

CBO TESTIMONY

Statement of
Peter R. Orszag
Director

The Long-Term Budget Outlook

before the
Committee on the Budget
U.S. House of Representatives

December 13, 2007

This document is embargoed until it is delivered at 10:00 a.m. (EST) on Thursday, December 13, 2007. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.



CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Mr. Chairman, Congressman Ryan, and Members of the Committee, I am pleased to testify before you this morning on the Congressional Budget Office's long-term budget outlook.

Introduction and Summary

Significant uncertainty surrounds long-term fiscal projections, but under any plausible scenario, the federal budget is on an unsustainable path—that is, federal debt will grow much faster than the economy over the long run. In the absence of significant changes in policy, rising costs for health care and the aging of the U.S. population will cause federal spending to grow rapidly. If federal revenues as a share of gross domestic product (GDP) remain at their current level, that rise in spending will eventually cause future budget deficits to become unsustainable. To prevent deficits from growing to levels that could impose substantial costs on the economy, revenues must rise as a share of GDP, or projected spending must fall—or some combination of the two outcomes must be achieved.

For decades, spending on Medicare and Medicaid—the federal government's major health care programs—has been growing faster than the economy, as has health spending in the private sector. The rate at which health care costs grow relative to national income—rather than the aging of the population—will be the most important determinant of future federal spending. The Congressional Budget Office (CBO) projects that under current law, federal spending on Medicare and Medicaid measured as a share of GDP will rise from 4 percent today to 12 percent in 2050 and 19 percent in 2082—which, as a share of the economy, is roughly equivalent to the total amount that the federal government spends today. (Unless otherwise indicated, all years referred to in this testimony are calendar years.) The bulk of that projected increase in health spending reflects higher costs per beneficiary rather than an increase in the number of beneficiaries associated with an aging population.

The rise in health care spending is the largest contributor to the growth projected for federal spending. Therefore, efforts to reduce overall government spending will require potentially painful actions to slow the rise of health care costs. There may be ways, however, in which policymakers can reduce costs without harming the health of Medicare and Medicaid beneficiaries. Changing those programs in ways that reduce the growth of costs—which will be difficult, in part because of the complexity of health policy choices—is ultimately the nation's central long-term challenge in setting federal fiscal policy.

The aging of the population, though not the primary factor driving higher government spending in the future, will nonetheless exacerbate fiscal pressures. For example, future growth in spending on Social Security will largely reflect demographic changes; CBO projects that such spending will increase from about 4 percent of GDP today to 6 percent in 25 years and then will roughly stabilize at that rate thereafter. Federal spending on programs other than Medicare, Medicaid, and Social Security—including national defense and a wide variety of domestic programs—is likely to contribute far less, if anything, to the upward trend in federal outlays as a share of GDP.

All of those projections raise fundamental questions of economic sustainability. If outlays increased as projected and revenues did not grow at a corresponding rate, deficits would climb and federal debt would grow significantly. Substantial budget deficits would reduce national saving, which would lead to an increase in borrowing from abroad and lower levels of domestic investment that in turn would constrain income growth in the United States. In the extreme, deficits could seriously harm the economy. Such economic damage could be averted by putting the nation on a sustainable fiscal course, which would require some combination of less spending and more revenues than the amounts now projected. Making such changes sooner rather than later would lessen the risk that an unsustainable fiscal path poses to the economy.

Table 1.**Assumptions About Spending and Revenue Sources Underlying CBO’s Long-Term Budget Scenarios**

	Extended-Baseline Scenario	Alternative Fiscal Scenario
	Assumptions About Spending	
Medicare	As scheduled under current law	Physician payment rates grow with the Medicare economic index (rather than using the lower growth rates scheduled under the sustainable growth rate mechanism)
Medicaid	As scheduled under current law	As scheduled under current law
Social Security	As scheduled under current law	As scheduled under current law
Other Spending Excluding Interest ^a	As projected in CBO’s 10-year baseline through 2017, then remains at the projected 2017 level as a share of GDP	Remains at the 2007 share of GDP
	Assumptions About Revenue Sources	
Individual Income Taxes	As scheduled under current law	2007 law with AMT parameters indexed for inflation after 2007
Corporate Income Taxes	As scheduled under current law	As scheduled under current law
Payroll Taxes	As scheduled under current law	As scheduled under current law
Excise and Estate and Gift Taxes	As scheduled under current law	Constant as a share of GDP for the entire period
Other Revenues	As scheduled under current law through 2017; constant as a share of GDP thereafter	As scheduled under current law through 2017; constant as a share of GDP thereafter

Source: Congressional Budget Office.

Notes: The extended-baseline scenario adheres closely to current law, following CBO’s 10-year baseline budget projections from 2008 to 2017 and then extending the baseline concept in its projections for the rest of the years in the 75-year projection period, to 2082. The alternative fiscal scenario deviates from CBO’s baseline projections even during the next 10 years, incorporating some changes in policy that are widely expected to occur and that policymakers have regularly made in the past.

GDP = gross domestic product; AMT = alternative minimum tax.

- a. Federal spending on the refundable portions of the earned income tax credit and the child tax credit is not held constant as a percentage of GDP but is instead modeled with the revenue portion of the scenarios.

Long-term projections rely on numerous assumptions about economic and fiscal factors, and many different assumptions are possible. For this analysis, CBO presents two scenarios that are based on different assumptions about the federal budget over the next 75 years (see Table 1).

- The “extended-baseline scenario” adheres most closely to current law, following CBO’s 10-year baseline for the first decade and then extending the baseline concept beyond that 10-year window.¹ The scenario’s assumption of current law implies that many policy adjustments that lawmakers have routinely made in the past will not occur.

