GAO

The Federal Government's Long-Term Fiscal Outlook

January 2010 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. More recently, GAO has also begun publishing separate long-term fiscal simulations for the state and local government sector. Additional information on both simulations is available at http://www.gao.gov/special.pubs/longterm/index.html.

GAO runs two simulations:

- "Baseline Extended" follows the Congressional Budget Office's (CBO) January 2010 baseline estimates for the first 10 years and then simply holds revenue and spending other than large entitlement programs constant as a share of gross domestic product (GDP).
- The "Alternative" simulation is based on historical trends and policy preferences. Discretionary spending grows with GDP rather than inflation during the first 10 years, Medicare physician payment rates are not reduced as in CBO's baseline, all tax provisions are extended to 2020, and the alternative minimum tax (AMT) exemption amount is indexed to inflation through 2020; revenues are then brought back to their historical level.

This update incorporates CBO's most recent baseline projections that were released in January 2010.

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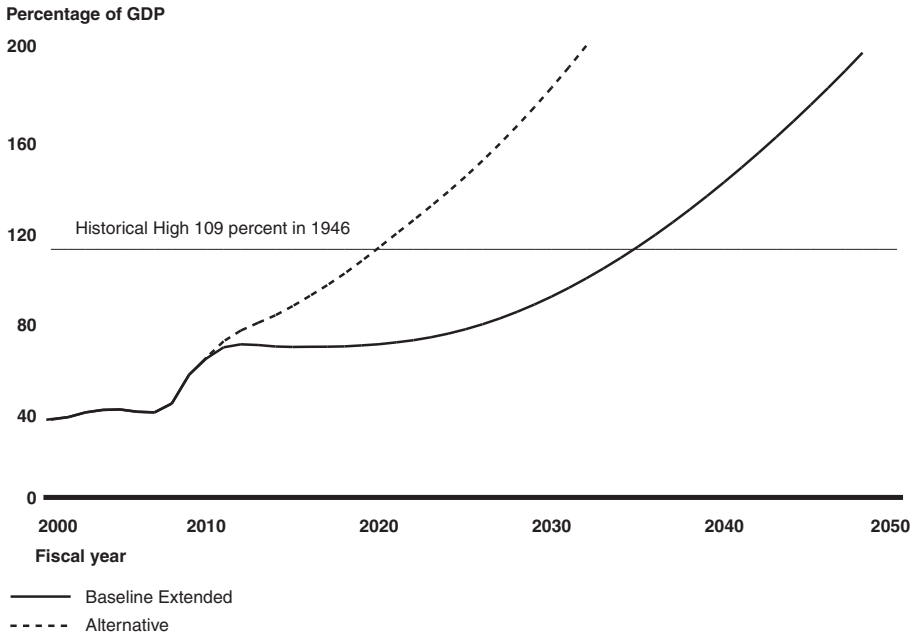
The economic downturn and the federal government's response continue to shape the near-term budget outlook. In fiscal year 2009 the overall federal deficit reached 9.9 percent of GDP—the largest since 1945, and the deficit is expected to decline only slightly in 2010. While deficits are projected to decrease further as federal support for states and the financial sector wind down and the economy recovers, the increased debt and related interest costs will remain. Our long-term simulations show that absent policy changes the federal government faces an unsustainable growth in debt. Under our Alternative simulation, debt held by the public as a share of GDP could exceed the historical high reached in the aftermath of World War II by 2020 (see fig. 1)—10 years sooner than our simulation showed just 2 years ago.

Figure 1: Debt Held by the Public under Two Fiscal Policy Simulations



Source: GAO.

Note: Data are from GAO's January 2010 analysis based on the Trustees' assumptions for Social Security and Medicare.

Recent events have made the fiscal challenge greater. Although the economy is still fragile, there is wide agreement on the need to begin to change the long-term fiscal path as soon as possible without slowing the recovery because the magnitude of the changes needed grows with time. Congress recently enacted a return to statutory PAYGO and, in February, the President established a commission to identify policies to change the fiscal path and stabilize the debt-to-GDP ratio.

