



# The Nation's Long-Term Fiscal Outlook

## August 2007 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. GAO developed its 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's simulations were updated with the CBO's August budget projections and economic assumptions and continue to indicate that the long-term federal fiscal outlook remains unsustainable. This update combined with our analysis of the fiscal outlook of state and local governments demonstrates that the fiscal challenges facing all levels of government are linked and should be considered in a strategic and integrated manner.

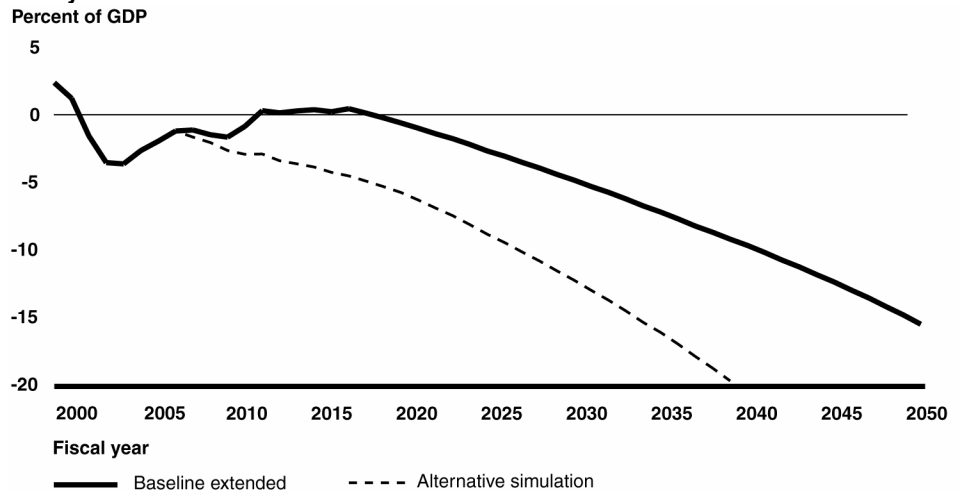
GAO updates its simulations three times a year as new estimates become available from:

- CBO's Budget and Economic Outlook (January),
- Social Security and Medicare Trustees Reports (spring), and
- CBO's Budget and Economic Outlook: An Update (late summer).

This product responds to congressional interest in receiving updated simulation results. Additional information about the GAO model, its assumptions, data, and charts can be found at <http://www.gao.gov/special.pubs/longterm/>. For more information, contact Susan J. Irving at (202) 512-9142 or [irvings@gao.gov](mailto:irvings@gao.gov).

## Despite Recent Improvement in the Annual Deficit, Federal Fiscal Policy Remains Unsustainable

**Figure 1: Unified Surpluses and Deficits as a Share of GDP under Alternative Fiscal Policy Simulations**



Source: GAO's August 2007 analysis.

GAO's updated long-term simulations illustrate that despite some improvement in the annual deficit estimate for this fiscal year, the long-term fiscal outlook remains essentially the same and is clearly unsustainable—ever-larger deficits lead to a federal debt burden that ultimately spirals out of control. Figure 1 shows two alternative fiscal paths. The first is “Baseline Extended,” which extends the Congressional Budget Office's (CBO) August baseline estimates beyond the 10-year projection period, and the second is an Alternative based on recent trends and policy preferences. Under these alternative assumptions, discretionary spending grows with the economy during the first 10 years, Medicare physician payments are not reduced as in current law,<sup>1</sup> and revenues are brought to their historical level. Although the timing of deficits and the resulting debt buildup varies depending on the assumptions used, both simulations show that we are on an unsustainable fiscal path.

<sup>1</sup>Under the sustainable growth rate system in current law, physician payments are scheduled to be reduced by 10 percent in 2008 and 5 percent in each subsequent year through 2016.

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By definition, what is unsustainable will not be sustained. The question is how and when our current imprudent and unsustainable path will end. At some point, action will be taken to change the Nation's fiscal course. 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. Acting sooner rather than later will give us more time to phase in gradual changes, while providing more time for those likely to be most affected to make compensatory changes.