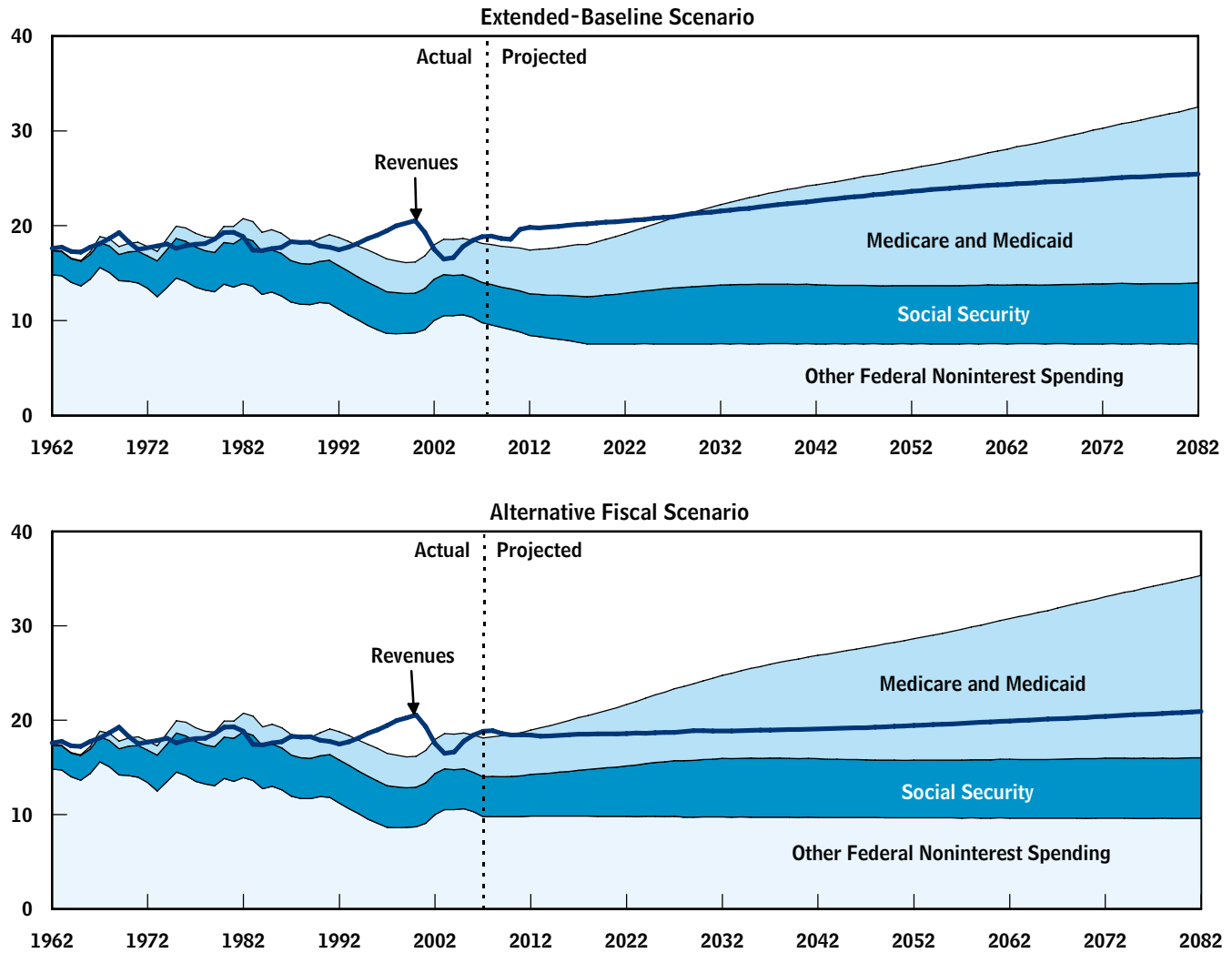
- The “alternative fiscal scenario” represents one interpretation of what it would mean to continue today’s underlying fiscal policy. This scenario deviates from CBO’s baseline even during the next 10 years because it incorporates some changes in policy that are widely expected to occur and that policymakers have regularly made in the past. Different analysts may perceive the underlying intention of current policy differently, however, and other interpretations are possible.

1. CBO’s baseline is a benchmark for measuring the budgetary effects of proposed changes in federal revenues or spending. The projections of budget authority, outlays, revenues, and the deficit or surplus that it comprises are calculated according to rules set forth in the Balanced Budget and Emergency Deficit Control Act of 1985.

Figure 1.

Revenues and Spending Excluding Interest, by Category, as a Percentage of Gross Domestic Product Under CBO's Long-Term Budget Scenarios

(Percent)



Source: Congressional Budget Office.

Note: The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections from 2008 to 2017 and then extending the baseline concept in its projections for the rest of the years in the 75-year projection period, to 2082. The alternative fiscal scenario deviates from CBO's baseline projections even during the next 10 years, incorporating some changes in policy that are widely expected to occur and that policymakers have regularly made in the past.

Under both scenarios, total primary spending (all spending except interest payments on federal debt) would grow sharply in coming decades, CBO estimates, rising from its current level of 18 percent of GDP to more than 30 percent by 2082, the end of the 75-year period that CBO's long-term projections span (see Figure 1). If spending policy did not change and outlays did indeed grow to such levels relative to the economy, maintaining a

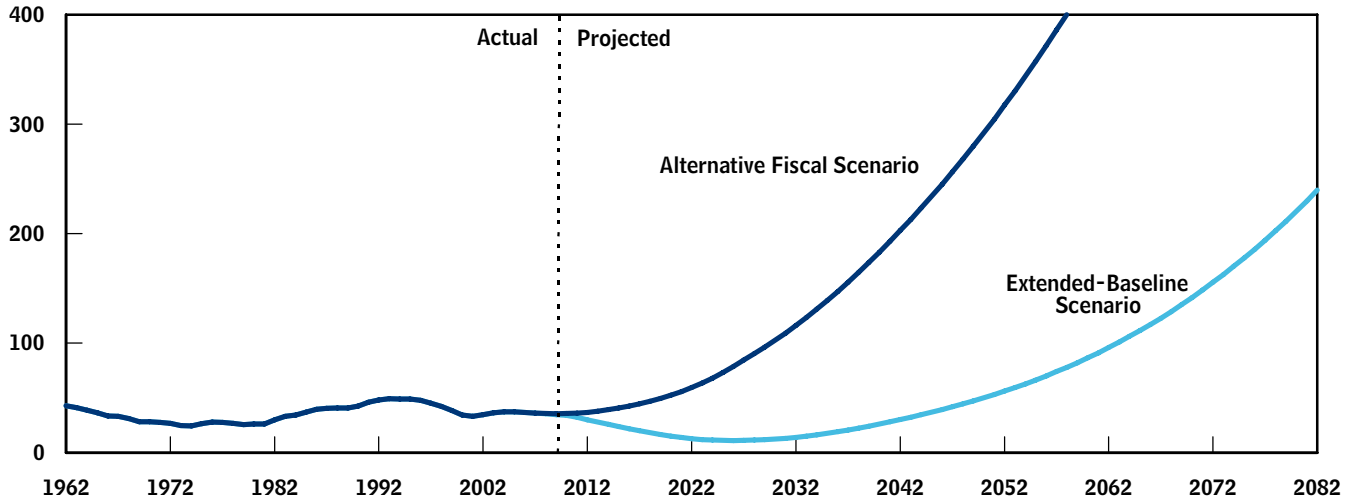
sustainable budget path would require that federal taxation rise similarly. In the past half-century, total federal revenues have averaged 18 percent of GDP and peaked at nearly 21 percent, well below projected levels of future spending.

Ultimately, both scenarios involve an unsustainable fiscal path, but they differ significantly in their projections of

Figure 2.

Federal Debt Held by the Public as a Percentage of Gross Domestic Product Under CBO's Long-Term Budget Scenarios

(Percent)



Source: Congressional Budget Office.

Note: The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections from 2008 to 2017 and then extending the baseline concept in its projections for the rest of the years in the 75-year projection period, to 2082. The alternative fiscal scenario deviates from CBO's baseline projections even during the next 10 years, incorporating some changes in policy that are widely expected to occur and that policymakers have regularly made in the past.

revenues and in the extent and timing of substantial increases in federal debt:

■ Under the extended-baseline scenario, revenues would reach substantially higher levels than have ever been recorded during the nation's history.² Under this scenario, the 2001 and 2003 legislation that lowered tax rates would expire as scheduled at the end of 2010, and the impact of the alternative minimum tax (AMT) would expand substantially over time (because its parameters, unlike most parts of the tax system, are not indexed to inflation).³ In addition, ongoing increases in real income (that is, income after an adjustment for inflation) would push taxpayers into higher income tax brackets. As a result, by 2082, federal revenues would reach 25 percent of GDP. With

the projected revenue increases embodied in this scenario, federal debt held by the public would fall relative to GDP until 2026. Then it would start to climb, and if federal spending were allowed to grow as projected, policymakers would have to raise revenues further to keep the growth of debt from outpacing the growth of the economy (see Figure 2 and Table 2).

