



The Nation's Long-Term Fiscal Outlook

January 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.

Our simulations were updated with CBO's January budget and economic projections 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.

We update our simulations three times a year as new estimates become available from

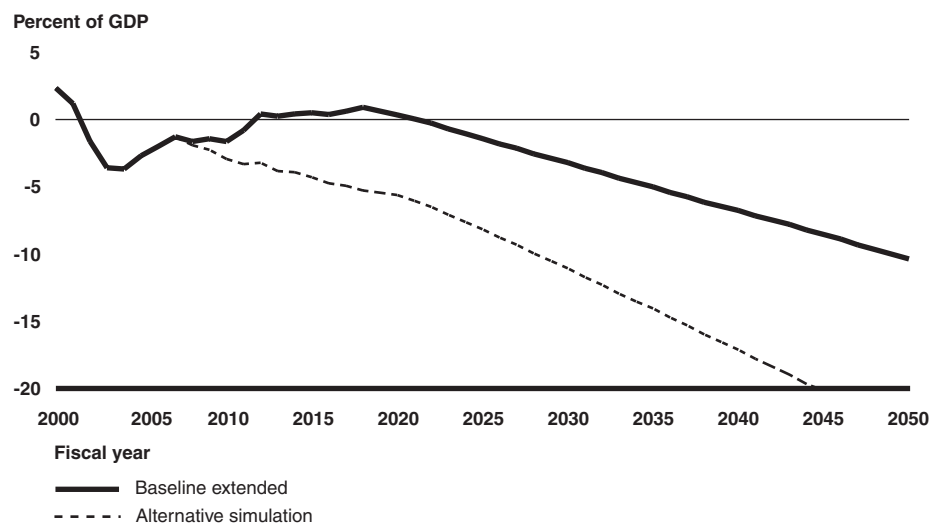
- CBO's *Budget and Economic Outlook* (January),
- Social Security and Medicare *Trustees Reports* (spring), and
- CBO's *Budget and Economic Outlook: An Update* (late summer).

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.

The Long-Term Fiscal Challenge Looms, as the Baby Boom Generation Begins to Retire

Our updated simulations continue to illustrate that the long-term fiscal outlook is unsustainable. (See fig. 1.) Despite a 3-year decline in the unified budget deficit, the federal government still faces large and growing structural deficits driven primarily by rising health care costs and known demographic trends. Last month, a baby boomer claimed Social Security retirement benefits for the first time, and this cohort 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 of its size, the real driver of the long-term fiscal outlook is health care spending. Medicare and Medicaid are both large and projected to continue growing rapidly in the future.

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



Source: GAO's January 2008 analysis.

Figure 1 shows two alternative fiscal paths. The first is “baseline extended,” which follows the Congressional Budget Office’s (CBO) January 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 second is an alternative based on historical trends and recent policy preferences. Under these alternative assumptions, discretionary spending grows with the economy rather than inflation during the first 10 years, Medicare physician payments are not reduced as in current law,¹ and revenues are brought down to their historical level.

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). 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.

By definition, what is unsustainable will not be sustained. The question is how and when the nation’s 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 provide more time to phase in gradual changes, while also providing more time for those likely to be most affected to make compensatory changes.

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, and Social Security) especially health care programs. The retirement of the baby boom generation is one key element of this. Already the first members of the baby boom generation have begun receiving Social Security retirement benefits and in 2011 will become eligible for Medicare benefits. In the next two decades America’s

