would be shortsighted for both health and budgetary reasons. Of all the provisions in the ACA, health experts agree that the CMS Innovation Center, if properly implemented, holds the most promise for reducing runaway health care costs and improving care. The CMS Innovation Center must be fully funded and supported by Congress in order to realize its considerable cost-saving and care-improvement potential.

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[36] National Commission on Fiscal Responsibility and Reform, in *The Moment of Truth* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf> [accessed 22 April 2011]
[37] Kathleen Sebelius, "Speech at Atlanta Press Club", in *U.S. Department of Health & Human Services* <http://www.hhs.gov/secretary/about/speeches/sp20110419.html> [accessed 26 April 2011]
[38] Center for Medicare & Medicaid Innovation, "Our Charge", in *Center for Medicare & Medicaid Innovation* <http://innovations.cms.gov/about-us/our-charge/> [accessed 28 April 2011]

# ❍Expand Cost-Cutting Mechanisms

A number of cost-cutting mechanisms are already being pursued by the federal government. Yet many of these programs have fallen short of their cost-saving potential because of a variety of hurdles. These range from an aversion to upfront costs (as with investment in oversight measures in Medicare) to a fear of changing benefits (as with comparative effectiveness research). Many of these cost-curbing mechanisms are worth pursuing not only to save dollars, but also to improve quality. Now is the time to overcome these hurdles and expand and accelerate existing cost-cutting programs in order to achieve bigger savings and higher quality care.

## RECOMMENDATION 5 → $0.9 BILLION IN SAVINGS OVER 10 YEARS[39, 40]

### ►*Expand investment in comparative effectiveness research and allow findings to be used in setting payment rates.*

Comparative effectiveness research (CER) has the potential to significantly lower health care costs and improve care. Unfortunately, CER has been mischaracterized as "rationing" and has not received the attention it deserves.

> **"Studies show that only half of patients receive the recommended care, and approximately one third of all treatments and procedures performed have no proven benefit."**

First off, CER is not rationing. It is common-sense research of medical treatments to determine which ones achieve the best results. In other words, it provides physicians with the most up-to-date information about which treatments work best. Most patients believe physicians are already making decisions based on the best, most current information. However, studies show that only about half of patients receive the recommended care, and approximately one third of all treatments and procedures performed have no proven benefits.[41] This unnecessary care, including the overuse of antibiotics and diagnostic tests, is driving up costs, and by some estimates accounts for $250 to $325 billion in annual health care spending.[42] Comparative effectiveness research could

[39] Congressional Budget Office, "Budget Options Volume 1: Health Care", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf> [accessed 25 April 2011]

[40] This savings estimate, from the CBO's 2008 *Budget Options: Health Care*, is for 2010-2019. Assuming inflation, the savings figure should increase for later 10 year periods including 2011-2020 and 2012-2021.

[41] Elizabeth A McGlynn et al., "The Quality of Health Care Delivered to Adults in the United States", in *The New England Journal of Medicine* <http://www.nejm.org/doi/full/10.1056/NEJMsa022615#t=article> [accessed 26 April 2011]

[42] Robert Kelley, "Where Can $700 Billion in Waste Be Cut Annually from the U.S. Health Care System?", in *Thomson Reuters* <http://img.en25.com/Web/ThomsonReuters/WASTEWHITEPAPER_FINAL11_3_09.pdf> [accessed 3 May 2011]

reduce this unnecessary care, improve outcomes, and reduce total health care spending in the U.S. by $8 billion over 10 years, according to CBO estimates.[43]

The federal government has acknowledged the benefits of CER and has recently increased investment in such research. The American Recovery and Reinvestment Act (ARRA) included funds for CER, and the ACA created the new Patient-Centered Outcomes Research Institute and allocated $2.9 billion for CER. Further, the ACA created the Patient Centered Outcomes Research Institute (PCORI), an independent organization designed to indentify priorities and pursue research that compares the effectiveness of different therapies and treatments for the same disease. These funds and programs should be maintained and expanded in order to reap the full benefits of CER.

But investment in CER is not enough. We need to start linking reimbursement decisions with evidence of effectiveness. Unfortunately, the new health care law expressly prohibits the results of effectiveness research from being used to set payment rates for Medicare. Under current law, Medicare pays for any treatment it deems "reasonable and necessary", regardless of whether it is proven to be as effective as or more effective than another treatment. These prohibitions need to relaxed, and Medicare needs to be allowed to preferentially pay for treatments proven to achieve better results.

The idea of basing coverage and reimbursement determinations on comparative effectiveness is scary to some critics who fear it may reduce access and stymie innovation. However, some creative proposals designed to find balance between paying for effectiveness and ensuring access and innovation are being developed.

Researchers Steven Pearson of the Institute for Clinical and Economic Research and Peter Bach of the Sloan-Kettering Cancer Center recently put forward a proposal that would "encourage Medicare to pay equally for services that provide comparable patient outcomes."[44] Their plan would allow Medicare to reimburse at high levels for services proven to provide "superior benefits compared to alternative options."[45] New treatments, which have not been proven to be effective, would also be fully reimbursed, but only for three years. After three years, treatments proven to be more effective than the standard treatment would continue to be reimbursed in full, but those found to be as effective would only be reimbursed at the same level as the standard treatment.

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[43] Congressional Budget Office, "Budget Options Volume 1: Health Care", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf> [accessed 25 April 2011]
[44] Steven D Pearson and Peter B Bach, "How Medicare Could Use Comparative Effectiveness Research In Deciding On New Coverage And Reimbursement", in *Health Affairs* <http://content.healthaffairs.org/content/29/10/1796.abstract> [accessed 28 April 2011]
[45] Steven D Pearson and Peter B Bach, "How Medicare Could Use Comparative Effectiveness Research In Deciding On New Coverage And Reimbursement", in *Health Affairs* <http://content.healthaffairs.org/content/29/10/1796.abstract> [accessed 28 April 2011]

The CBO also outlined a proposal that would allow the Secretary of Health and Human Services (HHS) to modify Medicare's coverage of preventive services based on evidence of effectiveness. The United States Preventive Services Task Force (USPSTF), which is sponsored by HHS, currently conducts independent, impartial research on the effectiveness of preventive services. The task force grades the effectiveness of various preventive services. For example, a service with significant benefits that causes no harm would receive a grade of A, while a service that is found to be ineffective or whose harm outweighs its benefits would receive a grade of D. Only seven of the 18 preventive services covered by Medicare received grades of A or B.[46] This option would allow the Secretary to adjust Medicare's coverage of preventive services that experts have determined are ineffective or harmful. Assuming the Secretary decided not to cover preventive services with a grade of D, the CBO estimates $850 million could be saved over 10 years.[47]

Our tax dollars should only pay for procedures that are proven to work. If two treatments or drugs are equally effective from a clinical standpoint, then all payers—from private health plans to Medicare and Medicaid—should refuse to pay for the most expensive one. CER is about researching the best, most cost-effective treatments in order to improve care and reduce costs, and the federal government should prioritize this research and allow its findings to guide reimbursement decisions.

## RECOMMENDATION 6 → $9 BILLION IN SAVINGS OVER 10 YEARS[48]

### ►*Help CMS to combat Medicare waste, fraud, and abuse.*

Conservatively, an estimated $60 billion—approximately three percent of total annual health care spending—is lost to fraud every year.[49] Further, half of the government's "improper payments", which totaled $72 billion in 2008, came from improper payments to Medicare and Medicaid providers, suppliers, and vendors.[50] Medicaid has an estimated improper-payment

[46] Congressional Budget Office, "Budget Options Volume 1: Health Care", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf> [accessed 25 April 2011]
[47] Congressional Budget Office, "Budget Options Volume 1: Health Care", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf> [accessed 25 April 2011]
[48] National Commission on Fiscal Responsibility and Reform, in *The Moment of Truth* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf> [accessed 22 April 2011]
[49] Kay L Daly, "Improper Payments: Progress Made but Challenges Remain in Estimating and Reducing Improper Payments", in *Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate* <http://hsgac.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=8a30c529-84d8-4453-8929-9d99fc3e6b94> [accessed 28 April 2011]
[50] Kay L Daly, "Improper Payments: Progress Made but Challenges Remain in Estimating and Reducing Improper Payments", in *Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate* <http://hsgac.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=8a30c529-84d8-4453-8929-9d99fc3e6b94> [accessed 28 April 2011]

rate of $18.6 billion, or 10.5 percent—the highest of any federal program.[51] And according to a former administrator of CMS, "the total amount of Medicare fraud is unknown."[52] One of the key reasons this waste continues is because Congress refuses to appropriate adequate funds to combat health care fraud. Medicare spends less than one fifth of one percent of its budget on anti-fraud measures, which is a fraction of what private insurers spend.[53]

In an effort to combat the fraud and waste plaguing the federal health care programs, the administration has initiated a number of anti-fraud measures that include the Health Care Fraud and Prevention Enforcement Action Team (HEAT), which in its first year found more than $50 million in false Medicare claims in Detroit and charged eight individuals in Miami for creating fake clinics and submitting phony bills for more than $100 million.

**"Medicare spends less than one fifth of one percent of its budget on anti-fraud measures, which is a fraction of what private insurers spend."**

The new health care law also calls for a number of reforms including expanded provider screening, enhanced oversight of new providers and suppliers, an enrollment freeze in areas identified as "high risk" for fraud, and the creation of a database to collect and share vital data between federal and state programs. While these anti-fraud activities require some up-front investment, that investment can pay dividends. According to the HHS Office of the Inspector General, for every $1 they invest in health care fraud investigations, they get $17 back.[54] Further, the National Commission on Fiscal Responsibility and Reform argues that increasing the ability of CMS to combat waste, fraud, and abuse by giving the agency new statutory authority and increasing its resources could save $1 billion in 2015 and $9 billion through 2020.[55]

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[51] Kathleen M King and Kay L Daly, "Medicare and Medicaid Fraud, Waste and Abuse: Effective Implementation of Recent Laws and Agency Actions Could Help Reduce Improper Payments", in *United States Government Accountability Office* <http://www.gao.gov/new.items/d11409t.pdf> [accessed 26 April 2011]
[52] Kerry N Weems and Benjamin E Sasse, "Is Government Health Insurance Cheap?", in *The Wall Street Journal* <http://online.wsj.com/article/SB123966918025015509.html> [accessed 28 April 2011]
[53] Elizabeth A McGlynn et al., "The Quality of Health Care Delivered to Adults in the United States", in *The New England Journal of Medicine* <http://www.nejm.org/doi/full/10.1056/NEJMsa022615#t=article> [accessed 26 April 2011]
[54] Thomson Reuters, "Fighting Fraud and Abuse, Funding Reform" <http://info.thomsonhealthcare.com/?elqPURLPage=475> [accessed 27 April 2011]
[55] National Commission on Fiscal Responsibility and Reform, in *The Moment of Truth* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf> [accessed 22 April 2011]

### RECOMMENDATION 7 → $6.2 BILLION IN SAVINGS OVER 10 YEARS[56]

### ►*Recoup Incorrect Payments to Medicare Advantage Insurers*

Under current law, Medicare Advantage (MA) plans receive payments from the government based on which high-cost health conditions a beneficiary has. In 2008, the Centers for Medicare and Medicaid (CMS) announced a plan to audit a sample of MA plan records, also known as a validation audit, in order to verify the accuracy of the health conditions documented by the plans and the adjusted payments received by the plans. Under the pilot, CMS only required plans to pay back overpayments for the sample audit. But the President Obama's Fiscal Year 2012 budget puts forward a proposal that would require CMS to extrapolate the error rate found in the validation audits to the entire Medicare Advantage plan payment for a given year. According to the President's proposed budget, recouping these erroneous payments will generate $6.2 billion over ten years.[57]

## ➊Reduce Drug Costs

Prescription drugs are the third most costly sector of our health care system, accounting for 10 percent of spending, which ranks behind only hospital care (31 percent) and physician and clinical services (21 percent).[58]

Spending on prescriptions has been a key contributor to the growth in health care spending. It has grown from just 5.6 percent of health care spending in 1990 to over 10 percent today.[59] In 1990, spending on prescription drugs in the U.S. totaled $40.3 billion, but by 2008 that number had reached $234 billion, a 584 percent increase.[60]

This cost growth is driven by three key factors: (1) an increase in the use of expensive specialty drugs, (2) an increase in the number of prescriptions being written as the population ages, and (3) price inflation. Although the rate of growth in pharmaceutical spending has dropped

[56] Office of Management and Budget, "Fiscal Year 2012 Terminations, Reductions, and Savings: Budget of the U.S. Government" <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/trs.pdf> [accessed 22 April 2011]
[57] Office of Management and Budget, "Fiscal Year 2012 Terminations, Reductions, and Savings: Budget of the U.S. Government" <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/trs.pdf> [accessed 22 April 2011]
[58] The Henry J. Kaiser Family Foundation, "U.S. Health Care Costs" <http://www.kaiseredu.org/Issue-Modules/US-Health-Care-Costs/Background-Brief.aspx> [accessed 27 April 2011]
[59] Centers for Medicare & Medicaid Services, "National Health Expenditure Data: Historical" <https://www.cms.gov/NationalHealthExpendData/02_NationalHealthAccountsHistorical.asp#TopOfPage> [accessed 27 April 2011]
[60] The Henry J. Kaiser Family Foundation, "U.S. Health Care Costs" <http://www.kaiseredu.org/Issue-Modules/US-Health-Care-Costs/Background-Brief.aspx> [accessed 27 April 2011]

somewhat in recent years, the growth rate is still projected to exceed the growth rates for hospital services and other professional services from 2010 through 2019.[61]

This rise in the cost of prescription medicines not only harms government's budget, but it also hurts the pocketbooks of thousands of Americans trying to afford their life-saving medications. Steps must be taken to reverse or slow the growth prescription drug costs and ensure the availability of much-needed drugs. Outlined below are three reform options aimed at reining in growing drug costs.

## RECOMMENDATION 8 → $2.3 BILLION IN SAVINGS OVER 10 YEARS[62]

### ►*Shorten exclusivity period for brand name biologic drugs.*

The 1984 Hatch-Waxman Act created a regulatory approval system for conventional generic drugs. It has been extremely successful in lowering the cost of prescription drugs by allowing generics to compete. The Generic Pharmaceutical Association estimates that the use of generic drugs has saved the American health system more than $734 billion over the past decade.[63]

Unfortunately, biologic drugs, which are grown from living cells (rather than made chemically like conventional drugs), have for many years lacked a regulatory pathway for generics, thereby avoiding generic competition and increasing their prices. Biologic drugs on average cost 22 times more than ordinary drugs, which places them out of reach for many people. The cost of biologics is rising each year, consuming an increasingly larger portion of health care costs. In 2008, 28 percent of sales from the pharmaceutical industry's top 100 products came from biologics, but by 2014 that share is expected to rise to 50 percent.[64] And according to the Medicare Payment Advisory Commission, the top six biologics already consume 43 percent of the drug budget for Medicare Part B.[65]

The ACA created a pathway for biologics to become generics, setting the exclusivity period at 12 years and giving drug manufacturers broad "evergreening" authority (the ability to make minor changes, such as slightly altering the dosage, in order to receive an additional 12 years of exclusivity). Some advocates, such as Representative Waxman and President Obama, have

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[61] Congressional Budget Office, "Technological Change and the Growth of Health Care Spending", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/89xx/doc8947/01-31-TechHealth.pdf> [accessed 28 April 2011]

[62] Office of Management and Budget, "Fiscal Year 2012 Terminations, Reductions, and Savings: Budget of the U.S. Government" <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/trs.pdf> [accessed 22 April 2011]

[63] The Generic Pharmaceutical Association, "Generic Pharmaceuticals Saved $734 Billion over Last Decade" <http://www2.prnewswire.com/mnr/GPhA/38110/> [accessed 27 April 2011]

[64] Anthony D So and Samuel L Katz, "Biologics Boondoggle" <http://sanford.duke.edu/news/features/so_com030810.php> [accessed 27 April 2011]

[65] The Medicare Payment Advisory Commission, "Improving Incentives in the Medicare Program", in *The Medicare Payment Advisory Commission* <http://www.medpac.gov/documents/Jun09_EntireReport.pdf> [accessed 27 April 2011]

pushed for a shorter exclusivity period of five or seven years in order to make cheaper generic biologics available more quickly. Included in the President's proposed Fiscal Year 2012 budget is a proposal to change the brand name biologic exclusivity period to seven years and prohibit drug manufacturers from receiving additional exclusivity for minor adjustments beginning in 2012.[66]

According to a study by the Federal Trade Commission, 12 years of exclusivity is not necessary to promote innovative new biologics and could even harm patients by directing the limited drug development funding toward proven drugs rather than new products (that could provide relief for unmet medical needs).[67] Many health experts, including Anthony D. So and Samuel L. Katz of Duke University, also argue that 12 years is too long and that a five year exclusivity period should be adopted in order to save billions of dollars and give patients access to much-needed generic biologic drugs.[68]

According to cost estimates in the Fiscal Year 2012 budget proposal, implementing seven years of exclusivity for name brand biologics and prohibiting the "evergreening" of products to gain additional years of exclusivity could save $2.34 billion between 2012 and 2021.[69] This option would create competition, reduce costs for both the government and private payers, and ensure greater access to needed medications.

## RECOMMENDATION 9→ $8.8 BILLION IN SAVINGS OVER 10 YEARS[70]

### ► *Prohibit pay-for-delay agreements.*

Under current law, name brand drug manufacturers can settle patent lawsuits by paying generic drug manufacturers to delay introduction of generic drugs into the market. This practice not only increases costs to consumers, but it also can prevent low-income individuals from accessing life-saving drugs. Included in the President's Fiscal Year 2012 budget proposal is a provision that would give the Federal Trade Commission the authority to prohibit pay-for-

[66] Office of Management and Budget, "Fiscal Year 2012 Terminations, Reductions, and Savings: Budget of the U.S. Government" <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/trs.pdf> [accessed 22 April 2011]
[67] Federal Trade Commission, "Emerging Health Care Issues: Follow-on Biologic Drug Competition", in *Federal Trade Commission* <http://www.ftc.gov/os/2009/06/P083901biologicsreport.pdf> [accessed 27 April 2011]
[68] Anthony D So and Samuel L Katz, "Biologics Boondoggle" <http://sanford.duke.edu/news/features/so_com030810.php> [accessed 27 April 2011]
[69] Office of Management and Budget, "Fiscal Year 2012 Terminations, Reductions, and Savings: Budget of the U.S. Government" <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/trs.pdf> [accessed 22 April 2011]
[70] Office of Management and Budget, "Fiscal Year 2012 Terminations, Reductions, and Savings: Budget of the U.S. Government" <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/trs.pdf> [accessed 22 April 2011]

delay agreements, thereby increasing access to cheaper generic drugs and saving the government $8.8 billion over 10 years.[71]

## RECOMMENDATION 10 → $100 BILLION IN SAVINGS OVER SEVEN YEARS[72, 73]

### ►*Allow Medicare to require minimum rebates from drug companies.*

Medicare Part D, which provides prescription drug coverage, is administered by private insurers rather than by the government (like the rest of the Medicare program). The thinking behind this organization was that allowing private insurers to administer the program would increase competition and bring down costs. However, Medicare Part D pays on average 30 percent more for drugs than Medicaid, which is administered by the government.[74] Further, administrative costs of Medicare Part D are close to six times higher than the administrative costs of traditional Medicare.[75]

In an effort to reduce drug costs, Medicare Part D also allows the private insurers who provide the coverage to negotiate for drug rebates and find the lowest price. But this system of negotiation has resulted in drug rebates averaging only 8.1 percent since 2006.[76] Rather than allowing private insurers to negotiate for the drug rebates, Medicaid sets a required minimum rebate percentage, which drug companies must pay. Medicaid's required rebate amount was set at 15.1 percent for all single-source drugs, but was recently increased to 23.1 percent in the ACA.

In order to reduce drug costs under the Medicare Part D program, two options could be pursued. One option would be to allow Medicare Part D, like Medicaid, to set a minimum rebate percentage of 23.1 percent. The Bipartisan Policy Center estimates this option could

[71] Office of Management and Budget, "Fiscal Year 2012 Terminations, Reductions, and Savings: Budget of the U.S. Government" <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/trs.pdf> [accessed 22 April 2011]

[72] The Debt Reduction Task Force, "Restoring America's Future", in *Bipartisan Policy Center* <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [accessed 27 April 2011]

[73] This estimate for the 2012-2018 period. Assuming that savings continue after 2018, this number could increase, as it would if we were accounting for inflation.

[74] Majority Staff of the Committee on Oversight and Government Reform, "Medicare Part D: Drug Pricing and Manufacturer Windfalls", in *Committee on Oversight and Government Reform* <http://www.cmhda.org/breaking_news/documents/0807_Breaking%20News_Medicare%20Part%20D%20report%20house%20of%20reps%207-08.pdf> [accessed 27 April 2011]

[75] Majority Staff of the Committee on Oversight and Government Reform, "Medicare Part D: Drug Pricing and Manufacturer Windfalls", in *Committee on Oversight and Government Reform* <http://www.cmhda.org/breaking_news/documents/0807_Breaking%20News_Medicare%20Part%20D%20report%20house%20of%20reps%207-08.pdf> [accessed 27 April 2011]

[76] The Debt Reduction Task Force, "Restoring America's Future", in *Bipartisan Policy Center* <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [accessed 27 April 2011]

save $100 billion over seven years.[77] The other option to reduce drugs costs would be to allow Medicare, rather than the private insurers, to negotiate for drugs. According to a 2008 report issued by the Oversight and Government Reform Committee, if Medicare were able to negotiate directly with the drug manufacturers for prescription drugs and achieved the prices that Medicaid receives, the savings to the taxpayers could be $156 billion over 10 years.[78] However, two bills introduced in 2007 that would have required the Secretary of HHS to negotiate prescription drug prices were scored by the CBO as having "a negligible effect on federal spending."[79] At this time, the effectiveness of allowing the Secretary to negotiate for cheaper drugs is still being debated.

## ❍Increase Medicaid Efficiency

### RECOMMENDATION 11→ $2.6 BILLION IN SAVINGS OVER 10 YEARS[80]

### ►*Eliminate double payments to states for Medicaid administrative costs.*

The three major public aid programs—Temporary Assistance for Needy Families (TANF), Supplemental Nutrition Assistance Program (SNAP), and Medicaid—share many similar administrative functions (such as collecting information on a family's income and assets). Prior to the passage of welfare reform in 1996, all three of these programs reimbursed states for half of most administrative costs. States usually charged all of their administrative costs to one program, the AID to Families with Dependent Children (AFDC), which was replaced by TANF block grants under 1996 welfare reform. Today, when TANF block grants are calculated, they are based on past federal spending and often include common administrative costs for all three programs.

However, even though Medicaid administrative costs are reimbursed through TANF, Medicaid still reimburses states for Medicaid's share of common administrative costs, essentially paying states twice for Medicaid's administrative costs. According to the CBO, limiting the federal reimbursement for administrative costs for the Medicaid program to the amount not included in the state's TANF block grant would save $2.6 billion over 10 years.[81] This adjustment would simply end the current double payment being made to states for Medicaid administrative fees.

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[77] Congressional Budget Office, "Budget Options Volume 1: Health Care", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf> [accessed 25 April 2011]
[78] Majority Staff of the Committee on Oversight and Government Reform, "Medicare Part D: Drug Pricing and Manufacturer Windfalls", in *Committee on Oversight and Government Reform* <http://www.cmhda.org/breaking_news/documents/0807_Breaking%20News_Medicare%20Part%20D%20report%20house%20of%20reps%207-08.pdf> [accessed 27 April 2011]
[79] Peter R Orszag, "Letter to the Honorable Ron Wyden", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/79xx/doc7992/DrugPriceNegotiation.pdf> [accessed 27 April 2011]
[80] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]
[81] Congressional Budget Office, "Budget Options Volume 1: Health Care", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf> [accessed 25 April 2011]

## RECOMMENDATION 12 → $12 BILLION IN SAVINGS OVER 10 YEARS[82]

### ►*Allow enrollment of dual eligibles in Medicaid managed care.*

Beginning in the 1990s, state Medicaid programs have done a commendable job of enrolling low-income individuals in managed care programs, which improve access to care and reduce health care spending. As of 2008, 71 percent of Medicaid beneficiaries had received some services through managed care programs, and 65 percent were enrolled in full-risk plans.[83] However, states have not been as successful in enrolling dual eligibles, those low-income seniors and disabled individuals eligible for both Medicare and Medicaid. In 2008, only 12.6 percent of dual eligibles were enrolled in full-risk managed care plans.