■ Under the alternative fiscal scenario, by contrast, none of the changes to tax law scheduled after 2007 would take effect, and the AMT would be indexed to inflation. As a result, revenues would remain roughly constant as a share of GDP. The combination of roughly constant revenues and significantly rising expenditures would quickly create an unstable fiscal situation.

2. The projections that make up CBO's baseline are not intended to be predictions of future budgetary outcomes; rather, they represent CBO's best judgment of how economic and other factors would affect federal revenues and spending if current laws and policies remained in place. For details, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2017* (January 2007), p. 5.

3. The AMT is a parallel income tax system with fewer exemptions, deductions, and rates than the regular income tax. Households must calculate their tax liability (the amount they owe) under both the AMT and the regular income tax and pay the larger of the two amounts.

Table 2.**Projected Spending and Revenues as a Percentage of Gross Domestic Product Under CBO's Long-Term Budget Scenarios**

(Percent)

	2007 ^a	2030	2050	2082
Extended-Baseline Scenario				
Primary Spending				
Social Security	4.3	6.1	6.1	6.4
Medicare ^b	2.7	5.6	8.9	14.8
Medicaid	1.4	2.5	3.1	3.8
Other noninterest	9.9	7.7	7.6	7.6
Subtotal, Primary Spending	18.2	21.8	25.7	32.5
Interest	1.7	0.6	2.3	11.0
Total, Federal Spending	20.0	22.4	28.1	43.6
Revenues	18.8	21.4	23.5	25.5
Deficit (-) or Surplus				
Primary deficit (-) or surplus	0.5	-0.4	-2.3	-7.1
Total deficit	-1.2	-1.0	-4.6	-18.1
Alternative Fiscal Scenario				
Primary Spending				
Social Security	4.3	6.1	6.1	6.4
Medicare ^b	2.7	5.9	9.4	15.6
Medicaid	1.4	2.5	3.1	3.7
Other noninterest	9.9	9.8	9.7	9.6
Subtotal, Primary Spending	18.2	24.2	28.3	35.3
Interest	1.7	4.8	13.6	40.1
Total, Federal Spending	20.0	29.0	41.8	75.4
Revenues	18.8	18.9	19.4	20.9
Deficit (-) or Surplus				
Primary deficit (-) or surplus	0.5	-5.3	-8.9	-14.4
Total deficit	-1.2	-10.1	-22.5	-54.5

Source: Congressional Budget Office.

Note: The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections from 2008 to 2017 and then extending the baseline concept in its projections for the rest of the years in the 75-year projection period, to 2082. The alternative fiscal scenario deviates from CBO's baseline projections even during the next 10 years, incorporating some changes in policy that are widely expected to occur and that policymakers have regularly made in the past.

- a. For 2007, numbers are actual and on a fiscal year basis.
b. Spending for Medicare beneficiaries is net of premiums.

A useful metric for the size of the adjustments in either spending or revenues required to avoid unsustainable increases in government debt is provided by the so-called fiscal gap. The gap measures the immediate change in spending or revenues necessary to generate a stable fiscal trajectory over a given period. Under the extended-baseline scenario, the fiscal gap would amount to 0.6 per-

cent of GDP through 2057 and 1.7 percent of GDP through 2082 (see Box 1). In other words, under that scenario, an immediate and permanent reduction in spending or an immediate and permanent increase in revenues of 1.7 percent of GDP—or an even larger percentage, if the change in policy was delayed—would be necessary to create a sustainable fiscal path through 2082.

Box 1.

The Fiscal Gap

One perspective on the federal government’s financial status can be garnered by examining projections of annual revenues and outlays. Present-value measures augment those annual data by summarizing the expected long-term flows of receipts and spending in a single number. (A present-value calculation adjusts future payments for the time value of money to make them comparable with payments today.) The fiscal gap is a present-value measure of the nation’s fiscal imbalance.

That imbalance is a measure of federal shortfalls over a given period. It represents the extent to which the government would need to immediately and permanently either raise tax revenues or cut spending—or do both, to some degree—to make the government’s debt the same size (in relation to the economy) at the end of that period as it was at the beginning.

The Congressional Budget Office (CBO) calculates the present value of a stream of future revenues by taking the revenues for each year, discounting each value to 2007 dollars, and then summing the resulting series. The same method is applied to the projected stream of outlays.¹ CBO also computes a present value for future gross domestic product (GDP). (The table to the right presents the present value of outlays and revenues as a share of the present value of GDP.)

Federal Fiscal Gap Under CBO’s Long-Term Budget Scenarios

(Percentage of gross domestic product)

Projection Period	Revenues	Outlays	Fiscal Gap
Extended-Baseline Scenario			
25 Years (2008-2032)	20.2	19.5	-0.7
50 Years (2008-2057)	21.3	21.9	0.6
75 Years (2008-2082)	22.1	23.8	1.7
Alternative Fiscal Scenario			
25 Years (2008-2032)	18.6	21.4	2.8
50 Years (2008-2057)	18.8	24.1	5.2
75 Years (2008-2082)	19.2	26.1	6.9

Source: Congressional Budget Office.

Note: The extended-baseline scenario adheres closely to current law, following CBO’s 10-year baseline budget projections from 2008 to 2017 and then extending the baseline concept in its projections for the rest of the years in the 75-year projection period, to 2082. The alternative fiscal scenario deviates from CBO’s baseline projections even during the next 10 years, incorporating some changes in policy that are widely expected to occur and that policymakers have regularly made in the past.

1. To allow for the increase in the nominal value of the debt that would occur, even if that debt was maintained at its current share of gross domestic product (GDP), the present value of outlays is adjusted to account for that change in debt. Specifically, the current debt is added to the outlay measure, and the present value of the target end-of-period debt is subtracted. (The end-of-period debt is equal to GDP in the last year of the period multiplied by the 2007 debt-to-GDP ratio.)

Under the alternative fiscal scenario, the fiscal gap would be much larger, amounting to 5.2 percent of GDP through 2057 and 6.9 percent through 2082.

Under both scenarios, growing budget deficits and the resulting increases in federal debt could lead to slower economic growth. The effects would be most striking under the alternative fiscal scenario—debt would begin

to climb rapidly and would reach roughly 300 percent of GDP by 2050. That rising federal debt would affect the capital stock (businesses’ equipment and structures as well as housing). In CBO’s estimation, debt would reduce the capital stock—compared with what it would be if deficits were held to their share of the economy in 2007—by 40 percent in 2050 and would lower real gross

national product (GNP) by 25 percent.⁴ Although the outlook for the economy under the extended-baseline scenario would be more auspicious in the near term, over the long run, rising deficits would also lead to significant economic harm.

