United States General Accounting Office

GAO

Testimony

Before the Committee on the Budget, U.S. Senate

For Release on Delivery
Expected at
10 a.m.
Wednesday,
February 25, 1998

BUDGET ISSUES

Long-Term Fiscal Outlook

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GAO/T-AIMD/OCE-98-83

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to appear before you to discuss GAO's work on long-term budget issues.

A long-term perspective is important for broader fiscal policy as well as for budget decisions on individual programs. Today's decisions affect tomorrow's reality. In our previous work, we have noted that the nation's economic future depends in large part upon today's budget and decisions—both public and private—about investments.[1] At the macro level, the budget needs to provide a long-term framework grounded on a linkage of fiscal policy with the long-term economic outlook. This requires a focus on both overall fiscal policy and the composition of federal activity. Beginning in 1992, congressional leaders have requested that we provide this perspective by modeling the long-term implications of differing fiscal policy paths for the nation's economy. We have periodically updated our model to account for changes in the fiscal and economic environment, and this testimony reflects the fourth iteration of our simulation efforts.

Since each generation is in part custodian for the economy it hands the next, the President, the Congress, and the public need to think about the longer term when making fiscal policy choices. A longer-term horizon is also important because (1) some changes are best phased in over long periods of time, and (2) to make informed decisions, policymakers need information on the long-term cost consequences of today's commitments. This is especially true of those programs and activities where a longer time horizon is necessary to understand the fiscal and spending implications of the government's commitment. Examples include Social Security, Medicare, retirement programs, pension guarantees, and environmental cleanup.

In my testimony today, I will first discuss the results of GAO's simulations updated to incorporate the Congressional Budget Office's (CBO) new budget projections. Then I will turn to another important aspect of budget policy—the programmatic composition and design of federal spending—for which policymakers need to consider the long-term fiscal and spending implications of the government's commitments.

[1]Budget Policy: Prompt Action Necessary to Avert Long-Term Damage to the Economy (GAO/OCG-92-2, June 5, 1992), The Deficit and The Economy: An Update of Long-Term Simulations (GAO/AIMD/OCE-95-119, April 26, 1995), Budget Issues: Analysis of Long-Term Fiscal Outlook (GAO/AIMD/OCE-98-19, October 22, 1997), and Budget Issues: Deficit Reduction and the Long Term (GAO/T-AIMD-96-66, March 13, 1996).

Long-Term Simulations

Long-term simulations are useful for comparing the potential outcomes of alternative fiscal policies within a common economic framework. Such simulations can help the Congress assess the long-term costs and benefits of fiscal policy decisions that are made today. Adopting a long-term perspective is particularly important because the long-term consequences of today's actions are not as visible as their short-term effects, a point made vividly by the economist Charles Schultze when he compared budget deficits to "termites in the basement." Long-term modeling can help illuminate these consequences for policymakers faced with difficult budget choices.

While long-term simulations provide a useful perspective that is often lacking in budget debates, they should be interpreted carefully. Given the range of uncertainty about future economic changes and the responses to those changes,[2] these simulations should not be viewed as forecasts of budgetary or economic outcomes 50 years in the future. Rather, they should be seen only as illustrations of the budget or economic outcomes associated with alternative policy paths based on current information about demographic and budgetary trends and the functioning of the economy. While any long-term analysis is inherently uncertain, one thing is certain: the population is growing older. And this factor is a principal driver of our simulation results, as will be discussed below.

In our simulations, we employ a model originally developed by economists at the Federal Reserve Bank of New York that relates long-term gross domestic product (GDP) growth to economic and budget factors. The key interaction between the budget and the economy is the effect of the federal deficit/surplus on the amount of national saving available for investment. In general, government budget deficits represent dissaving—they subtract from national saving by absorbing funds that otherwise could be used for investment. Conversely, government surpluses add to saving.

For our budget assumptions, we incorporate CBO's most recent 10-year budget projections.[3] After 10 years, we rely on the long-term actuarial

[2]The impact of federal spending reduction on aggregate national saving and investment depends on how consumers respond to such reductions. For example, a reduction in federal Medicaid spending may result in greater private spending on nursing home care thereby diminishing the effect on total national saving.

[3]Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1999-2008, January 1998.

assumptions for the Social Security and Medicare programs.[4] For Medicaid, we use the growth rates assumed by CBO in its March 1997 report on long-term simulations.[5] Interest spending is determined by interest rates—which are held constant over the long term—and the level of federal debt held by the public, which depends on the path of deficits/surpluses within each simulation. All other spending, along with federal revenue, is assumed to grow at essentially the same rate as the economy.[6]

Attachment I provides more details on the model and our assumptions, but one point bears further discussion. Recognizing the inherent uncertainties of long-term simulations, we have deliberately chosen conservative assumptions to estimate the economic consequences of federal fiscal policy. For example, we have held the interest rate and productivity growth constant over the long term, even for budget scenarios for which escalating deficits and declining national savings would imply a substantial worsening of these indicators. Similarly, the economic benefits derived from long-term budget balance scenarios would also tend to be understated due to our constant interest rate and productivity growth assumptions.