Health Care Costs and Demographic Trends Are Already Affecting the Near-Term Budget Outlook

While the drivers of the long-term fiscal outlook have not changed, the sense of urgency has. As the table below shows, many of the long-term challenges highlighted in past updates, including health care cost growth and the aging population, have already begun to affect the federal budget—in some cases sooner than previously estimated—and the pressures only grow in the coming decade. For example, Social Security cash surpluses have served to reduce the unified budget deficit. However, CBO recently estimated that due to current economic conditions the program will run small temporary cash deficits for the next 4 years and then, similar to the Trustees estimates, run persistent cash deficits beginning in 2016. The fluctuation and eventual disappearance of the Social Security cash surplus will put additional pressure on the rest of the budget.

Table 1: Challenges Affecting the Federal Budget in the Near Term

2008	Oldest members of the baby-boom generation became eligible for early Social Security retirement benefits
2008	Medicare Hospital Insurance (HI) outlays exceeded cash income
2010	Social Security runs first cash deficit since 1984[a]
2011	Oldest members of the baby-boom generation become eligible for Medicare
2014	45 percent of Medicare outlays funded by general revenue[b]
2016	Social Security begins running consistent annual cash deficits and redeeming trust fund assets (i.e., nonmarketable Treasury securities) in order to pay beneficiaries
2017	Medicare HI trust fund exhausted. Income sufficient to pay about 81 percent of benefits[b]
2020	Debt held by the public under GAO's Alternative simulation exceeds the historical high reached in the aftermath of World War II

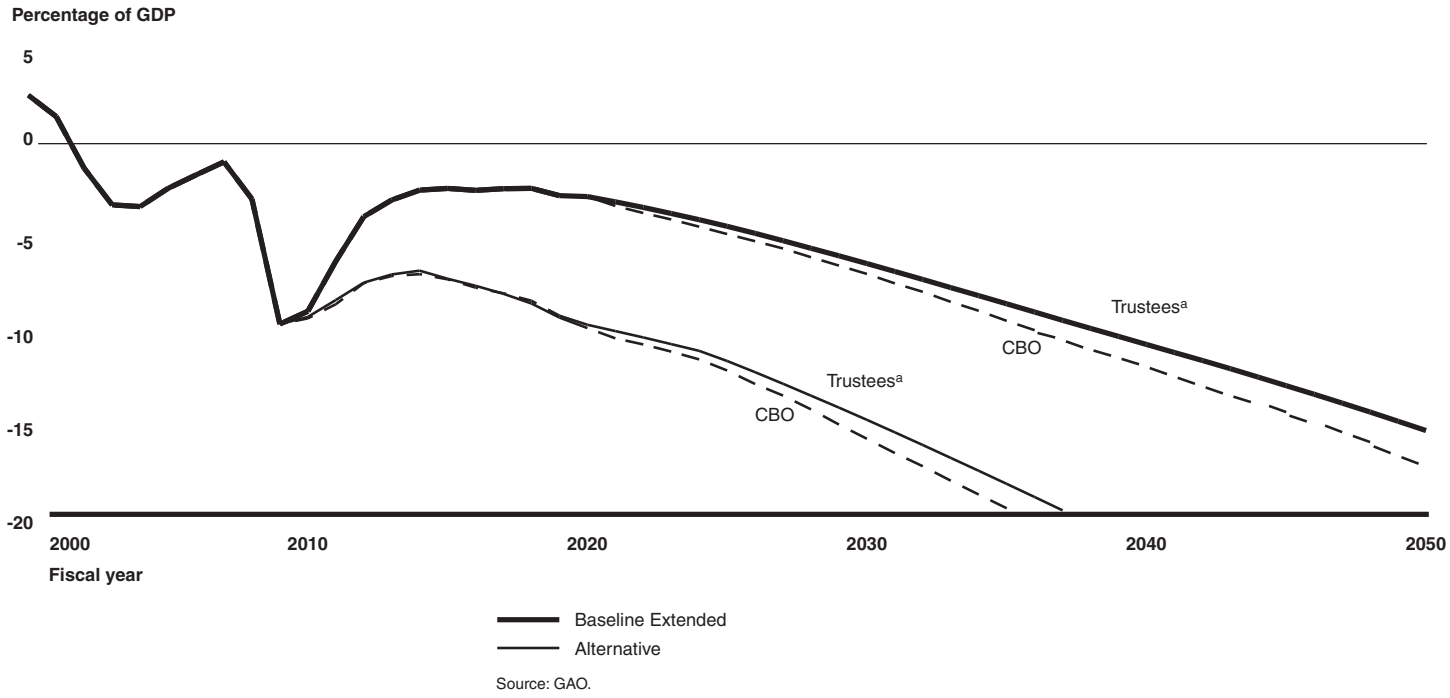
Source: GAO.

