



The Nation's Long-Term Fiscal Outlook

September 2008 Update

GAO's Long-Term Fiscal Simulations

Since 1992, GAO has published long-term fiscal simulations of what might happen to federal deficits and debt levels under varying policy assumptions. We developed our long-term model in response to a bipartisan request from Members of Congress who were concerned about the long-term effects of fiscal policy.

GAO runs two simulations

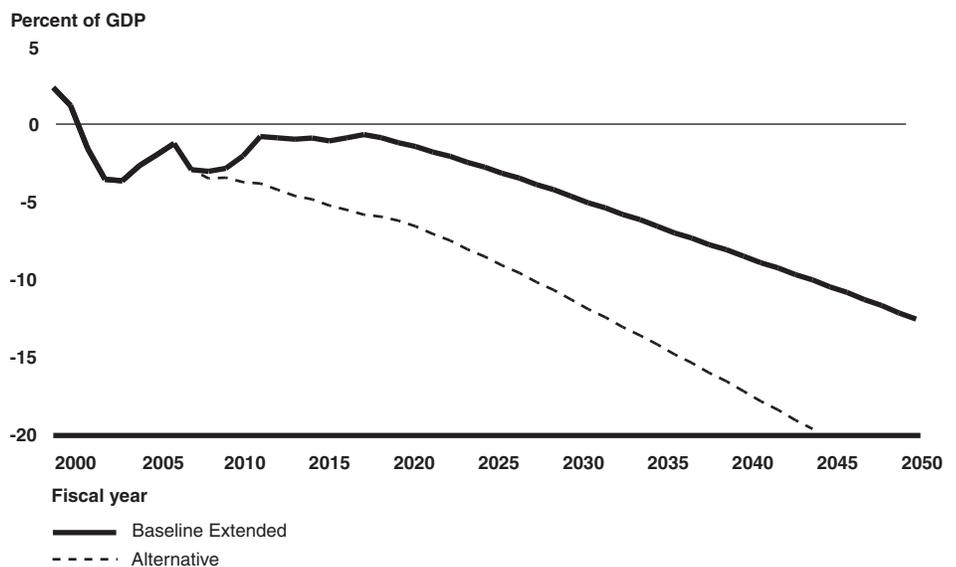
- “Baseline Extended” follows the Congressional Budget Office’s (CBO) September baseline estimates for the first 10 years and then simply holds revenue and spending other than large entitlement programs constant as a share of gross domestic product (GDP).
- The “Alternative” simulation is based on historical trends and recent policy preferences. Discretionary spending grows with GDP rather than inflation during the first 10 years, Medicare physician payment rates are not reduced as in CBO’s baseline, and all tax provisions are extended until 2018 and then revenues are brought back to about their historical level.

We update our simulations as new estimates become available from CBO and the Social Security and Medicare Trustees. This update incorporates CBO’s most recent baseline projections that were released in September.

This product responds to congressional interest in receiving updated simulation results. For more information, contact Susan J. Irving at (202) 512-8288 or irvings@gao.gov.

Recently the President, the Congress, and the American people have been focused on addressing problems with financial markets and the appropriate response to a weakening economy. However, once the current challenges are resolved, the next President, the next Congress, and the nation will need to focus with the same intensity on the nation’s long-term fiscal challenge. As shown in figure 1 below, our updated simulations continue to show escalating and persistent deficits that illustrate the long-term fiscal outlook is unsustainable. The federal government faces large and growing structural deficits driven primarily by rising health care costs and known demographic trends. Furthermore, these simulations do not yet reflect recent actions taken by the federal government to support the financial sector.

Figure 1: Unified Surpluses and Deficits under Alternative Fiscal Policy Simulations



Source: GAO's September 2008 analysis based on the Social Security and Medicare Trustees' assumptions.