Differences between the economic costs of one policy for achieving long-term fiscal sustainability and those of another are generally modest in comparison with the costs of allowing deficits to grow to unsustainable levels. In particular, the difference in economic costs between acting to address projected deficits (by either reducing spending or raising revenues) and failing to do so is generally much larger than the cost implications of pursuing one approach to deficit reduction rather than another. Nonetheless, a policy of reducing the growth of spending would in general impose smaller macroeconomic costs than one of increasing tax rates, although the economic effects would depend in part on the specific measures that were adopted.

On the spending side of the budget, the most significant cause of future long-term growth—health care costs—is also particularly complicated to address. Policymakers face both challenges and opportunities in trying to reduce those costs. Over long periods, cost growth per beneficiary in the Medicare and Medicaid programs has tended to track cost trends in private-sector markets for health care. Many analysts therefore believe that significantly constraining the growth of costs for Medicare and Medicaid is possible only in conjunction with slowing the growth of costs in the health sector as a whole.

A variety of evidence suggests that opportunities exist to constrain costs without incurring adverse consequences for health outcomes—and even perhaps to simultaneously reduce cost growth and improve health. So a central challenge will be to restrain the growth of costs without harming the incentives to provide appropriate care and develop valuable new health treatments. Moving the nation toward that possibility—which would inevitably be an iterative process in which policy steps were tried,

4. Gross national product measures the income of residents in the United States after deducting net payments to foreigners. Gross domestic product, by contrast, measures the income that is generated by the production of goods and services on U.S. soil, including the production that is financed by foreign investors. Because rising deficits can increase borrowing from foreigners, GNP is a better measure of the economic effects of deficits than is GDP.

evaluated, and perhaps reconsidered—is essential to moving the country toward a sounder long-term fiscal footing.

The Outlook for Federal Spending

For much of its history, the United States devoted only a small fraction of its resources to the activities of the federal government. But the second half of the 20th century marked a period of sustained higher peacetime spending by the federal government. For the past 50 years, federal outlays have averaged about 20 percent of GDP. In fiscal year 2007, those outlays totaled \$2.7 trillion.

Not only has the amount of such spending grown, but its composition has changed dramatically. Spending for mandatory programs has increased from less than one-third of total federal outlays in the early 1960s to more than one-half in recent years. Most of that growth has been concentrated in Medicare, Medicaid, and Social Security. Together, gross outlays for those programs now account for about 45 percent of federal outlays, compared with 2 percent in 1950 (before the health programs were created) and 25 percent in 1975.

The most significant factor in the future growth of federal spending, as noted earlier, will be spending on Medicare and Medicaid. Rising costs for health care are boosting spending for those programs to a greater degree than can be explained solely by increases in enrollment and general inflation. Since 1975, all factors, including policy changes, have caused annual costs per Medicare enrollee (after adjustments for changes in the age distribution, or profile, of the beneficiary population) to grow an average of 2.4 percentage points faster than per capita GDP—a difference referred to as excess cost growth. Over the same period, excess cost growth in Medicaid was 2.2 percent.

For its long-term projections, CBO assumed that even in the absence of changes in federal law, rates of spending growth in the Medicare and Medicaid programs would probably moderate to some degree. As costs continue to rise, regulatory changes are likely at the federal level. At the state level, both legal and regulatory changes will probably occur; those changes would directly affect Medicaid, which is a joint federal–state program. And actions by employers, households, and insurance firms to slow the rate of health cost growth in the private sector are likely to affect the public insurance programs to some

Box 2.

Aging, Excess Cost Growth in Health Spending, and the Federal Budget

The nation's long-term fiscal outlook is affected by the rapid growth of health care costs and an aging population. Health care costs and demographics each affect government spending and revenues independently. The interaction of demographics and health care costs is also important.

One method for estimating the effect of aging on spending growth for Medicare, Medicaid, and Social Security is to ask how much spending would rise if aging were the only factor driving that growth.¹ The first approach examines the increase in spending for Medicare, Medicaid, and Social Security when the population profile is allowed to change over time as the population ages but excess cost growth is constrained to be zero. (Excess cost growth is the percentage by which the growth of health care costs per individual exceeds the growth of per capita gross domestic product, or GDP.) Under that method, aging would account for 27 percent of the total projected increase in Medicare, Medicaid, and Social

Security spending as a share of GDP through 2050 and 20 percent through 2082.² The relative effect of aging is projected to decrease over time as the impact of excess cost growth accumulates.

Another way to measure the effect of aging on spending is to ask how much lower spending would be if the aging factor was removed from the projections. Suppose that excess cost growth was consistent with the assumptions underlying the Congressional Budget Office's (CBO's) alternative fiscal scenario but the population profile is constrained not to change over time. Under that method, spending on Medicare, Medicaid, and Social Security as a share of GDP through 2050 would be 39 percent lower than it would be if the population's aging was a factor in the calculations; through 2082, that spending would be 38 percent lower. The effects on spending that can be attributed to aging would be greater under this approach than under the previous method because excess cost growth would amplify those effects.

1. For the purposes of assessing the effects of an aging population, the Congressional Budget Office (CBO) used the assumptions of the alternative fiscal scenario. For the calculations above, CBO used the path for gross domestic product from the alternative fiscal scenario.

2. However, as noted in CBO's November 2007 report *The Long-Term Outlook for Health Care Spending*, if Medicare and Medicaid were considered on their own, aging would account for only 10 percent of the projected spending increase through 2082.

extent.⁵ Yet even under an assumption of slowing growth rates, total federal Medicare and Medicaid outlays over the next 75 years would grow from 4 percent of GDP to 19 percent, CBO projects.

The retirement of the baby-boom generation (the large group of people born between 1946 and 1964) portends a long-lasting shift in the age profile of the U.S. population, a shift that will substantially alter the balance between the population's working-age and retirement-age components. The share of people age 65 or older is projected to grow from 12 percent in 2007 to 19 percent in

2030, and the share of people ages 20 to 64 is expected to fall from 60 percent to 56 percent. Aging will contribute to the growth of health care spending, but excess cost growth will remain the dominant factor.

By comparison, aging will be the primary factor in the growth of costs in the Social Security program. CBO projects that the number of workers per Social Security beneficiary will decline significantly over the next three decades, dropping from about 3.2 now to 2.1 in 2030. Unless immigration, fertility, or mortality rates change markedly, that number will continue to slowly fall after 2030. The interaction of growth in the retired population and the current structure of Social Security leads CBO to project that the total cost of Social Security benefits will

5. See Congressional Budget Office, *The Long-Term Outlook for Health Care Spending* (November 2007).

Box 2.

Continued

CBO also measured the relative effects of excess cost growth and the coming age shifts in the population by examining how those factors might affect the fiscal gap and projected federal debt in 2082.³ As under the first method above, the results from a scenario that incorporates no excess cost growth but allows the population's age profile to change was compared with the overall fiscal gap. From that comparison, aging would account for 21 percent of the fiscal gap through 2057 and 20 percent through 2082.

The second method described above can also be used to consider how removing the aging population's effects would influence the fiscal gap. Under that method, aging would account for 31 percent of the gap through 2057 and 32 percent through 2082. As with the measures of spending described earlier, the effects on the gap attributable to aging would be greater under this approach because of the interaction with excess cost growth.

3. For all of the fiscal gap calculations described here, the paths for GDP and revenues match those generated under the alternative fiscal scenario. The fiscal gap is a measure of federal shortfalls over a given period. It represents the extent to which the government would need to immediately and permanently either raise tax revenues or cut spending—or do both, to some degree—to make the government's debt the same size (in relation to the economy) at the end of that period as it was at the beginning.