[a]Based on CBO's January 2010 baseline projections.
[b]Based on *2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (May 12, 2009). Projections showing the percentage of funding from general revenue reaching 45 percent by law trigger a "Medicare funding warning," requiring a proposal from the President in response.

No one can say with certainty what the next 75-years will bring, but simulations by GAO, the Office of Management and Budget, CBO and others, which use some different assumptions, all show an unsustainable long-term fiscal path. For example, in the figure below, we compare the long-term outlook using two different sources for long-term Social Security, Medicare, and Medicaid projections (see fig. 2). One of the key differences between these sources is the amount by which they assume the growth in health care costs per person exceeds the growth in GDP per person—what is known as "excess cost growth." Between 1975 and 2007, excess cost growth averaged 2.3 percent for Medicare and 1.9 percent for Medicaid. In the first set of simulations based on the Trustees' projections, excess cost growth averages 1.0 percent over the long term for both Medicare and Medicaid. In the second set based on CBO's projections, excess cost growth averages 1.5 percent over the long-term for Medicare and 0.6 percent for Medicaid. While the simulations using CBO assumptions yield less favorable outcomes, the results of these simulations are not materially different.[1]

[1]More information on the different assumptions underlying the two sets of simulations appears on pages 10 and 11.

Figure 2: Federal Surpluses and Deficits under Two Fiscal Policy Simulations with Different Entitlement Projections



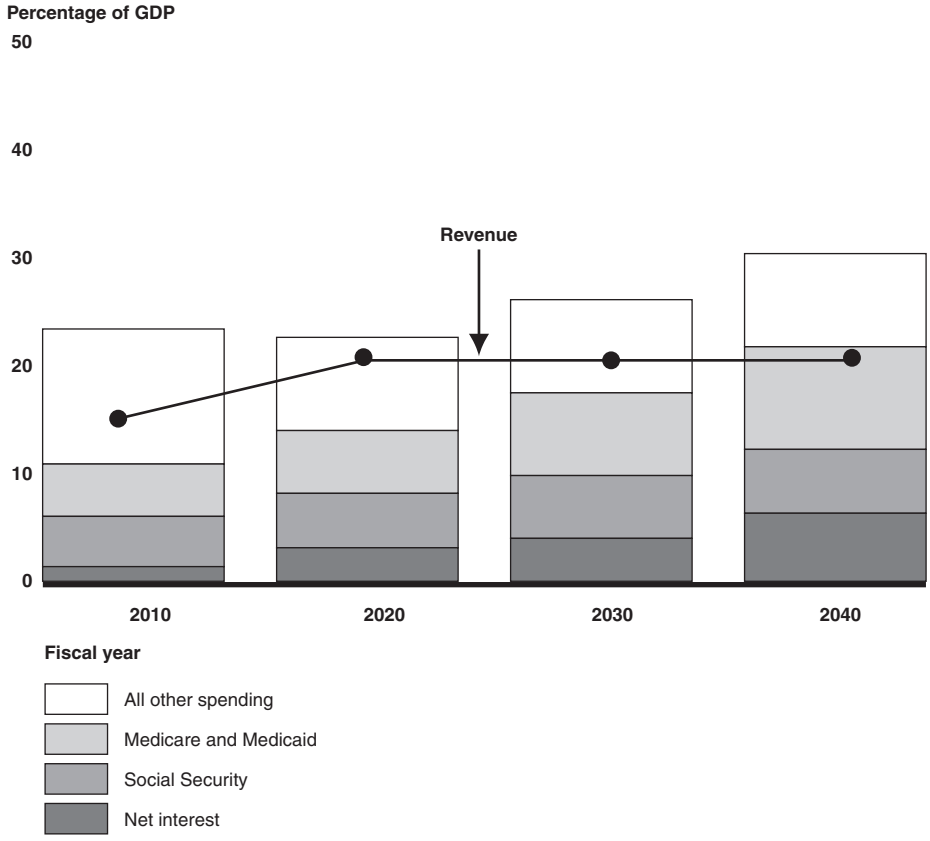
Source: GAO.