Outlook Continues to Improve, but Current Policies Remain Unsustainable Over the Long Term

In our October 1997 report to you and Chairman Kasich, we said that the long-term outlook has improved greatly from when we did our first report in 1992 and our update in 1995. Since our October report was issued, CBO's 10-year budget projections have shown continued improvement in the short term. CBO now projects that the budget is already virtually in balance and that, in a few years, we could experience a period of budget surpluses on a unified budget basis. At your request for this testimony, we updated our simulations to reflect CBO's new baseline.[7]

Our *no action* simulation assumes no changes in current policies. Since current policies include caps on discretionary spending, our *no action* path assumes compliance with these caps—a real cut in discretionary

[4]The 1997 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Trust Funds, The 1997 Annual Report of the Board of Trustees of the Federal Hospital Insurance Trust Fund, and The 1997 Annual Report of the Board of Trustees of the Federal Supplementary Medical Insurance Trust Fund.

[5]Congressional Budget Office, Long-Term Budgetary Pressures and Policy Options, March 1997.

[6]This means that both revenues and other spending remain constant as a share of GDP.

[7]CBO's September budget projections, and thus our October 1997 simulations using CBO data, reflected the net effect of the Balanced Budget Act of 1997 as well as the Taxpayer Relief Act of 1997. CBO's new projections, incorporated into our update, reflect subsequent legislation, but CBO estimated that legislative actions taken since September did not materially change the long-term outlook.

spending of 10 percent by 2002 assuming CBO's inflation projections. The budget surpluses that occur in the early years of the *no action* path are assumed to reduce debt held by the public as in CBO's baseline.

The major improvement in the fiscal outlook discussed in our October 1997 report was due to both policy actions and the performance of the economy. Since then, the fiscal outlook has continued to improve due to the strong economy and the slower growth in health care costs that underlie the changes in CBO's baseline projections. Despite this improvement, our model shows that a fiscal policy of *no action* is still unsustainable over the long term due to the spending pressures caused by the retirement of the baby boom generation and growth in health care costs.

Our February 1998 *no action* simulation is a "good news but" picture. Figure II.1 in attachment II illustrates both the good and bad news in our current *no action* simulation. It shows how our *no action* deficit path has changed since our initial report in 1992. Both our 1992 and 1995 *no action* simulations indicated that deficits would have reached 10 percent of GDP by 2016 at the latest. In contrast, our current *no action* simulation indicates that the federal budget would be in surplus in the early years of the 21st century and deficits would not reach the 10 percent level until about 2040. Despite this good news, under the current *no action* simulation, deficits would reemerge in 2015, less than a decade after the baby boom generation begins to retire. These deficits would then escalate quickly, reaching unsustainable levels as shown in figure II.1. The ratio of debt held by the public to GDP tells a similar story—near-term improvement followed by rapid deterioration to nearly 100 percent of GDP by 2040. Such deficits and debt imply a substantial reduction in national saving, private investment, and the capital stock. Assuming no policy change, GDP would inevitably begin to decline under this scenario.

The *no action* simulation is neither plausible nor sustainable. The negative effects of rapidly increasing deficits and debt on the economy would force action at some point before the end of the simulation period. Policymakers would likely act before facing the probable consequences, such as rising inflation, higher interest rates, and the unwillingness of foreign investors to invest in a weakening American economy. Therefore, as we have noted in our past work, the *no action* simulation is not a prediction of what will happen in the future. Rather, it underscores the need for additional action to address the nation's long-term fiscal challenges.

The primary causes of the large deficits in the *no action* simulation are (1) the aging of the U.S. population, which corresponds to slower growth in the labor force and federal revenues and faster growth in entitlement spending, and (2) the rising costs of providing federal health care benefits. Ten years from now, the first baby boomers will be eligible for early retirement benefits. As this relatively large generation retires, labor force growth is expected to slow considerably and, eventually, stop altogether.

These demographic changes mean fewer workers to support each retiree. Between 1997 and 2030, the number of workers per Social Security beneficiary is projected to drop from 3.3 to 2.0, a decline of nearly 40 percent. Without a major increase in productivity, low labor force growth will inevitably lead to slower growth in the economy and in federal revenue. This slower revenue growth will come at the same time that a large retired population will place major expenditure demands on Social Security, Medicare, and Medicaid. In view of this combination of slower revenue growth and increased expenditure demands, the Social Security Trustees project that in less than 15 years the program's annual tax revenue would be insufficient to cover annual benefits and, in 2029, the program's balance would be exhausted.