Figure 1 shows GAO’s two alternative fiscal policy simulations based on the Social Security and Medicare Trustees’ projections.¹ CBO also produces long-term estimates of these programs. Beginning with this update, we show the long-term outlook under both sets of projections. A comparison of the two sets of simulations is presented later in this report.² Under either set of projections, the long-term outlook is unsustainable.

¹The excess health care cost growth assumption for Medicaid is also based on the Trustees’ assumptions, but the base amount of Medicaid spending is based on CBO’s projections.

²More information on the assumptions underlying our simulations is on pp. 10–14.

Why Does It Matter?

Our long-term simulations show that absent policy actions aimed at deficit reduction, the federal government faces unsustainable growth in debt. Such growth would inevitably result in declining GDP and future living standards. Even before such effects, these debt paths would likely result in rising inflation, higher interest rates, and the unwillingness of foreign investors to invest in a weakening American economy.

Furthermore, under our Alternative simulation, which assumes revenue to be at about the 40-year historical average, growth in spending on major entitlement programs and the interest on national debt will absorb the lion's share of the government's resources. Just 10 years from now in this simulation that is based on historical trends and recent policy preferences, 76 cents of every dollar of federal revenue will be spent on retirees and their health care providers, health care providers for the poor, and our bond holders. This leaves little room for other priorities, such as national defense and investment in infrastructure and alternative energy sources, and threatens the government's fiscal ability to respond to national emergencies, both natural and manmade.

The longer action to deal with the nation's long-term fiscal outlook is delayed, the greater the risk that the eventual changes will be disruptive and destabilizing. For example, even under our more optimistic Baseline Extended scenario, waiting until 2040 to balance the budget would require drastic change. To balance the budget in that year, federal revenue as a share of GDP would have to increase by more than 40 percent or noninterest federal spending would have to be cut by more than one-third. If changes in federal individual income taxes were the sole means used to balance the budget, these would have to increase by more than three-quarters in that year assuming no changes to the composition of revenues after 2018. Sudden, drastic changes of either kind—and revenues at such a level—have not been seen in this country since the end of World War II. Acting sooner rather than later will provide more time to phase in gradual changes, while also providing more time for those likely to be most affected to make compensatory changes.

Reducing the deficit and associated borrowing can free up resources in the budget to address national priorities and generate increases in economic growth by increasing national saving and private investment. Domestic investment can boost productivity of the nation's workforce and lead to higher real wages and greater economic growth over the long term.

What Has Changed since Our Last Federal Model Update?

Our simulations were updated using CBO's most recent 10-year baseline projections.³ Deterioration in the long-term budget outlook was expected because of the supplemental funding for the global war on terrorism that was enacted in June and the continued weak economic outlook.

CBO's September projections show a dramatic worsening in the budget outlook since March due in part to the baseline conventions that CBO follows. Specifically, in developing its 10-year projections, CBO adjusts appropriations for the most recent year for inflation. CBO's baseline includes \$111 billion in supplemental appropriations for 2008 and \$75.5 billion for 2009 based on legislation passed in June. This increased spending in CBO's baseline by \$1.2 trillion over the 10-year projection period and led to changes in our long-term assumptions for discretionary spending of about 0.7 percent of GDP in our Baseline Extended simulation and 0.2 percent of GDP in our Alternative simulation.

Another large contributor to the worsened budget outlook is the economy. Rising energy and food prices led CBO to increase its inflation projections for 2008 and 2009. Higher inflation can increase government spending because it leads to higher cost-of-living adjustments for programs such as Social Security and Food Stamps, and increased interest payments on the debt. CBO also reduced its projection of real GDP growth. According to CBO, the deficit worsened by about \$85 billion per year over the first 10 years largely due to a near-term jump in inflation and the weakening economy.

Recent actions taken to stabilize the financial system and economy, such as those regarding Fannie Mae and Freddie Mac, are not included in CBO's baseline estimates but will be incorporated into the federal budget estimates in January 2009. The overall effect on the budget outlook is unknown at this time.