Due to the numerous benefits of managed care plans, states support expanding enrollment but often face administrative barriers to enrolling dual eligibles. The Debt Reduction Task Force convened by the Bipartisan Policy Center has outlined two proposals to overcome these barriers. One proposal would require the federal government to clearly outline criteria for managed care programs, thereby allowing states to design their plans accordingly and receive faster approval.[84]

The second proposal would alter the rules governing the upper payment limit—the aggregate reimbursements made to different classes of providers—to incentivize providers to accept dual eligibles in risk contract arrangements.[85] The Bipartisan Policy Center estimates that eliminating these barriers to enrollment of dual eligibles in managed care would save $5 billion between 2012 and 2018.[86] Similarly, the National Commission on Fiscal Responsibility and Reform estimates that placing dual eligibles in Medicaid managed care would save $12 billion over 10 years.[87]

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[82] National Commission on Fiscal Responsibility and Reform, in *The Moment of Truth* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf> [accessed 22 April 2011]

[83] Kaiser Commission on Medicaid and the Uninsured, "Medicaid and Managed Care: Key Data, Trends, and Issues", in *Henry J. Kaiser Family Foundation* <http://www.kff.org/medicaid/upload/8046.pdf> [accessed 28 April 2011]

[84] The Debt Reduction Task Force, "Restoring America's Future", in *Bipartisan Policy Center* <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [accessed 27 April 2011]

[85] The Debt Reduction Task Force, "Restoring America's Future", in *Bipartisan Policy Center* <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [accessed 27 April 2011]

[86] The Debt Reduction Task Force, "Restoring America's Future", in *Bipartisan Policy Center* <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [accessed 27 April 2011]

[87] National Commission on Fiscal Responsibility and Reform, in *The Moment of Truth* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf> [accessed 22 April 2011]

# ❍Consider Other Options

The Affordable Care Act has laid a solid foundation for further cost-curbing mechanisms. However, while the bill included many cost-containment provisions, several were not included and warrant further examination. Outlined below are four reforms that have been proposed by a number of health and budget experts. While there are pros and cons to each, the purpose of listing them here is to advance the conversation about creative ways we can reduce the growing costs of government health care entitlements.

These ideas may be viewed by some as controversial and the implementation of each should be carefully considered, but difficult choices must be made in order to maintain solvency of our health entitlements and ensure they continue to provide much needed care long into the future.

## OPTION 1 → $124.8 BILLION IN SAVINGS OVER 10 YEARS[88]

### ►*Gradually raise Medicare eligibility age to 67.*

The age at which individuals are eligible to receive Medicare, currently 65, was set when Medicare was created 46 years ago. Medicare was originally created to provide health care for older individuals who could not find coverage in the private market. Those who support gradually increasing the Medicare eligibility age tend to argue that because life expectancy has risen since 1965 and will continue to rise, the Medicare eligibility age should reflect this fact. Longer life spans also mean longer participation in the workforce, and older individuals who continue to work may be able to obtain coverage through their employers.

> **"Our priority must be ensuring that older Americans have access to the high-quality, affordable care they need."**

The CBO outlines an option that would gradually raise the age of eligibility for Medicare by two months every year beginning in 2014 until the eligibility age reached 67 in 2025, where it would stay. Unlike Social Security, Medicare's eligibility age is not already rising under current law. This age increase would put Medicare benefits on par with Social Security, and the CBO estimates the savings would total over $125 billion over 10 years.[89]

The concern with raising the eligibility age of Medicare is that those seniors without access to Medicare may fall into a coverage gap and be unable to obtain affordable coverage. This

[88] Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/120xx/doc12085/03-10-ReducingTheDeficit.pdf> [accessed 27 April 2011]
[89] Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/120xx/doc12085/03-10-ReducingTheDeficit.pdf> [accessed 27 April 2011]

problem could be solved as the new state-based insurance exchanges are set to provide coverage for such individuals beginning in 2014. For example, we could make an increase in the Medicare eligibility age contingent on the success of the exchanges in providing affordable care to older Americans. If the exchanges do offer viable coverage options, then we should consider raising the Medicare eligibility age. But our priority must be ensuring that older Americans have access to the high-quality, affordable care they need. We should keep in mind a recent report from The Kaiser Family Foundation that found that raising the Medicare eligibility age would shift some costs to seniors and employers.

Any change in the Medicare eligibility age would have to be carefully constructed so as to not impact access to affordable health care. Still, Medicare is a program designed to provide care for the elderly. As our society changes and life expectancy grows, we have to honestly assess such programs and responsibly alter them to fit a changing society.

## OPTION 2 → $241.2 BILLION IN SAVINGS OVER 10 YEARS[90]

### ►*Gradually increase all Medicare Part B premiums from 25 to 35 percent.*

Medicare Part B, which covers physicians and other outpatient services, was originally designed to provide a premium that would cover 50 percent of the each enrollee's costs. But because medical spending grew faster than inflation, enrollees' premium cost-sharing fell to below 25 percent. Eventually, it was locked in at 25 percent as part of the Balanced Budget Act of 1997.

The CBO has outlined a reform option that would gradually raise the basic Part B premium per enrollee from 25 percent to 35 percent of costs over five years. The current income-related premium sharing provisions would be maintained and the "hold-harmless" provision, which protects seniors from a reduction in their net Social Security payment, would also be maintained. The CBO estimates this option would save $241.2 billion over 10 years.[91]

While this would increase cost-sharing for most enrollees, 35 percent cost-sharing is still much lower than the 50 percent envisioned in the original law. Additionally, approximately 18 percent of low-income enrollees eligible for Medicaid would be unaffected. The Bipartisan Policy Center also supports a gradual increase in Part B premiums over five year.[92]

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[90] Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/120xx/doc12085/03-10-ReducingTheDeficit.pdf> [accessed 27 April 2011]
[91] Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/120xx/doc12085/03-10-ReducingTheDeficit.pdf> [accessed 27 April 2011]
[92] The Debt Reduction Task Force, "Restoring America's Future", in *Bipartisan Policy Center* <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [accessed 27 April 2011]

## OPTION 3 → $26.4 BILLION IN SAVINGS OVER 10 YEARS[93]

### ►*Modernize Medicare cost-sharing.*

Medicare's current benefit structure, which was first implemented in 1966, has failed to keep pace with trends in the private sector (such as capping catastrophic illness costs and increasing patient cost-sharing). The current benefit structure is also extremely complex, making it difficult for Medicare beneficiaries to assess how much they are paying for each service and to weigh the costs of care against the benefits.

For example, beneficiaries must pay very high deductibles for inpatient services, like hospital stays, but pay much less for outpatient services, and have no cost-sharing for laboratory services and home health care. This confusing system conceals the true costs of care from beneficiaries and can cause overutilization of services and associated costs.

One solution for this overly complex system would be (1) to replace the current cost-sharing requirements with a unified, annual deductible for all Part A (hospital and acute care) and Part B (physician and outpatient services) services, (2) to establish a single coinsurance rate of 20 percent for all amounts above that deductible, and (3) to set an annual cap on total cost-sharing.

According to the CBO, setting the combined deductible at $525 and pegging the catastrophic limit at $5,250 (set to grow at the rate of Medicare costs per capita) would save $26.4 billion over 10 years.[94] Updating and simplifying the Medicare benefit structure in this way would provide the following benefits: (1) Beneficiaries would be better protected from serious illness costs by the catastrophic cap, (2) beneficiaries would have greater incentive to use services more prudently because they would be more aware of the costs associated with their care, and (3) the cost reductions in Medicare Part B would result in lower premiums for all enrollees.[95] The Bipartisan Policy Center[96] and the National Commission on Fiscal Responsibility and Reform[97] have also expressed support for such a redesign of Medicare's benefit structure.

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[93] Congressional Budget Office, "Budget Options Volume 1: Health Care", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf> [accessed 25 April 2011]

[94] Congressional Budget Office, "Budget Options Volume 1: Health Care", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf> [accessed 25 April 2011]

[95] Congressional Budget Office, "Budget Options Volume 1: Health Care", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf> [accessed 25 April 2011]

[96] The Debt Reduction Task Force, "Restoring America's Future", in *Bipartisan Policy Center* <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [accessed 27 April 2011]

[97] National Commission on Fiscal Responsibility and Reform, in *The Moment of Truth* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf> [accessed 22 April 2011]

### OPTION 4 → $1.7 BILLION IN SAVINGS OVER 10 YEARS[98]

### ►*Require Medicare carriers to inform physicians about peer profiling.*

The Medicare Payment Advisory Commission (MedPAC) has found that a relatively small number of Medicare providers account for a disproportionately high share of costs for the program compared to their peers in the same specialty areas. These increased costs are primarily due to their high use of expensive services. In order to identify and target these high use providers, some health care plans have to create "peer profiles", which compare the service use rates of physicians in the same specialties. This information can be used to award bonus payments to more efficient physicians and provide constructive feedback to physicians with unusual practice patterns. Such feedback can apply downward pressure on the use of health care services.

The CBO outlined an option that would require Medicare to develop peer profiles and reduce payments to physicians whose use of resources was "excessively high relative to that of peers."[99] Any comparison would be between physicians of the same specialty and market area, and would adjust for differences in patients' health status. The implementation of such a comparison system would save $1.7 billion over 10 years and could greatly improve health outcomes.[100]

# Conclusion

Rising health care costs are at the root of our unsustainable deficits. The math is simple: In recent years, federal health spending has grown by approximately two percentage points per year faster than GDP while federal revenues have only kept pace with GDP. In other words, we are spending more than we are taking in, and this pattern cannot be sustained in the long-term.

As a percentage of the economy, federal health care spending is expected to grow from 5.5 percent of GDP in 2011 to about 10 percent of GDP in 2035, and to more than 17 percent by 2080.[101] Further, as a percentage of the federal budget, health care spending is projected to rise from 23 percent today to 29 percent by 2020, crowding out other federal priorities.

Despite these ominous numbers, there are reasons to hopeful. Much of this cost growth is from unnecessary care that does not contribute to health and simply drives up costs. We know

[98] Congressional Budget Office, "Budget Options Volume 1: Health Care", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf> [accessed 25 April 2011]
[99] Congressional Budget Office, "Budget Options Volume 1: Health Care", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf> [accessed 25 April 2011]
[100] Congressional Budget Office, "Budget Options Volume 1: Health Care", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf> [accessed 25 April 2011]
[101] Congressional Budget Office, "The Long-Term Budget Outlook", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf> [accessed 22 November 2010]

close to one third of medical care goes to tests and procedures that do not actually improve health outcomes,[102] and up to 98,000 people die each year from preventable medical errors.[103] This unnecessary and sometimes harmful care is largely a byproduct of our payment and health care delivery system, which rewards volume of care over value of care. Yet, as we have seen in both the private and public sphere, there are solutions—delivery system reforms, for example—that would significantly reduce costs and improve care. For too long we have abided by the rule that more is better, but empirical evidence shows us that more is not always better and can in fact be worse.

**"For too long we have abided by the rule that more is better, but empirical evidence shows us that more is not always better and can in fact be worse."**

The federal government, which runs Medicare, the largest and most influential health care provider in the country, is in a unique position to lead the way in delivery system reform. Medicare could help transform our health care system from one that pays for quantity to one that pays for quality. We can do this by adopting delivery system reforms found to be effective, investing in comparative effectiveness research and using its findings to determine coverage, and strengthening the Independent Payment Advisory Board to allow it to make more comprehensive recommendations for all providers.

The Affordable Care Act laid the foundation for many of these reforms, but Congress and the Administration must ensure that the cost-containment mechanisms in the Act are implemented on schedule. Lastly, we must reexamine the rules governing Medicare and Medicaid and update them to reflect today's conditions. We have come a long way in reforming our health care system and we have much further to go, but using the reforms outlined above, we can significantly reduce costs and improve care at the same time.

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[102] Elliot S Fisher et al., "The Implications of Regional Variations in Medicare Spending, Part 1: The Content, Quality, and Accessibility of Care", in *Annals of Internal Medicine* <http://www.annals.org/content/138/4/273.full.pdf+html> [accessed 28 April 2011]

[103] Institute of Medicine, "To Err is Human: Building a Safer Health System", in *Institute of Medicine* <http://www.iom.edu/~/media/Files/Report%20Files/1999/To-Err-is-Human/To%20Err%20is%20Human%201999%20%20report%20brief.pdf> [accessed 27 April 2011]

# Reinventing Defense Spending

## Our Twelve Key Recommendations

### Realign Military Forces

- ***Recommendation 1: Reduce nuclear arsenal and infrastructure.***
  - ***Potential Savings: $56 billion over 10 years***
- ***Recommendation 2: Reduce troops in Europe and Asia.***
  - ***Potential Savings: $80 billion over 10 years***
- ***Recommendation 3: Reduce troops in Iraq and Afghanistan.***
  - ***Potential Savings: $147 billion over 10 years***
- ***Recommendation 4: Reduce Navy fleet.***
  - ***Potential Savings: $43.6 billion over 10 years***

### Improve Department of Defense Efficiency

- ***Recommendation 5: Reduce military overhead.***
  - ***Potential Savings: $100 billion over five years***
- ***Recommendation 6: Double Secretary Gates's cuts to contractors.***
  - ***Potential Savings: $10.8 billion over six years***
- ***Recommendation 7: Cut 10 percent of commercial activities.***
  - ***Potential Savings: $54 billion over 10 years***

### Reform Defense Acquisition

- ***Recommendation 8: Reduce F-35 procurement.***
  - ***Potential Savings: $27.1 billion over five years***
- ***Recommendation 9: Cut the Expeditionary Fighting Vehicle.***
  - ***Potential Savings: $8.5 billion over 10 years***
- ***Recommendation 10: Delay KC-X Aerial Refueling Tanker procurement for five years.***
  - ***Potential Savings: $9.9 billion over 10 years***
- ***Recommendation 11: End procurement of the MV-22 Osprey.***
  - ***Potential Savings: $11 billion over 10 years***
- ***Recommendation 12: Reduce research and development costs.***
  - ***Potential Savings: $80 billion over 10 years***

## Recommended Minimum Potential Savings

## ➲ $600-700 billion over 10 years

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### ➲ Consider Other Options

► ***OPTION 1: Modernize DOD's health care system.***

➲***Potential Savings: $60 billion over 10 years***

# Our Approach to Defense Spending Reform

We need to match today's resources to today's threats. Defense spending has doubled since 2001, growing to $719 billion in Fiscal Year 2010 dollars, its highest since World War II.[104] Spending on defense has been the largest contributor to growth in discretionary spending, accounting for 65 percent of discretionary spending growth since 2001.[105] Much of this increase can be attributed to the direct costs of the wars in Afghanistan and Iraq, which have now surpassed $1 trillion. Still, nearly 37 percent of defense spending growth falls under the "base" or "peacetime" military budget.[106] As Admiral Mike Mullen has noted, rapidly increasing defense budgets have meant that parts of the Department of Defense have never had to practice fiscal responsibility. At close to 20 percent of federal outlays, defense spending cannot be ignored as we look to put the budget on a sustainable path.[107]

Defense spending has traditionally been off limits when it comes to budget cuts. This is evidenced by the President's past decision to explicitly exclude all security-related programs from the discretionary spending freeze. However, critics of unchecked defense spending have begun to argue not only that our defense spending can be cut, but also that cuts must be made in order to preserve our national security. As Admiral Mullen noted, "the most significant threat to our national security is our debt." A new report by the Sustainable Defense Task Force, which includes security experts from across the political spectrum, finds that we could save close to $1 trillion over the next 10 years without jeopardizing our national security, and still maintain the global reach and capabilities.[108] The report, *Debt, Deficits and Defense: A Way Forward*, outlines a whole menu of reform options ranging from reducing oversized nuclear stockpiles to cutting the force structure in Europe and Asia.

These reforms are merited, not only because we need to improve our long-term fiscal outlook, but also because our threat environment has changed and must change how we spend in order

[104] Gordon Adams, "Testimony before the House Committee on Oversight and Government Reform Subcommittee on National Security and Foreign Affairs", in *House Committee on Oversight and Government Affairs* <http://oversight.house.gov/images/stories/subcommittees/NS_Subcommittee/7.20.10_DoD_Budget/Adams_Statement.pdf> [accessed 13 December 2010]

[105] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]

[106] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]

[107] Gordon Adams, "Testimony before the House Committee on Oversight and Government Reform Subcommittee on National Security and Foreign Affairs", in *House Committee on Oversight and Government Affairs* <http://oversight.house.gov/images/stories/subcommittees/NS_Subcommittee/7.20.10_DoD_Budget/Adams_Statement.pdf> [accessed 13 December 2010]

[108] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011] Note: Some savings estimates in the Debt, Deficit & Defense have been questioned by budget experts. For an analysis of cost-savings estimates see: Stephen Daggett, "Defense budget cuts proposed by the Sustainable Defense Task Force," *Congressional Research Service*, 2010

to meet the new threats. 66 years have passed since the end of World War II and 22 since the end of Cold War and yet the U.S. maintains a military focused on combating a traditional adversary like the Soviet Union. Today, the U.S. spends more than two and half times as much on its military as its current and potential adversaries, including Russia and China.[109] In other words, the U.S. could cut its defense spending in half and still be spending more than its current and potential adversaries.

The U.S. spends billions maintaining its robust nuclear arsenal and stationing thousands of troops at bases scattered across Europe and Asia. We have to question whether these investments in traditional defense are contributing to U.S. national security in a world where our chief enemy is a global network of extremists who find safe haven in ungoverned spaces and failed states around the world. As Secretary of Defense Robert Gates pointed out in a 2010 speech, "We learned last year, you don't necessarily need a billion-dollar guided missile destroyer to chase down and deal with a bunch of teenage pirates wielding AK-47s and RPGs."[110] Other critics of defense spending, such as Benjamin Friedman of the Cato Institute, point out that fighting terrorists is "primarily an intelligence and policing task," rather than a task that requires a traditional military mobilization.[111] Osama bin Laden, for example, was killed in a targeted Navy SEALs operation that relied on painstaking intelligence gathering. The military assets most useful for this type of counterterrorism are relatively inexpensive and include surveillance technologies, special operations forces, and drones.

**"New adversaries require a new strategy and a budget that fits that reality."**

New adversaries require a new strategy and a budget that reflects this reality. In the face of a growing deficit and emerging threats, America's national security plan should be reexamined and reinvented. We need to start over and ask ourselves: If we created this program, weapon system, or force structure today, what would it look like? How would we design it to meet tomorrow's needs? What do we need to keep America safe in tomorrow's threat environment?

Measured against this benchmark, many of our military expenditures seem necessary. As Secretary Gates recently admitted, "very rarely is the [budget] ever fundamentally re-examined—either in terms of quantity, type, or whether it should be conducted at all. That

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[109] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]

[110] Robert M Gates, "Remarks as Delivered by Secretary of Defense Robert M. Gates, Gaylord Convention Center, National Harbor, Maryland, Monday, May 03, 2010", in *Department of Defense* <http://www.defense.gov/Speeches/Speech.aspx?SpeechID=1460> [accessed 29 April 2011]

[111] Benjamin H Friedman, "Testimony of Benjamin Friedman before the Subcommittee on National Security and Foreign Affairs: Military Restraint and Defense Savings", in *Cato Institute* <http://www.cato.org/testimony/ct-bf-07202010.html> [accessed 29 April 2011]

needs to change."[112] We have lost sight of our core mission—keeping America safe—and have taken on myriad other responsibilities. These other responsibilities have ultimately driven up our costs without increasing our security.

With that in mind, we strongly support the nomination of Leon Panetta to succeed Mr. Gates as Secretary of Defense. Mr. Panetta has an impressive background that includes a tour as Director of the OMB, and we believe that he is the right choice to continue Mr. Gates's record of cost reduction, reform, and bold leadership at DOD. Outlined in this section are twelve recommendations for reforming our security budget that we hope will be adopted by the incoming Secretary.

[112] Robert M Gates, "Remarks as Delivered by Secretary of Defense Robert M. Gates, Abilene, KS, Saturday, May 08, 2010", in *Department of Defense* <http://www.defense.gov/speeches/speech.aspx?speechid=1467> [accessed 29 April 2011]

# OUR TWELVE KEY RECOMMENDATIONS

## ❍Realign Military Forces

### RECOMMENDATION 1 → $56 BILLION IN SAVINGS OVER 10 YEARS[113]

### ►*Reduce U.S. nuclear arsenal and infrastructure.*

The U.S. currently maintains 1,968 operationally-deployed strategic nuclear warheads and 5,000 active warheads in its stockpile.[114] This nuclear stockpile was built up during the Cold War, but in today's security environment most experts agree that there is no need to maintain a nuclear force of this magnitude.

Cuts in strategic nuclear offensive forces proposed by the Sustainable Defense Task Force could save $30 billion over 10 years[115] and provide more than enough deterrence.[116] Such cuts would reduce the U.S. nuclear warhead total to 1,050 (with 1000 launchers and 50 in store), cut minuteman missiles to 160, allow for 7 Ohio-class SSBNs, retire the bomber leg of the triad, and stop work on the Trident II missile.[117] The Task Force on a Unified Security Budget (USB) concurs that the U.S.'s nuclear arsenal should be reduced and calls for a steeper reduction to 600 warheads (with 400 in reserve), and the elimination of the Trident II nuclear missile.[118]

The Senate recently ratified the U.S.-Russia START treaty that requires both countries to reduce each's nuclear stockpiles to 1,550. However, many experts believe even these reduced numbers are too high. David Hoffman, author of *The Dead Hand: The Untold Story of the Cold War Arms Race and Its Dangerous Legacy*, argues that even under the new agreement we are "left with excess—thousands of nuclear weapons that do not make us any safer."[119] Hoffman further points out that even President Obama's nuclear posture review acknowledged that we

[113] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]
[114] Department of Defense, "Fact Sheet: Increasing Transparency in the U.S. Nuclear Weapons Stockpile", in *Department of Defense* <http://www.defense.gov/npr/docs/10-05-03_fact_sheet_us_nuclear_transparency__final_w_date.pdf> [accessed 29 April 2011].
[115] Stephen Daggett, "Defense budget cuts proposed by the Sustainable Defense Task Force," *Congressional Research Service*, 2010
[116] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]
[117] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]
[118] Institute for Policy Studies, "A Unified Security Budget for the United States, FY 2011", in *Institute for Policy Studies* <http://www.ips-dc.org/files/2361/USB_FY2011.pdf> [accessed 29 April 2011]
[119] David E Hoffman, "Despite new START, the U.S. and Russia still have too many nuclear weapons" <http://www.washingtonpost.com/wp-dyn/content/article/2010/04/09/AR2010040903260.html> [accessed 27 April 2011]

are only maintaining our current level of nuclear weapons because we don't want to go any lower than Russia. [120]

Some security experts agree that U.S. nuclear forces could be significantly reduced without damaging our security. In 2008, George Shultz, William Perry, Henry Kissinger, and Sam Nunn wrote a joint op-ed in the *Wall Street Journal* in which they argued the U.S. could vastly reduce its nuclear stockpile without harming national security.[121] Other security experts, such Ivo Daalder of the Brookings Institute and Jan Lodal, a senior DOD and White House official under Presidents Nixon, Ford and Clinton, similarly posit America's nuclear stockpile could be reduced to no more than 1,000 total weapons.[122] Further, in a recent article, the Air Force Strategic Plans and Policy Division and two Air Force War College professors agreed that 311 warheads are sufficient to achieve deterrence.[123] China, the United Kingdom and France all have similarly-sized nuclear arsenals ranging from 200-400 warheads. While the ranges vary, the consensus remains that the U.S. can maintain its security with significantly fewer nuclear weapons.