Notes: Data are from GAO's January 2010 analysis.

[a]Some adjustments are made to Trustees' assumptions.

Figures 3 and 4 show the composition of federal spending using different revenue and spending assumptions. In the Baseline Extended, discretionary spending is lower as a share of the economy and revenues are higher than the 40-year historical average. In the Alternative, both discretionary spending and revenue as a share of the economy are nearly at the historical averages. Both simulations show that absent changes to federal entitlement programs, spending on Social Security, Medicare, Medicaid, and interest on the federal debt will account for an ever-growing share of the economy. As figure 3 shows, assuming revenue remains constant at 20.2 percent of GDP—higher than the historical average—by 2030 there will be little room for "all other spending," which consists of what many think of as "government," including national defense, homeland security, investment in highways and mass transit and alternative energy sources, plus smaller entitlement programs such as Supplemental Security Income, Temporary Assistance for Needy Families, and farm price supports.

Figure 3: Potential Fiscal Outcomes under the Baseline Extended Simulation: Revenues and Composition of Spending

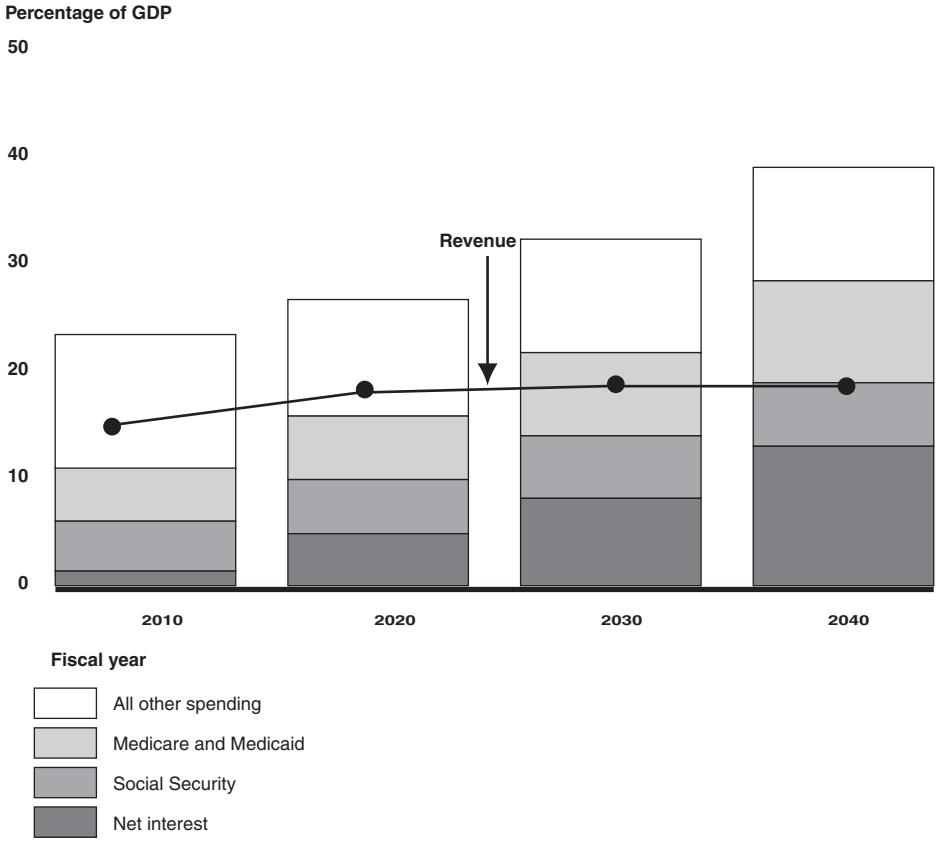


Source: GAO.

Note: Data are from GAO's January 2010 analysis based on the Trustees' assumptions for Social Security and Medicare.

In our Alternative simulation, which assumes expiring tax provisions are extended through 2020 and then revenue is held constant at the 40-year historical average, roughly 93 cents of every dollar of federal revenue will be spent on the major entitlement programs and net interest costs by 2020. By 2030, net interest payments on the federal government's accumulating federal debt exceed 8 percent of GDP—making it the largest single expenditure in the federal budget.

Figure 4: Potential Fiscal Outcomes under the Alternative Simulation: Revenues and Composition of Spending



Source: GAO.

Note: Data are from GAO's January 2010 analysis based on the Trustees' assumptions for Social Security and Medicare.