As Social Security and health spending rise, their share of GDP and of federal spending grows dramatically in our *no action* simulation. (See figure II.2 in attachment II.) These spending pressures cause large deficits to reemerge, adding substantially to the debt held by the public. Rising debt, in turn, increases spending on interest, which compounds the deficit problem, resulting in a vicious circle. By about 2040, spending for Social Security, health programs, and interest alone would consume more than 100 percent of federal revenues.

We are not the only agency to call attention to these unsustainable long-term trends. CBO also conducts long-term simulations that produce similar results.[8]

[8]Statement of June E. O'Neill on "The Economic and Budget Outlook: Fiscal Years 1999-2008" before the U.S. Senate Committee on the Budget, January 28, 1998. Also see Congressional Budget Office, Long-Term Budgetary Pressures and Policy Options, March 1997.

Effects of Alternative Fiscal Paths on the Fiscal and Economic Outlook

As in our prior reports, we have simulated alternatives to the *no action* fiscal policy scenario, using the same underlying economic assumptions. However, unlike our prior reports, one of the simulations discussed here would actually worsen the long-term fiscal outlook. In our past work, the *no action* simulation always represented the least desirable fiscal path. We chose this approach because, in an era of large budget deficits, the fiscal policy debate usually centered on how to reduce these deficits. Policy alternatives that would have increased deficits received less attention, particularly after enactment of the Budget Enforcement Act of 1990, which set up procedural hurdles to deter such policies.

Currently, however, the dramatic drop in the deficit and the expected budget surpluses for the near future have changed the fiscal policy climate. While our *no action* path remains an unsustainable policy over the long term, it does include a period of budget surpluses over the next 15 years, consistent with CBO's current baseline. Some recent policy proposals have suggested using at least part of these prospective surpluses to increase spending or cut taxes rather than to reduce the debt held by the public.

Thus, as agreed with your office, we present two alternatives to the *no action* simulation in this testimony. The first alternative—*no surplus*—assumes that short-term surpluses are not achieved due to policy actions that permanently increase spending and/or reduce revenues.[9] In this simulation, the budget would be in balance rather than surplus over the next decade. Thereafter, revenue and spending would grow according to the assumptions of the *no action* simulation, but from different baseline levels—that is, revenues would be lower and spending would be higher than in *no action*. As shown in figure II.3 in attachment II, the deficit would reach 10 percent of GDP under the *no surplus* scenario by 2033, or 8 years earlier than the *no action* scenario where the surpluses are used to reduce debt held by the public.

The second alternative—*maintain balance*—assumes short-term budget surpluses are used to reduce debt held by the public as in the *no action* scenario, but then assumes policy actions are taken to prevent deficits from recurring. Beginning in 2015—when deficits reemerge in the *no action* path—the maintain balance simulation assumes that the budget is kept in balance through the end of the simulation period, as shown in figure II.3 in attachment II. Unlike *no action* and *no surplus*, the *maintain*

[9]Assuming that spending increases or revenue reductions were temporary, rather than permanent, would produce different results. Such a path would diverge less from the *no action* baseline than the one used in our analysis.

balance simulation is one example of a sustainable fiscal path under which government activities can be maintained without a continual rise in the debt as a share of GDP.[10]

The *maintain balance* simulation would require some combination of policy or program changes that reduce spending and/or increase revenues. We make no assumptions about the mix of those changes in our analysis and recognize that such actions would not be taken without difficulty. They would require the nation to make choices resulting in a greater share of national income devoted to saving. While consumption would be reduced in the short term, it would be increased over the long term. Early action would permit changes to be phased in and so give those affected by changes in, for example, Social Security or health care benefits, time to adjust.