A reduction in our nuclear arsenal would also allow for a reduction in our nuclear infrastructure. Three new nuclear facilities are currently being built. Yet a significant reduction in our nuclear arsenal would reduce the need for these new facilities. Further, reducing our stockpile would facilitate a reduction in warhead-related research and development. Finally, the need for a planned B61 bomb refurbishment study is unclear, especially given discussions with allies of eliminating this weapon.

Forgoing construction of the three nuclear facilities, increasing efficiency within warhead-related R&D, and canceling the B61 refurbishment study could save an additional $26 billion over 10 years.[124] The current U.S. nuclear arsenal and infrastructure far exceed what is needed to deter a nuclear attack on the U.S. or our allies, and could be reduced to achieve significant savings without imperiling our national security.

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[120] David E Hoffman, "Despite new START, the U.S. and Russia still have too many nuclear weapons" <http://www.washingtonpost.com/wp-dyn/content/article/2010/04/09/AR2010040903260.html> [accessed 27 April 2011]

[121] George P Schultz et al., "Toward a Nuclear-Free World", in *Nuclear Security Project* <http://www.nuclearsecurityproject.org/atf/cf/%7B1FCE2821-C31C-4560-BEC1-BB4BB58B54D9%7D/TOWARD_A_NUCLEAR_FREE_WORLD_OPED_011508.PDF> [accessed 28 April 2011]

[122] Ivo Daalder and Jan Lodal, "The Logic of Zero," in *Foreign Affairs.* November/December 2008.

[123] James Wood Forsyth Jr., B Chance Saltzman and Gary Schaub Jr., "Remembrance of Things Past: The Enduring Value of Nuclear Weapons", in *Strategic Studies Quarterly* <http://www.au.af.mil/au/ssq/2010/spring/forsythsaltzmanschaub.pdf> [accessed 29 April 2011]

[124] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]

## RECOMMENDATION 2 → $80 BILLION IN SAVINGS OVER 10 YEARS[125, 126]

### ►*Alter force structure: reduce U.S. troops in Europe and Asia.*

As of September 30, 2010, close to 300,000 active duty U.S. military personnel were serving overseas, with approximately 125,000 personnel in Europe and Asia.[127] America's presence in Europe and Asia was originally designed to deter opponents, support our allies, and intervene in the aftermath of World War II and during the Cold War.

However, Benjamin Friedman of the Cato Institute and other critics argue we no longer face the threats of the Cold War, and that Europe, with a bigger combined economy than the U.S., is capable of defending itself.[128] Other critics of America's force structure abroad, such as Doug Bandow, former special assistant to President Reagan, question why the U.S. maintains over 30,000 U.S. troops in Japan 66 years after World War II and 22 after the Cold War ended.[129] Japan is no longer a threat and, with its stable economy, should be able to defend itself.[130]

Further, should a conflict arise, the U.S. has unparalleled capacity and flexibility to rapidly deploy troops and military assets. The Cato Institute argues that forces can be brought in by sea to deter and defeat adversaries as an alternative to maintaining permanent land bases.[131] This means that we could significantly reduce the number of troops at foreign bases, particularly in Europe and Asia.

Reducing U.S. troops in Europe and Asia by 50,000 could save $80 billion over the next 10 years, according to the Sustainable Defense Task Force.[132] The National Commission on Fiscal Responsibility and Reform also supports reducing the numbers of troops in Europe and Asia by one-third,[133] and the Bipartisan Policy Center supports 'significant' reductions in U.S. troops in

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[125] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]

[126] This cost estimate includes reductions in associated costs from operations, procurement and construction. For more on this cost estimate see: Stephen Daggett, "Defense budget cuts proposed by the Sustainable Defense Task Force," *Congressional Research Service*, 2010

[127] Department of Defense, "Active Duty Military Personnel Strengths by Regional Area and by Country" <http://siadapp.dmdc.osd.mil/personnel/MILITARY/history/hst1009.pdf> [accessed 27 April 2011]

[128] Benjamin H Friedman, "Testimony of Benjamin Friedman before the Subcommittee on National Security and Foreign Affairs: Military Restraint and Defense Savings", in *Cato Institute* <http://www.cato.org/testimony/ct-bf-07202010.html> [accessed 29 April 2011]

[129] Doug Bandow, "Japan Can Defend Itself" <http://nationalinterest.org/print/commentary/japan-can-defend-itself-3594> [accessed 27 April 2011]

[130] Doug Bandow, "Japan Can Defend Itself" <http://nationalinterest.org/print/commentary/japan-can-defend-itself-3594> [accessed 27 April 2011]

[131] Benjamin H Friedman and Christopher Preble, "Budgetary Savings from Military Restraint", in *Cato Institute* <http://www.cato.org/pubs/pas/PA667.pdf> [accessed 27 April 2011]

[132] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]

[133] National Commission on Fiscal Responsibility and Reform, "$200 Billion in Illustrative Savings", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf> [accessed 27 April 2011]

Asia and Europe.[134] The rationale that once justified the presence of significant American bases and troops abroad is growing weaker each year.

## RECOMMENDATION 3 → $147 BILLION IN SAVINGS OVER 10 YEARS[135, 136]

### ►*Alter force structure: reduce U.S. troops in Afghanistan and Iraq.*

A growing number of critics argue that our extended, large-scale counterinsurgency campaigns in Iraq and Afghanistan are strategically unwise and that there are better, more cost-effective ways to fight terrorism.[137] Foreign policy experts, such as Gilles Dorronsoro at the Carnegie Endowment for International Peace, believe the U.S. strategy in Afghanistan is "not working," and that General Petraeus should scale down the current offensive in favor of a lighter military presence on the ground.[138] These calls for troop reduction in Afghanistan and Iraq have become more pronounced now that Osama bin Laden has been killed.[139]

Other critics, such as Benjamin Friedman of the Cato Institute, point out that the U.S.'s historic attempts to "reorder these nations with military occupations [tend] to fail, despite great cost in blood and treasure", and that, in fact, these long-term occupations can cause the very terrorism the occupiers are attempting to end.[140]

Research conducted by the RAND Corporation supports the idea that military force is not the most effective means to combat terrorism. A RAND research brief, "How Terror Groups End," found that of 648 terror groups studied, most (40 percent) were eliminated by local police and intelligence agencies or dissolved through political reconciliation (43 percent), and in fact only seven percent of terror groups studied were ended because of military force.[141] Mounting

[134] The Debt Reduction Task Force, "Restoring America's Future", in *Bipartisan Policy Center* <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [accessed 27 April 2011]
[135] The Debt Reduction Task Force, "Restoring America's Future", in *Bipartisan Policy Center* <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [accessed 27 April 2011]
[136] This cost estimate includes reductions in associated costs from operations, procurement and construction. For more on this cost estimate see: Stephen Daggett, "Defense budget cuts proposed by the Sustainable Defense Task Force," *Congressional Research Service*, 2010
[137] Carl J Conetta, "Testimony: Rethinking our Defense Budget: Achieving National Security through Sustainable Spending", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/Conetta_testimony_07-20-10.pdf> [accessed 29 April 2011]
[138] Gilles Dorronsoro, "Change Course Now", in *New York Times* <http://www.carnegieendowment.org/publications/index.cfm?fa=view&id=41055> [accessed 27 April 2011]
[139] Stephanie Condon, "Calls for getting out of Afghanistan grow after bin Laden's death", in *CBS News* <http://www.cbsnews.com/8301-503544_162-20059841-503544.html#> [accessed 5 May 2011]
[140] Benjamin H Friedman, "Testimony of Benjamin Friedman before the Subcommittee on National Security and Foreign Affairs: Military Restraint and Defense Savings", in *Cato Institute* <http://www.cato.org/testimony/ct-bf-07202010.html> [accessed 29 April 2011]
[141] RAND Corporation, "How Terrorist Groups End: Implications for Countering al Qa'ida", in *RAND Corporation* <http://www.rand.org/content/dam/rand/pubs/research_briefs/2008/RAND_RB9351.pdf> [accessed 27 April 2011]

evidence indicates that large-scale military operations are not only costly, but also are not the best tool to combat terrorists.

The U.S. should wind down its ground forces in Iraq and Afghanistan. Cutting Army end strength from 547,400 to 482,400, reducing Marine Corp end strength by 22,000, and reducing Navy support personnel by 9,000, would save $147 billion over 10 years while still maintaining a robust force structure.[142] Drawing down troop levels as the wars in Iraq and Afghanistan come to a close is supported by groups including the Bipartisan Policy Center, and is a logical response to changing conditions on the ground.[143]

## RECOMMENDATION 4 → $43.6 BILLION IN SAVINGS OVER 10 YEARS[144]

### ►*Alter force structure: reduce U.S. Navy fleet.*

In addition to reducing ground forces, the U.S. could also reduce its sea and air power without harming national security. The U.S. Navy possesses far more firepower than the next 20 largest navies combined, and many of those navies are our strong allies.[145]

Some critics of reducing our naval fleet cite China's military expansion as justification for maintaining our current naval force structure. However, while we must remain cognizant of China's military ambitions, as China expert Drew Thompson points out, "Many experts … agree that China today simply does not have the military capability to challenge the United States in the Pacific, though its modernization program has increased its ability to engage the United States close to Chinese shores."[146] China's recent blue-water investments merit serious consideration but do not justify the maintenance of a legacy force structure designed to confront a peer adversary in open water conflict or nuclear war. Instead, these investments provide further urgency to adjust our force structure to be more nimble in order to address challenges China and other powers may present in the future: disruption of shipping lanes, aggressive overseas basing, and littoral conflict.

According to the Sustainable Defense Task Force, the U.S. Navy battle fleet could shrink from 286 ships to 230 while still remaining superior to all other navies in the world.[147] This option would cut two aircraft carriers and their associated air wings, require the Navy to buy 60 fewer

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[142] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]
[143] The Debt Reduction Task Force, "Restoring America's Future", in *Bipartisan Policy Center* <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [accessed 27 April 2011]
[144] Stephen Daggett, "E-mail to staff," *Congressional Research Service*, 2011
[145] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]
[146] Drew Thompson, "www.foreignpolicy.com" <http://www.foreignpolicy.com/articles/2010/02/22/think_again_chinas_military> [accessed 10 May 2011]
[147] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011].

F-35s, and cut seven nuclear missile subs and twelve attack subs. These procurement reductions would save $102 billion over 10 years, with another $24.6 billion in savings from associated operations, maintenance, and personnel costs.

The Sustainable Defense Task Force also recommends a more modest approach, which we support here, that would retire two Navy aircraft carriers and two naval air wings for savings of $50 billion over 10 years.[148] These savings come from cutting two aircraft carriers, 60 F-35's, 10 E-2D Advanced Hawkeye aircrafts, and reducing 11,000 associated naval personnel. Recommendation eight addresses reducing F-35s, so if we extract the savings from cutting F-35s to avoid duplication, the savings would total $43.6 billion instead of $50 billion.[149]

Reform groups such as the Sustainable Defense Task Force are not alone in their calls for reductions in the U.S. Navy. Secretary Gates questioned naval spending in a speech last year, asking, "Do we really need 11 carrier strike groups for another 30 years when no other country has more than one?"[150] According to the Task Force, all naval requirements of our recent wars could have been met with the 230-ship option. [151] To that end, retiring two Navy aircraft carriers (along with the associated naval air wings and personnel) would not only reduce unnecessary costs, but would still enable the U.S. to maintain its superiority at sea.

## ❍Improve Department of Defense Efficiency

### RECOMMENDATION 5 → $100 BILLION IN SAVINGS OVER FIVE YEARS[152, 153]

### ►*Reduce military overhead.*

By some measures, overhead costs comprise approximately 40 percent of the defense budget.[154] Close to 10 years ago, Secretary Rumsfeld complained that there were 17 layers of

[148] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]
[149] Daggett, Stephen. Specialist in Defense Policy and Budgets, Congressional Research Service. Cost estimates are from email to staff dated March 30, 2011.
[150] Robert M Gates, "Remarks as Delivered by Secretary of Defense Robert M. Gates, Gaylord Convention Center, National Harbor, Maryland, Monday, May 03, 2010", in *Department of Defense* <http://www.defense.gov/Speeches/Speech.aspx?SpeechID=1460> [accessed 29 April 2011]
[151] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]
[152] Robert M Gates, "Statement on Department Budget and Efficiencies", in *Department of Defense* <http://www.defense.gov/speeches/speech.aspx?speechid=1527> [accessed 27 April 2011]
[153] Although this recommendation is likely to continue producing savings in the second five years, we opted to err on the side of caution and not increase this to a 10 year estimate.
[154] Robert M Gates, "Remarks as Delivered by Secretary of Defense Robert M. Gates, Gaylord Convention Center, National Harbor, Maryland, Monday, May 03, 2010", in *Department of Defense* <http://www.defense.gov/Speeches/Speech.aspx?SpeechID=1460> [accessed 29 April 2011]

staff between him and a line officer. But today, those levels have grown, and in some cases the space between the Secretary and a line officer may contain as many as 30 layers.[155]

Secretary Gates has taken note of this top-heavy hierarchy, commenting in a speech last year in Kansas that "two decades after the end of the Cold War led to steep cuts in U.S. forces in Europe, our military still has more than 40 generals, admirals, or civilian equivalents based on the continent. Yet we scold our allies over the bloat in NATO headquarters."[156] In the same speech, Gates used the example of a dog-handling team in Afghanistan, which has to earn the approval of at least five four-star headquarters before it can see action.[157] Not only are so many layers of bureaucracy costly, but they also obstruct our war fighters and make us a less effective force.

**"Not only are so many layers of bureaucracy costly, but they also obstruct our war fighters and make us a less effective force."**

Last year, Secretary Gates announced plans to cut DOD overhead costs by $100 billion over five years. Within five months of that announcement, each of the three services had put forward detailed plans to cut tens of billions of dollars from their budgets, for total savings of approximately $100 billion. [158]

While these reductions are significant, it's important to note that most of these savings have been slated for reinvestment in DOD rather than for deficit reduction. But rather than simply pouring these savings back into DOD, they should be used to reduce the deficit. This proposal is supported by the Fiscal Commission [159] and the Bipartisan Policy Center in their deficit reduction proposals.[160]

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[155] Defense Business Board, "Reducing Overhead and Improving Business Operations", in *Defense Business Board* <http://dbb.defense.gov/MeetingFiles/presented.pdf> [accessed 27 April 2011]

[156] Robert M Gates, "Remarks as Delivered by Secretary of Defense Robert M. Gates, Abilene, KS, Saturday, May 08, 2010", in *Department of Defense* <http://www.defense.gov/speeches/speech.aspx?speechid=1467> [accessed 29 April 2011]

[157] Robert M Gates, "Remarks as Delivered by Secretary of Defense Robert M. Gates, Abilene, KS, Saturday, May 08, 2010", in *Department of Defense* <http://www.defense.gov/speeches/speech.aspx?speechid=1467> [accessed 29 April 2011]

[158] Robert M Gates, "Statement on Department Budget and Efficiencies", in *Department of Defense* <http://www.defense.gov/speeches/speech.aspx?speechid=1527> [accessed 27 April 2011]

[159] National Commission on Fiscal Responsibility and Reform, "Co-Chair's Proposal", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/CoChair_Draft.pdf> [accessed 27 April 2011]

[160] The Debt Reduction Task Force, "Restoring America's Future", in *Bipartisan Policy Center* <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [accessed 27 April 2011]

## RECOMMENDATION 6 → $10.8 BILLION IN SAVINGS OVER FIVE YEARS[161, 162]

### ►*Double Secretary Gates's cuts to defense contractors.*

In a recent speech at the Pentagon, Secretary Gates announced plans to cut service contracting by 10 percent over three years, for savings of $6 billion over five years.[163] Gates acknowledged that DOD has "become far too reliant on contractors to perform functions that should either be done by full-time employees or, in some cases, to staff activities that could—and should—be discontinued."[164] These service contractors support the work of DOD personnel, performing services ranging from mowing the grass to repairing weapons systems. The number of service contractors employed by DOD has tripled over the last decade, and now costs DOD $20 billion of its $154 billion contractor budget.[165]

The Fiscal Commission endorses the cuts proposed by Secretary Gates, estimating the savings at $5.4 billion over five years. They go further, however, and recommend doubling those cuts, thereby reducing the number of support contractor staff from 67,000 to 30,600, for total combined savings of $10.8 billion over five years.[166]

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[161] National Commission on Fiscal Responsibility and Reform, "$200 Billion in Illustrative Savings", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf> [accessed 27 April 2011]

[162] Although this recommendation is likely to continue producing savings in the second five years, we opted to err on the side of caution and not increase this to a 10 year estimate.

[163] Robert M Gates, "Statement on Department Budget and Efficiencies", in *Department of Defense* <http://www.defense.gov/speeches/speech.aspx?speechid=1527> [accessed 27 April 2011] & Stephen Daggett, "E-mail to staff," *Congressional Research Service*, 2011. Annual savings are approximately $1.3 billion when fully phased in, estimating 8,000 positions at 160,000 per position per year.

[164] Robert M Gates, "Statement on Department Budget and Efficiencies", in *Department of Defense* <http://www.defense.gov/speeches/speech.aspx?speechid=1527> [accessed 27 April 2011]

[165] National Commission on Fiscal Responsibility and Reform, "$200 Billion in Illustrative Savings", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf> [accessed 27 April 2011]

[166] National Commission on Fiscal Responsibility and Reform, "$200 Billion in Illustrative Savings", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf> [accessed 27 April 2011]

## RECOMMENDATION 7 → $54 BILLION IN SAVINGS OVER 10 YEARS[167, 168]

### ►*Eliminate 10 percent of commercial activities positions.*

The Defense Business Board (DBB), a group of Secretary-appointed experts tasked with recommending reforms to DOD, released a report last year outlining a number of efficiencies and reforms that should be pursued by DOD. According to the DBB report, "there are substantial gains yet to be made" within DOD by making them "more cost-effective through: business processes, consolidation of overhead function, elimination, and privatization."[169]

One of the most glaring inefficiencies highlighted by the DBB is the fact that too many of our most expensive, active duty military personnel are doing inherently governmental, commercial activities that should be done by DOD civilians.[170] Having active duty military personnel perform commercial tasks drives up costs and prevents active duty personnel from being deployed or training to be deployed. Approximately 340,000 active duty military are performing commercial activities, costing approximately $54 billion per year, or eight percent of the Fiscal Year 2010 base budget.[171]

Eliminating just 10 percent of commercial activities positions could save $5.4 billion annually, according to the DBB.[172] The Fiscal Commission, in its illustrative savings reports, outlines a similar option that would standardize the portion of military personnel performing commercial activities, lower the number of military performing these activities, and shift many commercial positions to less costly civilian personnel. These steps would save $5.4 billion in 2015, according to the Fiscal Commission.[173]

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[167] National Commission on Fiscal Responsibility and Reform, "$200 Billion in Illustrative Savings", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf> [accessed 27 April 2011]

[168] We assume consistent annual savings over the next 10 years. However, it's more likely that the savings would be smaller in earlier years and then increase with inflation, adding up to a total of approximately $54 billion over 10 years.

[169] Defense Business Board, "Reducing Overhead and Improving Business Operations", in *Defense Business Board* <http://dbb.defense.gov/MeetingFiles/presented.pdf> [accessed 27 April 2011]

[170] Defense Business Board, "Reducing Overhead and Improving Business Operations", in *Defense Business Board* <http://dbb.defense.gov/MeetingFiles/presented.pdf> [accessed 27 April 2011]

[171] Defense Business Board, "Reducing Overhead and Improving Business Operations", in *Defense Business Board* <http://dbb.defense.gov/MeetingFiles/presented.pdf> [accessed 27 April 2011]

[172] Defense Business Board, "Reducing Overhead and Improving Business Operations", in *Defense Business Board* <http://dbb.defense.gov/MeetingFiles/presented.pdf> [accessed 27 April 2011]

[173] National Commission on Fiscal Responsibility and Reform, "$200 Billion in Illustrative Savings", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf> [accessed 27 April 2011]

## ❍Reform Defense Acquisition

The defense acquisition process has long been plagued by delays and cost overruns. In 2008, the Government Accountability Office released a report revealing the cost of DOD's Fiscal Year 2007 weapons portfolio was $300 billion over initial estimates.[174] In an effort to address the serious flaws in the acquisition process, Congress recently passed the Weapons Systems Acquisition Reform Act of 2009, aimed at reducing inefficiencies in the acquisition process.

While procurement reform can yield significant savings, the bigger savings must come from a reduction in *what* we purchase. It's time to reexamine our defense budget and determine what is needed to keep us safe and what is in there simply because of inertia. Many items in DOD's weapons budget could be reduced or cancelled without endangering America's security or military superiority.

### RECOMMENDATION 8 → $27.1 BILLION IN SAVINGS OVER FIVE YEARS[175, 176]

### ►*Cut Marine Corps F-35 and substitute half of the Air Force and Navy F-35 planned buys with F-16 and F/A-18Es.*

> **"While procurement reform can yield significant savings, the bigger savings must come from a reduction in *what* we purchase."**

The F-35 Joint Strike Fighter is by far DOD's most expensive weapons program. While radar-evading stealth fighters are desirable from a strategic perspective, the F-35 program is four years behind schedule and more than 50 percent over budget.[177] Its critics charge that even if it were to perform as promised, its capabilities would substantially outmatch those of our rivals.

A number of critics have called for the complete cancelation of the F-35, but here we outline a proposal put forward by the Fiscal Commission that would cancel the Marine Corps version of the F-35 and reduce the number of F-35s

[174] Michael J Sullivan, "Defense Acquisitions: Fundamental Changes are Needed to Improve Weapon Program Outcomes", in *Government Accountability Office* <http://www.gao.gov/new.items/d081159t.pdf> [accessed 29 April 2011]

[175] National Commission on Fiscal Responsibility and Reform, "$200 Billion in Illustrative Savings", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf> [accessed 27 April 2011]

[176] Given uncertainty about the second five years, we opted to keep this as a five year estimate.

[177] Michael J Sullivan, "Significant Challenges Remain as DOD Restructures Program", in *Committee on Armed Services,U.S. Senate* <http://armed-services.senate.gov/statemnt/2010/03%20March/Sullivan%2003-11-10.pdf> [accessed 27 April 2011]

planned for the Air Force and Navy.[178] The Marine Corps version, the Fiscal Commission argues, can be cut due to "technical problems, cost overruns, schedule delays, and the adoption of the services of joint combat support in current wartime operations."[179] Secretary Gates has also voiced serious concerns about the Marine Corps F-35, stating in a recent speech that the variant is "experiencing significant testing problems" and that it will be put on a two-year probation period and cancelled if improvements are not made.[180]

Cutting the program now, as recommended by the Fiscal Commission in its illustrative savings, would save $17.6 billion for fiscal years 2012-2015.[181] The Fiscal Commission proposal also calls for half of the planned Air Force and Navy F-35s to be replaced with the significantly less expensive F-16 and F/A-18E. Each F-35 is estimated to cost $133 million, while the unit price of an F-16 is $40 million and an F-18E is $80 million. This option would save $9.5 billion for fiscal years 2011-2015, for a combined savings total of $27.1 billion over five years.[182]

## RECOMMENDATION 9 → $8.5 BILLION IN SAVINGS OVER 10 YEARS[183, 184]

### ►*Cut the Expeditionary Fighting Vehicle.*

On January 6, 2011, Secretary Gates announced plans to cut the Expeditionary Fighting Vehicle (EFV).[185] While Gates acknowledged that the EFV has significant advantages, he also explained that fully executing the EFV would "essentially swallow the entire Marine vehicle budget."[186] The EFV is five years behind schedule and each unit is expected to cost $24 million, a 176

[178] National Commission on Fiscal Responsibility and Reform, "$200 Billion in Illustrative Savings", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf> [accessed 27 April 2011]
[179] National Commission on Fiscal Responsibility and Reform, "$200 Billion in Illustrative Savings", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf> [accessed 27 April 2011]
[180] Robert M Gates, "Statement on Department Budget and Efficiencies", in *Department of Defense* <http://www.defense.gov/speeches/speech.aspx?speechid=1527> [accessed 27 April 2011]
[181] National Commission on Fiscal Responsibility and Reform, "$200 Billion in Illustrative Savings", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf> [accessed 27 April 2011]
[182] National Commission on Fiscal Responsibility and Reform, "$200 Billion in Illustrative Savings", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf> [accessed 27 April 2011]
[183] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]
[184] The original estimate was $8 to $9 billion over 10 years. We split the difference for our savings estimate.
[185] Robert M Gates, "Statement on Department Budget and Efficiencies", in *Department of Defense* <http://www.defense.gov/speeches/speech.aspx?speechid=1527> [accessed 27 April 2011]
[186] Robert M Gates, "Statement on Department Budget and Efficiencies", in *Department of Defense* <http://www.defense.gov/speeches/speech.aspx?speechid=1527> [accessed 27 April 2011]

percent increase over the original per-unit price.[187] In addition to its unsustainable costs, the EFV is simply unnecessary. According to Gates, "the most plausible scenarios requiring power projection from the sea could be handled through a mix of existing air and sea systems."[188] It is also worth asking if amphibious assault is even possible in an era when shore based precision guided weapons pose an existential threat to ships supporting such a landing.