Simulations are not forecasts or predictions. They are designed to ask the question "what if?" GAO's "what ifs" include that discretionary spending may grow slower than the 20-year historical average (as in Baseline Extended) or nearly at it (as in the Alternative), and revenues may be higher than the historical average (as in Baseline Extended) or be at the historical average (as in the Alternative), but in both cases, the Nation's long-term fiscal future is at risk. Under this range of assumptions, the risks posed to the Nation's future financial condition are too high to be acceptable.

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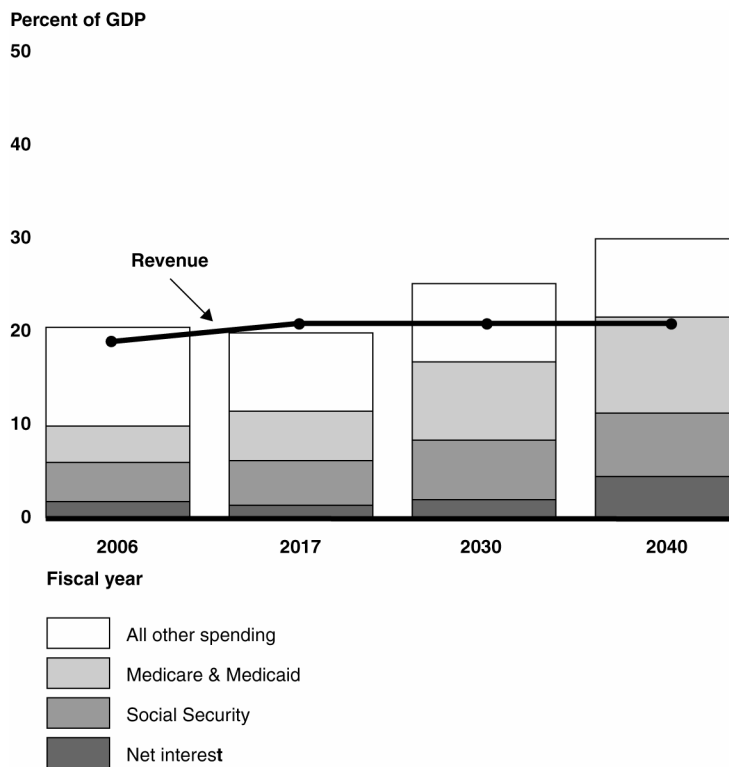
## What Drives Our Nation's Bleak Long-Term Fiscal Outlook?

The long-term fiscal outlook results from a large and persistent gap between expected revenues and expected spending. The spending that drives the outlook is primarily spending on the large federal entitlement programs (i.e., Medicare, Medicaid, Social Security) especially health care programs. The retirement of the baby boom generation is one key element of this. In 2008 the first boomers will be eligible to draw Social Security early retirement benefits, and in 2011 the first boomers will become eligible for Medicare. In the succeeding two decades America's population will age dramatically, and relatively fewer workers will be asked to support ever larger costs for retirees.

Although Social Security is a major part of the fiscal challenge, it is far from our biggest challenge. 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 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 2.5 percentage points faster than average annual GDP per capita, absorbing increasing shares of the Nation's resources, and this rapid growth is projected to continue. For this reason and others, rising health care costs pose a fiscal challenge not just to the federal budget but to American business and our economy and society as a whole.

Figures 2 and 3 look behind the deficit path to the composition of federal spending under the two scenarios. Both figures show that the estimated growth in the major entitlement programs leads to an unsustainable fiscal future—whether revenues as a share of gross domestic product (GDP) are above historical levels, as in Baseline Extended, or at about historical levels as in the Alternative simulation.