What Drives Our Nation's Long-Term Fiscal Outlook?

While the factors driving our near-term outlook can and have been quite volatile, the long-term fundamentals have not changed. Our population is still aging and health care costs are still rising faster than the economy. The oldest members of the baby-boom generation are now eligible for Social Security retirement benefits and will be eligible for Medicare benefits in less than 3 years. According to the Social Security Administration, nearly 80 million Americans will become eligible for Social Security retirement benefits over the next two decades—an average of more than 10,000 per day. Although Social Security is important because

³CBO's September 2008 projections can be accessed at <http://www.cbo.gov/budget/budproj.shtml>.

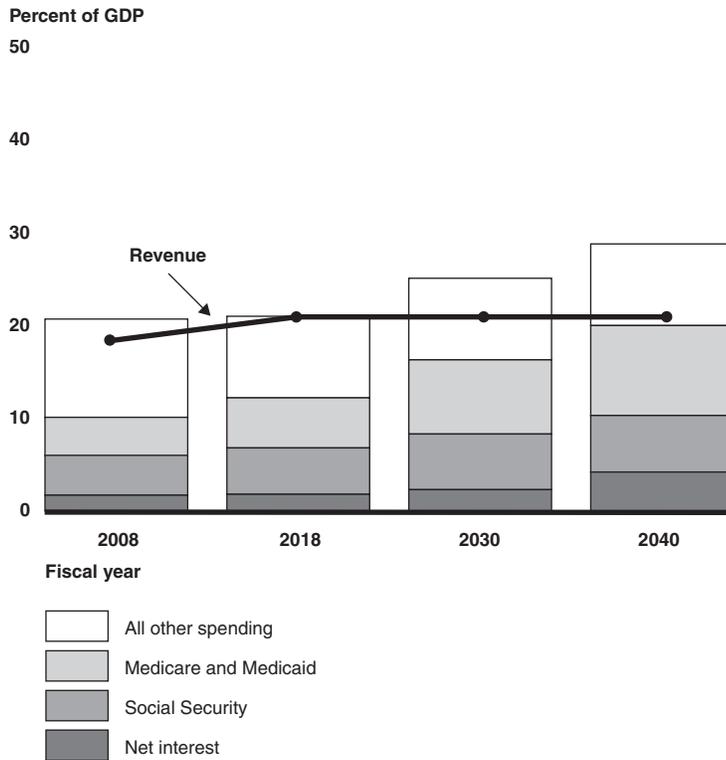
of its size, the real driver of the long-term fiscal outlook is health care spending.

Spending on the major federal health programs (i.e., Medicare and Medicaid) represents a much larger, faster-growing, and more immediate problem. In fact, the federal government's future obligations for Medicare Part D alone exceed the unfunded obligations for Social Security. Over the past several decades, health care spending per capita has grown on average about 2.5 percent faster than average annual real GDP per capita, absorbing increasing shares of the nation's resources. Several key factors have contributed to growth: (1) increased utilization of new and existing medical technology; (2) lack of reliable comparative information on medical outcomes, quality of care, and cost; and (3) increased prevalence of risk factors such as obesity that can lead to expensive chronic conditions. Rapid growth in health care spending is projected to continue.

Figures 2 and 3 show revenue and the composition of federal spending under our simulations based on the Trustees' assumptions. As these figures show, the growth in Social Security, Medicare, Medicaid, and interest on debt held by the public dwarfs the growth in all other types of spending. In these figures the category "all other spending" includes much of what many think of as "government"—discretionary spending on such activities as national defense, homeland security, veterans health benefits, national parks, highways and mass transit, and foreign aid, plus mandatory spending on the smaller entitlement programs such as Supplemental Security Income, Temporary Assistance for Needy Families, and farm price supports.⁴

⁴Discretionary spending refers to spending from budget authority provided in appropriations acts. Mandatory spending refers to spending resulting from budget authority that is provided in laws other than appropriations acts. Mandatory spending includes entitlement authority, which requires the federal government to make payments to eligible beneficiaries, and authority that otherwise obligates the government to make payments.

