

The Nation's Long-Term Fiscal Outlook

January 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.

In 1992 GAO said: *"The federal budget is structurally unbalanced. This will do increasing damage to the economy and is unsustainable in the long term. Regardless of the approach chosen, prompt and meaningful action is essential. The longer it is delayed, the more painful it will be."* These words are as relevant today as when GAO first published them.

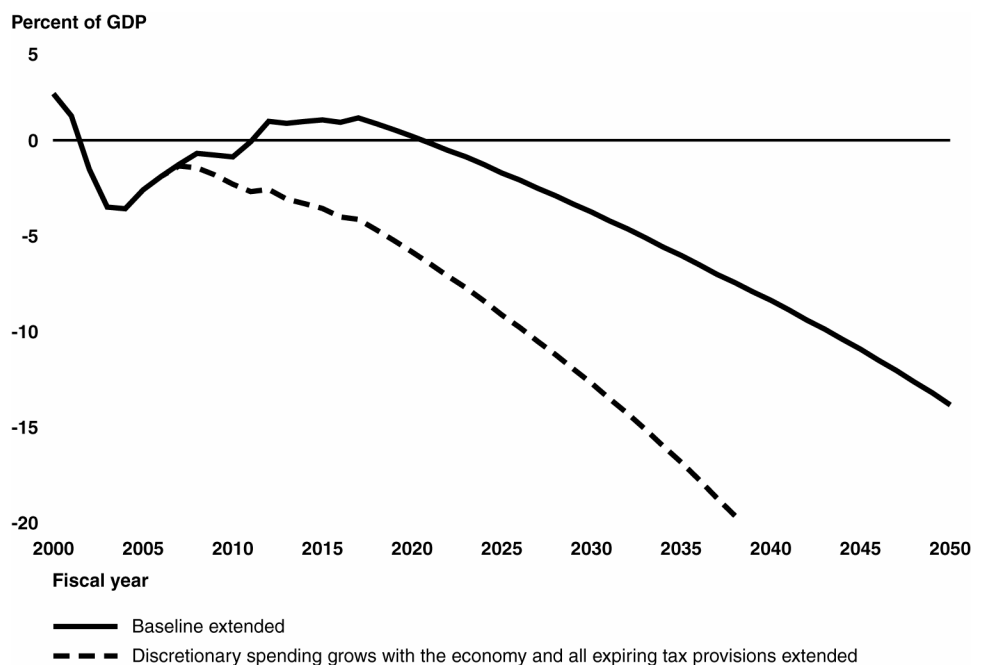
GAO updates its simulations three times a year as new estimates become available from:

- CBO's *Budget and Economic Outlook* (January),
- Social Security and Medicare Trustees Reports (early 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 Bottom Line: Federal Fiscal Policy Remains Unsustainable

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



Source: GAO's January 2007 analysis.

GAO's current long-term simulations continue to show ever-larger deficits resulting in a federal debt burden that ultimately spirals out of control. Figure 1 shows two alternative fiscal paths. As described below "Baseline extended" builds on the Congressional Budget Office (CBO) baseline—and results over the long term in revenues several points above the 20-year historical average and discretionary spending several points below the 20-year historical average. The modifications in the alternative scenario result over the long term in both revenues and discretionary spending slightly under the 20-year historical average. Although the timing of deficits and the resulting debt build up varies depending on the assumptions used, both simulations show that we are on an unsustainable fiscal path.

Under “Baseline extended” we follow CBO’s 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. Under the alternative scenario we assume all expiring tax provisions are extended, the 2006 exemption amount for the alternative minimum tax is continued but not indexed for inflation, and discretionary spending grows with the economy. In both simulations, after the first 10 years (i.e., the end of the projection period) both revenues and discretionary spending are held constant as a share of the economy.

Simulations are not forecasts or predictions. They are designed to ask the question “what if?” GAO’s “what ifs” are that discretionary spending may grow faster or slower, and tax cuts may be renewed or allowed to expire – but in both cases, the Nation’s long-term fiscal future is “at risk.” Under both sets of expectations about future spending and revenues, the risks posed to the Nation’s future financial condition are too high to be acceptable.

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. Importantly, the sooner appropriate actions are taken, the sooner the miracle of compounding will begin to work for the federal budget rather than against it. Conversely, 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.

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., Social Security, Medicare, Medicaid). 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 2 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 and faster growing 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 on average has grown much faster than the economy, 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 society as a whole.