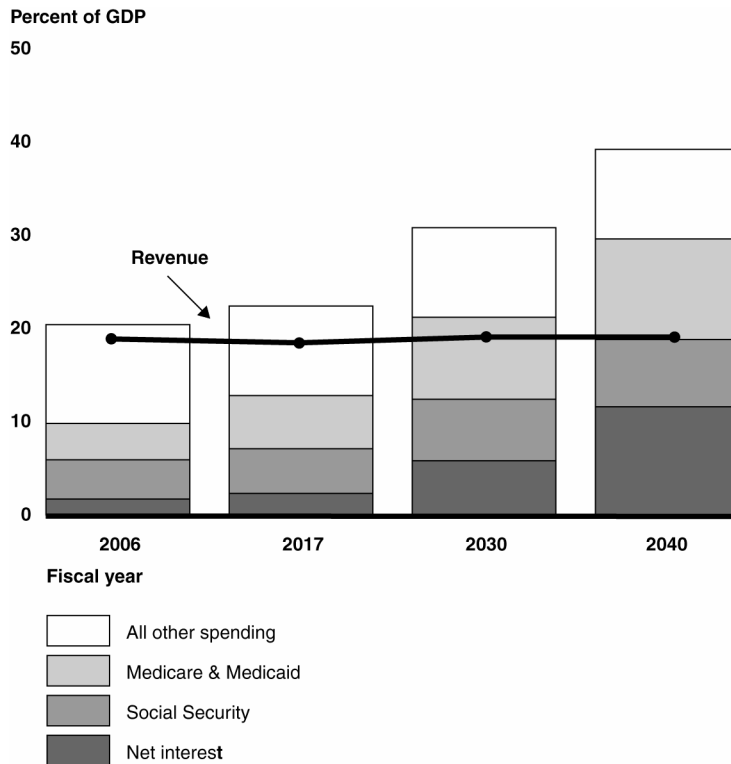
**Figure 2: Potential Fiscal Outcomes under Baseline Extended: Revenues and Composition of Spending as Shares of GDP**



Source: GAO's August 2007 analysis.

Note: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2017 due to (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 2017, 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: Revenues and Composition of Spending as Shares of GDP**



Source: GAO's August 2007 analysis.

Note: Discretionary spending grows with GDP after 2007. AMT exemption amount is retained at the 2006 level through 2017 and expiring tax provisions are extended. After 2017, revenue as a share of GDP is brought to its historical level of 18.3 percent of GDP plus expected revenues from deferred taxes (i.e., taxes on withdrawals from retirement accounts). Medicare spending is based on the Trustees April 2007 projections adjusted for the Centers for Medicare and Medicaid Services alternative assumption that physician payments are not reduced as specified under current law.

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, our national parks, highways and mass transit, foreign aid, plus mandatory spending on the smaller entitlement programs such as Supplemental Security Income, Temporary Assistance for Needy Families (TANF), and

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farm price supports.<sup>2</sup> The growth in Social Security, Medicare, Medicaid, and interest on debt held by the public dwarfs the growth in all other types of spending.

Under Baseline Extended we follow CBO's August 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. At the end of the 10-year period, revenues in Baseline Extended are at 20.3 percent of GDP—a couple of points above the 20-year historical average. Discretionary spending is 6.4 percent of GDP—somewhat below the 20-year historical average of 7.7 percent of GDP. For the remainder of the simulation period, levels of revenues and discretionary spending as shares of GDP are held constant, and for Social Security and Medicare, we use the Trustees' April 2007 intermediate estimates. The Medicare estimates assume the continuation of current law, under which fees for physicians treating Medicare patients would be cut in future years.<sup>3</sup>

Under the Alternative scenario in the first 10 years we assume that all expiring tax provisions are extended, and the 2006 exemption amount for the alternative minimum tax 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 7.6 percent of GDP throughout the simulation. This means that over the long term, discretionary spending is slightly under its 20-year historical average. In addition, the Alternative scenario uses Medicare estimates developed by the Centers for Medicare and Medicaid Services (CMS) that assume payment rates to physicians will not be reduced as specified under current law and assumed by the Trustees in their intermediate

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<sup>2</sup>Discretionary spending refers to spending based on authority provided in annual appropriations acts. Mandatory spending refers to spending that Congress has authorized in legislation other than appropriations acts that entitles beneficiaries to receive payment or that otherwise obligates the government to make payment.