Virtually every deficit reduction plan recently put forward, from the Fiscal Commission plan to the Bipartisan Policy Center plan, support cancelation of the EFV. According to the Sustainable Defense Task Force, terminating the expeditionary fighting vehicle will save $8 to $9 billion over 10 years.[189]

## RECOMMENDATION 10 → $9.9 BILLION IN SAVINGS OVER 10 YEARS[190]

### ►*Delay procurement of the KC-X Aerial Refueling Tanker for five years.*

The CBO has outlined a reform option that would delay the purchase of KC-X tankers for five years, and instead retain and upgrade 60 of the current refueling tankers, the KC-135E.[191] This option is supported by the Sustainable Defense Task Force and would save $9.9 billion over 10 years. Proponents of this option argue that the current KC-135Es still have "significant structural life remaining", and that converting the existing refueling tankers would be a cost-effective way to improve capabilities and reduce costs.[192]

## RECOMMENDATION 11 → $11 BILLION IN SAVINGS OVER 10 YEARS[193, 194]

### ►*End procurement of the MV-22 Osprey.*

The MV-22 Osprey is another example of an over-budget, underperforming military weapons system. The Osprey was originally created to allow Marines to carry troops and cargo faster, higher, and further than a traditional helicopter. The Osprey is now 186 percent over budget, costs $100 million per unit to produce, has killed 30 Marines in accidents, and is not suited to

[187] Michael J Sullivan, "Expeditionary Fighting Vehicle (EFV) Program Faces Cost, Schedule, and Performance Risks", in *Government Accountability Office* <http://www.gao.gov/new.items/d10758r.pdf> [accessed 28 April 2011]
[188] Robert M Gates, "Statement on Department Budget and Efficiencies", in *Department of Defense* <http://www.defense.gov/speeches/speech.aspx?speechid=1527> [accessed 27 April 2011]
[189] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]
[190] Congressional Budget Office, "Budget Options Volume 2", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf> [accessed 22 April 2011]
[191] Congressional Budget Office, "Budget Options Volume 2", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf> [accessed 22 April 2011]
[192] Congressional Budget Office, "Budget Options Volume 2", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf> [accessed 22 April 2011]
[193] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]
[194] The original estimate was $10 to $11 billion over 10 years. We split the difference for our savings estimate.

fly safely in extreme heat, excessive sand, or under enemy fire.[195] It frequently breaks down, achieving only 68 percent readiness in Iraq.[196]

The Government Accountability Office recommended that DOD reconsider procurement of the Osprey, and experts argue that an existing helicopter could achieve many of the objectives of the Osprey at a much lower cost. Yet DOD continues to procure this costly, ineffective machine. The Cato Institute, as part of its "strategy of restraint", also calls for the cancellation of the MV-22, arguing existing systems are perfectly suitable to perform the necessary missions.[197] All in all, cancellation of this underperforming, over-budget weapons system could save $10 billion over 10 years.[198]

## RECOMMENDATION 12 → $80 BILLION IN SAVINGS OVER 10 YEARS[199]

### ►*Curb research and development costs.*

Another area of defense procurement in need of reform is research and development, which has experienced more spending growth since 2001 than any other major DOD appropriations category.[200] Today, research and development receives $80 billion annually, or 33 percent more than during the Cold War peak in real terms, even though today we face no traditional adversary comparable to the Soviet Union.[201]

**"Today, research and development receives $80 billion annually, or 33 percent more than during the Cold War peak in real terms."**

In order to reduce research and development costs, the Sustainable Defense Task Force recommends DOD set priorities and achieve $5 billion in savings per year for a total of $50 billion over the next decade.[202] Both the Cato Institute and the Task Force on a Unified Security Budget agree research and development could be significantly improved

[195] Government Accountability Office, "Defense Acquisitions: Assessments Needed to Address V-22 Aircraft Operational and Cost Concerns to Define Future Investments", in *Government Accountability Office* <http://www.gao.gov/new.items/d09482.pdf> [accessed 29 April 2011]
[196] Government Accountability Office, "Defense Acquisitions: Assessments Needed to Address V-22 Aircraft Operational and Cost Concerns to Define Future Investments", in *Government Accountability Office* <http://www.gao.gov/new.items/d09482.pdf> [accessed 29 April 2011]
[197] Cato Institute, "Cato Handbook for Policymakers: The Defense Budget", in *Cato Institute* <http://www.cato.org/pubs/handbook/hb111/hb111-19.pdf> [accessed 28 April 2011]
[198] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]
[199] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]
[200] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]
[201] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]
[202] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]

without harming security. The Fiscal Commission and the Bipartisan Policy Center have also put forward proposals to reduce research and development costs. The Fiscal Commission, in its illustrative cuts, proposes reducing DOD's research, development, test, and evaluation (RDT&E) budget by 10 percent, for a savings of $7 billion in 2015, pointing out that this reduction would still leave DOD with "a level above the peak of the Reagan years in real systems".[203] The Bipartisan Policy Center offers a similar plan, calling for reduced funding for RDT&E proportional to the reduction in size of forces, or 18.5 percent.[204] We endorse a 10 percent cut in research and development spending, for savings of approximately $80 billion over 10 years.

## ❍Consider Other Options

### OPTION 1 → $60 BILLION IN SAVINGS OVER 10 YEARS[205]

### ►*Modernize DOD's health care system.*

Over the past decade, military health care costs have risen 100 percent in real terms.[206] The DOD Unified Medical Budget has risen far faster than inflation, growing from $19 billion in Fiscal Year 2001 to $50.7 billion in Fiscal Year 2010.[207] Despite this significant growth, enrollment fees, deductibles, and copayments for TRICARE have not increased since the mid-1990s.[208] For instance, the current TRICARE Prime enrollment fee was set in 1995 at $450 per year for a basic family plan and has never been raised.[209] The rates paid by military families—annual deductibles ranging from $150-$300—remain far below the national average of $600 to $1,000.[210] Additionally, the share of TRICARE's total health care covered by premiums has fallen from 27 percent in 1995 to just 9 percent today.[211]

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[203] National Commission on Fiscal Responsibility and Reform, "$200 Billion in Illustrative Savings", in *National Commission on Fiscal Responsibility and Reform* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf> [accessed 27 April 2011]

[204] The Debt Reduction Task Force, "Restoring America's Future", in *Bipartisan Policy Center* <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [accessed 27 April 2011]

[205] Congressional Budget Office, "The Effects of Proposals to Increase Cost Sharing in TRICARE", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/102xx/doc10261/TRICARE.pdf> [accessed 28 April 2011]

[206] The Sustainable Defense Task Force, "Debt, Deficits, and Defense: A Way Forward", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/1006SDTFreport.pdf> [accessed 27 April 2011]

[207] Gordon Adams, "Testimony before the House Committee on Oversight and Government Reform Subcommittee on National Security and Foreign Affairs", in *House Committee on Oversight and Government Affairs* <http://oversight.house.gov/images/stories/subcommittees/NS_Subcommittee/7.20.10_DoD_Budget/Adams_Statement.pdf> [accessed 13 December 2010]

[208] Congressional Budget Office, "The Effects of Proposals to Increase Cost Sharing in TRICARE", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/102xx/doc10261/TRICARE.pdf> [accessed 28 April 2011]

[209] Todd Harrison, "Evaluating Options for a Sustainable Defense", in *Commonwealth Institute* <http://www.comw.org/pda/fulltext/Harrison_Testimony.pdf> [accessed 29 April 2011]

[210] National Commission on Fiscal Responsibility and Reform, "$200 Billion in Illustrative Savings", in *National Commission on Fiscal Responsibility and Reform*

Secretary Gates has recently voiced serious concerns about TRICARE and the need to implement reforms: "Health-care costs are eating the Department of Defense alive…Many working age military retirees—who are earning full-time salaries on top of their full military pensions—are opting for TRICARE even though they could get health coverage through their employer, with the taxpayer picking up most of the tab as the result."[212]

In 2007, 2008, and 2009, DOD proposed that enrollment fees, deductibles, and copayments of some TRICARE beneficiaries be increased to encourage more efficient use of health services and to reduce medical costs.[213] Each year these proposals were rejected by Congress. According to a CBO cost estimate of DOD's Fiscal Year 2009 reform proposal, modestly raising enrollment fees, co-pays, and deductibles (closer to but still significantly below those paid by civilians) would save $60 billion over 10 years.[214]

Deficit reduction proposals put forward by the Sustainable Defense Task Force, the Fiscal Commission, and the Bipartisan Policy Center all include similar plans to reform and modernize TRICARE. We can realign our military health care system with today's standards in order to make the system more sustainable while still ensuring our military personnel receive the care they deserve.

# Conclusion

In a world of limited resources, we have to make tough choices. Unfortunately, we have passed the buck too often on defense spending reform. Rather than realigning our military budget to match emerging threats, we have simply layered new requirements over existing requirements. Even the most recent Quadrennial Defense Review fails to set reasonable priorities, explaining that the U.S. must be capable of protecting U.S. interests against "a multiplicity of threats, including two capable nation-state aggressors [and]…Conducting a wide range of operations"

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<http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/Illustrative_List_11.10.2010.pdf> [accessed 27 April 2011]

[211] Gordon Adams, "Testimony before the House Committee on Oversight and Government Reform Subcommittee on National Security and Foreign Affairs", in *House Committee on Oversight and Government Affairs* <http://oversight.house.gov/images/stories/subcommittees/NS_Subcommittee/7.20.10_DoD_Budget/Adams_Statement.pdf> [accessed 13 December 2010]

[212] Robert M Gates, "Remarks as Delivered by Secretary of Defense Robert M. Gates, Abilene, KS, Saturday, May 08, 2010", in *Department of Defense* <http://www.defense.gov/speeches/speech.aspx?speechid=1467> [accessed 29 April 2011]

[213] Congressional Budget Office, "The Effects of Proposals to Increase Cost Sharing in TRICARE", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/102xx/doc10261/TRICARE.pdf> [accessed 28 April 2011]

[214] Congressional Budget Office, "The Effects of Proposals to Increase Cost Sharing in TRICARE", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/102xx/doc10261/TRICARE.pdf> [accessed 28 April 2011]

including conflicts we are currently in and the wars we may someday face.[215] This is the sort of logic that leads Benjamin Friedman of the Cato Institute to say, "We spend too much because we choose too little."[216]

Most of our defense spending reflects yesterday's threats—threats that have receded in recent years while newer threats, primarily terrorism, have come to the forefront of our security agenda. What is certain is that today's threat environment does not justify current spending levels. Our security budget needs to be reinvented to meet new threats, including the threat of fiscal instability, and policy makers need to measure each security spending program against this benchmark: Is it essential to keep America safe?

**"We need to measure each security spending program against this benchmark: Is it essential to keep American safe?"**

This is even more important because the real consequence of overspending on defense is not only that we will have too many unnecessary ships, aircrafts, and missiles, but also that by diverting so many of our limited resources to needless defense programs, we are neglecting other vital, domestic investments in health care, education, and infrastructure that maintain our superpower status. President Dwight Eisenhower, a staunch critic of military spending, understood the dangers of overspending on defense and warned in a 1951 speech to NATO, "We must not destroy from within what we are trying to defend from without."

As we reassess our security budget and strategy we should heed his warning. Military power is not simply about spending more than our adversaries, but, as Kori Schake, a research fellow at the Hoover Institute, points out, it is also "fundamentally premised on the solvency of the American government and the vibrancy of the U.S. economy."[217] In order to maintain that vibrancy, we must get our fiscal house in order, and in doing so reexamine and reinvent our national security budget.

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[215] Department of Defense, "Quadrennial Defense Review Report", in *Department of Defense* <http://www.defense.gov/qdr/qdr%20as%20of%2029jan10%201600.pdf> [accessed 28 April 2011]
[216] Cato Institute, "Cato Handbook for Policymakers: The Defense Budget", in *Cato Institute* <http://www.cato.org/pubs/handbook/hb111/hb111-19.pdf> [accessed 28 April 2011]
[217] Kori Schake, "Stop Spending So Much on Defense", in *Foreign Policy Online* <http://shadow.foreignpolicy.com/posts/2010/01/20/stop_spending_so_much_on_Defense> [accessed 28 April 2011]

# Reinventing Tax Expenditures

## Our Fourteen Key Recommendations

### End Environmentally Destructive Tax Subsidies

▶ ***Recommendation 1: Cut oil and gas subsidies.***

➲ ***Potential Savings: $43.6 billion over 10 years***

▶ ***Recommendation 2: Cut coal subsidies.***

➲ ***Potential Savings: $2.6 billion over 10 years***

▶ ***Recommendation 3: Cut timber subsidies.***

➲ ***Potential Savings: $6.8 billion over 10 years***

▶ ***Recommendation 4: Cut parking subsidies.***

➲ ***Potential Savings: $34.7 billion over 10 years***

▶ ***Recommendation 5: Cut ethanol subsidies.***

➲ ***Potential Savings: $62.1 billion over 10 years***

### End Wasteful Corporate Tax Subsidies

▶ ***Recommendation 6: Reform the international tax system.***

➲ ***Potential Savings: $129.2 billion over 10 years***

▶ ***Recommendation 7: Cut subsidies for private-activity bonds.***

➲ ***Potential Savings: $23.0 billion over 10 years***

▶ ***Recommendation 8: Cut subsidies for Blue Cross/Blue Shield.***

➲ ***Potential Savings: $6.2 billion over 10 years***

▶ ***Recommendation 9: Cut subsidies for employment-based life insurance.***

➲ ***Potential Savings: $25.2 billion over 10 years***

▶ ***Recommendation 10: Cut subsidies for agribusinesses.***

➲ ***Potential Savings: $9.8 billion over 10 years***

### Limit Tax Subsidies for High Income Individuals

▶ ***Recommendation 11: Cut subsidies for income earned abroad.***

➲ ***Potential Savings: $71.2 billion over 10 years***

▶ ***Recommendation 12: Cut the mortgage interest deduction for vacation homes.***

➲ ***Potential Savings: $12.2 billion over 10 years***

▶ ***Recommendation 13: Limit deductions for high-income taxpayers.***

➲ ***Potential Savings: $321.3 billion over 10 years***

## ➲ Split Savings between Tax Cuts and Deficit Reduction.

► ***RECOMMENDATION 14: Reduce individual and corporate tax rates.***

➲ ***Variable deficit increase over 10 years.***

**Recommended Minimum Potential Savings**

**➲ $700-800 billion over 10 years**

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## ➲ Consider Other Options

► ***OPTION 1: Cap tax expenditures as a percent of GDP.***

➲ ***Potential Savings: $3.5 trillion over 10 years***

► ***OPTION 2: Cut most tax expenditures and split the savings.***

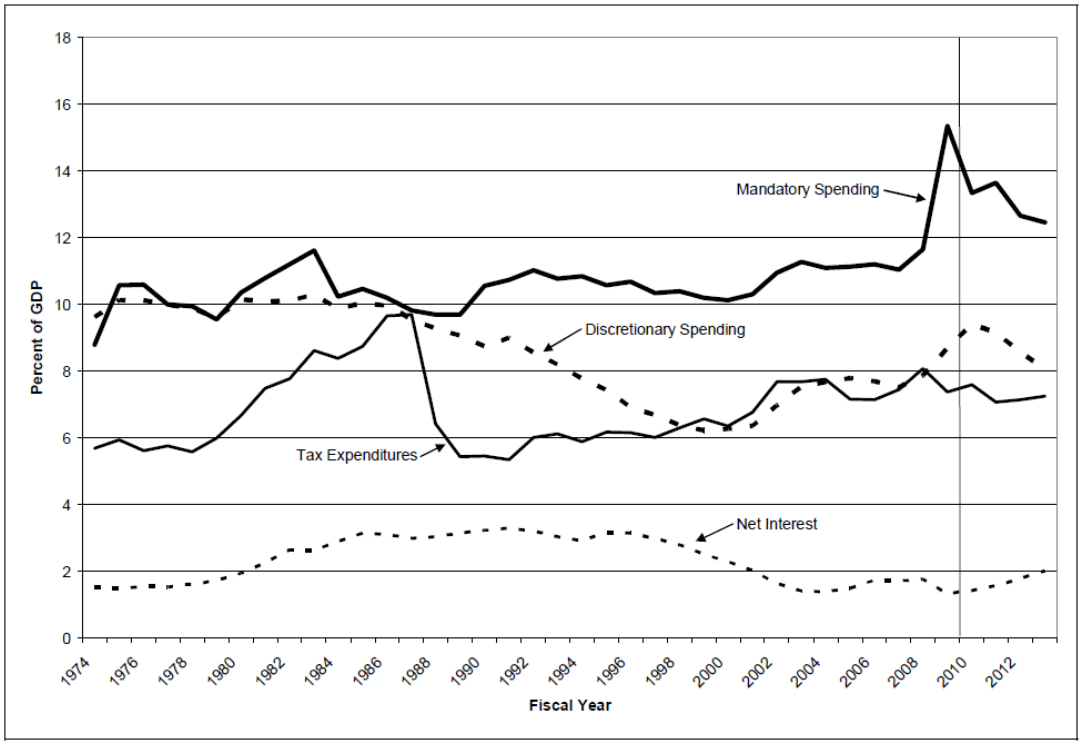
➲ ***Potential Savings: Variable***

# Our Approach to Tax Expenditure Reform

While health care and defense spending are the most commonly cited culprits in the unsustainable growth of federal budget deficits, tax expenditures are also to blame. Tax expenditures, sometimes called tax earmarks, are spending through the tax code. They are tax credits, deductions, exemptions, and other breaks that make government bigger by reallocating the public's resources.

Tax expenditures amount to approximately $1.2 trillion in forgone revenue that the federal government spends through the tax code each year.[218] To put that in context, total discretionary spending in 2010 amounted to $1.3 trillion, as did our 2010 deficit; and in just one year tax expenditures cost taxpayers as much as the last 10 years in Afghanistan and Iraq combined. For a comparison of the different types of expenditures, including tax expenditures, as a percent of GDP across time, see Figure 9 below.

## Figure 2: Total Expenditures FY1974 to FY2013[219]




**Source:** OMB, JCT, and CBO.

[218] Measuring tax expenditure spending is difficult because any individual tax expenditure's cost depends on the number of claimants each year. The JCT puts together tables that estimate the cost of each tax expenditure, but these are inevitably imprecise.

[219] Thomas L Hungerford, "Tax Expenditures and the Federal Budget", in *Congressional Research Service* <http://www.crs.gov/Products//rl/pdf/RL34622.pdf> [accessed 28 April 2011]

While not counted as spending in the official budget, tax expenditures are ripe with potential savings. This is not only because of their huge cost (between 1999 and 2004 they even cost more than all discretionary spending), but also because tax expenditures have been little scrutinized since the 1986 tax reform that eliminated many tax expenditures and broadened the tax base.[220] Since then, they've grown to over 250 in number and impact government revenue to such a degree that the Committee for a Responsible Federal Budget now talks about a "Swiss-cheese tax base filled with rifle-shot tax breaks." The point is that a few common sense tax expenditure reforms could go a long way towards shrinking our deficit.

**"Tax expenditures are ultimately a regressive way of distributing public resources."**

Tax expenditures are also problematic because they are regressive benefits. "For example," asks Len Burman, "would it make sense to design a health insurance voucher worth 35 cents per dollar for high-income families, but only 10 cents per dollar for those with low income?"[221] The answer is obviously no, but that's the system we've got in place. Tax expenditures are ultimately a regressive way of distributing public resources. They increase income inequality and create the (often deserved) perception that our tax code is unfair.

Savings generated from tax expenditure reform could be earned in one of three ways. First, specific tax expenditures could be modified or eliminated altogether. There are several candidates for modification or elimination that we discuss later in this section. Second, tax expenditures could be capped, either as a percent of GDP or on a per taxpayer basis. Third, most tax expenditures could be eliminated and the savings could be split between deficit reduction and tax cuts.

Our key recommendations, listed at the beginning of this section, include both the elimination of several specific tax expenditures as well as a cap on deductions taken by upper-income

[220] The Tax Reform Act of 1986, a bipartisan act of Congress championed by President Reagan, was able to cut the top individual income tax rate from 50 percent to 28 percent while remaining revenue neutral, according to Leonard Burman: Leonard Burman, "Let's freeze more than chump change", in *The Washington Post* <http://www.washingtonpost.com/wp-dyn/content/article/2010/02/01/AR2010020103072.html> [accessed 28 April 2011]. Burman also cites a 2008 study by the Tax Policy Center which found "that eliminating all [current] income tax expenditures would permit a 44 percent across-the-board cut in tax rates without reducing revenue. The top marginal rate could drop from 35 percent to 20 percent." Although we'd want to use some of the savings from tax expenditure cuts to shrink the deficit rather than to lower taxes, these figures are useful for illustrating the magnitude of the potential savings. See: Leonard Burman, Eric Toder and Christopher Geissler, "How Big are Total Individual Income Tax Expenditures, and Who Benefits from Them?", in *Tax Policy Center* <http://www.taxpolicycenter.org/UploadedPDF/1001234_tax_expenditures.pdf> [accessed 3 May 2011]

[221] Leonard Burman, "Let's freeze more than chump change", in *The Washington Post* <http://www.washingtonpost.com/wp-dyn/content/article/2010/02/01/AR2010020103072.html> [accessed 28 April 2011]

earners (a combination of the first two approaches listed in the previous paragraph). Together they add up to over $600-800 billion in savings over 10 years.[222]

Still, these are only first steps. There are plenty more tax expenditures in the tax code that should be candidates for elimination. But one potential problem is that once you start cutting one here and one there, you begin to pick winners and losers from the myriad groups and sectors of the economy that benefit from these tax expenditures. Still, tax expenditures inherently pick winners and losers, often according to arbitrary and little scrutinized criteria.

**"Tax expenditures inherently pick winners and losers, often according to arbitrary and little scrutinized criteria."**

And because tax expenditures already pick winners and losers, we believe that the next step must be *comprehensive tax reform*. That doesn't change the fact that some tax expenditures clearly deserve to be eliminated as soon as possible (and we make recommendations to that effect), but we also believe that a more broad-based approach must remain the end goal.

The term "comprehensive tax reform" has been thrown around to mean many things, including everything from deficit-financed tax cuts to a progressive tax increase and the closing of tax loopholes. We mean it to be a simplification of the tax code—by eliminating most tax expenditures—that divides the savings (over $1 trillion per year) between income and corporate tax rate reduction on the one hand, and deficit reduction on the other

**"Businesses would prosper under a simplified tax code."**

Liberal critics will say that this concedes too much to upper income taxpayers and corporate interests. Conservative critics will allege that this is a tax rate increase—even though it is quite the opposite. The fact is that the benefits of comprehensive tax reform would be large and wide-ranging. Business would prosper under a simplified tax code. Individuals would get to keep more of what they earn through lower income tax rates. Incentives that distort economic behavior and encourage overleveraging or environmentally destructive investment would be eliminated. And our deficit would be substantially reduced, depending of course on the ultimate balance between tax cuts and deficit reduction.