The Longer Action Is Delayed, the Larger the Changes Necessary

There are many ways to describe the federal government's long-term fiscal challenge. One method for capturing the challenge in a single number is to measure the "fiscal gap." The fiscal gap represents the difference, or gap, between revenue and spending in present value terms over a certain period, such as 75 years, that would need to be closed in order to achieve a specified debt level (e.g., today's debt to GDP ratio) at the end of the period.[2] From the fiscal gap, one can calculate the size of action needed—in terms of tax increases, spending reductions, or, more likely, some combination of the two—to close the gap; that is, for debt as a share of GDP to equal today's ratio at the end of the period. For example, under our Alternative simulation, the fiscal gap is 9.0 percent of GDP (or a little over $76 trillion in present value dollars) (see table 2). This means that revenue would have to increase by about 50 percent or noninterest spending would have to be reduced by 34 percent on average over the next 75 years (or some combination of the two) to keep debt at the end of the period from exceeding its level at the beginning of 2010 (53 percent of GDP).

Table 2: Federal Fiscal Gap under GAO's Simulations Based on the Trustees' Assumptions, 2010–2084

	Fiscal gap		Average percent change required to close gap			
			If action is taken today		If action is delayed until 2020	
	Trillions of present value 2009 dollars	Percent of GDP	Solely through increases in revenue	Solely through decreases in noninterest spending	Solely through increases in revenue	Solely through decreases in noninterest spending
Baseline Extended	41.1	4.8	24.2	20.0	29.1	23.4
Alternative	76.4	9.0	50.5	34.2	60.7	40.2

Source: GAO.

Note: Data are from GAO's January 2010 analysis based on the Trustees' assumptions for Social Security and Medicare.

Policymakers could phase in the policy changes so that the tax increases or spending cuts, or both, would grow over time allowing time for the economy to fully recover and for people to adjust to the changes.