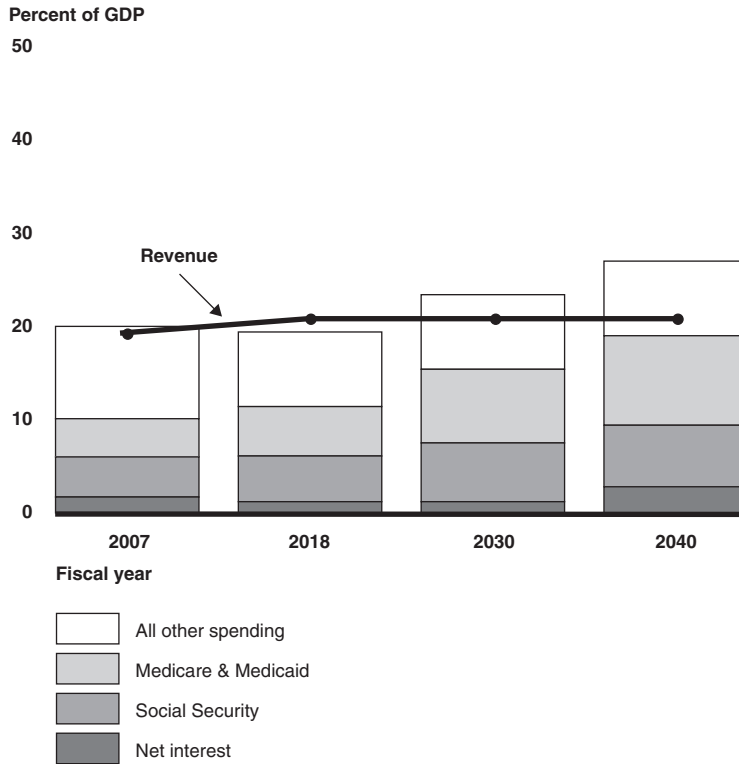
¹Under the sustainable growth rate system in current law, physician payments are scheduled to be reduced by 10 percent in 2008 and 5 percent in each subsequent year through 2016.

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 the 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 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 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 GDP are above historical levels, as in baseline extended, or at about historical levels as in the alternative simulation.

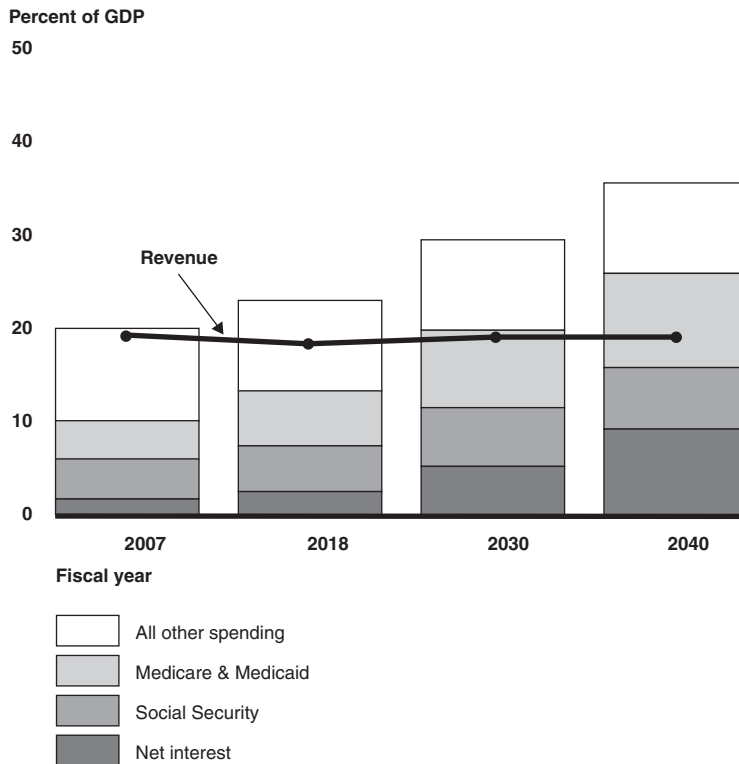
**Figure 2: Potential Fiscal Outcomes under Baseline Extended:
Revenues and Composition of Spending as Shares of GDP**



Source: GAO's January 2008 analysis.

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: Revenues and Composition of Spending as Shares of GDP



Source: GAO's January 2008 analysis.

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 historical level 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 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, 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, and farm price supports.² The

²Discretionary 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.