As the federal government's major health care programs, Medicare and Medicaid clearly are directly affected by the growth of health care costs. What is not so obvious is how such growth might affect revenues. First, a rise in health insurance premiums would reduce the portion of compensation that employees receive as wages. The amount of that reduction would then shift from being a taxed amount (part of wages) to being an untaxed form of compensation. Second, income tax deductions related to medical expenses would also rise relative to income as health care costs rose. (Such deductions include both the deduction of health insurance premiums for the self-employed and the itemized deductions for medical expenses.)

Relative to a scenario in which health care costs grew at the same rate as GDP per capita (in other words, a scenario incorporating no excess cost growth), income tax revenues in 2082 under the alternative fiscal scenario would be lower by 1.6 percentage points of GDP, in CBO's estimation. Payroll taxes in that year would be lower by 0.7 percentage points of GDP.⁴

4. Reductions in taxable payroll would also reduce Social Security benefits in the future.

rise from 4.3 percent of GDP in fiscal year 2007 to 6.1 percent in 2030. (For further discussion of the relationship between the aging of the population and federal outlays, see Box 2.)

The different assumptions underlying CBO's extended-baseline and alternative fiscal scenarios lead to different views of the future path of federal spending. In the case of spending for Medicare, for example, assumptions about the sustainable growth rate (SGR) mechanism for updating Medicare's payment rates for physicians would lead to

slightly lower spending under the extended-baseline scenario than under the alternative fiscal scenario. Under the extended-baseline's assumption that current law prevails, the SGR mechanism would reduce physician payment rates by about 4 percent or 5 percent annually for at least the next several years. However, since 2003, the Congress has acted to prevent such reductions. Therefore, under the alternative fiscal scenario, Medicare's physician payment rates would grow with the Medicare economic index (which measures inflation in the inputs used for physicians' services). The difference in spending for

Medicare under the two scenarios is less than 1 percent of GDP in all 75 years of the projection period.

A larger difference between the scenarios involves the assumption about other federal spending—that is, spending for programs other than Social Security, Medicare, and Medicaid but excluding interest on the public debt. Under the extended-baseline scenario, other federal spending in 2018 and later would equal about 7.7 percent of GDP, consistent with the projections for fiscal year 2017 in CBO’s March baseline and projected levels of refundable tax credits. Under the alternative fiscal scenario, other spending during the projection period would remain about at its current level of 9.8 percent of GDP.

Spending for Social Security and Medicaid would be identical under both scenarios. In addition, both scenarios incorporate the assumption that the Social Security and Medicare programs will continue to pay benefits as currently scheduled, notwithstanding the projected insolvency of the programs’ trust funds.⁶

Under the extended-baseline scenario, primary spending (outlays excluding interest payments) would grow from 18.2 percent of GDP in fiscal year 2007 to 21.8 percent in 2030, 25.7 percent in 2050, and 32.5 percent in 2082. The biggest factor in that growth would be the rise in spending in the Medicare and Medicaid programs.

Primary spending would be higher under the alternative fiscal scenario than under the extended-baseline scenario, largely because of the assumed difference in the amount of other federal spending. Under the alternative scenario, primary spending would reach 24.2 percent of GDP in 2030, 28.3 percent in 2050, and 35.3 percent in 2082.

The Outlook for Revenues

Like federal spending, revenues have been significantly higher in the past half-century than in previous eras, fluctuating between 16.1 percent and 20.9 percent of GDP since 1957. And just as spending priorities have changed during that period, the composition of revenues has

shifted. As a share of total receipts, social insurance payroll taxes (for Social Security, Medicare, unemployment insurance, and retirement programs for federal civilian employees) have increased along with the size of the underlying programs, whereas the shares of corporate income taxes and excise taxes have diminished.

In fiscal year 2007, total federal revenues were 18.8 percent of GDP. Under the extended-baseline scenario, the 2001 and 2003 tax cuts would expire as scheduled and the individual alternative minimum tax would be unchanged. Under that scenario, tax payments for the first 10 years of the 75-year projection period would be identical to CBO’s March 2007 baseline; payments would then rise relative to GDP thereafter, increasing by roughly 6.5 percentage points to reach 25 percent of GDP by 2082.

Over a long period, the cumulative effects of inflation and the real growth of income would interact with the tax system under the extended-baseline scenario (and, to a lesser extent, under the alternative fiscal scenario). The result would be higher average tax rates (that is, taxes as a share of income) and a significant change in the way the overall tax burden is distributed among households. Under the extended-baseline scenario, the cumulative effects of inflation would make about half of all households subject to the AMT by 2035. By 2082, more than three-quarters of households would be subject to it.

Under the alternative fiscal scenario, none of the scheduled changes in tax law after 2007 would take effect, and the parameters of the AMT would be indexed to inflation in 2008 and beyond. Under this scenario, tax receipts would rise by roughly 2 percent of GDP over the next 75 years.

Projected Deficits and Debt

For a path of spending and revenues to be sustainable, any resulting debt must eventually grow no faster than the economy. Sustained deficits lead to larger amounts of debt, which in turn result in more spending on interest. Therefore, even moderate primary deficits—deficits excluding interest costs—can lead to unsustainable growth in federal debt. A useful barometer of fiscal policy is the amount of government debt held by the public as a percentage of GDP. (For a discussion of why such debt is important, see Box 3.) At the end of fiscal year 2007, that

6. The funds’ balances represent the total amount that the government is legally authorized to spend on each program. For a fuller discussion of the legal issues related to trust-fund insolvency, see Congressional Research Service, *Social Security: What Would Happen If the Trust Funds Ran Out?* RL33514 (updated June 14, 2007).

debt was 37 percent of GDP, which is slightly above the average for the past 40 years.

Under the extended-baseline scenario's assumptions (specifically, that the 2001 and 2003 tax changes expire at the end of 2010 and the other-spending category declines substantially over the next 10 years), the federal budget would show a surplus from 2011 through 2024. Historically high levels of revenues and historically low levels of spending on programs other than Medicare, Medicaid, and Social Security would cause federal debt to fall substantially during that period, dropping to 11 percent of GDP in 2025—a smaller share than in any year since World War I. Debt would not return to its current share of GDP until 2045. However, if health costs continued to grow as projected under the scenario, deficits would return, and debt would start to climb rapidly. By the end of the 75-year projection period, debt would reach 239 percent of GDP and be poised to continue on an unsustainable path.

Under the alternative fiscal scenario, deficits would begin to grow immediately. In fiscal year 2007, the deficit was 1.2 percent of GDP; under the alternative fiscal scenario, it would grow to 1.8 percent of GDP in 2010 and 10.1 percent in 2030. The spiraling costs of interest payments would result in clearly unsustainable levels of debt relatively quickly. At the end of World War II, federal debt peaked at 109 percent of GDP; under the alternative fiscal scenario, debt would reach that share in 2031 and continue to rise sharply thereafter. Many budget analysts believe that the alternative fiscal scenario presents a more realistic picture of the nation's underlying fiscal policy than the extended-baseline scenario does (because, for example, the alternative fiscal scenario does not allow the impact of the AMT to substantially expand). To the extent that such a perspective is valid, the explosive path of federal debt under the alternative fiscal scenario should underscore the need for corrective steps to put the nation on a sustainable fiscal course.