<sup>3</sup>The Trustees noted in their April 2007 report that Medicare expenditures “are substantially understated because projected current-law physician payment updates are unrealistically reduced under the sustainable growth rate system (the statutory formula that governs fee updates) by about 10 percent in 2008 and 5 percent in each subsequent year through 2016. In practice, Congress is virtually certain to prevent some or all of the scheduled reductions through new legislation, as it has for 2003 through 2007.”

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projections.<sup>4</sup> As in Baseline Extended, after the first 10 years the Alternative scenario uses the Trustees' intermediate estimates for Social Security.

Both these figures show that waiting makes the size of the problem worse. For example, even under GAO's Baseline Extended scenario—under which revenues rise to about 20 percent of GDP and discretionary spending falls to 6.4 percent of GDP—waiting until 2040 to balance the budget would require drastic change. To close that gap in that year, federal revenue as a share of GDP would have to increase by almost 50 percent or noninterest federal spending cut by about 40 percent in order to balance the budget in that year. If changes in federal individual income taxes were the sole means used to balance the budget, these would have to increase by about 90 percent. Sudden, drastic changes of either kind—and revenues at such a level—are outside post-World War II historical experience in this country.

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## The Fiscal Gap— Another Way to Measure the Challenge

Many ways exist 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 today to keep debt as a share of GDP at or below today's ratio. In contrast to waiting until 2040 to balance the budget as described above, the fiscal gap is an estimate of the action needed today and maintained for each and every year to achieve fiscal balance over a certain time period. 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 3. The fiscal gap can be expressed as a share of the economy or in present value dollars. (See table 1.)

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<sup>4</sup>This reflects the fact that Congress has generally acted to prevent payment rates from being reduced. 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. GAO's Alternative simulation uses the 0-percent update estimates. For more information on these estimates, see CMS's April 2007 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](http://www.cms.hhs.gov/ReportsTrustFunds/05_alternativePartB.asp)

**Table 1: Federal Fiscal Gap 2007–2081**

|             | Fiscal gap                |              | Change required to close gap   |  |   |
|-------------|---------------------------|--------------|--------------------------------|--|---|
|             | Trillions of 2007 dollars | Share of GDP | Percentage increase in revenue | Percentage increase in individual income taxes | Percentage decrease in noninterest spending |
| Baseline    | \$31.1                    | 4.3%         | 22.9%                          | 50.6%  | 23.6%                                       |
| Alternative | \$54.3                    | 7.5%         | 39.9%                          | 88.2%  | 41.0%                                       |

Source: GAO analysis.

To close the fiscal gap under Baseline Extended would require action today equal to about a 23 percent increase in revenue or reduction in programmatic spending that would need to be maintained over the entire period. Under GAO’s Alternative simulation, the required action would be even more dramatic—about 40 percent. These annual tax increases and spending cuts would exceed the fiscal year 2006 deficit of 1.9 percent of GDP. Delaying action would make things worse. Under our Alternative simulation, waiting even 10 years would require a revenue increase of about 50 percent or noninterest spending cuts of about 46 percent.

This gap is too large for us to grow our way out of the problem. It would require decades of double-digit real economic growth, but the United States has not had a single year of double-digit real economic growth since World War II. To be sure, additional economic growth would certainly help the nation’s financial condition and our ability to address our fiscal gap, but it will not eliminate the need for action.