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 January baseline for the first 10 years: tax provisions that are scheduled to expire are assumed to do so (including the temporary increase in the 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 at 6.1 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, 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.³

Under the alternative scenario in the first 10 years we assume that all expiring tax provisions are extended, and 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 7.7 percent of GDP. This means that over the long term discretionary spending is nearly at its 20-year historical average. In addition, the alternative scenario uses Medicare estimates developed by CMS that assume payment rates to physicians will not be reduced as specified under current law and

³The 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.” In addition, CMS assumes excess medical cost growth on average of 1 percent over the long term, which is lower than the historical average of 2.5 percent. Together these differences result in lower Medicare spending than CBO's long-term projections. See Congressional Budget Office, *The Long-Term Outlook for Health Care Spending* (Nov. 2007).

assumed by the Trustees in their intermediate projections.⁴ As in baseline extended, the alternative scenario uses the Trustees' intermediate estimates for Social Security after the first 10 years.

Both these figures show that waiting makes the size of the problem worse. 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 one-third or noninterest federal spending would have to be cut by almost 30 percent. If changes in federal individual income taxes were the sole means used to balance the budget, these would have to increase by more than 60 percent 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.

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 above, 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.)

⁴This 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.

Table 1: Federal Fiscal Gap 2008–2082

	Fiscal gap		Change required to close gap compared to today's levels		
	Trillions of 2008 dollars	Share of GDP	Percentage increase in revenue	Percentage increase in individual income taxes	Percentage decrease in noninterest spending
Baseline	25.6	3.2	17.3	38.1	17.4
Alternative	55.3	7.0	37.7	82.5	37.3

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 17 percent or an equivalent reduction in today's programmatic spending and maintained over the entire period. Under our alternative simulation, the required action would be even more dramatic—about 37 percent of today's taxes or 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 about 42 percent.

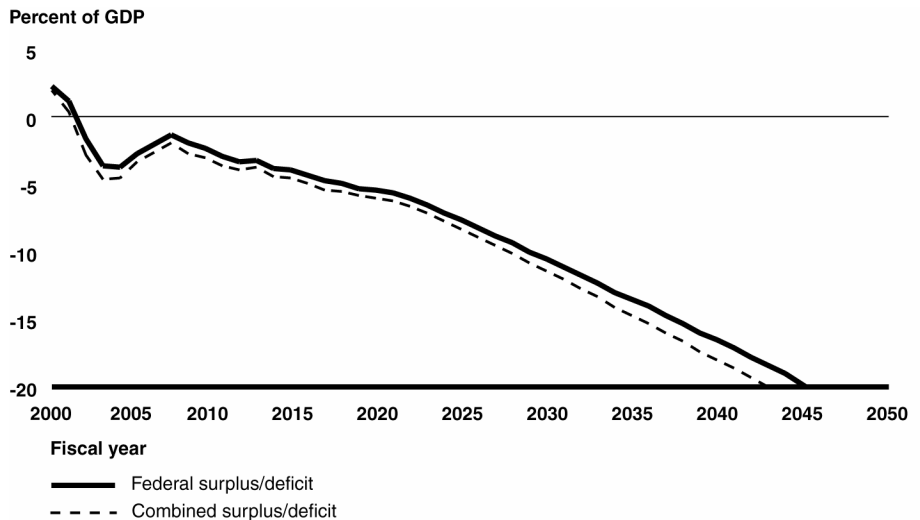
This gap is too large to simply grow out of the problem. To be sure, additional economic growth would help the nation's financial condition and the ability to address the fiscal gap, but it will not eliminate the need for action.

State and Local Governments Face Similar Long-Term Fiscal Challenges

In 2007 we expanded our work on the long-term fiscal outlook to develop a model of the state and local government sector.⁵ Figure 4 presents the results of our simulations that combine the federal government's fiscal outlook with that of the state and local government sector. 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.: Jan. 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 4: Federal and Combined Federal, State, and Local Surpluses and Deficits as a Share of GDP



Source: GAO's January 2008 analysis.

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.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.

Key Assumptions in GAO's Federal Simulations

We run two simulations that illustrate a range of possible outcomes based on different policy decisions on the long-term budget outlook. The first, baseline extended, is more optimistic and follows CBO's January baseline estimates over the next 10 years; beyond the 10-year projection period, revenue and spending on programs other than large entitlements are held constant as a share of GDP.⁷ CBO's baseline is not a forecast of future

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.: Sept. 2007).