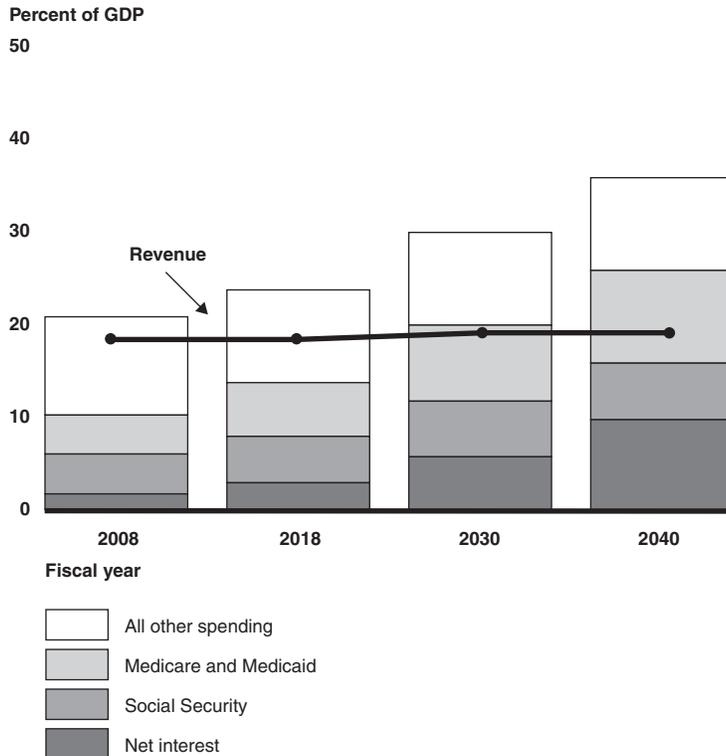
Figure 2: Potential Fiscal Outcomes under Baseline Extended: Revenue and Composition of Spending as Shares of GDP



Source: GAO's September 2008 analysis based on the Social Security and Medicare Trustees' assumptions.

Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2018 because of (1) real bracket creep, (2) more taxpayers becoming subject to the alternative minimum tax (AMT), and (3) increased revenue from tax-deferred retirement accounts. After 2018, revenue as a share of GDP is held constant—implicitly assuming that action is taken to offset increased revenue from real bracket creep, the AMT, and tax-deferred retirement accounts.

Figure 3: Potential Fiscal Outcomes under Alternative Simulation: Revenue and Composition of Spending as Shares of GDP



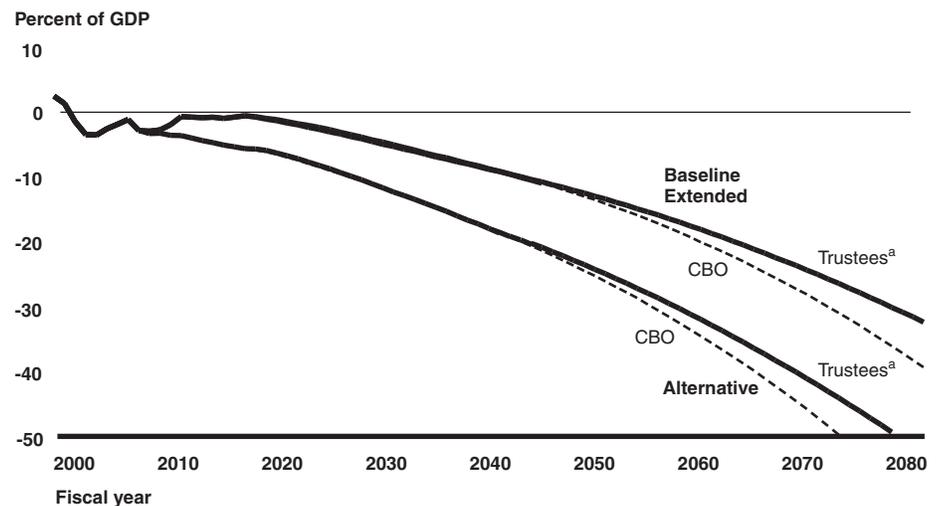
Source: GAO's September 2008 analysis based on the Social Security and Medicare Trustees' assumptions.