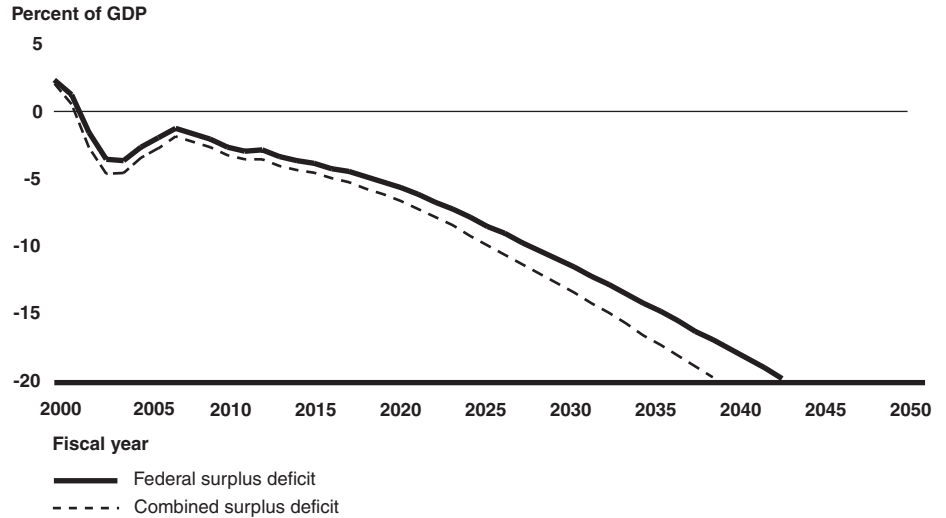
## State and Local Governments Face Similar Long-Term Fiscal Challenges

In 2007 GAO expanded its work on the long-term fiscal outlook to develop a model of the state and local government sector.<sup>5</sup> Figure 4 presents the results of GAO simulations that combine the federal government fiscal outlook with that of the state and local government sector.<sup>6</sup> The simulations imply that state and local fiscal challenges will add to the nation’s fiscal difficulties and suggest that the nation’s fiscal challenges cannot be remedied simply by shifting the burden from one sector to another.

<sup>5</sup>GAO, *State and Local Governments: Persistent Fiscal Challenges Will Likely Emerge within the Next Decade*, [GAO-07-1080SP](#) (Washington, D.C.: July 18, 2007).

<sup>6</sup>In order to combine the federal and state and local budget simulations using a consistent set of economic assumptions, we modified our methodology underlying our federal simulations to remove the negative feedback from deficits on economic growth. This change does not alter the conclusion that fiscal policy is unsustainable over the long term.

**Figure 4: Federal and Combined Federal, State, and Local Surpluses and Deficits as a Share of GDP**



Source: Historical data from National Income and Product Accounts, GAO analysis.

Note: Historical data from 2000 to 2006, projections from 2007 to 2050; federal simulation is the “Alternative” scenario; state and local balance measure is similar to the federal unified budget measure.

Rapidly rising health care costs are not simply a federal budget problem; they are our nation’s number one fiscal challenge. Growth in health-related spending—Medicaid and health insurance for state and local employees and retirees—is the primary driver of the fiscal challenges facing the state and local governments. 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.<sup>7</sup> 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.

<sup>7</sup>For 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).



## Key Assumptions in GAO's Federal Simulations

GAO's two simulations project current revenue and spending policies forward. The first, Baseline Extended, takes CBO's August 10-year baseline estimates<sup>8</sup> and extends them over a 75-year period and the second, Alternative simulation, is based on recent trends and policy preferences. As CBO recognized in both its January 2007 *Budget and Economic Outlook* and its August 2007 *Budget and Economic Outlook: An Update*, its baseline estimates incorporate some very problematic assumptions that we adjust for in our Alternative simulation as summarized below.

**Table 2: Assumptions for Baseline Extended and Alternative Simulations**

| Model inputs                     | Baseline Extended   | Alternative Simulation   |
|----------------------------------|---|--|
| Revenue                          | CBO's August 2007 baseline through 2017; thereafter remains constant at 20.3 percent of GDP (CBO's projection in 2017)  | All expiring tax provisions are extended through 2017; thereafter equal to 40-year historical average of 18.3 percent of GDP plus CBO's estimate of revenue from tax-deferred retirement plans |
| Social Security spending (OASDI) | CBO's August 2007 baseline through 2017; thereafter based on 2007 Social Security Trustees' intermediate projections  | Same as Baseline Extended  |
| Medicare spending                | CBO's August 2007 baseline through 2017; thereafter 2007 Medicare Trustees' intermediate projections prepared by CMS that assume per enrollee Medicare spending grows on average 1 percent faster than GDP per capita over the long term. | CMS's intermediate projections adjusted for alternative assumption of 0 percent physician payment updates in the first 10 years.   |
| Medicaid spending                | CBO's August 2007 baseline through 2017; thereafter CBO's December 2005 long-term projections under Scenario 2 that assume per enrollee Medicaid spending grows with GDP per capita plus 1 percent over the long term                     | Same as Baseline Extended  |
| Other mandatory spending         | CBO's August 2007 baseline through 2017; thereafter increases at the rate of economic growth (i.e., remains constant as a share of GDP)   | Baseline Extended through 2011, then adjusted for extension of certain tax credits through 2017; thereafter increases at the rate of economic growth   |
| Discretionary spending           | CBO's August 2007 baseline through 2017; thereafter increases at the rate of economic growth  | Increases at the rate of economic growth starting after 2007   |