How Would Rising Federal Debt Affect the Economy?

CBO's two long-term budget scenarios would have different effects on the economy. Under the extended-baseline

scenario, outcomes early on would be considerably more auspicious, but under both scenarios, the growth of debt would eventually accelerate as the government attempted to finance its interest payments by issuing more debt—leading to a vicious circle in which it issued ever-larger amounts of debt in order to pay ever-higher interest charges. In the end, the costs of servicing the debt would outstrip the economic resources available for covering those expenditures.

Sustained and rising budget deficits would affect the economy by absorbing funds from the nation's pool of savings and reducing investment in the domestic capital stock and in foreign assets. As capital investment dwindled, the growth of workers' productivity and of real wages would gradually slow and begin to stagnate. As capital became scarce relative to labor, real interest rates would rise. In the near term, foreign investors would probably increase their financing of investment in the United States, which would help soften the impact of rising deficits on productivity in the United States. However, borrowing from abroad would not be without its costs. Over time, foreign investors would claim larger and larger shares of the nation's output, and fewer resources would be available for domestic consumption.

To be sure, budget deficits are not always harmful. When the economy is in a recession, deficits can stimulate demand for goods and services and bring the economy back to full employment. But the deficits that would arise under CBO's long-term scenarios would occur not because the federal government was trying to pull the economy out of a recession but for a more fundamental reason: because the government was spending more and more for health care programs and for interest payments on accumulated debt. Over time, those deficits would crowd out productive capital investment in the United States.

How much would the deficits projected under the two budget scenarios affect the economy? CBO addressed that question by comparing results under the scenarios with those from another set of assumptions under which the deficit in the long run is stabilized at roughly its percentage of GDP in 2007. For that analysis, CBO used a textbook growth model that can assess how persistent

Box 3.

Why Is Federal Debt Held by the Public Important?

When the federal government's annual spending exceeds its annual revenues, the government's budget is in deficit. To finance the shortfall, the government generally has to borrow funds from the public by selling Treasury securities (bonds, notes, and bills).¹ That additional borrowing increases the total amount of federal debt held by the public, which reflects the accumulation of annual budget deficits offset by past budget surpluses.

Growth in such debt is not necessarily a problem. As long as the economy is also expanding just as fast and interest rates are stable, the ratio of debt to gross domestic product (GDP) and the share of GDP that must be devoted to paying interest on the debt will remain stable. Moreover, even if debt grows faster than GDP for a limited time, difficulties do not always arise. But such growth cannot go on forever; at some point, the economy will be unable to provide enough resources for the government to pay the interest due on the debt.

Gross debt is another measure of federal indebtedness that often receives attention, but it is not useful for assessing how the Treasury's operations affect the

economy. Gross federal debt comprises both debt held by the public and debt issued to various accounts of the federal government, including the major trust funds in the budget (such as those for Social Security). Because the debt issued to those accounts is intragovernmental in nature, it has no direct and immediate effect on the economy. Instead, it simply represents credits to the various government accounts that can be redeemed as necessary to authorize payments for benefits or other expenses. Although the Treasury assigns earnings in the form of interest to the funds that hold the securities, such payments have no net effect on the budget.

Debt as a Measure of Fiscal Sustainability

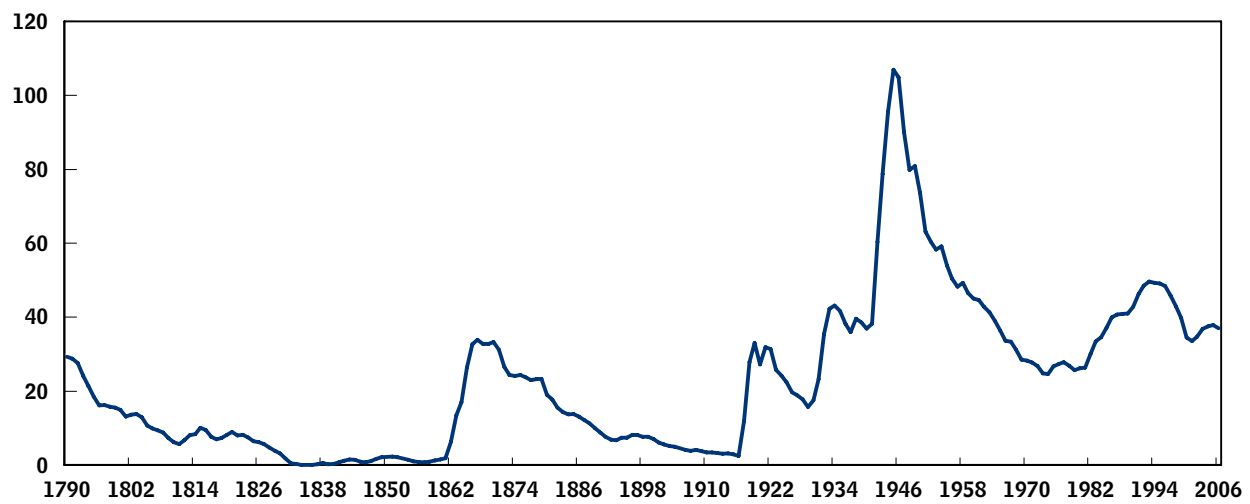
Long-term projections of federal debt held by the public (measured relative to the size of the economy) provide useful yardsticks for assessing the sustainability of fiscal policies. If budget projections are carried out far enough into the future, they can show whether current commitments imply that spending will consistently exceed revenues and will produce debt that grows faster than the economy. Projections of debt relative to GDP can thus indicate whether changes in current policies may be necessary at some point in the future.

1. In most years, the amount of debt that the Treasury borrows or redeems roughly equals the annual budget deficit or surplus. However, the correspondence is not exact because a small amount of the deficit can also be financed by changes in other means of financing (which include reductions or increases in the government's cash balances, seigniorage, changes in outstanding checks, changes in accrued interest costs included in the budget but not yet paid, and cash flows reflected in credit financing accounts). However, because changes in other means of financing are small, they play no significant role in the Congressional Budget Office's long-term projections of the deficit.

Box 3.

Continued

Federal Debt Held by the Public as a Percentage of Gross Domestic Product



Source: Congressional Budget Office.

Historical and Cross-Country Debt Comparisons

Comparisons with other times and places can provide some perspective on the sustainability of the deficits projected under the Congressional Budget Office's (CBO's) two long-term budget scenarios. The shortfalls anticipated in 2082 under either one would be large by any standard. Since the founding of the United States, the annual budget deficit has exceeded 10 percent of GDP in only a few instances, during major wars. Moreover, total federal debt held by the public has surpassed 100 percent of GDP only for a brief period during and just after World War II (see the figure, above). That budgetary situation was temporary, however. As soon as the war was over, federal debt held by the public began to decline as a share of the economy. In fact, until the 1980s, the ratio of debt to GDP had never risen significantly during a period of peace and prosperity.