Notes: Discretionary spending grows with GDP after 2008. The AMT exemption amount is retained at the 2007 level through 2018 and expiring tax provisions are extended. After 2018, revenue as a share of GDP is brought to its 40-year historical average of 18.3 percent plus expected revenues from deferred taxes (i.e., taxes on withdrawals from retirement accounts). Medicare spending is based on the Trustees' 2008 intermediate projections adjusted for the Centers for Medicare & Medicaid Services (CMS) alternative assumption that physician payment rates are not reduced as specified under current law.

A key assumption in examining the long-term outlook for the federal budget is excess health care cost growth, or the percentage by which growth of health care costs for an individual exceeds the growth of GDP per individual. Our simulations after the first 10 years have used the Medicare Board of Trustees' assumptions, which may be viewed as conservative. The Trustees assume that excess cost growth will average one percentage point, which is lower than the historical average of 2.5 percentage points.

As noted, CBO also produces long-term projections of these programs, and its assumptions yield even less favorable outcomes. Figure 4 compares the results from our simulations based on the Trustees' assumptions to simulations in which we use CBO's assumptions for Social Security, Medicare, and Medicaid. The outlook is very similar through about 2050 after which deficits under CBO's assumptions grow more rapidly. The key difference between CBO's and the Trustees' projections is the assumption about excess health care cost growth. Whereas the Medicare Trustees assume that excess cost growth will average one percent over the long term, CBO assumes excess cost growth will average 1.7 percentage points for Medicare and 0.9 percentage points for Medicaid. In general, CBO assumes health care cost growth will moderate when health care cost increases would otherwise cause a reduction in real nonhealth consumption. Medicaid spending growth slows more than Medicare spending growth because CBO assumes that states have more flexibility to respond to the budgetary pressures and are likely to take actions to reduce spending (e.g., limiting services or eligibility) even without changes to federal law.

Figure 4: Federal Surpluses/Deficits under Alternative Assumptions of Long-Term Entitlement Spending



Source: GAO's September 2008 analysis.

Notes: CBO's projections are from Updated Long-Term Projections for Social Security (August 2008) and The Long-Term Budget Outlook (December 2007).

^aSome adjustments are made to Trustees' assumptions.

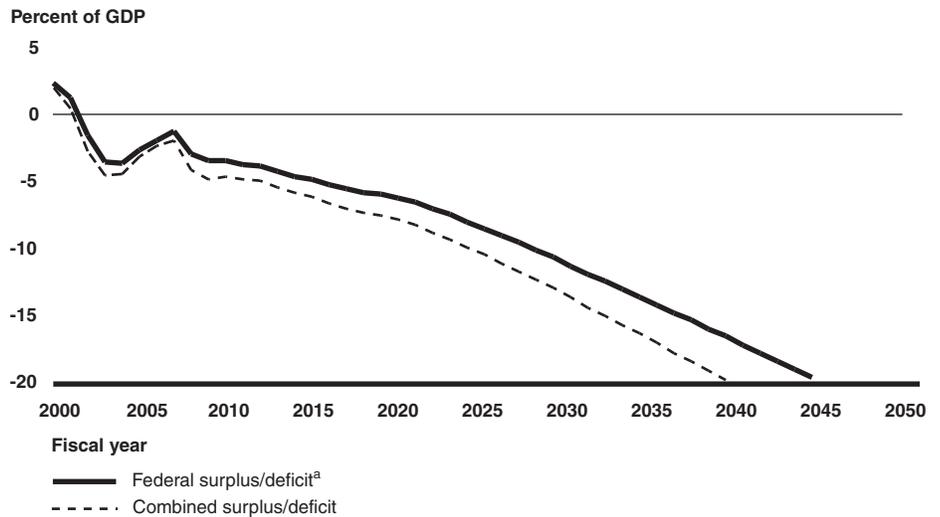
Indeed, the future growth of health care costs is uncertain, but figure 4 shows that under a range of reasonable assumptions, the long-term outlook is unsustainable.