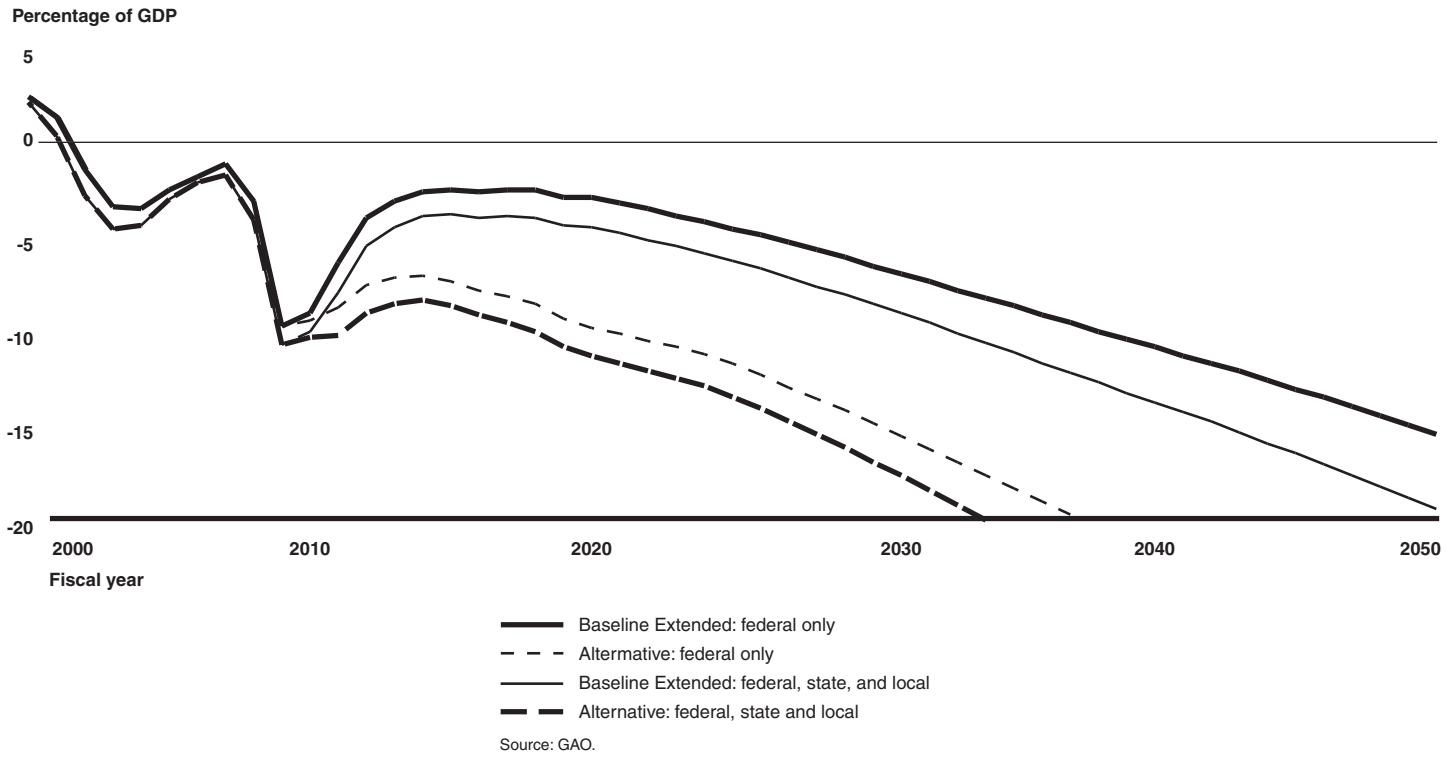
[2]Our present value calculations take into the account the time value of money by discounting future revenue and spending to reflect the equivalent amount needed today in current dollars. These calculations are sensitive to changes in interest rates, and a portion of the increase in the fiscal gap since our Fall 2009 update is caused by a small decline in our long-term interest rate assumption. More information on interest rates and other economic assumptions in our model can be found on page 12.

However, 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. Under our Alternative simulation, waiting even 10 years would increase the fiscal gap to 11.0 percent of GDP—meaning a revenue increase of about 61 percent or a noninterest spending cut of about 40 percent or some combination of the two would be required to bring debt back to today's level by 2084.