Source: GAO.

<sup>8</sup>The 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. Nevertheless, CBO continues to prepare baselines according to the methodology prescribed in that law.

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## Key Assumptions of GAO's State and Local Simulations

The GAO state and local model projects the level of receipts and expenditures of the state and local sector in future years based on current and historical spending and revenue patterns. To develop these long-run simulations, we make projections for each receipt and expenditure category of the state and local government sector in future years. On the receipt side, key categories of receipts for state and local governments include several types of taxes (personal income, sales, property, and corporate), income on assets owned by the sector, and grants from the federal government. Categories of expenditures include wages and salaries of state and local employees, health insurance costs, pension costs, social benefit payments (e.g. Medicaid and unemployment), depreciation expense on state and local capital stock, interest payments on state and local financial debt, and other expenditures of the sector. In the "base case" model we assume that the tax structure is not changed in the future and that the provision of real government services per capita remains roughly constant. That is, a basic assumption of the primary model is that the current set of policies in place across state and local governments remains constant.

In GAO simulations that combine the fiscal outcomes for all levels of government, the methodology underlying the federal simulations differs slightly from GAO's usual approach. Usually, GAO's federal budget simulations incorporate the negative effect on economic growth of large deficits that divert funds from private investment. In order to combine the federal and state and local budget simulations using a consistent set of economic assumptions, this feedback from deficits to economic growth is removed. With or without feedback, the simulations imply that fiscal policy is clearly unsustainable over the long term. The January 2008 update of GAO's federal budget simulations will exclude feedback except for an appendix comparing results with and without feedback.

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## What Changed in This Update?

GAO simulations have been updated with CBO's most recent budget and economic outlook.<sup>9</sup> Despite some near-term improvement in the projected deficit for fiscal year 2007, the long-term outlook remains largely unchanged and clearly unsustainable.

Since our last update in April, the Congress passed the emergency supplemental appropriation for the Global War on Terrorism (GWOT) and other activities.<sup>10</sup> Because of rules governing the baseline, CBO must

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<sup>9</sup>The CBO report can be accessed at [www.cbo.gov](http://www.cbo.gov).

<sup>10</sup>Pub. L. 110-28.

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assume that discretionary budget authority for fiscal years 2008–2017 are based on fiscal year 2007 funding, which includes both regular and supplemental appropriations. The use of supplementals and their timing can cause sharp swings in discretionary outlay projections. In this case, CBO's January baseline showed only \$70 billion for GWOT in fiscal year 2007. With the passage of the supplemental, fiscal year 2007 budget authority increased by \$100 billion leading to a move in the 10-year baseline projection of \$1 trillion between the January baseline and August update. This led to changes in GAO's long-term assumptions for discretionary spending of about 0.7 percent of GDP in our Baseline Extended simulation and 0.1 percent of GDP in our Alternative simulation. However, as we noted above, while the timing of deficits and the resulting debt buildup varies depending on the assumptions used, both simulations continue to show that we are on an unsustainable fiscal path.

This product is based on GAO's work on the long-term fiscal challenge, including reports and testimonies. These efforts were conducted in accordance with generally accepted government auditing standards.

Additional information and related products can be found at <http://www.gao.gov/special.pubs/longterm/longtermproducts.html>.

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