State and Local Governments Face Similar Long-Term Fiscal Challenges

Rapidly rising health care costs are not simply a federal budget problem; they are our nation's number-one long-term fiscal challenge. Growth in health-related spending—Medicaid and health insurance for state and local employees and retirees—is the primary driver of the long-term fiscal challenges facing the state and local governments. Figure 5 presents the results of our simulations that combine the federal government's fiscal outlook with that of the state and local government sector.⁵ Like the federal sector, the state and local sector's fiscal outlook has deteriorated. As is true in the federal simulations, the state and local simulation does not yet reflect stress in the financial sector. A forthcoming product will provide additional information on GAO's updated state and local sector model. The simulations imply that the aggregate fiscal outcome of the state and local government sector will add to the nation's fiscal difficulties and suggest that these fiscal challenges cannot be remedied simply by shifting the burden from one sector to another.

⁵GAO, *State and Local Governments: Growing Fiscal Challenges Will Emerge during the Next 10 Years*, GAO-08-317 (Washington, D.C.: January 2008) and *State and Local Governments: Persistent Fiscal Challenges Will Likely Emerge within the Next Decade*, GAO-07-1080SP (Washington, D.C.: July 18, 2007).

Figure 5: Federal and Combined Federal, State, and Local Surpluses and Deficits as a Share of GDP



Source: GAO's September 2008 analysis.
^aUnder GAO's Alternative simulation based on the Trustees' assumptions.

As we have noted elsewhere, the expected continued rise in health care costs poses a fiscal challenge not just to government budgets, but to American business and society as a whole.⁶ In short, the fundamental fiscal problems facing all levels of government are similar and are linked. As such, solutions to address these challenges should be considered in tandem.

The Fiscal Gap— Another Way to Measure the Challenge

There are many ways to measure the long-term fiscal challenge. One quantitative measure is called the fiscal gap. The fiscal gap is the amount of spending reduction or tax increases that would be needed to keep debt as a share of GDP at or below today's ratio. In contrast to balancing the budget in a particular year, such as in 2040 as described on page 2, the fiscal gap is an estimate of the action needed to achieve fiscal balance over a certain time period, such as 75 years. Another way to say this is that the fiscal gap is the amount of change needed to prevent the kind of debt explosion implicit in figure 1. The fiscal gap can be expressed as a share of the economy or in present-value dollars. (See table 1.)

⁶For example, see GAO, *Highlights of a Forum: Health Care 20 Years From Now—Taking Steps Today to Meet Tomorrow's Challenges*, GAO-07-1155SP (Washington, D.C.: September 2007).

Table 1: Federal Fiscal Gap under GAO’s Simulations Based on the Trustees’ Assumptions, 2008–2082

	Fiscal gap		Change required to close gap compared to today’s levels		
	Trillions of 2008 dollars	Percent of GDP	Percent increase in revenue	Percent increase in individual income taxes	Percent decrease in noninterest spending
Baseline Extended	\$31.3	3.9%	21.8%	47.7%	20.5%
Alternative	56.1	7.0	39.1	85.6	36.6

Source: GAO analysis.

To put this in perspective, the fiscal gap under Baseline Extended could be closed by an increase in today’s revenue of about 22 percent or a 21 percent reduction in today’s programmatic spending maintained over the entire period. Under our Alternative simulation, the required action would be even more dramatic—about 39 percent of today’s taxes or 37 percent of today’s spending. Policymakers could phase in the policy changes so that the tax increases or spending cuts would grow over time and allow people to adjust. However, delaying action would require larger changes. Under our Alternative simulation, waiting even 10 years would require a revenue increase of about 48 percent or noninterest spending cuts of 41 percent.