For both the federal government and the economy, the *no surplus* path leads to the worst outcomes over the long term. As shown in figures II.4 and II.5 in attachment II, eliminating surpluses in the short term increases interest costs over time and ultimately leads to lower living standards when compared to either the *no action* or *maintain balance* paths. Over the longer term, maintaining budget balance yields a vast improvement over either the *no action* or *no surplus* paths. However, running a surplus in the short term under the *no action* scenario helps reduce the fiscal actions needed to maintain budget balance over the longer term, compared to the *no surplus* path.[11]

Sharply reduced interest costs provide the most striking budgetary benefit from following a sustainable policy. Currently, interest spending represents about 15 percent of federal spending, a relatively large share that is a consequence of the deficits of the 1980s and early 1990s. After shrinking in the early years of the *no action* simulation, interest costs increase sharply over the long term, reaching nearly 25 percent of spending in 2050. Interest costs become even more burdensome in our *no surplus* scenario, topping one-third of all spending in 2050. In contrast, maintaining a balanced budget after the projected surpluses would reduce interest costs well below where they are now—to a level less than

[10]Our past reports and CBO's work have both illustrated a number of different policy paths that could be sustained over the long term. For a detailed analysis of sustainability, see Olivier Blanchard, Jean-Claude Chouraqui, Robert P. Hagemann, and Nicola Sartor, "The Sustainability of Fiscal Policy: New Answers to an Old Question," OECD Economic Studies, no. 15 (Autumn 1990). See also The Canadian Institute of Chartered Accountants, Indicators of Government Financial Condition, April 1997.

[11]In fact, our maintain balance path is premised on preserving short-term surpluses, i.e., using them to reduce debt held by the public, consistent with the CBO baseline.

1 percent of all federal spending. Any path that reduces debt held by the public and associated interest costs would help promote increased flexibility for future budget policymakers.

The economic benefits of a sustainable budget policy include increased saving and investment levels and faster economic growth, which results in higher living standards. For example, under the *maintain balance* simulation, per capita GDP would nearly double between 1997 and 2050. In contrast, under either the *no surplus* or *no action* simulations, growth in living standards slows considerably and living standards themselves would begin to decline in the 2040s, as shown by figure II.5 in attachment II. The differences graphically show the emerging gaps in long-term living standards that result from different fiscal policy paths. Although the *maintain balance* path would lead to higher living standards, the rate of growth would be significantly lower than that experienced over the past 50 years. Achieving and sustaining the historic growth rate would be extremely difficult given the slowdown in productivity growth that has occurred in recent decades.

As shown in table 1, by 2050, living standards would be over 50 percent lower under *no surplus* and 25 percent lower under *no action* than under the *maintain balance* simulation. This difference results from a wide gap in private investment. Under either of the unsustainable simulations, large deficits eventually drive per capita private investment spending down sharply while a balanced budget policy could produce a near doubling of investment per capita. As we have said in our earlier work, the surest way to increase the resources available for investment is to increase national saving, and the most direct way for the federal government to increase national saving is to achieve and sustain a balanced budget. Running budget surpluses would further increase saving and allow the government to reduce the level of federal debt held by the public.

Table 1: the Economic and Fiscal Position in 1997 (Preliminary) and 2050 (Simulated)

In per capita 1997 dollars

	1997	2050 No Surplus	2050 No Action	2050 Maintain Balance	Percent difference in 2050 between Maintain Balance and No Surplus	Percent difference in 2050 between Maintain Balance and No Action
Real GDP	$29,600	$36,600	$45,200	$56,500	54%	25%
Debt	$13,900	$129,700	$86,800	$2,000	–98%[a]	–98%[a]
Nonfarm business investment	$3,500	0	$1,500	$6,700	N/A	347%
Nonfarm capital stock	$29,900	$10,100	$26,600	$60,000	494%	126%

[a]These two numbers are not identical, but they round to the same full percent.

Legend

N/A=Not applicable

Long-Term Commitments Not Adequately Reflected in Budget Reporting

To some degree, the long-term fiscal policy of the nation is determined by the spending or revenue paths inherent in the design of federal programs. Without adequate information about the long-term cost implications of specific program (or revenue) designs, fiscal policy may not follow the expected path. Just as the current long-term projections are driven by a combination of demographics and the design of Social Security and federal health care programs, so future projections may also be affected by the long-term costs of other programs.

As the central process through which the President and the Congress select among and balance the competing demands for government activity in achieving various goals, the budget needs to provide more complete information on the costs of various alternatives—on a comparable basis—and on the nature of the government's commitment. Although the multiyear focus of the Budget Enforcement Act of 1990 represents significant progress in considering the longer term in budgeting, some programs require an even longer time horizon to understand the implications of commitments being made.

The future implications of current policy decisions reflected in our simulations and in other financial reports are generally not captured in the budget process. This is because the budget is largely a short-term, cash-based spending plan focusing on the short- to medium-term cash implications of government obligations and fiscal decisions. Accordingly, it does not provide comprehensive information on the longer term cost

implications stemming from the government's commitments. Of course, commitments the Congress created by statute may subsequently be changed by the Congress either modifying, amending, or repealing the underlying laws establishing the benefits. Nevertheless, a longer term perspective is necessary to understand the fiscal and spending implications of key government programs and commitments extending over a longer time horizon.[12] As demonstrated by our simulations, the nation's economic future depends in part upon today's budget and fiscal policy decisions. In considering what fiscal adjustments to make, policymakers need to be presented with more complete information on the costs of the government's long-term commitments.