⁷The CBO report can be accessed at www.cbo.gov.

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. Table 2 lists the key assumptions incorporated in the baseline extended and alternative simulations.

Table 2: Assumptions for Baseline Extended and Alternative Simulations

Model inputs	Baseline extended	Alternative
Revenue	CBO's January 2008 baseline through 2018; thereafter remains constant at 20.3 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 CBO's estimate of revenue from tax-deferred retirement plans
Social Security spending	CBO's January 2008 baseline through 2018; thereafter based on 2007 Social Security Trustees' intermediate projections	Same as Baseline Extended
Medicare spending	CBO's January 2008 baseline through 2018; 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 January 2008 baseline through 2018; thereafter CBO's December 2007 long-term projections adjusted to reflect excess cost growth consistent with the 2007 Medicare Trustees' intermediate projections	Same as Baseline Extended
Other mandatory spending	CBO's January 2008 baseline through 2018; thereafter remains constant as a share of GDP at 1.9 percent (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 as a share of GDP at 2.0 percent
Discretionary spending	CBO's January 2008 baseline through 2018; thereafter remains constant at 6.1 percent of GDP	Increases at the rate of economic growth starting after 2008 (i.e., remains constant at 7.7 percent of GDP)

Source: GAO.

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.

One assumption we change in our alternative simulation is discretionary spending. CBO's projections of discretionary spending for fiscal years 2009 through 2018 are based on fiscal year 2008 funding enacted to date, including any supplemental appropriations. CBO assumes discretionary spending grows over the next 10 years at the rate of inflation. As such, the use of supplemental appropriations and their timing can cause sharp swings in discretionary outlay projections.

For example, as of January 2008, \$88 billion had been appropriated for operations in Iraq and the Global War on Terror (GWOT) for fiscal year 2008. In contrast, the baseline underlying our August 2007 simulations reflected supplemental appropriations passed for fiscal year 2007 for Iraq and GWOT that totaled \$170 billion. As a result, both the jump off point for CBO's 10-year discretionary spending estimates and our long-term assumption for discretionary spending in our baseline extended simulation is lower. Specifically, compared to our August 2007 baseline extended simulation, discretionary spending in this update is lower by about 0.3 percent of GDP over the long term. However, this change may only be temporary; the administration has requested another \$105 billion in supplemental funding this fiscal year, which will lead to higher discretionary spending projections in CBO's August 2008 baseline (and subsequently our simulations). Despite these swings in discretionary spending, our simulations continually show that the nation is on an unsustainable fiscal path.

A more detailed description of the federal model and key assumptions can be found at <http://www.gao.gov/special.pubs/longterm/simulations.html>. 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*.⁹

Changes to the Federal Model in This Update

Previously, our federal budget simulations incorporated the negative effect on economic growth of large deficits that divert funds from private investment. This relationship between deficits and economic growth, or feedback, has been removed for this update in part to make the results of our federal model consistent with the results from our state and local model. As a result of this change, GDP grows steadily and our simulation results can be displayed over a longer period. Updated results of our simulations using our old methodology, which includes feedback, are shown in appendix I. The bottom line is that with or without feedback, our

⁹GAO-08-317.

simulations imply that the nation's current fiscal policy is unsustainable over the long term.