The next section makes the case for our key recommendations. Following that is a review of other options that we are not explicitly recommending but that merit a thoughtful discussion.

[222] It is important to recognize that at least some of this figure would have to be dedicated to lowering both individual income and corporate tax rates, as we suggest with our fourteenth recommendation.

# Our Fourteen Key Recommendations

## End Environmentally Unfriendly Tax Subsidies

### RECOMMENDATION 1 → $43.6 BILLION IN SAVINGS OVER 10 YEARS[223]

### ►*Cut oil and gas subsidies.*

Several tax expenditures subsidize the activities of oil and gas companies. Most of these should be eliminated, especially those that have little or no impact on employment figures or consumer prices. For the most part, these oil and gas companies already earn huge profits and don't need the crutch of taxpayer subsidies. Either way, the government should not be responsible for subsidizing entire industries on a permanent basis. And worse still, this is a subsidy that goes directly against the public interest by contributing to climate change by increasing the consumption of fossil fuels. Even Speaker John Boehner has admitted that oil and gas companies should pay "their fair share."[224]

> **"This is a subsidy that goes directly against the public interest by contributing to climate change."**

We support the White House proposal to cut eight tax expenditures that benefit oil and gas companies. These cuts could save taxpayers about $44 billion over the next 10 years.[225] Included among the tax expenditures that the White House recommends cutting are the following:

**Oil and gas subsidies**

1. Enhanced oil recovery credit
2. Credit for oil and gas produced from marginal wells
3. Expensing of intangible drilling costs
4. Deduction for tertiary injectants
5. Exemption to passive loss limitation for working interests in oil and natural gas properties
6. Percentage depletion for oil and natural gas wells
7. Domestic manufacturing deduction for oil and gas production
8. Short amortization period for independent producers (increase from two to seven years)

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[223] Department of Treasury, "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals", in *Department of Treasury* <http://www.treasury.gov/resource-center/tax-policy/Documents/Final%20Greenbook%20Feb%202012.pdf> [accessed 28 April 2011]

[224] Christi Parsons and Kathleen Hennessey, "Obama urges repeal of tax breaks for oil firms", in *Los Angeles Times* <http://articles.latimes.com/2011/apr/26/nation/la-na-obama-oil-subsidies-20110427> [accessed 5 May 2011]

[225] Department of Treasury, "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals", in *Department of Treasury* <http://www.treasury.gov/resource-center/tax-policy/Documents/Final%20Greenbook%20Feb%202012.pdf> [accessed 28 April 2011]

Eliminating these eight tax expenditures would have very little effect on consumer prices or on employment: the Joint Economic Committee has found that eliminating the largest of these deductions—the one for domestic oil and gas production—would have zero impact on consumer prices.[226] The Treasury Department has found that eliminating all of them would reduce domestic production by effectively zero (less than one tenth of one percent).[227] In essence, taxpayers continue to subsidize an industry with billions of dollars per year but get very little return on this investment, either in the form of domestic jobs or lower energy prices.

The oil industry also remains an incredibly profitable enterprise that doesn't need the crutch of taxpayer-provided subsidies. In 2008, the big five oil companies combined were averaging almost $30 billion in annual profits, an astronomical sum that suggests taxpayer subsidies are entirely unnecessary.[228] Also consider the fact that, thanks to taxpayer subsidies, ExxonMobil paid no federal income tax in 2009, in fact netting a $156 million tax refund.[229]

The truth is that these oil and gas companies would still be immensely profitable without taxpayer subsides. And if we cut these subsidies, we could save billions of dollars. To that end, we helped introduce a bill last June with Representative Earl Blumenauer and thirteen colleagues that would eliminate $30 billion in tax expenditures[230] benefitting oil and gas companies over the next 10 years. This bill, H.R.5644, the End Big Oil Tax Subsidies Act, is not only a concrete step towards fiscal sustainability, but also an environmentally responsible one. The new version of that bill, H.R.601, is now estimated to save approximately $40 billion over 10 years.[231] Taxpayers should not be subsidizing profitable oil companies at the cost of tens of billions of dollars over the succeeding 10 years.[232]

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[226] Majority Staff of the Joint Economic Committee, "The Proposed Modification of Internal Revenue Code Section 199 Will Not Increase Consumer Energy Prices", in *Joint Economic Committee* <http://jec.senate.gov/public/?a=Files.Serve&File_id=f26dccde-9ea6-4539-a44c-f638240fa055> [accessed 28 April 2011]

[227] Alan B Krueger, "Statement of Alan B. Krueger Assistant Secretary for Economic Policy and Chief Economist, US Department of Treasury Subcommittee on Energy, Natural Resources, and Infrastructure", in *Department of Treasury* <http://www.treasury.gov/press-center/press-releases/Pages/tg284.aspx> [accessed 29 April 2011]

[228] Rebecca Lefton, "BP Disaster Is Cheney's Katrina" <http://www.americanprogress.org/issues/2010/06/oil_timeline.html> [accessed 28 April 2011]

[229] Rebecca Lefton, "BP Disaster Is Cheney's Katrina" <http://www.americanprogress.org/issues/2010/06/oil_timeline.html> [accessed 28 April 2011]

[230] The terms "tax expenditure" and "tax subsidy" can be confused, but refer to roughly the same concept. Tax subsidies are that category of tax expenditures which could be most easily replaced by a comparable outlay program.

[231] Earl Blumenauer, "House Democrats Unveil $40 Billion in Cuts to Wasteful Big Oil Subsidies" <http://blumenauer.house.gov/index.php?option=com_content&task=view&id=1788&Itemid=73> [accessed 28 April 2011]

[232] Congressional Budget Office, "Budget Options", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/78xx/doc7821/02-23-BudgetOptions.pdf> [accessed 28 April 2011]

## RECOMMENDATION 2 → $2.6 BILLION IN SAVINGS OVER 10 YEARS[233]

## ►*Cut coal subsidies.*

In addition to the oil and gas industry subsidies listed above, we also recommend cutting four coal industry subsidies that are simply not in the public interest. These four coal subsidies, listed below, add up to $2.6 billion over 10 years and were targeted for elimination by the Obama Administration in its Fiscal Year 2012 budget.

**Coal subsidies**

1. Expensing of exploration and development costs
2. Percentage depletion for hard mineral fossil fuels
3. Capital gains treatment for royalties
4. Domestic manufacturing deduction for coal and other hard mineral fossil fuels

In evaluating these tax expenditures, we have to ask ourselves: should taxpayers be subsidizing an industry that each year causes 24,000 premature deaths, more than 550,000 asthma attacks, 38,000 heart attacks, and 12,000 hospital admissions?[234] The answer, in our view, is no.

## RECOMMENDATION 3 → $6.8 BILLION IN SAVINGS OVER 10 YEARS[235, 236]

## ►*Cut timber subsidies.*

Like oil, gas, and coal subsidies, timber subsidies are another example of spending programs that generally operate in direct contradiction of the public interest. In fact, as Calvin Johnson, a professor of law at the University of Texas, points out, "Timber is a high-yield, long-term investment that is subject to a negative tax rate under current law."[237] Two timber subsidies in particular contribute to this negative tax rate. They are (1) the special tax treatment for timber gains, and (2) the expensing of timber growing costs. Cutting these subsidies would save $6.8 billion over the next 10 years.

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[233] Department of Treasury, "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals", in *Department of Treasury* <http://www.treasury.gov/resource-center/tax-policy/Documents/Final%20Greenbook%20Feb%202012.pdf> [accessed 28 April 2011]

[234] Joseph Romm, "Using Tax Incentives to Drive the Clean Energy Economy" <http://www.americanprogressaction.org/issues/2010/04/tax_green_economy.html> [accessed 28 April 2011]

[235] Autumn Hanna and Benjamin Schreiber, "Green Scissors 2010", in *Green Scissors* <http://www.greenscissors.com/GreenScissors2010.pdf> [accessed 28 April 2011]

[236] The original cost savings estimate was $3.4 billion over five years. We believe that $6.8 billion over 10 years is a reasonable assumption because (1) timber subsidies are not one-off expenses and (2) we err on the side of caution and ignore inflation.

[237] Autumn Hanna and Benjamin Schreiber, "Green Scissors 2010", in *Green Scissors* <http://www.greenscissors.com/GreenScissors2010.pdf> [accessed 28 April 2011]

Currently, with these two tax subsidies on the books, we find the seemingly bizarre (but all too common) example of the Tongass rainforest in Alaska, the world's largest remaining temperate rainforest. There, "taxpayers [actually] pay more for the construction and maintenance of roads and other infrastructure needed to extract the timber than they receive from the royalties for the timber."[238] The tax code is clearly broken when a provision originally intended to raise revenue (royalties owed to the taxpayer) has been perverted into a net revenue loser that subsidizes the destruction of pristine wilderness. These timber subsidies should be cut and the revenue put towards deficit reduction.

**"The tax code is clearly broken when a provision originally intended to raise revenue has been perverted into a net revenue loser that subsidizes the destruction of pristine wilderness."**

## RECOMMENDATION 4 → $34.7 BILLION IN SAVINGS OVER 10 YEARS[239, 240]

### ►*Cut subsidies for employee parking expenses.*

Another federal subsidy for environmentally destructive behavior is the tax exemption for qualified parking expenses. While fringe benefits are generally taxable as employee compensation, parking expense benefits have been exempted from taxation. According to a joint report from the Brookings Institution and the World Resources Institute, this exemption "encourages commuting by vehicles and contributes more to fossil fuel use, global warming, and more pollution and congestion." This begs the question: why should taxpayers continue to subsidize an activity that is harmful to the environment?

We can't find a good reason, and so we believe that this federal subsidy for employee parking expenses should be cut. This would not stop anyone from driving to work, but it would remove the extra incentive to do so. Not only would this remove a federal subsidy for environmentally harmful behavior, but it would also "improve fairness in the relative tax treatment of employees who receive compensation in different forms."[241] And perhaps most importantly, it

[238] Autumn Hanna and Benjamin Schreiber, "Green Scissors 2010", in *Green Scissors* <http://www.greenscissors.com/GreenScissors2010.pdf> [accessed 28 April 2011]
[239] Office of Management and Budget, "Fiscal Year 2012 Budget of the U.S. Government", in *Office of Management and Budget* <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/teb2012.xls> [accessed 28 April 2011]
[240] The original cost savings estimate was $17.35 billion over five years. We believe that $34.7 billion over 10 years is a reasonable assumption because (1) parking subsidies are not one-off expenses and (2) we err on the side of caution and ignore inflation.
[241] Eric Toder, "Eliminating Tax Expenditures with Adverse Environmental Effects", in *Urban* <http://www.urban.org/UploadedPDF/1001080_tax_expenditures.pdf> [accessed 28 April 2011]

would generate considerable savings: at least $35 billion over 10 years, according to the Office of Management and Budget.[242]

## RECOMMENDATION 5 → $62.1 BILLION IN SAVINGS OVER 10 YEARS[243, 244]

### ►*Cut ethanol subsidies.*

Created more than 30 years ago, the Volumetric Ethanol Excise Tax Credit[245] (VEETC) subsidizes the production of corn ethanol. The most recent extension of the VEETC, through the end of 2011, was included in the tax cut deal signed by President Obama late last year.[246]

The VEETC cost U.S. taxpayers over $5 billion in 2010. The Natural Resources Defense Council estimates that a 2011-2015 extension would cost taxpayers an additional $31.05 billion.[247] Permanently ending the VEETC would save us at least $60 billion over the next 10 years.

The case for ending the VEETC is relatively straightforward. It costs too much and does more harm than good. Last year, I joined many of my colleagues in writing a letter to then-Speaker Nancy Pelosi and then-Minority Leader John Boehner that opposed an extension of the VEETC:

> We want to express our strong opposition to extending the Volumetric Ethanol Excise Tax Credit (VEETC) and the tariff on imported ethanol.
>
> This year, the U.S. will divert nearly 40 percent of the domestic corn crop from food and feed to fuel, which will contribute to already increasingly volatile and high commodity prices. According to the Congressional Budget Office (CBO), corn ethanol production accounted for 10-15 percent of the increase in food prices between April 2007-April 2008 and $600-900 million in additional costs to

[242] This $35 billion estimate is based on projected savings of $17.35 billion over five years which, adjusted for inflation, would almost certainly exceed $35 billion over 10 years.
[243] National Resource Defense Center, "Let the VEETC Expire: Save Billions in Tax Dollars Better Spent on Non-Polluting Energy Technologies", in *National Resource Defense Center* <http://www.nrdc.org/globalWarming/files/VEETCfs.pdf> [accessed 28 April 2011]
[244] The original cost savings estimate was $31.05 billion over five years. We believe that $62.1 over 10 years is a reasonable assumption because (1) ethanol subsidies are not one-off expenses and (2) we err on the side of caution and ignore inflation.
[245] The Volumetric Ethanol Excise Tax Credit is not technically a tax expenditure since it is a deviation from an excise tax rather than from the income tax. Nevertheless, we have included it here because this is more of a technicality than a substantive distinction.
[246] Technically, the VEETC terminates at the end of 2011. This means that under current law, it has no budgetary effect in 2012 or beyond. That said, the VEETC has been continually renewed by Congress and it's reasonable to believe that Congress will renew it again. One could frame the projected savings from VEETC termination projected in this report in the context of policy changes that deviate from the CBO's alternative baseline, a projection of likely policy rather than current law.
[247] National Resource Defense Center, "Let the VEETC Expire: Save Billions in Tax Dollars Better Spent on Non-Polluting Energy Technologies", in *National Resource Defense Center* <http://www.nrdc.org/globalWarming/files/VEETCfs.pdf> [accessed 28 April 2011]

the Supplemental Nutrition Assistance Program and other child nutrition programs in 2009 alone.

Higher food prices hurt Americans, particularly those who can least afford it, such as those on public assistance and working families.

In addition to escalating food and commodity prices, corn ethanol is not a cost-efficient way of achieving environmental benefits. A July 2010 study by the CBO found that every gallon of ethanol used to replace gasoline costs the Federal government $1.78 – adding up to billions for American taxpayers. Ethanol also does little to combat climate change, causing more global warming pollution than the gasoline it replaced.

We believe it is time to end or significantly reduce the subsidy for corn ethanol and the tariff on imported ethanol. We look forward to working with you to promote the development of truly sustainable advanced bio-fuels that meet both our food and environmental needs.

We continue to oppose an extension of the VEETC. If we are serious about fiscal responsibility, ending the VEETC has to be one our first steps.

## ⭘End Other Corporate Tax Subsidies

### RECOMMENDATION 6 → $129.2 BILLION IN SAVINGS OVER 10 YEARS[248]

### ►*Reform the international tax system.*

In his 2011 State of the Union address, President Obama pointed out that "over the years, a parade of lobbyists has rigged the tax code to benefit particular companies and industries. Those with accountants and lawyers to work the system can end up paying no taxes at all. But all the rest are hit with one of the highest corporate tax rates in the world."[249]

This is true for all areas of the corporate tax code, but it is particularly true for the way our international tax system operates. This is why reforming the international tax system is not just a way to raise revenue, but also a much needed reform in the name of fairness.

[248] Department of Treasury, "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals", in *Department of Treasury* <http://www.treasury.gov/resource-center/tax-policy/Documents/Final%20Greenbook%20Feb%202012.pdf> [accessed 28 April 2011]
[249] Barack Obama, "State of the Union Address", in *The White House* <http://www.whitehouse.gov/the-press-office/2011/01/25/remarks-president-state-union-address> [accessed 28 April 2011]

The reason our international tax system is unfair is that it has created incentives for "U.S.-based multinational corporations to invest abroad rather than in the United States."[250] On that point, Chuck Marr and Brian Highsmith at the Center on Budget and Policy Priorities observe that U.S. multinationals pay much lower taxes on profits from their overseas investments than on profits from their domestic investments. That gives corporations a strong incentive to shift economic activity and income from the United States to other countries."[251]

Appropriate reform of the international tax system would eliminate this unhelpful incentive to invest outside the United States. That is why we are endorsing President Obama's seven proposed corporate tax reforms that would raise $129 billion over the next 10 years:

1. Defer deduction of interest expense related to deferred income.
2. Determine foreign tax credit on a pooling basis.
3. Tax currently excess returns associated with transfers of intangibles offshore.
4. Limit shifting of income through intangible property transfers.
5. Disallow the deduction for non-taxed reinsurance premiums paid to affiliates.
6. Limit earnings stripping by expatriated entities.
7. Modify tax rules for dual capacity taxpayers.

## RECOMMENDATION 7 → $23.0 BILLION IN SAVINGS OVER 10 YEARS[252, 253]

## ►*Cut subsidies for private-activity bonds.*

Currently, private-activity bonds that serve a public interest are tax exempt. We believe that this exemption should be eliminated or the volume cap should be curtailed.

There are several reasons for ending this tax subsidy for private-activity bonds. Unlike *public*-activity bonds, private-activity bonds are used by the private sector (to finance projects like professional sports stadiums, hotels, and private golf courses).[254] These projects can only receive a tax exemption if the public can be shown to derive a benefit, but this determination is

[250] Office of Management and Budget, "Fiscal Year 2012 Budget of the U.S. Government", in *Office of Management and Budget* <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/budget.pdf> [accessed 28 April 2011]
[251] Chuck Marr and Brian Highsmith, "Six Tests for Corporate Reform: Reform Should Help Shrink Long-Term Deficits, Reduce Biases and Preferences in the Tax Code, and Discourage Tax Sheltering", in *Center on Budget and Policy Priorities* <http://www.cbpp.org/files/2-28-11tax.pdf> [accessed 28 April 2011]
[252] Congressional Budget Office, "Budget Options Volume 2", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf> [accessed 22 April 2011]
[253] This savings estimate, from the CBO's 2009 *Budget Options*, is for 2010-2019. Assuming inflation, the savings figure should increase for later 10 year periods including 2011-2020 and 2012-2021.
[254] Government Accountability Office, "Tax-Exempt Status of Certain Bonds Merits Reconsideration, and Apparent Noncompliance with Issuance Cost Limitations Should Be Addressed", in *Government Accountability Office* <http://www.gao.gov/highlights/d08364high.pdf> [accessed 28 April 2011]

highly subjective and relies on vague guidelines, leaving it vulnerable to the influence of lobbyists and other interested parties.[255]

Ending this tax expenditure would improve economic efficiency.[256] Private sector projects should stand on their own merits. If market-rate financing is inadequate, then these projects should probably not be financed. Further, even if we did wish to subsidize these private-sector projects, a tax exemption for private-activity bonds is a roundabout way to achieve that goal. There are far more direct methods of subsidizing these projects that do not sacrifice so much in the way of economic efficiency. If we rolled back subsidies for private-activity bonds, we could save approximately $23 billion over the next 10 years, according to the CBO.

## RECOMMENDATION 8 → $6.2 BILLION IN SAVINGS OVER 10 YEARS[257, 258]

### ►*Cut subsidies for Blue Cross/Blue Shield.*

Blue Cross/Blue Shield providers were originally awarded tax exempt status in the 1930s for their role in providing health insurance to high-risk individuals. But due to the more profit-oriented business activities that Blue Cross/Blue Shield providers adopted in subsequent decades, this tax exemption was partly rolled back in 1986.[259] Since then, only those Blue Cross/Blue Shield providers that meet community-service standards have qualified for this special tax treatment, which includes:

1. The right to be treated as a stock property insurance company instead of as a health insurance company.
2. The right to fully deduct unearned premiums, unlike other property and casualty insurance companies.
3. The right to take a special deduction of 25 percent of the year's health-related claims and expenses minus accumulated surplus at the beginning of the year.[260]

[255] Internal Revenue Service, "Tax-Exempt Private Activity Bonds", in *Internal Revenue Service* <http://www.irs.gov/pub/irs-pdf/p4078.pdf> [accessed 28 April 2011]
[256] Congressional Budget Office, "Budget Options Volume 2", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf> [accessed 22 April 2011]
[257] Office of Management and Budget, "Fiscal Year 2012 Budget of the U.S. Government", in *Office of Management and Budget* <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/teb2012.xls> [accessed 28 April 2011]
[258] The original cost savings estimate was $3.1 billion over five years. We believe that $6.2 billion over 10 years is a reasonable assumption because (1) the Blue Cross/Blue Shield subsidy is not a one-off expense and (2) we err on the side of caution and ignore inflation.
[259] Subsidy Scope, "Special BlueCross BlueShield Deduction" <http://subsidyscope.org/nonprofits/tax-expenditures/blue-cross-blue-shield/> [accessed 28 April 2011]
[260] Cornell Law School Legal Information Institute, "U.S. Code" <http://www.law.cornell.edu/uscode/26/usc_sec_26_00000833----000-.html> [accessed 2011 April 28]

However, the rationale supporting this special tax treatment is no longer substantiated by the facts. Originally, BlueCross/BlueShield received this special tax treatment because it was the main, if not the sole, provider of insurance to small group, high risk individuals. However, as Blue Cross/Blue Shield providers' business model became "commercial rather than charitable", Congress decided it wanted to avoid giving an unfair competitive advantage to BlueCross/BlueShield providers and limited the availability of the special tax treatment.[261]

Today, even this more limited special tax treatment no longer makes sense. The new health care reform law will make it so that BlueCross/BlueShield providers are no longer the main insurers of high risk individuals and small groups. This means that we can eliminate the special subsidy to Blue Cross/Blue Shield without adversely impacting these vulnerable individuals, and at the same time generate $6 billion in savings over the next 10 years.

## RECOMMENDATION 9 → $25.2 BILLION IN SAVINGS OVER 10 YEARS[262, 263]

### ►*Cut subsidies for employment-based life insurance.*

Under current law, life insurance provided by an employer is excluded from an employee's taxable income. This results in an "incentive for employees to buy more life insurance than they would if they paid the full cost themselves." The key questions for policymakers are (1) whether this subsidy is appropriately designed, and (2) whether it is in the public interest.

The first strike against this subsidy is that its design is extremely unfair. As the CBO puts it, the result of this incentive for employers to purchase life insurance, "In terms of fairness", is that "workers whose employers purchase life insurance for them pay less in taxes than do workers who have the same total compensation but who buy their own insurance."[264] There's no question that this is unfair to workers who have to buy their own taxable life insurance, especially since their taxes pay for the tax exemption on employer-provided life insurance that benefits others.

The second strike against this subsidy is that it is not in the public interest. While extra life insurance will likely not hurt anyone, the artificially low cost of employer-provided life insurance distorts the marketplace by drawing resources from other more potentially profitable activities. The CBO estimates that this subsidy will consume $25.2 billion in taxpayer dollars over the next 10 years. Were extra life insurance a public good, then the scale might be tilted

[261] The New York Times, "Blue Cross Tax Status is Challenged", in *The New York Times* <http://www.nytimes.com/1986/07/04/us/blue-cross-tax-status-is-challenged.html> [accessed 2011 April 28]
[262] Congressional Budget Office, "Budget Options Volume 2", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf> [accessed 22 April 2011]
[263] This savings estimate, from the CBO's 2009 *Budget Options*, is for 2010-2019. Assuming inflation, the savings figure should increase for later 10 year periods including 2011-2020 and 2012-2021.
[264] Congressional Budget Office, "Budget Options Volume 2", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf> [accessed 22 April 2011]

in the other direction, but there is no good reason to believe that the private marketplace cannot efficiently allocate resources to the purchase of life insurance.