The federal government's long-term commitments are wide-ranging and varied in nature. While the sustainability of the government's fiscal policy is driven primarily by future spending for Social Security and health care commitments, the federal government's commitments and responsibilities extend far beyond these programs. These commitments may themselves result in large costs that can encumber future fiscal resources and also constrain the government's future financial flexibility to meet all its commitments as well as any unanticipated or emerging needs. Although a portion of some of the government's commitments have already been recognized in the budget through appropriations for future costs there are others that are not recognized at all. In table 2, we show a number of federal liabilities and commitments whose total long-term costs have not been fully recognized in either the budget or in our long-term simulations. It must be noted that for some of these commitments, the budget has recognized a portion of the long-term costs. For example, for federal civilian employees hired since 1987, the full cost of pension benefits is recognized in the budget as they are earned over the working lives of the employees.

[12]Budget Process: Evolution and Challenges (GAO/T-AIMD-96-129, July 11, 1996).

Table 2: Examples of Long-Term Government Liabilities and Commitments Not Fully Recognized in the Federal Budget

Dollars in billions	
Examples of federal liabilities and commitments	**1996**
Deferred Compensation	
Civilian and military pensions	$1,321.9
Veterans' compensation and benefits	$240.0
Civilian and military retirees' health benefits	$344.2
Insurance	
Deposit insurance	$0.4[a]
Pension Benefit Guaranty Corporation	$10.8[b]
Other insurance	$16.0[c]
Environmental liabilities (DOE/DOD)	$246.5
Unadjudicated Claims	$71.7
Liabilities for pre-credit reform loan guarantees	$2.7[d]

[a]Financial Audit: Federal Deposit Insurance Corporation's 1996 and 1995 Financial Statements (GAO/AIMD-97-111, June 30, 1997) and National Credit Union Administration 1996 Annual Report.

[b]Pension Benefit Guaranty Corporation 1996 Annual Report.

[c]Analytical Perspectives, Budget of the United States Government, fiscal year 1999.

[d]Governmentwide figure not available. Amount reported is calculated from agency financial statements and includes only the Departments of Education, Agriculture, and Veterans Affairs and the Small Business Administration.

Source: GAO analysis of data from the fiscal year 1996 prototype Consolidated Financial Statements of the United States Government issued by Department of the Treasury, except as noted. These statements were not audited, which limits their usefulness and reliability. GAO is auditing these statements for fiscal year 1997.

While this list is not comprehensive and may not be universally agreed with, it provides some perspective on the range and magnitude of these commitments. Some of the federal government's liabilities are similar to those found on the balance sheet of a typical business, such as deferred compensation. Other commitments—not shown in this table—are of a different nature. For example, the table we constructed does not show the implied commitments for social insurance programs such as Unemployment Insurance, Black Lung benefits, Railroad Retirement, and Medicaid, nor does it show those programs which, in the absence of a change in law, would go on forever. In some of these cases, earmarked revenue, such as in the form of individual contributions, has helped build public perception of an enduring commitment by the government. Also, the federal government has other ongoing responsibilities, such as providing for the common defense of the nation, that are not shown in the

table. Still another category of long-term commitments may arise from those programs or activities that commit the government to future operating and maintenance expenses or from the expectation that a partially funded capital project—such as the space station—will receive future funding to complete the project.

Possible Budget Process and Reporting Improvements

The broad range of long-term federal commitments complicates the challenge of integrating more complete information on their expected future cost into the budget process. The diverse nature of the commitments, combined with the varying quality and amount of information available outside the budget process, suggests that across-the-board changes in budget reporting or process may not be the most effective way to proceed.

We think that it may be more useful to look at different categories of the government's long-term commitments to identify the most useful approach for incorporating a longer term perspective into current policy actions affecting those commitments. Alternatives could range from enhancing the information available in the budget to developing new frameworks for budgetary incentives and control, as the Congress did for credit programs under the Federal Credit Reform Act of 1990. Thus, for different categories of commitments, changes in the information provided or in the existing incentives and controls could be selectively tailored to address specific problems. For some types of commitments, the problem may be a lack of information to judge the expected future costs of programs as they are created or modified. For other commitments, such as insurance, the problem may be that the incentives or signals provided by information reported in the budget are misleading.