State and Local Governments Face Similar Fiscal Challenges

Rising health care costs are not only a federal problem; they are a national problem. GAO's most recent long-term state and local government simulations show that growth in health-related spending—Medicaid and health insurance for state and local employees and retirees—continues to be the primary driver of the long-term outlook at the state and local level. As we, CBO, and others have previously reported, the continued rise in health care costs also poses challenges to American businesses, families, and societies as a whole. Figure 5 overlays the simulated fiscal imbalance of the state and local government sector onto the Baseline Extended and the Alternative federal deficits. The overlay shows that the state and local governments' fiscal situation imposes further challenges for the nation's economy in the next several decades.

Figure 5: Federal and Combined Federal, State, and Local Surpluses and Deficits



Source: GAO.

Recent Developments

Our long-term simulations show that absent policy actions the federal government faces unsustainable growth in debt. Although the economy is still fragile, there is wide agreement on the need to begin to shift the long-term fiscal path as soon as possible without slowing the recovery. Congress recently enacted a return to statutory PAYGO—a budgetary control requiring that the aggregate impact of increases in mandatory spending or reductions in revenue generally be offset.[3] Although this can prevent further deterioration of the fiscal position, it does not deal with the existing imbalance. In February, the President established a commission to identify policies to change the fiscal path and stabilize the debt-to-GDP ratio. Several bipartisan groups have suggested the establishment of a medium-term fiscal goal—such as a ratio of publicly held debt to GDP or of deficit to GDP. While there is no consensus on either the specific target or on the appropriate policy actions to achieve it,

[3]For details on the rules governing the implementation of PAYGO, see Public Law 111-139.

these proposals seek to facilitate the policy discussion by setting a benchmark against which to measure future progress.

Key Assumptions in Our Federal Simulations

This update incorporates CBO's most recent baseline projections that were released in January 2010. Table 3 lists the key assumptions incorporated in the Baseline Extended and Alternative simulations for the simulations based on the Trustees' assumptions.

Table 3: Assumptions for Baseline Extended and Alternative Simulations Based on the Trustees' Assumptions for Social Security and Medicare

Model inputs	Baseline Extended	Alternative
Revenue	CBO's January 2010 baseline through 2020; thereafter remains constant at 20.2 percent of GDP (CBO's projection in 2020)	CBO's estimates assuming expiring tax provisions are extended through 2020 and the 2009 AMT exemption amount is indexed to inflation through 2020; thereafter is phased into the 40-year historical average of 18.1 percent of GDP
Social Security spending	CBO's January 2010 baseline through 2020; thereafter based on 2009 Social Security Trustees' intermediate projections adjusted to reflect wage growth implied in GAO's simulations	Same as Baseline Extended
Medicare spending	CBO's January 2010 baseline through 2020 that assumes cuts in physician fees will occur as scheduled under current law[a]; thereafter 2009 Medicare Trustees' intermediate projections that assume per enrollee Medicare spending grows on average 1 percent faster than GDP per capita over the long term	Based on the Centers for Medicare & Medicaid Services' (CMS) alternative scenario that assumes physician fees will remain at current levels (i.e., a physician fee schedule update of 0 percent) instead of being reduced as scheduled under current law[a]
Medicaid spending	CBO's January 2010 baseline through 2020; thereafter CBO's June 2009 long-term projections adjusted to reflect excess cost growth consistent with the 2009 Medicare Trustees' intermediate projections	Same as Baseline Extended
Other mandatory spending	CBO's January 2010 baseline through 2020; thereafter remains constant at 2.2 percent of GDP (implied by CBO's projection in 2020)	Baseline Extended adjusted for extension of certain tax credits through 2020; thereafter is phased back to 2.2 percent of GDP by 2025 (same as Baseline Extended)
Discretionary spending	CBO's January 2010 baseline through 2020; thereafter remains constant at 6.7 percent of GDP (CBO's projection in 2020)	Discretionary spending other than Recovery Act spending increases at the rate of economic growth after 2010 (i.e., remains constant at 8.7 percent of GDP); Recovery Act spending is included but assumed to be temporary

Source: GAO.