Other nations have accumulated large amounts of debt, but the amount projected for the United States under CBO's two scenarios would eventually be greater than the amount of debt other industrialized countries have carried in the post-World War II period. For example, during the second half of the 1990s, net public debt averaged about 103 percent of GDP in Italy and 110 percent in Belgium.² However, those countries' experiences involved debt that, relative to GDP, fell modestly (in Italy) or dropped significantly (in Belgium), not debt that rose ever faster. Even so, to keep their debt under control, those governments had to make significant changes in fiscal policy simply to cover the interest payments on their debt.

2. Organisation for Economic Co-operation and Development, *Economic Outlook* (Paris: OECD, June 2007).

deficits might affect the economy over the long term. The model incorporates the assumption that deficits affect capital investment in the future as they have in the past.⁷

Alternative Fiscal Scenario

The model's simulations indicate that the rising level of federal debt under this scenario could reduce the capital stock in 2040 by about 25 percent compared with what it would be if the deficit were held to its 2007 share of GDP. The reduction in the capital stock (and the increased indebtedness to foreigners) would in turn reduce real GNP in 2040 by about 13 percent. Losses to the U.S. economy would grow rapidly after 2040. By 2050, rising federal debt would reduce the capital stock by more than 40 percent and real GNP by more than 25 percent. (Beyond 2062, projected deficits become so large and unsustainable that CBO's textbook growth model cannot calculate their effects.)

Such estimates, if anything, understate the risk to economic growth under this scenario. They are based on a model that incorporates the assumption that people do not anticipate future changes in debt; as a result, the model predicts a gradual change in the economy as federal debt rises. In actuality, the economic effects of rapidly growing debt would probably be much more disorderly and could occur well before 2063 under this scenario. If foreign investors began to expect a crisis, they might significantly reduce their purchases of U.S. securities, causing the exchange value of the dollar to plunge, interest rates to climb, consumer prices to shoot up, or the economy to contract sharply. Amid the anticipation of declining profits and rising inflation and interest rates, stock prices might fall and consumers sharply reduce their purchases. In such circumstances, the economic problems in this country would probably spill over to the rest of the world and seriously weaken the economies of the United States' trading partners.

Adopting a policy of higher inflation by printing money to finance the deficit would reduce the real value of the government's debt and provide relief in the short run, but printing money is not a feasible long-term strategy for dealing with persistent budget deficits. Without question, an unexpected increase in inflation would, in the short run, enable the government to repay its debt in cheaper

7. For a description of the textbook growth model, see Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008* (March 2007), Appendix D.

dollars. But financial markets would not be fooled for long, and investors would eventually demand higher interest rates. If the government continued to print money to finance deficits, the policy would eventually lead to hyperinflation (as Germany experienced in the 1920s, Hungary in the 1940s, Argentina in the 1980s, and the Federal Republic of Yugoslavia in the 1990s). Moreover, interest rates could remain high for some time even after inflation was brought back under control. High inflation causes governments to lose credibility in financial markets, and once that credibility has been lost, regaining it can be difficult. In the end, printing money to finance deficits cannot address the fundamental problem that spending exceeds revenues.

Extended-Baseline Scenario

The extended-baseline scenario, by contrast, offers a less threatening budget outlook, at least for the next several decades. Under that scenario, the federal budget would move to a surplus in 2011 and remain in that positive fiscal condition until about 2025. After that, the scenario shows budget deficits emerging again, but the outstanding stock of federal debt would remain at or below its current share of GDP for several decades.

The budget surplus under the extended-baseline scenario would be generated in large part from higher revenues. By CBO's calculations, marginal tax rates on capital (that is, the tax rate on the last dollar of capital income) would increase from 14 percent in 2007 to 16 percent in 2040; marginal tax rates on labor would climb from 28 percent in 2007 to 31 percent in 2040. Those higher tax rates could affect the economy in various ways, and because their effects are uncertain, CBO's analysis used two different economic models to estimate their impact.⁸ The models encompass a wide range of views about how taxes affect the economy.

What would happen to the economy if tax rates rose to the levels projected under the extended-baseline scenario

8. One model is the textbook growth model; the other is a forward-looking life-cycle model that includes wage uncertainty and constraints on borrowing. CBO uses both models in its annual analysis of the President's budget. For more information on the models, see Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*. In using the life-cycle model to analyze the extended-baseline scenario, CBO compared steady-state economies only. The simulations of the life-cycle model thus do not incorporate an analysis of the transitional effects between 2007 and 2040.

in 2040 and remained at those levels thereafter? CBO found that in that case, real GNP could fall 1 percent to 4 percent below what it would be in that year if tax rates were held at their 2007 levels.⁹ Although such a reduction in GNP would be noticeable, it is small in comparison with how much the economy could grow over the same period under a sustainable budget policy. If the budget was put on a sustainable path by keeping tax and spending rates close to their current levels, real GNP could grow by 110 percent between 2007 and 2040. Although under the extended-baseline scenario, the higher tax rates in 2040 would reduce that growth, real GNP would still be 101 percent to 108 percent higher than it is today, CBO estimates.

The modest effect that taxes have on the economy in those simulations stems largely from the fact that under the extended-baseline scenario, marginal tax rates would not increase very much between 2007 and 2040; instead, most of the additional revenues generated under the scenario would stem from a broadening of the tax base. If revenues were raised mainly through higher marginal tax rates, the economic effects would be more negative.¹⁰

The outlook for the economy under the extended-baseline scenario is more problematic in the decades after 2050. Under the scenario's assumptions, by 2080, federal debt would be more than 200 percent of GDP, and according to the textbook growth model, that debt would reduce the capital stock by about 40 percent and real GNP by more than 25 percent. For the same reasons cited earlier, forward-looking financial markets would probably precipitate a crisis before 2080 under this scenario.

9. In the simulations, spending would also increase to match the path of spending under the extended-baseline scenario. However, the forward-looking life-cycle model would require further adjustments in policy to finance the budget deficit that is projected to emerge under the extended-baseline scenario in 2040. (Because the textbook growth model is not a forward-looking model, it does not require explicit assumptions about how the deficit in 2040 would be financed.) For the simulations of the life-cycle model, CBO assumed that the deficit in that year would be financed by reducing spending on benefit payment to individuals.

10. See Congressional Budget Office, *Financing Projected Spending in the Long Run* (July 9, 2007).

What Are the Costs of Delaying Action on the Budget?

The choice facing policymakers is not whether to address rising deficits and debts but when and how to address them. Under the extended-baseline scenario, projected revenue increases would be sufficient to avoid serious budgetary and economic troubles until after 2050, but those increases would result in federal revenues that were much higher, as a percentage of GDP, than the nation has been accustomed to. Under the alternative fiscal scenario, such troubles would begin in the next couple of decades, and the longer that policy action on the budget was put off, the more costly and difficult it would be to resolve those expected long-term budgetary imbalances.