### RECOMMENDATION 10 → $9.8 BILLION IN SAVINGS OVER 10 YEARS[265, 266]

### ►*Cut subsidies for agribusinesses.*

Agribusiness benefits from a number of federal subsidies, many of which are discussed later in this report. But three of those subsidies are delivered through the tax code. They are:

**Agribusiness subsidies**

1. Capital gains treatment for agricultural items
2. Expensing of certain multi-period planting costs
3. Expensing of capital outlays for fertilizer and feed

As the Center for American Progress points out, "These are special tax subsidies that other industries do not get. Certain portions of their income are taxed at a much lower rate, and they are able to immediately write off many of their costs instead of recouping those costs over a number of years as companies in most other industries do."[267] We also support cutting these tax subsidies for agribusinesses, which would save approximately $10 billion over the next 10 years.

## ⭘Limit Tax Subsidies for High Income Individuals

### RECOMMENDATION 11 → $71.2 BILLION IN SAVINGS OVER 10 YEARS[268]

### ►*Cut subsidies for income earned abroad.*

Currently, U.S. citizens living abroad can exclude a large part of their foreign-earned income from taxation. For calendar year 2009, the excludable income was any income up to $91,400.[269] Cutting this subsidy for earning income abroad would still retain a tax credit for taxes paid to foreign governments.

The best reason for eliminating this tax subsidy is one of fairness. As the CBO explains, "U.S. citizens with similar income should incur similar tax liabilities, regardless of where they live or

[265] Michael Ettlinger and Seth Hanlon, "Cut Spending in the Tax Code", in *Center for American Progress* <http://www.americanprogress.org/issues/2011/03/pdf/tax_expenditures.pdf> [accessed 2011 April 28]
[266] The original cost savings estimate was $4.9 billion over five years. We believe that $9.8 billion over 10 years is a reasonable assumption because (1) the agribusiness subsidies are not one-off expenses and (2) we err on the side of caution and ignore inflation.
[267] Michael Ettlinger and Seth Hanlon, "Cut Spending in the Tax Code", in *Center for American Progress* <http://www.americanprogress.org/issues/2011/03/pdf/tax_expenditures.pdf> [accessed 2011 April 28]
[268] Congressional Budget Office, "Budget Options Volume 2", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf> [accessed 22 April 2011]
[269] Congressional Budget Office, "Budget Options Volume 2", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf> [accessed 22 April 2011]

what services they receive from the government. That principle is violated if people can move to low-tax foreign countries and escape U.S. taxation while retaining their U.S. citizenship."[270] Eliminating this subsidy would save the U.S. government at least $71 billion over the next 10 years.

## RECOMMENDATION 12 → $12.2 BILLION IN SAVINGS OVER 10 YEARS[271, 272]

### ►*Cut the mortgage interest deduction for vacation homes.*

Each year, the federal government forgoes $104.5 billion in tax revenue that would otherwise be collected by the baseline tax code. This huge sum of money subsidizes the purchase of homes by allowing homeowners to deduct their mortgage interest payments from their tax liability. But many economists are unconvinced that the mortgage interest deduction actually encourages homeownership. Either way, the mortgage interest deduction should not be subsidizing the purchases of *vacation* homes and yachts,[273] which by definition do not increase home ownership rates. But vacation home and yacht deductions end up costing approximately $1.2 billion each year, or $12 billion over 10 years.

**"The mortgage interest deduction should not be subsidizing the purchases of vacation homes and yachts, which by definition do not increase home ownership rates."**

We recommend limiting the mortgage interest deduction to primary residences. There is no reason for American taxpayers to be subsidizing the purchase of pleasure boats and expensive vacation homes.[274]

## RECOMMENDATION 13 → $321.3 BILLION IN SAVINGS OVER 10 YEARS[275]

### ►*Limit deductions for high-income taxpayers.*

Another way to generate savings from tax expenditures would be to cap them on a per taxpayer basis. This could be done for all taxpayers, or just for those in the upper income

[270] Congressional Budget Office, "Budget Options Volume 2", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf> [accessed 22 April 2011]
[271] Michael Ettlinger and Seth Hanlon, "Cut Spending in the Tax Code", in *Center for American Progress* <http://www.americanprogress.org/issues/2011/03/pdf/tax_expenditures.pdf> [accessed 2011 April 28]
[272] The original cost savings estimate was $6.1 billion over five years. We believe that $12.2 billion over 10 years is a reasonable assumption because (1) the continuing mortgage interest deduction for second homes and yachts is not a one-off expense and (2) we err on the side of caution and ignore inflation.
[273] This statement applies only to boats that are classified as second residences.
[274] We do not recommend cutting the deduction for boats that are used as primary residences.
[275] Office of Management and Budget, "Fiscal Year 2012 Budget of the U.S. Government, Receipts", in *Office of Management and Budget* <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/receipts.pdf> [accessed 28 April 2011]

brackets. This approach would avoid the tricky logistical issues of other caps while still generating billions of dollars in savings.

Capping tax expenditures for just the upper income brackets seems like the best approach given the already regressive nature of tax expenditures. Considering this same issue, Leonard Burman asks, "For example, would it make sense to design a health insurance voucher worth 35 cents per dollar for high-income families, but only 10 cents per dollar for those with low income?"[276] The answer is obviously no, but that's the system we've got in place. However, were we to cap tax expenditure benefits for upper income taxpayers, we could compensate for the regressive nature of tax expenditures.

President Obama has proposed a cap on upper income itemized tax expenditure benefits in several budgets, including for Fiscal Year 2012.[277] His proposal would "limit the tax rate at which high-income taxpayers can take itemized deductions to 28 percent." In other words, a deduction could not be worth more than 28 percent of its full value to upper income earners, even if they're in the 35 percent income tax bracket. As the Tax Policy Center explains it, "If you're in the 35 percent bracket, a $100 deduction is worth $35. If you are in the 10 percent bracket, it is only worth $10. The Obama plan would take a step towards turning these deductions into quasi-credits by limiting their value to no more than 28 percent, no matter how much you earn."[278] This would generate approximately $321 billion in savings over 10 years.

## ❍Split Savings between Tax Cuts and Deficit Reduction

### RECOMMENDATION 14 → VARIABLE DEFICIT INCREASE OVER 10 YEARS

### ►*Reduce individual and corporate tax rates.*

Nearly all of the tax reforms described in this section involve cutting tax subsidies, which are essentially spending programs in disguise. While our long-term fiscal situation demands that a large portion of the savings from cutting those spending programs goes towards deficit reduction, it does not require that some cannot also be used to reduce the tax burden on corporations and individuals.

The question is not whether individual and corporate taxes should be lowered, but rather by how much. The cuts to tax subsidies that we have recommended in this section add up to

[276] Leonard Burman, "Let's freeze more than chump change", in *The Washington Post* <http://www.washingtonpost.com/wp-dyn/content/article/2010/02/01/AR2010020103072.html> [accessed 28 April 2011]
[277] Office of Management and Budget, "Fiscal Year 2012 Budget of the U.S. Government", in *Office of Management and Budget* <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/budget.pdf> [accessed 28 April 2011]
[278] Howard Gleckman, "Obama's Plan to Cap Tax Deductions", in *Tax Policy Center* <http://taxvox.taxpolicycenter.org/2009/02/26/obama%e2%80%99s-plan-to-cap-tax-deductions/> [accessed 28 April 2011]

$600-800 billion in savings over the next 10 years. We believe that some percentage of that should be used to lower individual and corporate tax rates.

## ❍Consider Other Options

In addition to our 14 key recommendations, we have included a few more tax expenditure reform ideas that merit consideration. The first of these is an alternative to the cap on deductions for high-income earners and would instead cap the total amount of tax expenditures as a percent of GDP. The second option is a comprehensive tax reform that would eliminate most tax expenditures and divide the savings between tax cuts and deficit reduction. However, we also believe that, short of eliminating all or most tax expenditures, there are still plenty more that should be cut. Implementing a tax expenditure performance review system like the one we recommended in our *Part One* report might help us identify the less justifiable tax expenditures.

### OPTION 1 → $3.5 TRILLION IN SAVINGS OVER 10 YEARS[279]

### ►*Cap tax expenditures as a percent of GDP.*

Another option for tax expenditure reform is to cap tax expenditures as a percent of GDP. This could complement other approaches, especially insofar as it would force policymakers to prioritize among existing tax expenditures, modifying or eliminating the less important ones so that the entire tax expenditure budget could fit within the cap.

Leonard Burman, a professor of economics at Syracuse University and the former director of the Urban-Brookings Tax Policy Center, supports this top-down cap. His plan would take President Obama's proposed freeze on domestic discretionary spending—which would generate $250 billion in savings over 10 years—and apply it to tax expenditures beginning in the year 2012. Then, beginning in 2015, Burman would allow the cap to rise, indexing it for inflation.[280] How much does this plan generate in savings? —A whopping $3.5 trillion over 10 years. This is an impressive number, no doubt, but there are reasons to be skeptical.

First, there's really no mechanism in place to sort out which tax expenditures should be preserved and which should be discarded. Perhaps this could take place in the two tax-writing committees, but the idea of imposing limits on tax-writers is fraught with difficulty. Not only are loopholes likely to proliferate, but there's no precedent of similar controls working for the appropriations process.

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[279] Leonard Burman, "Let's freeze more than chump change", in *The Washington Post* <http://www.washingtonpost.com/wp-dyn/content/article/2010/02/01/AR2010020103072.html> [accessed 28 April 2011]

[280] Leonard Burman, "Let's freeze more than chump change", in *The Washington Post* <http://www.washingtonpost.com/wp-dyn/content/article/2010/02/01/AR2010020103072.html> [accessed 28 April 2011]

Second, not having a specific price tag attached to any more than a few of these tax expenditures is problematic. Whereas most spending programs are appropriated to a specific dollar amount, tax expenditures are usually open-ended in commitment. Capping tax expenditures would require a complicated claims system that would end up creating an incentive to claim benefits before the cap was reached. In the end, this could create marketplace distortions that would do more harm than good.

However, Citizens for Tax Justice has observed that there are ways to overcome these difficulties. Specifically, Congress could cap tax expenditures at a particular amount each year, and any increase above that amount, as projected by the Joint Committee on Taxation, would have to be made up through cuts in tax expenditures. However, should Congress fail to agree to the necessary amount of cuts, then a automatic trigger would be in place to reduce certain tax expenditures (say itemized deductions) by the necessary amount. The idea is that these automatically triggered reductions in tax expenditures would be so politically unpalatable as to impel Congress to pass its own agreed-upon cuts to the necessary amount.

This plan may work, but given the complex steps necessary in its implementation, it is probably not an ideal option. Still, the potential savings from this plan—$3.5 trillion over 10 years!—necessitate its inclusion in our list of options worth considering.

## OPTION 2 → VARIABLE SAVINGS OVER 10 YEARS[281]

### ►*Eliminate most tax expenditures and split the savings.*

Recommendation 12 in this section suggests dividing any tax expenditure savings between deficit reduction and broad-based tax cuts. However, that would only apply to the tax expenditures that we have identified for elimination in our earlier recommendations. One could go several steps further and make the case for comprehensive tax reform that would eliminate most, if not all, tax expenditures and other similar loopholes while (1) dramatically reducing the deficit and (2) lowering broad-based rates.

The National Commission on Fiscal Responsibility and Reform did exactly that. In its tax reform plan, the Commission lists three options: (1) Eliminate all tax expenditures, (2) Eliminate all except keep the Child Tax Credit and the Earned Income Tax Credit (EITC), and (3) Eliminate all except the Child Tax Credit, the EITC, the mortgage interest deduction for principal residences, the exemption for employer-provided health insurance, and those tax benefits for charitable giving, retirement savings, and pensions. Even under this third option, which keeps several big tax expenditures, the corporate tax rate would drop from 35 percent to 28 percent, and individual income tax rates would be no higher than 28 percent (for current 33 and 35 percent

[281] National Commission on Fiscal Responsibility and Reform, in *The Moment of Truth* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf> [accessed 22 April 2011]

brackets), 22 percent (for current 25 and 28 percent brackets), and 12 percent (for current 10 and 15 percent brackets).

This sort of comprehensive tax reform plan, when paired with a deficit reduction plan, makes a lot of sense and, if executed properly, would go a long way towards making our long-term fiscal path more sustainable.

# Conclusion

Our recommendations in this section will generate savings of $600-800 billion over the next 10 years. These savings should be split between deficit reduction on the one hand and broad-based tax cuts on the other.

One important reason to go after tax expenditures is that many are low-hanging fruit for reform or elimination. For years, the tax code has been used to disguise these spending programs as either tax cuts or as "normal" elements of the tax code. For this reason, tax expenditures have escaped the scrutiny that budgeted spending programs receive on an annual basis. This cannot continue any longer. Tax expenditures are spending programs without the intermediate step of tax collection. Rather than having the IRS collect taxes and the government spend them, tax expenditures skip that collection step and directly redistribute wealth from all Americans to the special interests that have lobbied most effectively.

In our last report, *Part One*, we explored several reforms that could increase oversight of tax expenditures. We strongly support those reforms, and we also believe that now is the time to cut those tax expenditures which are no longer justifiable.

# REINVENTING SOCIAL SECURITY

## OUR SEVEN KEY RECOMMENDATIONS

### Revenue Increases

► ***RECOMMENDATION 1: Extend the payroll tax to capture 90 percent of covered wages.***

➲ ***Potential Savings: $107 billion over 10 years; $1.4 trillion over 30 years***

► ***RECOMMENDATION 2: Include non-covered state and local government workers.***

➲ ***Potential Savings: $4 billion over 10 years; $566 billion over 30 years***

► ***RECOMMENDATION 3: Improve the collection of existing taxes.***

➲ ***Potential Savings: $580 billion over 10 years***

### Benefit Adjustments

► ***RECOMMENDATION 4: Adopt a chained consumer price index.***

➲ ***Potential Savings: $92 billion over 10 years; $1.4 trillion over 30 years***

► ***RECOMMENDATION 5: Gradually increase retirement age to 68 for those born after 1976.***

➲ ***Potential Savings: 23-25 percent of the Trust Fund shortfall***

► ***RECOMMENDATION 6: Modify the benefits formula to add a third bend point.***

➲ ***Potential Savings: 25 percent of the Trust Fund shortfall***

### Increased Support for Low-Income Individuals

► ***RECOMMENDATION 7: Restructure the minimum payment for low-income individuals.***

➲ ***Increases 75 year Trust Fund shortfall by eight percent***

**Recommended Shortfall Closed**

**➲ 100 percent[282]**

[282] Based on staff calculations and pending review by the actuaries of the Social Security Administration.

# Our Approach to Social Security Reform

Of all this country's fiscal woes, Social Security's problems should be—in theory, at least—among the easiest to fix. We agree there is a problem; we know the fiscal magnitude of the problem; we still have time to fix it. And it's an issue in which every working American holds a stake.

It took the threat in 1983 of Trust Fund insolvency to prompt President Reagan and a Democratic Congress to approve a package of tax increases and benefit cuts to maintain Social Security's solvency for the last 28 years. Since then, however, Social Security has become the epicenter of an ideological battle over the role of government, thwarting any attempt at meaningful change.

> ***"Social Security...is not a dole or a device for giving everybody something for nothing. True Social Security must consist of rights which are earned rights—guaranteed by the law of the land."***
> **– Harry Truman, August 13, 1945**

Some argue the government can fix Social Security by effectively privatizing it—allowing beneficiaries to divert a portion of the payroll taxes into personal accounts invested in stocks and bonds. But we believe that Social Security—and the defined benefit it guarantees, regardless of stock market volatility or economic twists and turns—is an elemental part of the compact this country has with its workers.

Still, it is an expensive relationship. Social Security has morphed into a $700-plus billion budgetary gorilla, paying benefits last year to 52.5 million Americans. In 2011, Social Security covers an estimated 157 million workers, according to the Social Security Administration.[283]

Despite $2.6 trillion in assets and total income in 2010 of $781 billion, the program's trust fund is projected to be exhausted in 2037, when incoming revenues will pay for about 78 percent of scheduled annual benefits. It is estimated that between 2010 and 2084, the Social Security system's unfunded obligation nears $5.4 trillion—or about 0.6 percent of the GDP.[284]

In the near term, Social Security officials project that the system will spend more than it receives in tax revenues in 2010 and 2011 before operating at a surplus for a few years. Beginning in 2015, however, cash flow deficits will remain permanent—barring changes to the system—and will deplete the Trust Fund in 2037.

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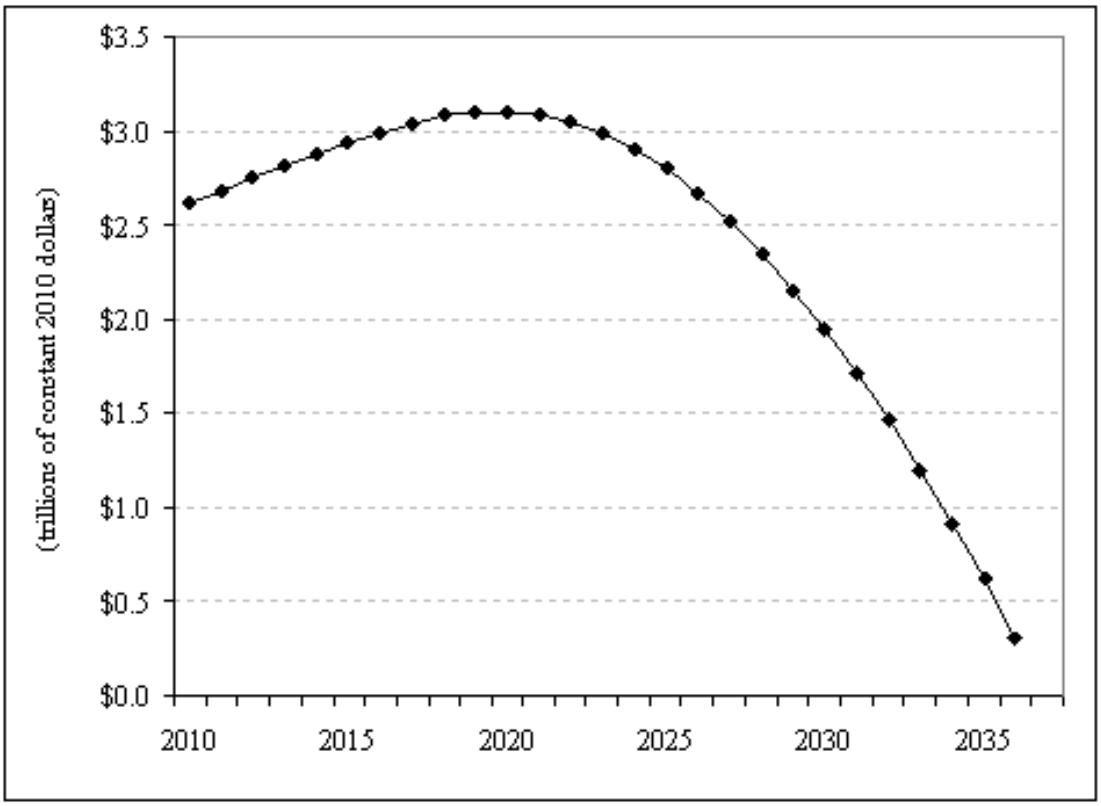
[283] Social Security Administration, "Social Security Administration" <http://www.ssa.gov/> [accessed 9 May 2011]
[284] The Board of Trustees, Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, "The 2010 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds", in *Social Security Administration* <http://www.ssa.gov/OACT/TR/2010/tr2010.pdf> [accessed 3 May 2011]

## Figure 3: Projected Social Security Trust Fund Balances 2010-2036[285]




An aging populace and a shrinking number of workers largely account for the bleak fiscal forecast. Between 2010 and 2030, the number of beneficiaries will increase by 68 percent. Meanwhile, the number of workers supporting the system will increase by only 19 percent. That means the number of workers supporting each Social Security recipient will decline from 2.9 today to 2.1 in 2035, according to the Social Security Board of Trustees.

Meanwhile, the cost of benefits continues to rise. Social Security benefits are tied to wages rather than prices. Since wages typically rise faster than prices, initial monthly benefits have increased in real terms for each generation. And these benefits are crucial. For more than half of elderly beneficiaries, Social Security provides the majority of their cash income. For about 25 percent of elderly beneficiaries, the program provides more than 90 percent of their income. For 15 percent of elderly beneficiaries, Social Security is the sole source of retirement income. The average retired worker benefit is about $14,000 a year. In 2010, the maximum benefit paid was $28,000.

[285] The Board of Trustees, Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, "The 2010 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds", in *Social Security Administration* <http://www.ssa.gov/OACT/TR/2010/tr2010.pdf> [accessed 3 May 2011]

The increase in life expectancy has contributed to the program's fiscal woes. Since 1940, men and women reaching age 65 are likely to live about six years longer than previously expected—to about 83 for men and 85 for women.

The statutory Social Security payroll tax rate is 12.4 percent and the current taxable maximum for 2011 is $106,800. Prior to 1975, this maximum was periodically revised by Congress, but the annual adjustments became mostly automatic thereafter, based on average wage growth. Although the maximum taxable is indexed to average wage growth, the actual proportion of covered wages subject to the tax has decreased since the early 1980s, as wages have fragmented. Wages are now less equally distributed, with a larger share of high-wage earners above the taxable maximum.

Against this demographic backdrop, program costs have continued to escalate rapidly. Spending for Social Security will approach 4.8 percent of the GDP in 2010 and climb to 6.1 percent of the GDP by 2035. If there is *one lesson* to be learned from all of these statistics, it is this: The longer we delay, the worse the problem becomes—and the more expensive to fix.

For example, the Congressional Budget Office looked at two proposed changes to Social Security—changes that we do not necessarily endorse—and examined the potential costs of delaying their implementation. What is instructive are not the specifics of the proposals, but the fact that decisive action saved billions.

***"To every American out there on Social Security, to every American supporting that system today, and to everyone counting on it when they retire, we made a promise to you, and we are going to keep it."***
**– George H.W. Bush, January 31, 1990**

In the first case, the CBO examined a two percent boost to the payroll tax over the next 20 years. The agency found that if the plan were implemented in 2012, the boost in revenue would have a more significant impact on the Trust Fund balance, prolonging a positive balance until 2083. Delaying the increase by 10 years, however, would knock nearly 30 years off the Trust Fund's life, leading to a negative balance in 2056.

Similarly, when the CBO looked at the impact of a 15 percent cut in benefits for new beneficiaries, delaying the changes from 2017 to 2027 required that the cuts be increased by one-third to achieve the same effect. These two examples illustrate the fiscal pitfalls of delay. Irrespective of the package of adjustments we ultimately choose, it will be more cost effective to implement changes now rather than later.

In the recommendations that follow, we take key steps in restoring Social Security to firm financial footing, greatly closing—if not eliminating—the Trust Fund shortfall that threatens this vital program. We believe these recommendations, which would not apply to those 55 years of

age or older, reflect the fiscal, social, and demographic realities that now define our society. And most importantly, we believe these changes will allow America to keeps its promise to older Americans—a promise of dignity and a measure of security in retirement.

# Our Seven Key Recommendations

## ❍Revenue Increases

### RECOMMENDATION 1 → $107 BILLION OVER 10 YEARS; $1.4 TRILLION OVER 30[286]

### ►*Extend the Social Security payroll tax to capture 90 percent of covered wages.*

When the Roosevelt Administration first advanced the idea of Social Security, it did not include a maximum taxable wage—nor did the draft bill that went to Congress include a limit. Roosevelt was concerned about the number of elderly living in poverty at the time and intended the program to provide the indigent with a safety net.

But the lack of a cap changed as the Social Security legislation winded its way through Congress, ultimately emerging with a $3,000 ceiling on taxable earnings. In the 1970s, as a means of financing Social Security cost of living adjustments, Congress implemented a process to automatically adjust the maximum taxable wage.

Currently workers pay Social Security tax on salaries up to $106,800, with the cap indexed to mirror the increase in average earnings. Congress envisioned about 90 percent of covered wages being subject to the tax. But there has been faster wage growth at the upper end of the wage spectrum, and the cap now covers only about 83 percent of wages in covered employment. This growing disparity helps make the argument that the 90 percent tax level should be restored—and maintained with periodic adjustments.