While there is a great deal of information available to decisionmakers on the future cost implications of the government's two largest commitments—Social Security and Medicare—long-term simulations like GAO's put the information in context by helping focus attention on the broader fiscal and economic implications of these commitments. These models can be updated periodically to help the Congress and the public assess the future consequences of current or proposed policies and programs. Such long-term simulation models could provide information to help judge the future implications of current or alternative fiscal policy paths. The effects of congressional budget resolutions could be simulated over the long term to gauge their potential impact on the long-term outlook. Thus, use of economic simulations could help establish a

long-term framework linking budget planning and long-term fiscal policy goals.

With regard to program categories for which the budget currently provides misleading or incorrect incentives and signals, we recently reported that the cash-based budget provides neither complete cost information for budget decision-making nor the incentives necessary to control costs for federal insurance programs.[13] While smaller than the government's social insurance commitments, federal insurance is provided to individuals and businesses against a wide variety of risks, ranging from natural disasters under the flood and crop insurance programs to bank and employer bankruptcies under the deposit and pension insurance programs. These commitments could result in potentially large future obligations; however, their costs are not currently reflected in the budget at the time the government extends the insurance. Although it is often hard to predict the timing and magnitude of insured losses, estimates of the expected long-term costs of these future claims are available for many of the federal insurance programs. In our report, we recommended that the Office of Management and Budget work with the insurance program agencies to improve these estimates and report this supplemental information in the budget. Reporting of such accrual-based insurance costs would improve recognition of the government's commitments.

Another area in which the budget provides incomplete cost information and misleading incentives is future civilian and military retiree health costs. None of the accruing costs of civilian or military retiree health benefits are recognized in the budget. The budgetary information and incentives to control costs for these programs could potentially be improved through the use of accrual concepts, which would recognize the full cost of these benefits in the budget as they are earned.

The cost of environmental cleanup resulting from federal operations, which under federal accounting standards is reported as a liability on financial statements, represents another category of long-term costs, most of which have not been recognized in the budget. While it will be up to the Congress to decide on the most appropriate way to deal with this large accumulated liability, we believe that decisions to purchase capital assets should take into account the cost of any new environmental liabilities to be created with the operation or decommissioning of the asset. The cost of

[13]See Budget Issues: Budgeting for Federal Insurance Programs (GAO/AIMD-97-16, September 30, 1997).

future environmental liabilities could be provided as supplemental information or recorded in budget authority before the asset is purchased.

Information about the cost of some of these commitments will be increasingly available as agencies produce audited financial statements. Financial reports based on federal financial accounting standards will provide an additional perspective on the government's various long-term commitments and finances. The new standards require new reports on a broad range of liabilities and commitments. Liabilities such as deferred compensation and environmental costs will be reported on the balance sheet. Information on the government's commitments for programs like Social Security and Medicare, while not treated as balance sheet liabilities, will be presented in stewardship reports. These are new reports supplementing the basic financial statements that are intended to provide additional financial and nonfinancial information useful for assessing the government's stewardship over the resources entrusted to it and the responsibilities it has assumed.

Conclusion

The economy and policy actions have combined to create a major change in the near-term deficit outlook. Current projections—assuming compliance with discretionary spending limits set in the Balanced Budget Act of 1997—are for surpluses through 2013. Although near-term budgetary improvement is a welcome achievement, unsustainable deficits nonetheless would reemerge over the longer term as a smaller generation of workers will be challenged to finance the costs of public programs for baby boom retirees.

Our near-term fiscal policy will have a decided impact on the future budgets and economy inherited by the next generations. Our simulations suggest that preserving the anticipated budget surpluses now makes some tangible difference for the long term, most notably by reducing the burden of debt and interest passed on in future budgets. However, a sustainable policy will, at some point in the future, require further fiscal actions to avoid the vicious cycle of exploding deficits and debt—actions that could be more or less painful based on our decisions today. A budget reporting and accounting framework making the future implications of today's decisions more transparent would help the nation better understand the stakes underlying the choices it faces.

Mr. Chairman, this concludes my written statement. I would be happy to answer any questions you or your colleagues may have. We look forward to working with you as you address the important long-term issues I have discussed today.

The Economic Model and Assumptions

This update of GAO's work[1] on the long-term economic and budget outlook relies in large part on a model of economic growth developed by economists at the Federal Reserve Bank of New York (FRBNY). The major determinants of economic growth in the model include changes in the labor force, capital formation, and the growth in total factor productivity. To analyze the long-term effects of fiscal policy, we modified the FRBNY's model to include a set of relationships that describe the federal budget and its links to the economy, using the framework of the National Income and Product Accounts (NIPA). The simulations generated using the model provide illustrations, not forecasts, of the budget or economic outcomes associated with alternative policy paths. The model depicts the links between the budget and the economy over the long-term, and does not reflect their interrelationships during short-term business cycles.