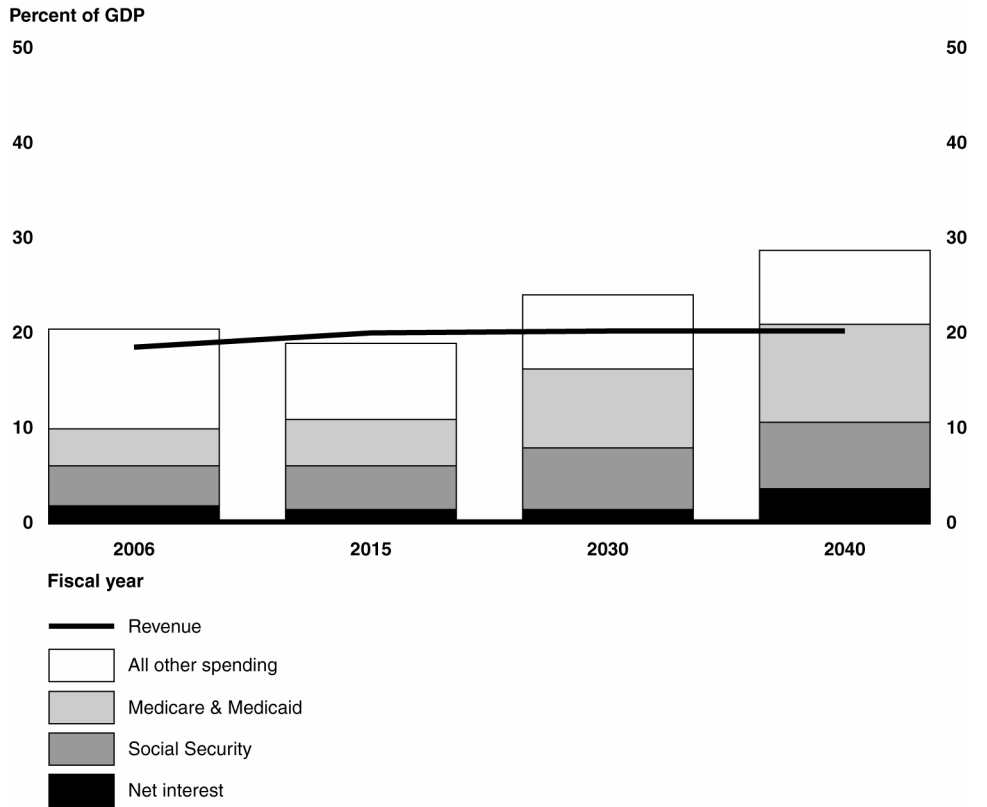
Figures 2 and 3 look behind the deficit path to the composition of federal spending under the two scenarios. In these figures the category "all other spending" includes much of what many think of as "government"—"discretionary" spending on such activities as national defense, homeland security, veterans health benefits, our national parks, highways and mass transit, foreign aid, plus "mandatory spending" on the smaller entitlement programs such as Supplemental Security Income, TANF, and farm price supports.¹ The growth in Social Security, Medicare, Medicaid, and interest on debt held by the public dwarfs the growth in all other types of spending.

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 over the past 20 or 40 years, as in Baseline extended, or somewhat below them as in the alternative simulation.

¹ "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.

Figure 2: Potential Fiscal Outcomes Under Baseline Extended

Revenues and Composition of Spending as a Share of GDP

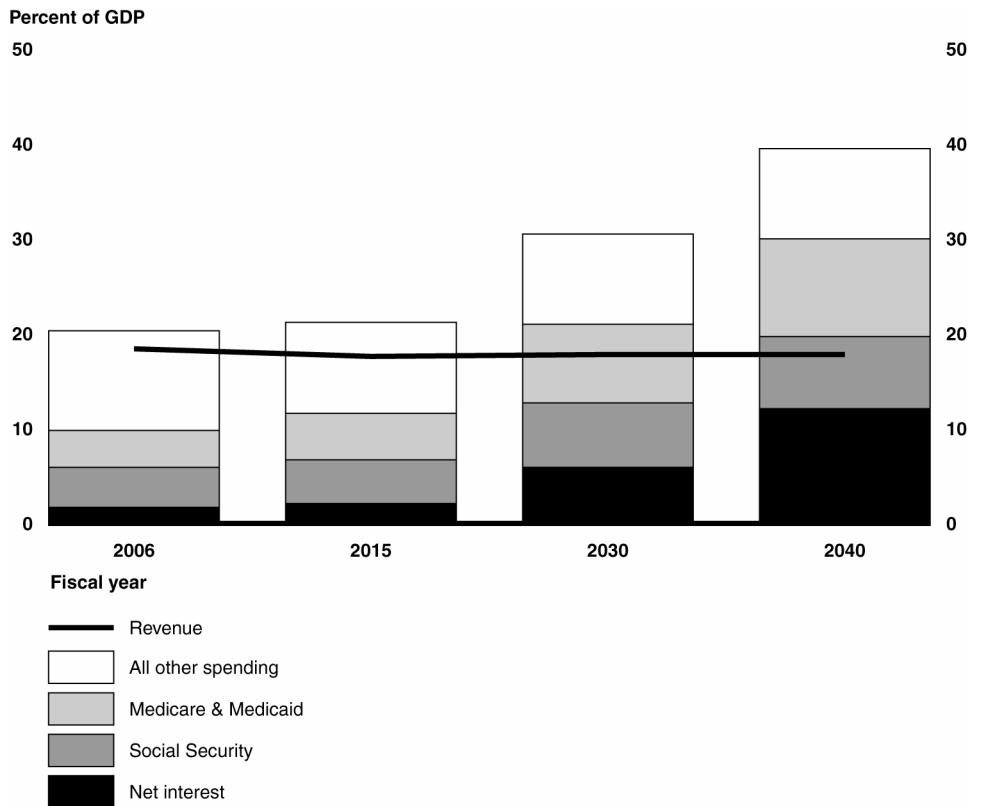


Source: GAO's January 2007 analysis.