Delays in taking action would create three major problems:

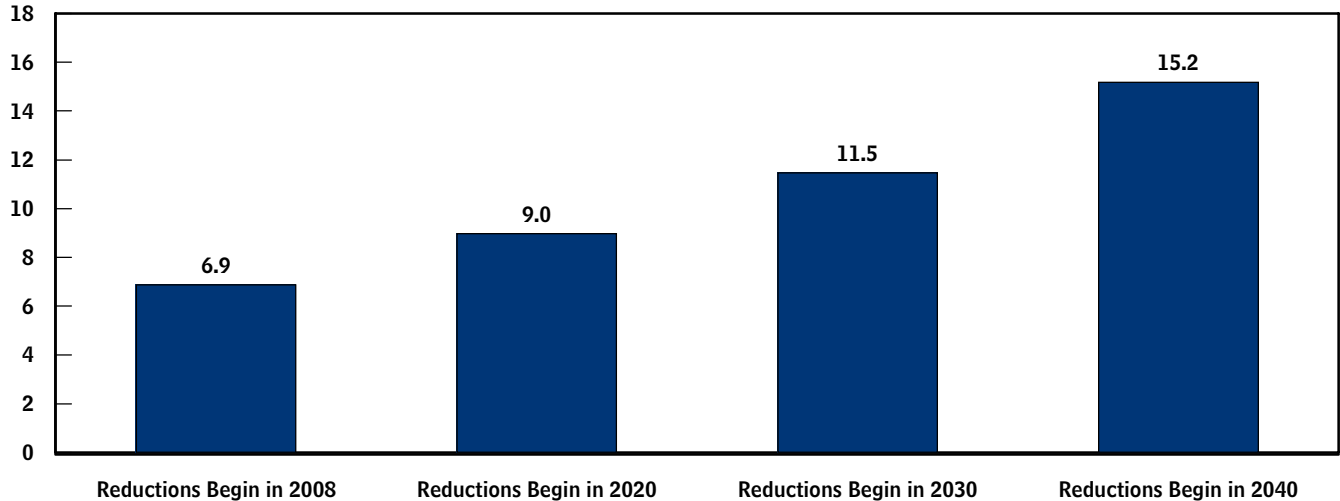
- First, delay would cause the amount of government debt to rise, which would displace private capital (reducing the total resources available in the economy) and increase borrowing from abroad.
- Second, delay would exacerbate uncertainty. The longer that action was put off, the greater the chance that policy changes would occur suddenly, which could create difficulties for some individuals and households, especially those near or in retirement. Announcing changes in popular entitlement programs or in the tax structure well before they take place gives people time to adjust their plans for saving and retirement. Those adjustments can significantly reduce the impact of changes in policy on people's standard of living.
- Third, delay would raise the cost of interest on the federal debt, so that lawmakers would have to make ever-larger changes in policy to finance those additional costs. As interest costs rose, policymakers would be less able to finance other national spending priorities and would have less flexibility to deal with unexpected developments (such as a war or recession). Moreover, rising interest costs would make the economy more vulnerable to a crisis.

CBO's simulations indicate that under the alternative fiscal scenario, delaying action could substantially increase the size of the policy adjustments needed to put the budget on a sustainable path. The impact of delaying changes in policy would be large even before accounting for

Figure 3.

Reductions in Noninterest Spending Needed to Close the Fiscal Gap in Various Years Under CBO’s Alternative Fiscal Scenario

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Notes: The fiscal gap is a measure of federal shortfalls over a given period. It represents the extent to which the government would need to immediately and permanently either raise tax revenues or cut spending—or do both, to some degree—to make the government’s debt the same size (in relation to the economy) at the end of that period as it was at the beginning.

The alternative fiscal scenario deviates from CBO’s baseline projections during the next 10 years, incorporating changes in policy that are widely expected to occur and that policymakers have regularly made in the past.

potential macroeconomic feedback effects. If policymakers wanted to close the fiscal gap in 2020 by altering spending (and economic feedbacks were not part of the calculation), they would have to reduce noninterest outlays permanently by 9 percent of GDP (see Figure 3). If they delayed action on the budget until 2040, to close the fiscal gap in that year, they would have to reduce noninterest outlays permanently by 15 percent of GDP. Waiting until 2040 to close the fiscal gap would allow spending to grow significantly before that year; however, the reductions required in spending in 2040 and in subsequent years would have to be substantial—and much

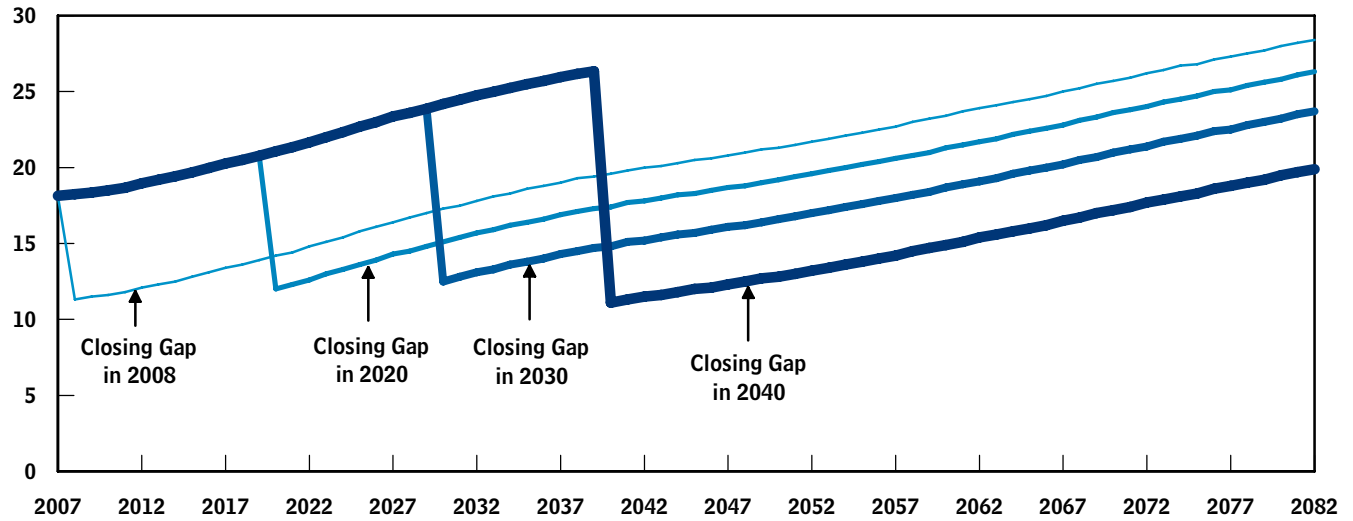
larger than would have been necessary if action had been taken earlier (see Figure 4).

How soon the fiscal gap is closed will affect how much the government would have available to spend on various priorities. If the fiscal gap was closed in 2040, spending (excluding interest) in 2050 could be no more than 13 percent of GDP; if the fiscal gap was closed in 2020, by 2050, the available resources for noninterest spending could be as much as 19 percent of GDP. A similar logic would also apply if changes in tax policy were used to address budgetary imbalances: Delaying action would only increase the size of the tax increases that would eventually be needed to close the fiscal gap.

Figure 4.

Spending Excluding Interest Under Various Assumptions About Closing the Fiscal Gap in CBO's Alternative Fiscal Scenario

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Notes: The fiscal gap is a measure of federal shortfalls over a given period. It represents the extent to which the government would need to immediately and permanently either raise tax revenues or cut spending—or do both, to some degree—to make the government's debt the same size (in relation to the economy) at the end of that period as it was at the beginning.

The alternative fiscal scenario deviates from CBO's baseline projections during the next 10 years, incorporating changes in policy that are widely expected to occur and that policymakers have regularly made in the past.