The main influence of budget policy on long-term economic performance in the model is through the effect of the federal deficit or surplus on national saving. Higher federal deficits or lower surpluses reduce national saving while lower deficits or higher surpluses increase national saving. The level of saving affects investment and, hence, GDP growth.

GDP is determined by the labor force, capital stock, and total factor productivity.[2] GDP in turn influences nonfederal saving, which consists of the saving of the private sector and state and local government surpluses or deficits. Through its effects on federal revenues and spending, GDP also helps determine the federal budget deficit or surplus. Nonfederal and federal saving together comprise national saving, which influences private investment and the next period's capital stock. Capital combines with labor and total factor productivity to determine GDP in the next period and the process continues.

There are also important links between national saving and investment and the international sector. In an open economy such as the United States, a decrease in saving due to, for example, an increase in the federal budget deficit, does not require an equivalent decrease in investment. Instead, part of the saving shortfall may be filled by foreign capital inflows. A portion of the net income that results from such investments flows

[1]Budget Policy: Prompt Action Necessary To Avert Long-Term Damage to the Economy (GAO/OCG-92-2, June 5, 1992), The Deficit and The Economy: An Update of Long-Term Simulations (GAO/AIMD/OCE-95-119, April 26, 1995), and Budget Issues: Analysis of Long-Term Fiscal Outlook (GAO/AIMD/OCE-98-19, October 22, 1997).

[2]Total factor productivity reflects sources of growth not captured in aggregate labor and capital measures, including technological change, labor quality improvements, and the reallocation of resources to more productive uses.

abroad. In this update, we retained the assumption in our prior work that net foreign capital inflows rise by one-third of any decrease in the national saving rate.

Table I.1 lists the key assumptions incorporated in the model. The assumptions used tend to provide conservative estimates of the benefit of reducing deficits or running surpluses and of the harm of increasing deficits. The interest rate on the national debt is held constant, for example, even when deficits climb and the national saving rate plummets. Under such conditions, the more likely result would be a rise in the rate of interest and a more rapid increase in federal interest payments than our results display. Another conservative assumption is that the rate of total factor productivity growth is unaffected by the amount of investment. Productivity is assumed to advance 1 percent each year even if investment collapses. Such assumptions suggest that changes in deficits or surpluses could have greater effects than our results suggest.

We have made several modifications to the model, but the model's essential structure remains the same as in our previous work. We have incorporated the change in the definition of government saving in the NIPAs adopted in late 1995 by adding a set of relationships determining government investment, capital stock, and the consumption of fixed capital.

The more recent data prompted several parameter changes. For example, the long-term inflation rate is now assumed to be 2.5 percent, down from 2.7 in our October 1997 report, 3.4 percent in our 1995 report and 4.0 percent in our 1992 report. In this update, the average federal borrowing rate steadily declines to 5.1 percent, compared to our assumption of 7.2 percent in 1995 and 7.8 percent in 1992. Our work also incorporates the marked improvement in the economic and budget outlook reflected in the 10-year projections that CBO published in January 1998.

As we use a broad NIPA framework for our long-term simulations, the presentation of the mandatory and discretionary spending trends implied by our results are only approximations. We adopted the NIPA-based budget assumptions from CBO's most recent 10-year economic and budget outlook, which reflect the assumption that discretionary spending equals the statutory caps from fiscal years 1998 through 2002 and increases at the rate of inflation from fiscal years 2003 through 2008. For the period following fiscal year 2008, we assumed that those NIPA categories broadly

corresponding to discretionary spending would keep pace with GDP growth.

Mandatory spending includes Health (Medicare and Medicaid), Old Age Survivors and Disability Insurance (OASDI, or Social Security), and a residual category covering other mandatory spending. Following NIPA definitions, we did not net out premiums and contributions from these categories. Medicare reflects CBO's assumptions through 2007, and increases at the Health Care Financing Administration's (HCFA) projected rate in subsequent years. Medicaid is based on CBO's January 1998 assumptions; thereafter it increases at the rates embodied in CBO's March 1997 report on the long-term budget outlook. OASDI reflects the April 1997 Social Security Trustees' Alternative II projections.

Other mandatory spending is a residual category consisting of non-health, non-Social Security mandatory spending. It equals CBO's NIPA projection for Transfers, Grants, and Subsidies less Health, OASDI, and discretionary spending that is included in NIPA projections for these items. Through 2007, CBO assumptions are the main determinant of other mandatory spending, after which its growth is linked to that of GDP.

The interest rates for 1997-2007 are consistent with the average effective rate implied by CBO's interest payment projections. We assume that the average rate remains at the 2007 rate of 5.1 percent for the rest of the simulation period.