Notes: CBO's projections are from *The Budget and Economic Outlook: Fiscal Years 2010 to 2020* (January 2010) and *The Long-Term Budget Outlook* (June 2009). The Trustees' projections are from *The 2009 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* and *2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* that were

both issued on May 12, 2009. We assume that Social Security and Medicare benefits are paid in full regardless of the amounts available in the trust funds.

[a]Under current law, the fees paid for physician services are scheduled to be reduced by about 21 percent in 2010 and additional amounts in subsequent years. Over the past 7 years, in which Congressional action averted scheduled cuts in updates to the physician fee schedule, such updates grew at an average rate of 0.9 percent. Based on historical trends, a 0 percent physician fee update is a conservative assumption for estimating future Medicare spending.

In the second set of simulations, we use CBO's projections for Social Security, Medicare, and Medicaid. Table 4 shows the assumptions that differ from those shown in table 3.

Table 4: Key Assumptions Underlying GAO's Simulations Using CBO's Entitlement Spending Projections

Model inputs	Baseline Extended	Alternative
Social Security spending	CBO's January 2010 baseline through 2020; thereafter based on CBO's August 2009 long-term projections for Social Security. These projections are based on the 2009 Social Security Trustees' demographic projections and CBO's own economic assumptions.	Same as Baseline Extended
Medicare spending	CBO's January 2010 baseline through 2020; thereafter based on CBO's June 2009 long-term projections. Per enrollee Medicare spending grows on average 1.5 percentage points faster than GDP per capita over the long term.	Based on CBO's projections that assume physician payment rates grow with inflation (using the Medicare Economic Index)[a]
Medicaid spending	CBO's January 2010 baseline through 2020; thereafter CBO's June 2009 long-term projections. Per enrollee Medicaid spending grows on average 0.6 percentage points faster than GDP per capita over the long term.	Same as Baseline Extended

Source: GAO.

Notes: CBO's projections are from *CBO's Long-Term Projections for Social Security: 2009 Update* (August 2009) and *The Long-Term Budget Outlook* (June 2009). CBO assumes that full benefits are paid regardless of the amounts available in the trust funds.

[a]Since 2003, inflation in the inputs used for physicians' services measured by the Medicare Economic Index averaged 2.5 percent per year.

Table 5 shows the key economic assumptions that underlie all of our simulations. GDP is held constant across simulations and does not respond to changes in fiscal policy.

Table 5: Key Economic Assumptions Underlying All of GAO's Long-term Federal Simulations

Model inputs	All simulations
Labor: growth in hours worked	2009 Social Security Trustees' intermediate projections
Nonfederal saving: gross saving of the private sector and state and local government sector	Increases gradually over the first 10 years to 18.5 percent of GDP (the average nonfederal saving rate from 1950 to 2009)
Current account balance (percent of GDP)	From 2010 to 2020, 2009 share of GDP plus one-third of any change in gross national saving from 2009; thereafter equal to 2020 nominal level plus one-third of any change in gross national saving from 2009 (that is, a declining share of GDP)
Total factor productivity growth	1.3 percent through 2020 (CBO's January 2010 short-term assumption); 1.4 percent thereafter (long-term average from 1950 to 2009)
Inflation (percent change in GDP price index)	CBO January 2010 baseline through 2020;1.8 percent thereafter (CBO's projection in 2020)
Interest rate (on publicly held debt)	Rate implied by CBO's January 2010 baseline net interest payment projections through 2020; 5.0 percent thereafter (the rate implied in 2020)

Source: GAO.

We conducted our work from January 2010 to March 2010 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions.

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