Experts say gradually raising the cap would mean that earnings up to around $180,000 would be initially subject to the Social Security tax. Increasing the cap will not only restore equity, but it will also close about 30 percent of the 75-year Trust Fund deficit—with a relatively small percentage of workers affected. This proposal has received wide support from many experts, ranging from the Bipartisan Policy Center to the President's Fiscal Commission.

### RECOMMENDATION 2 → $4 BILLION OVER 10 YEARS; $566 BILLION OVER 30 YEARS[287]

### ►*Include non-covered state and local government workers.*

Currently, 93 percent of all workers are covered by Social Security, but an estimated four million state and local government employees have their own pension plans and have opted

[286] The Debt Reduction Task Force, "Restoring America's Future", in *Bipartisan Policy Center* <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [accessed 27 April 2011]

[287] The Debt Reduction Task Force, "Restoring America's Future", in *Bipartisan Policy Center* <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [accessed 27 April 2011]

out of Social Security. That makes for complicated retirement planning and, given the dire fiscal health of some state and local pension plans, creates unnecessary risk for workers.

By requiring new state and local government hires to participate in Social Security, another nine percent of the 75-year Trust Fund shortfall would be closed. This is an idea advanced by others, including President Obama's Fiscal Commission—and it makes fiscal sense.

### RECOMMENDATION 3 → $580 BILLION IN SAVINGS OVER 10 YEARS[288]

### ►*Improve the collection of existing payroll taxes.*

According to a 2010 hearing held by the Senate Special Committee on Aging, the IRS reports that approximately $58 billion in Social Security tax goes uncollected annually. The gap is largely due to under-reported self-employment taxes. The Committee concluded that "increasing the collection of unpaid Social Security payroll taxes could significantly reduce the funds needed to make Social Security solvent over the next 75 years." We agree.

## ➊Benefit Adjustments

### RECOMMENDATION 4 → $92 BILLION OVER 10 YEARS; $1.4 TRILLION OVER 30 YEARS[289]

### ►*Adopt a chained consumer price index.*

Social Security benefits are currently adjusted using one cost-of-living measure known as the CPI-W. But government economists have developed a new measure that more accurately reflects changes in prices because it tracks changes in purchasing across a range of consumer categories.

But this "chained" CPI grows at an annual rate 0.3 percent slower than the traditional measure. Critics say that this will result in lower benefits for seniors, but the current formula overstates inflation. Adopting this provision will help close the funding gap in the Trust Fund by about 25 percent, thereby contributing to the fiscal health of the entire program.

[288] United States Senate Special Committee on Aging, "Social Security Modernization: Options to Address Solvency and Benefit Adequacy", in *United States Senate Special Committee on Aging* <http://aging.senate.gov/ss/ssreport2010.pdf> [accessed 3 May 2011]

[289] The Debt Reduction Task Force, "Restoring America's Future", in *Bipartisan Policy Center* <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [accessed 27 April 2011]

## RECOMMENDATION 5 → 23-25 PERCENT OF THE TRUST FUND SHORTFALL[290]

### ►*Gradually increase full retirement age to 68 for those born after 1976.*

Americans are living longer. When Social Security became law, the average life expectancy was 64 and the retirement age was 65. On average, Americans now spend 20 years in retirement, and Social Security needs to reflect the new reality.

Gradually increasing the full retirement age to 68 for people born in 1977 or later—and speeding up the increase in retirement age to 67 for those born in 1953 or later—would eliminate nearly one-quarter of the long-term Trust Fund deficit. The increase provides adequate time for those future beneficiaries, who are still in their 30s, to plan their retirements. This increase also maintains the current ratio of retirement years to work years.

Some will argue the increase favors higher wage employees, who have longer life expectancies than their blue-collar contemporaries. Accordingly, a hardship provision should be implemented to protect disabled workers from an increase in the FRA.

## RECOMMENDATION 6 → 25 PERCENT OF THE TRUST FUND SHORTFALL[291]

### ►*Modify the benefits formula to add a third bend point.*

Modifying the benefit formula by adding an additional "bend point" would achieve two important aims of Social Security: it would increase the progressivity of benefits to the advantage of lower- and middle-wage earners and help close the projected 75-year Trust Fund shortfall.

> **"The goal is to increase the progressivity of benefits to the advantage of lower- and middle-wage earners and help close the projected 75-year Trust Fund shortfall."**

As has been suggested by the President's Fiscal Commission and others, we favor a benefit formula that adds a third bend point, creating a four-bracket formula, and modifies the replacement factors. The goal is to change the formula in such a way that achieves a 25 percent reduction in the projected Trust Fund solvency gap *and* protects benefits for lower- and middle-wage earners.

We believe that one way to attain that goal would be to change the current replacement factor structure from 90 percent, 32 percent, and 15 percent to a more progressive structure of 90

[290] United States Senate Special Committee on Aging, "Social Security Modernization: Options to Address Solvency and Benefit Adequacy", in *United States Senate Special Committee on Aging* <http://aging.senate.gov/ss/ssreport2010.pdf> [accessed 3 May 2011]

[291] American Association of Retired Persons, "Reform Options for Social Security", in *American Association of Retired Persons* <http://assets.aarp.org/rgcenter/econ/i3_reform.pdf> [accessed 3 May 2011]

percent, 55 percent, 25 percent, and 12 percent. The exact changes to the formula—such as the dollar amounts for each bend point —would be determined at the time of implementation.

Whatever the final numbers, the goals of the changes remain the same: a 25 percent reduction in the projected Trust Fund shortfall and the enhancement of benefit adequacy — a pillar of the Social Security program.

## ❍Increased Support for Low-Income Individuals

### RECOMMENDATION 7 → INCREASES 75 YEAR SHORTFALL BY EIGHT PERCENT[292]

### ►*Restructure the minimum payment for low-income individuals.*

The very soul of Social Security centers on protecting the most vulnerable of society. According to the CBO, eight percent of all Social Security beneficiaries over age 65 are considered poor. That percentage nearly doubles for single senior citizens.

Current law includes a special minimum benefit for workers who have toiled for years in low-paying jobs. Currently, that special benefit tops out at $763 a month—or about 85 percent of federal poverty guidelines—for workers with 30 years of Social Security-covered wages.

> **"The very soul of Social Security centers on protecting the most vulnerable of society."**

But this benefit is reaching fewer beneficiaries each year—from 142,000 in 2000 to about 82,000 in 2009. That's because the special minimum benefit is tied to prices, while Social Security benefits are indexed to wages (which have traditionally risen faster than prices). Since a worker is awarded the special minimum only if it exceeds the regular benefit, the Social Security Administration predicts that by 2012, the special minimum will cease to raise benefits for workers reaching age 62. In order to provide a higher initial benefit for a larger number of low-wage workers in a job covered by Social Security, we advocate providing a new minimum benefit that equals 125 percent of the poverty line and is indexed to wages.

This restructuring would be based on the number of years of qualifying work, increasing the benefit in accordance with the length of employment up to 30 years. The CBO estimates in 2012 that the monthly benefit for a person age 65 who has worked 30 years would be about $1,170 a month—or 125 percent of the poverty level. For workers with less than 30 years, the special minimum would be decreased to zero for employees with less than 10 years of work. Benefits would increase about 30 percent for low wage earners born in 2000.

[292] Congressional Budget Office, "Social Security Policy Options", in *Congressional Budget Office* <http://www.cbo.gov/ftpdocs/115xx/doc11580/07-01-SSOptions_forWeb.pdf> [accessed 3 May 2011]

A number of groups, including President Obama's Fiscal Commission, have advocated increasing the special minimum benefit—and we agree.[293] Expansion of this benefit serves an important societal role despite its impact on the Trust Fund.

Expanding the new minimum benefit to 125 percent of the poverty level would add about eight percent to the 75-year Trust Fund shortfall. But when implemented in concert with the other recommended measures, it would not upend the Trust Fund's financial stability, and it would move the Social Security system more in line with its original mission.

# Conclusion

Social Security represents one of the pillars of social justice in this country: the right of workers to retire in dignity instead of poverty. The 1983 reforms to Social Security—accomplished through the collaboration of a Republican President and Democratic Speaker of the House—restored the fiscal health of the program for the next 25 years.

We have the chance to accomplish something even more dramatic. Changes to income subject to taxable income limits, modest adjustments to retirement age, and expanding coverage to some state and local employees could assure retirees of a defined benefit for decades to come. These adjustments will not have any impact on people over the age of 55.

Private accounts—while politically attractive in this anti-government era—are fraught with unknowns: How much will these accounts costs? Who will manage them? Where in the federal budget will the money come from to cover the transition costs? Ironically, those advocating private accounts in the name of smaller government will actually be creating another layer of government in order to manage the accounts.

To minimize the impact on future beneficiaries—and to restrain costs—we must act now to ensure the solvency of Social Security. Our children depend on it.

[293] National Commission on Fiscal Responsibility and Reform, in *The Moment of Truth* <http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf> [accessed 22 April 2011]

# REINVENTING FARM SUBSIDIES

## OUR FIVE KEY RECOMMENDATIONS

### Introduce Market-Based Reforms

► ***RECOMMENDATION 1: Reduce and eventually eliminate direct payments to farmers.***

➲ ***Potential Savings: $50 billion over 10 years***

► ***RECOMMENDATION 2: End counter-cyclical payments to farmers.***

➲ ***Potential Savings: $6 billion over 10 years***

### Set Caps on Payments and Income Level

► ***RECOMMENDATION 3: Set a cap on payments to farmers and ranchers.***

➲ ***Potential Savings: $1.1 billion over 10 years***

► ***RECOMMENDATION 4: Lower the cap on adjusted gross income (AGI).***

➲ ***Potential Savings: $1.5 billion over 10 years***

### Make Farm Subsidy Programs More Efficient

► ***RECOMMENDATION 5: Scale back ineffective programs like ACRE and SURE.***

➲ ***Potential Savings: $35 billion over 10 years***

**Recommended Minimum Potential Savings**

**➲ $50-60 billion over 10 years**

# Our Approach to Farm Subsidy Reform

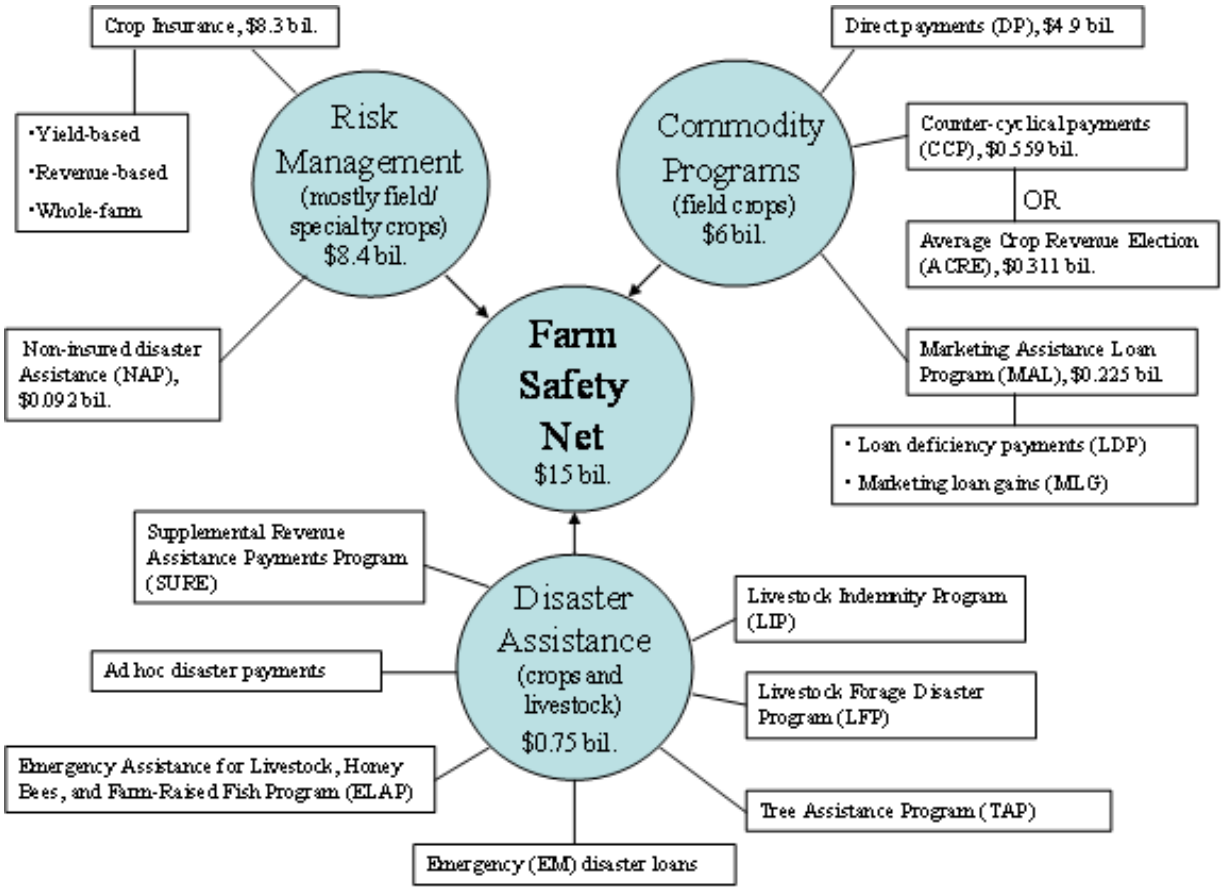
Agricultural (or farm) subsidies, which are paid to landowners by the U.S. Department of Agriculture (USDA), are a favorite topic within the budgetary reform community for several reasons. First, it's clear that larger farms are shifting production towards the eight crops that bring in the most federal dollars: wheat, corn, barley, oats, sorghum, rice, cotton, and oilseeds.[294] This directly contributes to the decline of smaller farms. Second, the artificial incentive to produce cash crops—which go to foreign markets, not American kitchen tables—distorts international trade, thereby violating current trade agreements and WTO policy.

The Environmental Working Group estimates that payments to farmers[295] under federal farm programs totaled one quarter of a trillion dollars between 1995 and 2009.[296] Farm safety net programs can be divided into three main categories:

1. **Commodity programs:** These programs average $6 billion in payments annually and include direct payments, counter-cyclical payments, ACRE (Average Crop Revenue Election) Program, and marking assistance (for example, Farm Service Agency Loan Deficiency Payments/marking assistance loans).
2. **Risk management tools:** These programs average $8.4 billion in payments annually, and include crop insurance and NAP (Noninsured Crop Disaster Assistance Program), which is essentially catastrophic coverage for non-insurable crops.
3. **Disaster assistance:** These programs, totaling $2 billion in payments and brand new in the 2008 farm bill, include Supplemental Revenue Assistance Payments (SURE), the Landowner Incentive Program (LIP), Livestock Forage Program (LFP), Livestock, Honey Bees, and Farm-Raised Fish Program (ELAP), and the Tree Assistance Program (TAP).

[294] Government Accountability Office, "Farm Programs: Information on Recipients of Federal Payments", in *Government Accountability Office* <http://www.gao.gov/new.items/d01606.pdf> [accessed 2 May 2011]
[295] This includes disaster assistance and conservation payments.
[296] Ken Cook, "Government's Continued Bailout of Agribusiness" <http://farm.ewg.org/summary.php> [accessed 29 April 2011]

**Figure 4: Farm Safety Net Programs under the 2008 Farm Bill and Other Legislation**[297]



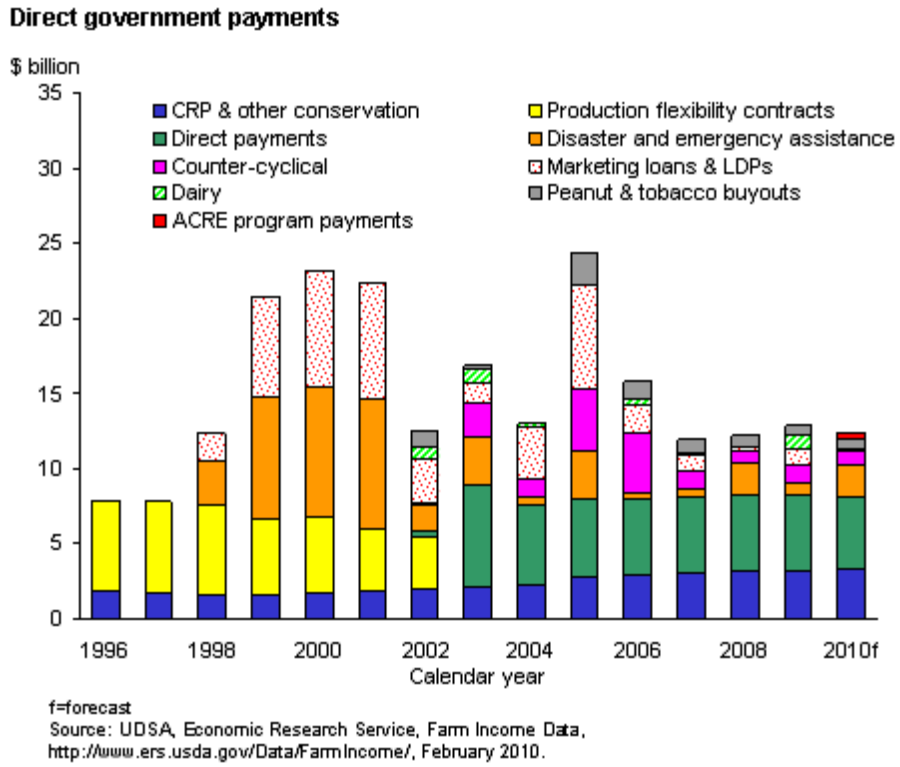

Within these three categories of farm safety net programs, there are three basic ways that farmers get paid: (1) direct payments, (2) counter-cyclical payments, and (3) market-loss payments.

1. **Direct payments**: Farmers and landowners receive payments regardless of crop prices and farm profits, and even if the recipient does not plant a crop that year. Payments are based on historic rather than actual yield, as well as on historical ("base") acres. Direct payments have averaged around $5 billion per year since 2005.[298]
2. **Counter-cyclical payments**: These payments are made available when crop prices fall below a level set in law by Congress in the Farm Bill (reauthorized roughly every five years). Counter-cyclical payments totaled $1.2 billion in 2009. It's important to note that, as with direct payments, countercyclical payments are tied to a farm's base acres. In other words, even though the countercyclical payment rate formula depends on

[297] Dennis A Shields, Jim Monke and Randy Schnepf, "Farm Safety Net Programs: Issues for the Next Farm Bill", in *Congressional Research Service* <http://www.crs.gov/Products/R/PDF/R41317.pdf> [accessed 29 April 2011]
[298] Ken Cook, "Government's Continued Bailout of Agribusiness" <http://farm.ewg.org/summary.php> [accessed 29 April 2011]

market prices, it does not require that the farmer produce any of the crop or commodity.

3. **Market-loss payments**: These payments are made available to specific producers (MILC, the Milk Income Loss Contract, is one such program for dairy) when prices fall below a specified level, as set by Congress in the Farm Bill.




Payments to farmers under federal farm programs are estimated to have totaled one quarter of a trillion dollars between 1995 and 2009. During that time, "the largest and wealthiest top 10 percent of farm program recipients received 74 percent of all farm subsidies with an average total payment over 15 years of $445,127 per recipient. The bottom 80 percent of farmers received an average total payment of just $8,682 per recipient."[299]

These discrepancies paint a very clear picture of the ineffective and inefficient nature of current farm subsidy programs. This is not to say that farm subsidies should be cut entirely, but rather that as we face record federal deficits and an economy struggling to return to sustainable economic growth and job creation, it is in our best interest to modernize and reform these farm subsidy programs.

[299] Ken Cook, "Government's Continued Bailout of Agribusiness" <http://farm.ewg.org/summary.php> [accessed 29 April 2011]

# Our Five Key Recommendations

## Introduce Market-Based Reforms

In this section, we discuss several long-term reforms that could be implemented over the next few years, beginning with the passage of the next Farm Bill. While we present full 10 year savings estimates for these reforms, it's unlikely that those savings would be realized in the next 10 years. For that we reason, we have adjusted our grand total projection ($50-60 billion over 10 years) downward from a substantially bigger number.

### RECOMMENDATION 1 → $50 BILLION IN SAVINGS OVER 10 YEARS[300, 301]

### ►*Reduce and eventually eliminate direct payments to farmers.*

Historically, farm bills have responded to the needs of farmers and ranchers at the times they were enacted. Needs change with the environment (reacting to the Dust Bowl in the 1930s, Congress passed the Soil Conservation and Domestic Allotment Act in 1936). So what we should be asking ourselves today, in the wake of the greatest recession we've seen in decades, is this: What are the current needs of our farmers and ranchers and how can the farm bill help fill those needs while being mindful of our fiscal challenges?

> **"We should reform our farm policy to support producers through market-oriented risk management tools that adjust with market prices and pay farmers only when they need it."**

Ultimately, direct payments can and should be eliminated—this would save us approximately $50 billion over 10 years. However, in the short-term, capping direct payments is more achievable and was discussed during the last Farm Bill debate in 2007-2008. We could cap payments at $10,000 or $20,000, or simply qualify payments on adjusted gross income (AGI), say at $150,000. In this example, once a farmer hits an AGI of $150,000, support would stop. These caps could be an effective transition to ultimate elimination of direct payments.

The most important idea to highlight here is that the Farm Bill is the place for agricultural subsidy reform. We should reform our agricultural policy to support producers through market-oriented risk management tools that adjust with market prices and pay farmers only when they need it (when they suffer a real loss in revenue due to weather or some other

[300] Environmental Working Group, "Farm Subsidy Database" <http://farm.ewg.org/progdetail.php?fips=00000&progcode=total_dp&regionname=theUnitedStates> [accessed 29 April 2011]

[301] To calculate this figure, we averaged direct payment outlays between 2003 and 2009. This average, $5 billion, was then assumed to be the approximate payments level for each of the next 10 years. We erred on the side of caution and did not assume any cost inflation.

catastrophic event) and move away from payments based on base acres or historic yields. In other words, we should pay them based on what a farmer *actually does* produce rather than what we *think* a farmer will produce.

### RECOMMENDATION 2 → $6 BILLION IN SAVINGS OVER 10 YEARS[302, 303]

### ►*Reduce and eventually eliminate counter-cyclical payments to farmers.*

Today, counter-cyclical payments are not actually paying that much to farmers because commodity prices, which determine the payments, are strong across the board. This indicates a couple of things: (1) that this type of payment is not working, but also (2) that some of the target prices (as established by Congress in the Farm Bill) are inappropriate. Consider the target price for corn at $2.63. Today, corn is trading at over $7 a bushel. A farmer would be completely out of business before corn dropped to $2.63 a bushel, negating the entire formula and program.

One solution might be eliminating the counter-cyclical program but keeping strong crop insurance for producers, thus giving them a share of the risk but providing some insurance in case of natural disasters. We endorse this option, which would save $6 billion over ten years.

## ⭘Set Caps on Payments and Income Level

In this section, in contrast to the last section, we recommend several intermediate reforms that could be implemented immediately. While we present full 10 year savings estimates for these reforms, it's likely we'd want to phase them out as more permanent solutions (such as the previous two recommendations) were implemented. For that reason, we have adjusted our grand total projection downward.

### RECOMMENDATION 3 → $1.1 BILLION IN SAVINGS OVER 10 YEARS[304]

### ►*Set a cap on payments to ranchers and farmers.*

Senator Chuck Grassley of Iowa introduced a bill in August 2010 that would cap payments to farmers. As we move towards eventual elimination of direct and counter-cyclical payments, per the above recommendations, this cap on payments could provide a safety net for current producers while the markets adjust to a world without direct and counter-cyclical payments.

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[302] Dennis A Shields, Jim Monke and Randy Schnepf, "Farm Safety Net Programs: Issues for the Next Farm Bill", in *Congressional Research Service* <http://www.crs.gov/Products/R/PDF/R41317.pdf> [accessed 29 April 2011]

[303] The original cost savings estimate was $0.6 billion per year. We believe that $6 billion over 10 years is a reasonable assumption because (1) counter-cyclical payments are not one-off expenses and (2) we err on the side of caution and ignore inflation.