This gap is too large to simply grow out of the problem. To be sure, additional economic growth would help the nation’s financial condition and the ability to address the fiscal gap, but it will not eliminate the need for action.

Key Assumptions in Our Federal Simulations

Simulations are not forecasts or predictions. They are designed to ask the question “what if?” Our “what ifs” include what if discretionary spending is lower than the 20-year historical average and revenue higher than the historical average (as in Baseline Extended) or nearly at the historical averages (as in the Alternative). The two simulations illustrate a range of possible outcomes based on different policy decisions for the long-term budget outlook. Although the timing of deficits and the resulting debt buildup varies depending on the assumptions used, both simulations show that the federal government is on an unsustainable fiscal path.

The first simulation, Baseline Extended, follows CBO’s September baseline for the first 10 years: tax provisions that are scheduled to expire are assumed to do so (including the temporary increase in the alternative minimum tax [AMT] exemption amount) and discretionary spending is

assumed to grow with inflation. The Medicare estimates in this simulation assume the continuation of current law, under which fees for physicians treating Medicare patients would be cut in future years.⁷ At the end of the 10-year period, revenues in Baseline Extended are at 20.4 percent of GDP—a couple of points above the 20-year historical average. Discretionary spending is at 6.8 percent of GDP—somewhat below the 20-year historical average of 7.6 percent of GDP. For the remainder of the simulation period, levels of revenues and discretionary spending as shares of GDP are held constant.

CBO's baseline is not a forecast of future outcomes; rather, it is based on the assumption that current laws and policies remain the same.⁸ As such, we change some assumptions in our Alternative simulation to reflect historical trends and recent policy preferences. Under the Alternative scenario in the first 10 years we assume that all expiring tax provisions are extended and that the 2007 exemption amount for the AMT is continued but not indexed for inflation. After the first 10 years we bring revenues to their historical share of the economy—18.3 percent—plus expected revenues from deferred taxes (i.e., taxes on withdrawals from retirement accounts). Discretionary spending grows with the economy throughout the simulation period—it remains at 7.9 percent of GDP. This means that over the long term discretionary spending is within the range of historical averages. In addition, in the Alternative scenario we assume that payment rates to physicians will not be reduced as specified under current law and in CBO's baseline.⁹

We use two different sources for long-term projections of Social Security, Medicare, and Medicaid. In the first set of simulations, Social Security and

⁷Under the sustainable growth rate system and in CBO's baseline, physician payment rates are projected to be reduced by about 21 percent in 2010 and more each year thereafter. The Trustees noted in their 2008 report that Congress is virtually certain to prevent some or all of the scheduled reductions.

⁸The Balanced Budget and Emergency Deficit Control Act of 1985, which established rules that govern the calculation of CBO's baseline, expired on September 30, 2006. CBO continues to prepare baselines according to the methodology prescribed in that law.

⁹This reflects the fact that Congress has generally acted to prevent payment rates from being reduced. The Centers for Medicare & Medicaid Services (CMS) developed two illustrative Medicare estimates that vary from the intermediate estimates. One set of estimates assumes a 0 percent update to physician fees; the other assumes updates for medical inflation. Our Alternative simulation based on the Trustees' assumptions uses the 0 percent update estimates. For more information on these estimates, see CMS's March 2008 memorandum, "Projected Medicare Part B Expenditures under Two Illustrative Scenarios with Alternative Physician Payment Updates," available at http://www.cms.hhs.gov/ReportsTrustFunds/05_alternativePartB.asp.