Note: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2017 mainly due to (1) real bracket creep, (2) more taxpayers becoming subject to the 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: Discretionary Spending Grows with GDP After 2007 and All Expiring Tax Provisions are Extended

Revenues and Composition of Spending as a Share of GDP



Source: GAO's January 2007 analysis.

Note: 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 held constant—implicitly assuming that action is taken to offset increased revenue from real bracket creep, the AMT, and tax-deferred retirement accounts.

These figures also 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 below 6 percent of GDP—waiting until 2040 to close the gap would require drastic change. Taxes as a share of GDP would have to increase by about 40 percent or total spending cut by almost a third in order to balance the budget in that year. Sudden, drastic changes of either

kind—and revenues at such a level—are outside post-World War II historical experience in this country.

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 needed to keep debt as a share of gross domestic product (GDP) at or below today’s ratio. 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.

For GAO’s “Baseline extended” simulation, closing the fiscal gap would require spending cuts or tax increases equal to 3.6 percent of the entire economy each year over the next 75 years, or a total of \$26 trillion in present value terms. For GAO’s alternative simulation, the gap is 7.5 percent of the economy, or about \$55 trillion in present value terms. To put this in perspective, if we were to invest enough today to pay off these amounts over the next 75 years, the sums needed would amount to about \$87,000 to \$182,000 per person, or about \$208,000 to \$435,000 for each full-time worker.

Under either set of assumptions, the size of the change we would need to make in the federal budget would be larger than last year’s unified deficit—and that is just the change in the first year of the 75-year window. Waiting even 10 years to close the fiscal gap would require larger, more drastic changes. For example, under GAO’s Baseline extended simulation the fiscal gap would grow from 3.6 percent of the economy today to 4.7 percent in 2017 simply by waiting to act.

Additional economic growth is critical and will help to ease the burden, but the projected fiscal gap is so great that it is unrealistic to expect we will grow our way out of the problem. To do so under any reasonable set of assumptions would require double-digit real economic growth for many decades to eliminate the long-term fiscal challenge. However, since the end of World War II we have not seen economic growth of this kind. 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.

Other ways to think about the size of the long-term challenge may also be found in <http://www.gao.gov/cghome.htm>

What Is Assumed in GAO's Simulations?

GAO's two simulations project current policies on revenue and spending forward. The first is "Baseline extended," and the second is an alternative based on recent trends and policy preferences. They vary in how they deal with the first 10 years:

- Baseline extended. This takes the 10-year baseline estimates² of the Congressional Budget Office (CBO) and extends them over a 75-year period. CBO assumes in its baseline estimates that discretionary spending grows at the rate of inflation—a slower growth rate than that witnessed in many recent years. CBO also assumes no changes to today's laws. As CBO recognized in its *January 2007 Budget and Economic Outlook*, this results in some very problematic assumptions. For example, since the Administration's request for supplemental appropriations of almost \$100 billion had not been submitted at the time CBO published its *Outlook*, CBO noted that its January baseline omits some likely discretionary spending in 2007 for military operations in Iraq and Afghanistan. Another implication of following current law is that CBO assumes that all tax cuts originally enacted in 2001 and 2003 are permitted to expire as currently scheduled, including the temporary increase in the AMT exemption amount.
- Discretionary spending grows with the economy (that is, with GDP) and all expiring tax reductions are extended. This simulation alters two key assumptions of CBO's baseline. First, discretionary spending is allowed to grow with the economy in the first 10 years rather than being constrained to grow with inflation. Second, all expiring tax cuts are extended permanently.

In each simulation, consistent with our practice of many years, at the end of the 10-year period we take the levels of revenue and discretionary spending as shares of GDP and hold these constant for the rest of the simulation period. We have done so in order not to make any long-range policy assumptions. In addition, after the first 10 years, both simulations use the Social Security and Medicare Trustees' 75-year intermediate ("best") estimates for those programs and assume that promised benefits will be paid in full.

² 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.

What Changed in This Update?

Despite improvement in recent years and in near-term projections, the long-term outlook has not changed significantly since the last simulations: it remains unsustainable.

As CBO noted, the favorable outlook suggested by its 10-year projections does not indicate a substantial change in the nation's long-term budgetary challenges. CBO pointed out that changes in its baseline between August and January overstate the fundamental improvement in the underlying budget outlook because roughly half of the total change stems from the baseline's treatment of previous supplemental appropriations for disaster relief and the irregular pattern of funding for military operations in Iraq and Afghanistan. Importantly, one undeniable change from August is that we have moved closer to the start of the retirement of the baby boom generation and its fiscal consequences.

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GAO's simulations were updated using CBO's 10-year baseline budget and economic estimates in its January *Budget and Economic Outlook: An Update*. CBO's report can be found at <http://www.cbo.gov/showdoc.cfm?index=7731&sequence=0>

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>