[304] Chuck Grassley, "Grassley, Feingold Introduce Legislation to Focus Farm Payments on Small and Medium-Sized Farmers" <http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=28041> [accessed 29 April 2011]

In his release, Senator Grassley wrote, "Rural America can't continue to withstand the pressure that unlimited payments create. The farm program was never intended to help big farmers get bigger; instead it was created to help those who couldn't withstand the political whims of Washington or the fierce reckonings of Mother Nature. When 10 percent of the nation's farmers receive more than 70 percent of the payments, it erodes public confidence in federal farm programs, and this legislation is a way to stop that trend from growing."

Senator Grassley's bill caps all payments at $250,000. More specifically, it caps direct payments at $40,000, counter-cyclical payments at $60,000, and marketing loan gains, loan deficiency payments, and commodity certificates at $150,000. The bill also focuses on closing loopholes that farmers and ranchers often use to maximize payments. For the sake of this report, we recommend lower numbers that come out to a $100,000 total cap on payments.

## RECOMMENDATION 4 → $1.5 BILLION IN SAVINGS OVER 10 YEARS[305]

### ►*Lower the cap on adjusted gross income (AGI).*

Capping AGI was discussed during the last Farm Bill negotiations. The Bush Administration recommended a cap at $200,000 AGI, which makes it all the more surprising that the current cap is $750,000 for farm income and $500,000 for non-farm. That means a producer could make $745,000 on-farm and $495,000 off-farm for a total income of $1.24 million, and still receive a check from the government! We propose a cap in line with former President Bush's proposal: $200,000, or perhaps even lower.

An alternative might be a hybrid cap on both payments and a lower AGI. For example, President Obama's Fiscal Year 2012 budget recommends lowering the direct payment cap from $40,000 to $30,000, and reducing the AGI limitation by $250,000 for farm and non-farm income. This would work out to $500,000 adjusted gross on-farm income and $250,000 adjusted gross non-farm income. This is similar to President Bush's proposal, which would also have redistributed the $360,000 limit across the payment types, eliminated the three-entity rule[306], and applied a single limit to all commodities. This plan, which we endorse, would save $596 million over five years and $1.5 billion over 10 years, according to the CBO.[307]

[305] Jim Monke, "Payment Limits for Farm Commodity Programs: Issues and Proposals", in *National Council for Science and the Environment* <http://ncseonline.org/NLE/CRSreports/06Oct/RS21493.pdf> [accessed 2 May 2011]
[306] Under the three-entity rule, an individual could receive a full payment directly and up to a half payment from each of two additional entities.
[307] This savings estimate dates to 2006.

# ➊Make Farm Subsidy Programs More Efficient

## RECOMMENDATION 5 → $35 BILLION IN SAVINGS OVER 10 YEARS[308, 309]

## ►*Scale back ineffective programs like ACRE and SURE.*

Pulling the rug out from under American agriculture could have disastrous effects on our domestic food production. Still, the support programs that producers and ranchers rely on are too often inefficiently designed and duplicative. Responsible reform could save taxpayers billions of dollars annually.

In February 2011, Carl Zulauf, an agricultural economist at Ohio State University, recommended a set of reforms that would base agricultural subsidy support on actual risk and loss.[310] Zulauf asks important questions about our current subsidy structure: "Is it fair to receive farm program payments even if a loss does not exist?" he asks. "For example, even though many crops had record revenue, direct payments were made in 2007 and 2008. To many, especially non-farmers, this seems unfair," Zulauf continues.

Zulauf proposes implementing a loss condition for receipt of all farm program payments similar to the one that's used in the ACRE program (Average Crop Revenue Election): "…imposing an ACRE farm crop loss condition for the receipt of direct payments will result in an average eligibility share of around 50 percent, translating into average annual savings of around $2.5 billion per year", or $25 billion over 10 years.[311] Ultimately, these direct payments should be eliminated. But until that is feasible, we endorse an alternative, like the implementation of a loss condition for payments.

Another duplicative program is the SURE (Supplemental Revenue Assistance) Program, which provides assistance for whole-farm production disaster. Since its inception in the 2008 Farm Bill, SURE has had a mixed track record. According to the USDA, it is the most complex program the USDA Farm Service Agency has ever undertaken. Many farmers also question its fairness.

The Congressional Research Service has echoed these concerns. Dennis Shields, in a December 2010 CRS report, writes that SURE "has faced a number of implementation challenges in terms of program administration, such as collecting and tabulating a significant amount of data for

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[308] Dennis A Shields, "A Whole-Farm Crop Disaster Program: Supplemental Revenue Assistance Payments (SURE)", in *Congressional Research Service* <http://www.nationalaglawcenter.org/assets/crs/R40452.pdf> [accessed 29 April 2011] & Carl Zulauf, "Suggestions for Current Farm Safety Net Programs While Cutting Cost", in *The Ohio State University* <Suggestions for Current Farm Safety Net Programs While Cutting Cost> [accessed 29 April 2011]

[309] This estimate is a rough calculation by the authors. Actual savings will vary widely year to year.

[310] Carl Zulauf, "Suggestions for Current Farm Safety Net Programs While Cutting Cost", in *The Ohio State University* <Suggestions for Current Farm Safety Net Programs While Cutting Cost> [accessed 29 April 2011]

[311] Carl Zulauf, "Suggestions for Current Farm Safety Net Programs While Cutting Cost", in *The Ohio State University* <Suggestions for Current Farm Safety Net Programs While Cutting Cost> [accessed 29 April 2011]

individual farmers, as well as crop price data that are not readily available. Another issue has been accounting for various insurance products when determining the farmer's guarantee level."[312]

SURE is one of 37 farm programs that does not have a baseline in the 2012 Farm Bill. This means the program could simply sunset on its own. Absent major reforms to the program, we support a sunset of the SURE program in the upcoming Farm Bill. This would save about $10 billion over the next 10 years.[313] The two reforms discussed in the section combined add up to $35 billion in savings over 10 years.

# Conclusion

Agricultural subsidy reform will be painful—there are no two ways about it. But at the heart of this issue should be the idea that programmatic support for farmers and ranchers is something that should be there when they need it and not when they don't. There is clearly a place for disaster assistance and for market- and risk-based support. These programs help ensure that we can continue to produce food here at home. But if farmers aren't producing, they shouldn't be receiving a check, plain and simple.

There are agriculture experts across the country, some of whom we've cited here (Professor Zulauf and Senator Grassley, for example), offering thoughtful and pragmatic ways to reform our farm subsidy programs. We encourage this dialogue and look forward to debating the next Farm Bill, which should not only address the needs of farmers, but must also help put our budget back on sustainable path.

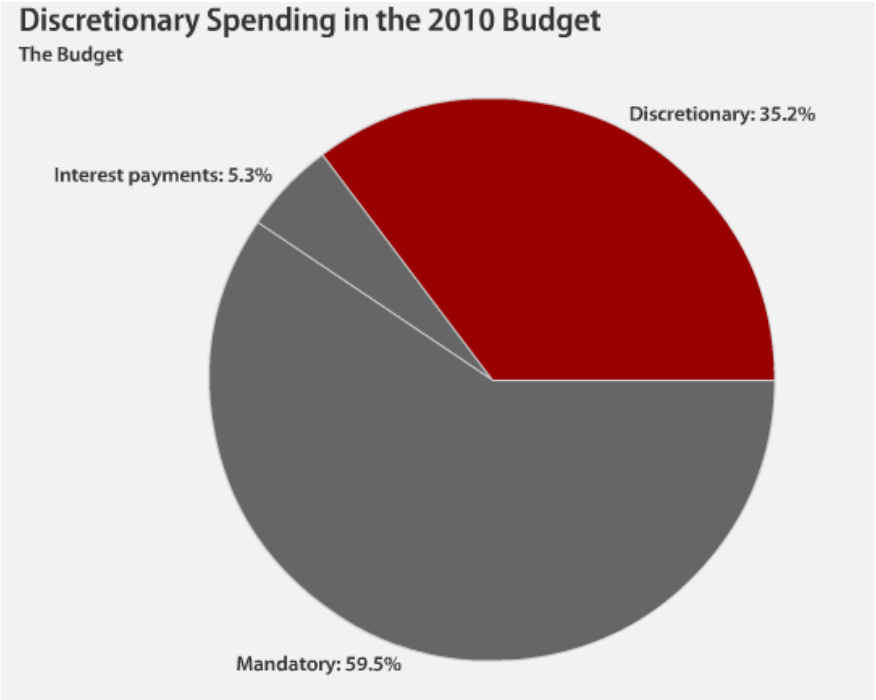
[312] Dennis A Shields, "A Whole-Farm Crop Disaster Program: Supplemental Revenue Assistance Payments (SURE)", in *Congressional Research Service* <http://www.nationalaglawcenter.org/assets/crs/R40452.pdf> [accessed 29 April 2011]

[313] In 2010, the U.S. Department of Agriculture (USDA) issued more than $2.0 billion for 2008 crop losses under the SURE program, with the level of payments by state generally proportional to indemnities. Over 10 years, we estimate that eliminating SURE could save $10 billion. But the numbers will vary greatly year to year given the unpredictability of disasters.

# Reinventing Non-Defense Discretionary

## Discretionary Spending (Appropriations) in the Budget

Discretionary spending is spending Congress must appropriate each year. This is in contrast to mandatory spending programs like Social Security or Medicare which spend federal dollars without appropriation from Congress. Discretionary spending made up approximately 35.2 percent of the total budget in 2010,[314] or $1.25 trillion total.[315] Discretionary spending can be split into two main categories: defense and non-defense, with well over half going to defense. This is to say that of the total federal budget, approximately 15 percent is allocated to non-defense discretionary spending.[316]



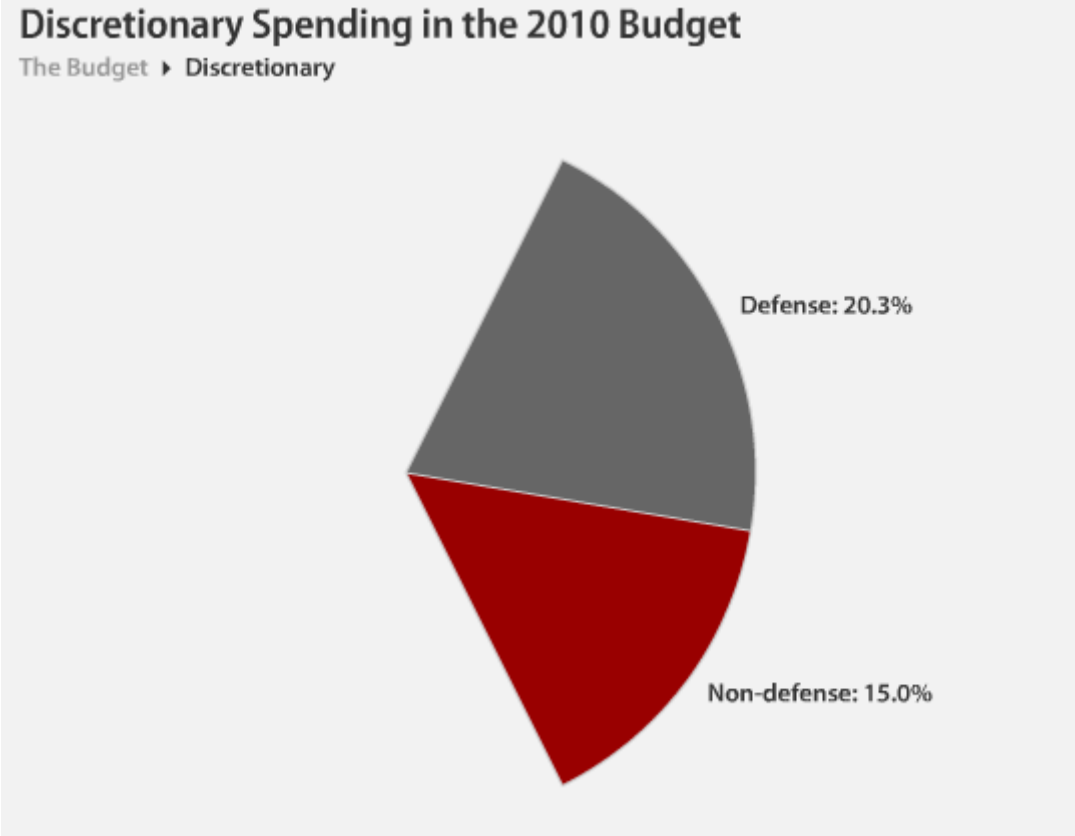

## Non-Defense (Domestic) Discretionary Spending

Given that non-defense discretionary spending adds up to only 15 percent of the government's overall budget (see the graph on the next page),[317] cuts to non-defense discretionary spending

[314] Michael Linden and Michael Ettlinger, "Interactive: What Is Non-Defense Discretionary Spending?", in *Center for American Progress* <http://www.americanprogress.org/issues/2010/03/discretionary_spending_interactive.html> [accessed 29 April 2011]
[315] Office of Management and Budget, "Fiscal Year 2012 Budget of the U.S. Government", in *Office of Management and Budget* <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/budget.pdf> [accessed 28 April 2011]
[316] Michael Linden and Michael Ettlinger, "Interactive: What Is Non-Defense Discretionary Spending?", in *Center for American Progress* <http://www.americanprogress.org/issues/2010/03/discretionary_spending_interactive.html> [accessed 29 April 2011]
[317] Michael Linden and Michael Ettlinger, "Interactive: What Is Non-Defense Discretionary Spending?", in *Center for American Progress* <http://www.americanprogress.org/issues/2010/03/discretionary_spending_interactive.html> [accessed 29 April 2011]

would produce only modest reductions in the overall federal budget deficit.[318] Still, reform of domestic discretionary spending programs—to reduce waste, fraud, and abuse, in particular—are an important part of our larger conversation about reinventing government and reducing our deficits.

What sort of impact could we achieve with cuts to domestic discretionary spending? A five percent reduction would save roughly as much as the assumed phase-down of military forces in Iraq and Afghanistan, according to former OMB Director Peter Orszag.[319]



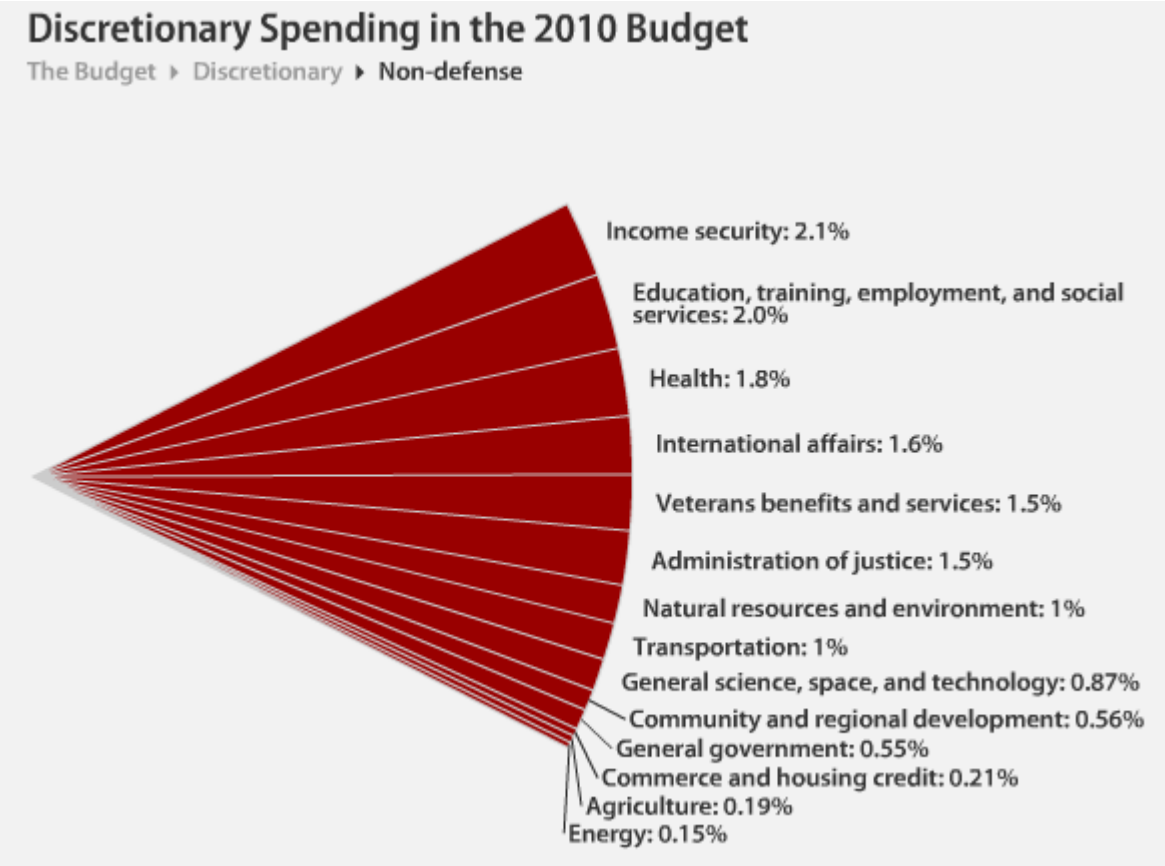

## Modifications, Reforms, and Reductions

We have to look at domestic discretionary spending in the context of how bad our overall fiscal situation is, acknowledging that our current fiscal path is simply unsustainable. Part of the solution, but not all of it, must come from domestic discretionary spending—we'll have to make some difficult decisions that will rein in spending in some very specific areas. There can be no sacred cows in this process.

[318] Michael Linden and Michael Ettlinger, "Interactive: What Is Non-Defense Discretionary Spending?", in *Center for American Progress* <http://www.americanprogress.org/issues/2010/03/discretionary_spending_interactive.html> [accessed 29 April 2011]

[319] Peter R Orszag, "One Nation, Two Deficits", in *New York Times* <http://www.nytimes.com/2010/09/07/opinion/07orszag.html> [accessed 29 April 2011]

In the past, some have supported a freeze in non-defense discretionary spending. That may improve our long-term fiscal outlook, but it ignores the fact that many, if not most, domestic spending programs serve an important purpose. To put it simply, government's mission matters, and it matters a lot right now when millions of Americans are unemployed or underemployed and depend on temporary support from the government. We can't set arbitrary numbers across the board and cut for the sake of cutting. We must strengthen programs that work and cut those that don't while still bearing in mind the overall level of cuts that are necessary. The chart below[320] highlights the different areas of non-defense discretionary spending.




## How to Limit Non-Defense Discretionary Spending

Many budget experts believe that the five-year discretionary spending caps that were first passed in the Budget Enforcement Act of 1990 were a major reason the federal government achieved four balanced budgets in the 1990s. Susan J. Irving, the GAO Director of Federal Budget Analysis, testified before the House Budget Committee in 2001 that the 1990s-era spending caps were effective in restraining spending:

[320] Michael Linden and Michael Ettlinger, "Interactive: What Is Non-Defense Discretionary Spending?", in *Center for American Progress* <http://www.americanprogress.org/issues/2010/03/discretionary_spending_interactive.html> [accessed 29 April 2011]

> Enforcement is more successful when it is tied to actions controlled by the Congress and the President. Both the BEA (Budget Enforcement Act) spending caps and the PAYGO enforcement rules were designed to hold the Congress and the President accountable for the costs of the laws enacted each session—not for costs that could be attributed to economic changes or other factors.[321]

But despite their success, the caps were allowed to expire in 2002, leading to what many saw as a series of fiscally irresponsible budgets.

Spending caps for domestic discretionary spending have been proposed in several different budget plans. One vision of spending caps can be found in the "Blue Dog Blueprint for Fiscal Reform" released last year. The Blue Dogs, a group of conservative and moderate Democrats who emphasize fiscal responsibility, recommend the following: "Cut non-security discretionary spending by two percent for each of the next three years, and freeze spending levels for the subsequent two years". According to the Blue Dogs, this would save American taxpayers over $400 billion over the next 10 years.[322]

**"Discretionary spending cuts must not exclude security and defense spending—there can be no sacred cows in deficit reduction."**

Another version of discretionary spending caps was included in President Obama's Fiscal Year 2011 budget. The President proposed freezing non-security discretionary spending for the next three fiscal years, 2011 through 2013. However, this cap would exempt the entire Department of Defense, as well as the Department of Homeland Security and the Department of Veterans Affairs. The President's proposed freeze, if enacted, would save approximately $250 billion over the next 10 years.[323] We support cuts to non-defense discretionary spending, but we also believe that these cuts must not exclude security and defense spending.

In March of 2010, U.S. Senators Jeff Sessions (R-AL), Claire McCaskill (D-MO), and Jon Kyl (R-AZ) proposed imposing binding caps on total defense and non-defense discretionary spending for fiscal years 2010-2014, locking in the modest increases approved in the Fiscal Year 2010 Congressional Budget Resolution, which averaged less than two percent annually. We believe that this Senate-proposed cap would be more successful in limiting deficits than a cap that only targets domestic discretionary spending.

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[321] Susan J Irving, "Considerations for Updating the Budget Enforcement Act", in *General Accounting Office* <http://www.gao.gov/new.items/d01991t.pdf> [accessed 29 April 2011]
[322] Heath Shuler, "Blue Dog Blueprint for Fiscal Reform" <http://shuler.house.gov/legis/fiscal-reform-blueprint.shtml> [accessed 29 April 2011]
[323] Mindy R Levit, "Impact on the Federal Budget of Freezing Non-Security Discretionary Spending", in *Congressional Research Service* <http://www.crs.gov/Products/R/PDF/R41174.pdf> [accessed 2 May 2011]

### KEY RECOMMENDATION 1 → VARIABLE SAVINGS OVER TEN YEARS[324]

### ►*Implement a cap on the debt to GDP ratio.*

We find a spending cap to be an incomplete solution. There's still a danger that Congress could skirt this cap by shifting spending into the tax code with tax expenditures. Spending caps would also unreasonably limit Congress's flexibility in responding to an emergency situation. This is why Third Way has called spending caps "the next Smoot-Hawley".[325]

Ultimately, we support a slightly different approach: a debt cap (similar to what has been proposed by President Obama and the Peterson Pew Commission on Budget Reform).[326] This debt cap would target a sustainable level of debt which, "if we failed to hit it, [would] make automatic cuts to both spending and to tax expenditures."[327]

This is probably the best proposal we've seen for limiting non-defense discretionary spending. It forces spending cuts if our debt increases to an unsustainable level, and does so without incentivizing further proliferation of tax expenditures in the tax code.

# Conclusion

Any credible deficit reduction plan will have to include savings from all areas of the budget, including non-defense discretionary spending. While this report has mostly focused on mandatory spending, we thought it was important to include some discussion of our discretionary spending deficit reduction priorities.

At the same time, we reject the idea that the deficit should be reduced by cutting only non-defense discretionary spending. Domestic discretionary spending only amounts to 15 percent of the budget and clearly can't yield enough savings to reduce our entire budget shortfall, as some would contend. Regardless, Congress will have to be extra judicious going forward about how and for what it appropriates non-defense discretionary spending.

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# Part Two Conclusion and Next Steps

This report has made 60 recommendations to put our federal budget back on a sustainable path. These recommendations would save approximately $2 trillion over the next 10 years without getting rid of important social safety nets and other vital spending programs. Our belief that government's mission matters has vitally underpinned our thinking as we prepared these recommendations.

Moving forward, Congress and President Obama need to work together to pass a long-term budget reform package. This effort must address all areas of the budget. It also must consider both the spending and revenue sides of the equation. There can be no sacred cows when it comes to deficit reduction. We must reinvent the way government does business, and we must be prepared to make the tough choices that reinvention requires. We have tried to make some of those tough choices in this report, and we hope that our work will make it easier to reach a bipartisan compromise in the coming weeks and months.

For more information, please go to:

**http://quigley.house.gov/reinventing**

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