Medicare are based on the Trustees' 2008 estimates. Medicaid spending is based on CBO's projections but adjusted to reflect excess cost growth consistent with the Trustees. Table 2 lists the key assumptions incorporated in the Baseline Extended and Alternative simulations for the simulations based on the Trustees' assumptions. In the second set of simulations, we use CBO's projections for Social Security, Medicare, and Medicaid. Table 3 shows the assumptions that differ from those shown in table 2.

Table 2: Assumptions for Baseline Extended and Alternative Simulations Based on the Trustees' Assumptions for Social Security and Medicare

Model inputs	Baseline Extended	Alternative
Revenue	CBO's September 2008 baseline through 2018; thereafter remains constant at 20.4 percent of GDP (CBO's projection in 2018)	All expiring tax provisions are extended through 2018; thereafter equal to 40-year historical average of 18.3 percent of GDP plus revenue from tax-deferred retirement plans
Social Security spending	CBO's September 2008 baseline through 2018; thereafter based on 2008 Social Security Trustees' intermediate projections	Same as Baseline Extended
Medicare spending	CBO's September 2008 baseline through 2018; thereafter 2008 Medicare Trustees' intermediate projections that assume per enrollee Medicare spending grows on average 1 percent faster than GDP per capita over the long term	2008 Trustees' intermediate projections adjusted for the Centers for Medicare & Medicaid Services' (CMS) alternative assumption of 0 percent physician payment rate updates in the first 10 years
Medicaid spending	CBO's September 2008 baseline through 2018; thereafter CBO's December 2007 long-term projections adjusted to reflect excess cost growth consistent with the 2008 Medicare Trustees' intermediate projections	Same as Baseline Extended
Other mandatory spending	CBO's September 2008 baseline through 2018; thereafter remains constant as a share of GDP at 2.0 percent of GDP (i.e., increases at the rate of economic growth)	Baseline Extended through 2011, then adjusted for extension of certain tax credits through 2018; thereafter remains constant at 2.1 percent of GDP
Discretionary spending	CBO's September 2008 baseline through 2018; thereafter remains constant at 6.8 percent of GDP	Increases at the rate of economic growth starting after 2008 (i.e., remains constant at 7.9 percent of GDP)

Source: GAO analysis.

Table 3: Key Assumptions Underlying GAO’s Simulations Using CBO’s Entitlement Spending Projections

Model inputs	Baseline Extended	Alternative
Social Security spending	CBO’s September 2008 baseline through 2018; thereafter CBO’s August 2008 projections that assume full benefits as calculated under current law are paid regardless of the amounts available in the trust funds. These projections are based on the 2008 Social Security Trustees’ demographic projections and CBO’s own economic assumptions.	Same as Baseline Extended
Medicare spending	CBO’s September 2008 baseline through 2018; thereafter CBO’s December 2007 projections based on current law. Per enrollee Medicare spending grows on average 1.7 percentage points faster than GDP per capita over the long term.	CBO’s projections that assume physician payment rates grow with inflation (using the Medicare economic index [MEI]) ^a
Medicaid spending	CBO’s September 2008 baseline through 2018; thereafter CBO’s December 2007 long-term projections based on current law. Per enrollee Medicaid spending grows on average 0.9 percentage points faster than GDP per capita over the long term.	Same as Baseline Extended

Source: GAO analysis.

Notes: CBO’s projections are from Updated Long-Term Projections for Social Security (August 2008) and The Long-Term Budget Outlook (December 2007).

^aThis is slightly higher than the assumption used in GAO’s alternative using the Trustees’ assumptions. In the Trustees’ analysis, expenditures under the MEI-based update are 22.5 percent higher than current law by 2017, whereas expenditures under the 0 percent update are only 16.8 percent higher.

A more detailed description of the federal model and key assumptions can be found at <http://www.gao.gov/special.pubs/longterm/>. Details on the state and local fiscal model can be found in appendix I of *State and Local Governments: Growing Fiscal Challenges Will Emerge during the Next 10 Years*.¹⁰

We conducted this work from September through October 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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¹⁰GAO-08-317.

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