AMERICAN ACTION FORUM

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MEMORANDUM TO: The 45th President and 115th Congress

FROM: Douglas Holtz-Eakin and Gordon Gray

SUBJECT: Balanced: 2028

Introduction

The debt currently stands at over $14 trillion and is growing, while the economy is on track to grow at a rate of only about two percent per year. Left unchanged, these trends endanger the future prosperity of the nation. The debt is no longer an abstract, distant challenge, but rather a headwind to economic growth that must be addressed now. Persistently sluggish economic growth will bequeath to the next generation a standard of living unworthy of the American Experiment. Both of these challenges threaten to break the nation's social compact that successive generations bequeath to the next a brighter future. But this is only one possible future. An alternative can promise declining debt through a balanced budget and future surpluses and a policy environment to support higher economic growth.

Top Three Policy Recommendations

A brighter future is achievable by focusing on what is driving the structural budgetary challenges confronting the nation, and where federal policy is failing the economy. Addressing the nation's broken tax code, the rapid growth of health, retirement, and other entitlement programs, and the U.S.'s irrational immigration system will improve both the nation's fiscal and economic outlook and should be the top three priorities of the administration.

Tax Reform

Fundamental modernization and simplification of the tax system has been an elusive dream for Congresses and administrations over the past 30 years. Indeed, over the 100-year history of the U.S. income tax system, only a handful of meaningful simplification efforts have seen success. This administration should defy history and enact comprehensive tax reform. This effort should be even more ambitious than the 1986 Tax Reform Act. Instead, this administration should pursue a wholesale rewrite of the tax code, one that moves to a consumption-based system that, while retaining progressivity, spurs savings and investment and imposes taxes on commerce in the least harmful way.

"Balanced: 2028" would eliminate the current individual and corporate tax code. Businesses would be taxed on cash flows, with businesses able to deduct purchases and employee compensation, at a flat rate initially set at the same top rate as the household portion of tax.

Individuals above an exemption would be taxed progressively up to a top rate of 35 percent. The plan would raise adequate revenue to fund the nation's priorities, but do so in a manner that is far more efficient, and therefore more conducive to economic growth, than the current system—indeed such a reform could boost long-term economic growth by 6 percent.

Entitlement Reform

The primary causes for our growing debts have been largely untouched by past deficit reduction efforts. Discretionary spending, reduced by the Budget Control Act, and tax revenue, recently hiked, are not driving debt. Mandatory spending and interest payments are. Mandatory spending has been growing as the nation ages, health costs grow, and policy-makers create new entitlements and expand old ones. In 1974, mandatory spending was 41 percent of the budget. By 2025, it will be 64 percent. Meanwhile, interest payment on the debt will continue to crowd out the budget as the debt portfolio remains outsized, and interest rates normalize.

These pressures reflect legacy costs—past promises—crowding out investment in the future in the form of infrastructure, basic research, and education. This budget pressure strains the capacity to adequately fund what should be the first priority of the federal government: national defense. Absent restraint on entitlement programs, the United States will be unable to budget for these priorities.

Immigration Reform

The demography of the nation is graying. Low U.S. birth rates are falling short of the aging of the population. As the baby-boom generation continues to reach retirement age, the U.S. labor force will face additional downward pressure, and with it, the economy as a whole. A rational immigration system that refocuses on economic goals could help reverse this trend by raising population and labor force growth, and thus economic growth as a whole.

In addition to the mere mechanics of raising the U.S. population, immigrants have displayed entrepreneurial rates above that of the native-born population. New entrepreneurial vigor embodied in new capital and consumer goods can raise the standard of living.

Conclusion

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In the absence of fundamental reforms to every major federal policy area and on both sides of the nation's ledger book, the U.S. faces the threat of debt-driven financial crisis and stagnant trend economic growth. "Balanced: 2028" proposes overhauls of the nation's tax code, and reform to every major area of federal spending—reducing growth in spending over time and reaching balance by 2028. These reforms target the drivers of the nation's budget challenges and the policy impediments to economic growth. While the incoming administration should pursue each of the elements of this blueprint—it should start with the three most important: tax, entitlement, and immigration. If pursued successfully, the administration will have 4 more years to implement the rest of the plan.