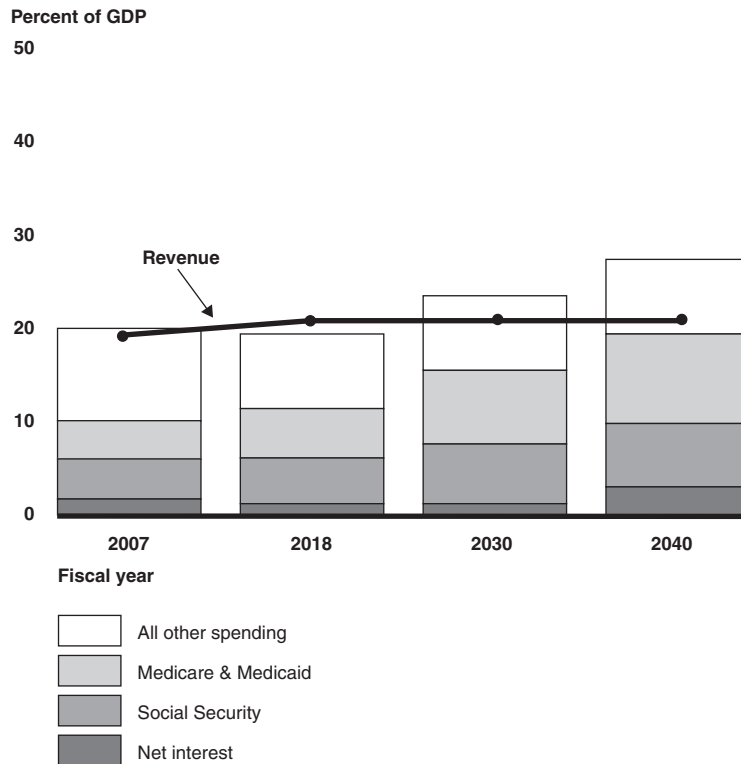
For this update, we also incorporated CBO's most recent long-term projections for Medicaid spending that were released in December 2007. We adjust CBO's Medicaid path to make the excess cost growth assumptions consistent with the Trustees assumption.

We conducted this performance audit from January 2008 to March 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.

This product is based on our work on the long-term fiscal challenge, including reports and testimonies. Related products can be found at <http://www.gao.gov/special.pubs/longterm/longtermproducts.html>.

Appendix I: GAO's Long-Term Simulations with Economic Feedback

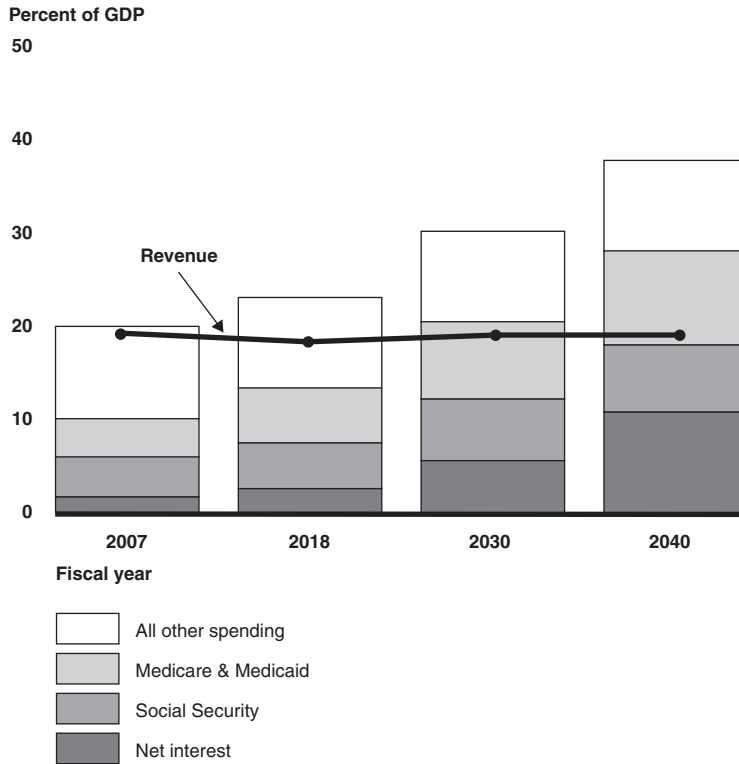
Figure 5: Potential Fiscal Outcomes under Baseline Extended with Economic Feedback: Revenues and Composition of Spending as Shares of GDP



Source: GAO's January 2008 analysis.

Notes: In addition to the expiration of tax cuts, revenue as a share of gross domestic product (GDP) increases through 2018 mainly 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 6: Potential Fiscal Outcomes under Alternative Simulation with Economic Feedback: Revenues and Composition of Spending as Shares of GDP



Source: GAO's January 2008 analysis.

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 returns 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.

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