Receipts follow CBO's dollar projections through 2007. Thereafter, they continue at 20.5 percent of GAO's simulated GDP, which is the rate projected for 2007.

As these assumptions differ somewhat from those used in our earlier reports, only general comparisons of the results can be made.

Table I.1: Key Assumptions

	Assumptions
Saving rate: gross saving of the private and state and local government sectors	17.5 percent of GDP
Labor: growth in hours worked	Follows the Social Security Trustees' Alternative II projections
Total factor productivity growth	1 percent
Inflation rate	Follows CBO through 2008; 2.5 percent thereafter
Interest rate (average on the national debt)	Average effective rate implied by CBO's interest payment projections through 2007; 5.1 percent (CBO's 2007 implied rate) thereafter
Surplus/Deficit	Follows CBO's budget surplus/deficit as a percentage of GDP through 2007; GAO projections thereafter
NIPA categories covering discretionary spending and other mandatory spending	CBO through 2007; increases at the rate of economic growth thereafter
Medicare	CBO through 2007; increases at HCFA's projected rate thereafter
Medicaid	CBO's projections and simulation
OASDI	Follows the Trustees' Alternative II projections
Receipts	CBO's assumed levels through 2007; in subsequent years receipts equal 20.5 percent of GDP (2007 ratio)

Note: In our work, all CBO budget projections were converted from a fiscal year to a calendar year basis. The last year of CBO's projection period is fiscal year 2008, permitting the calculation of calendar year values through 2007.

Figures

Figure II.1: Deficit Paths Under GAO's Past and Present No Action Simulations

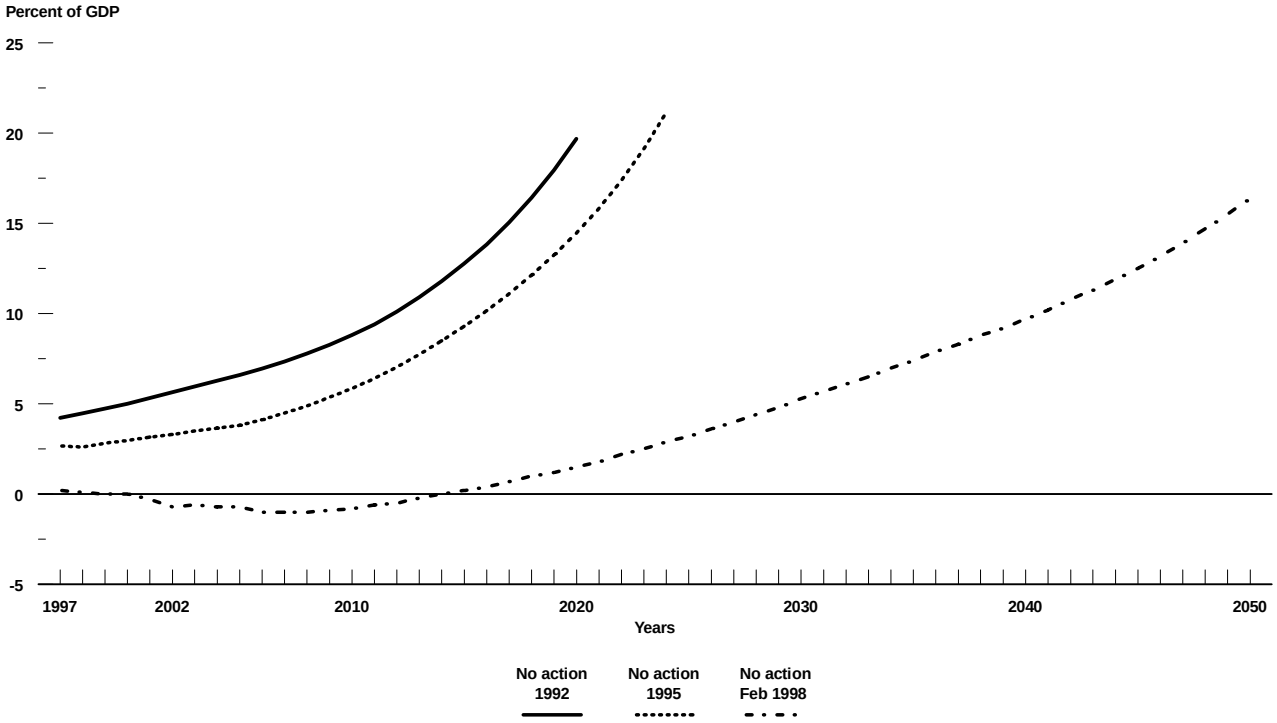


Figure II.2: Long-Term Change in Composition of Spending as a Percentage of GDP Under No Action Simulation

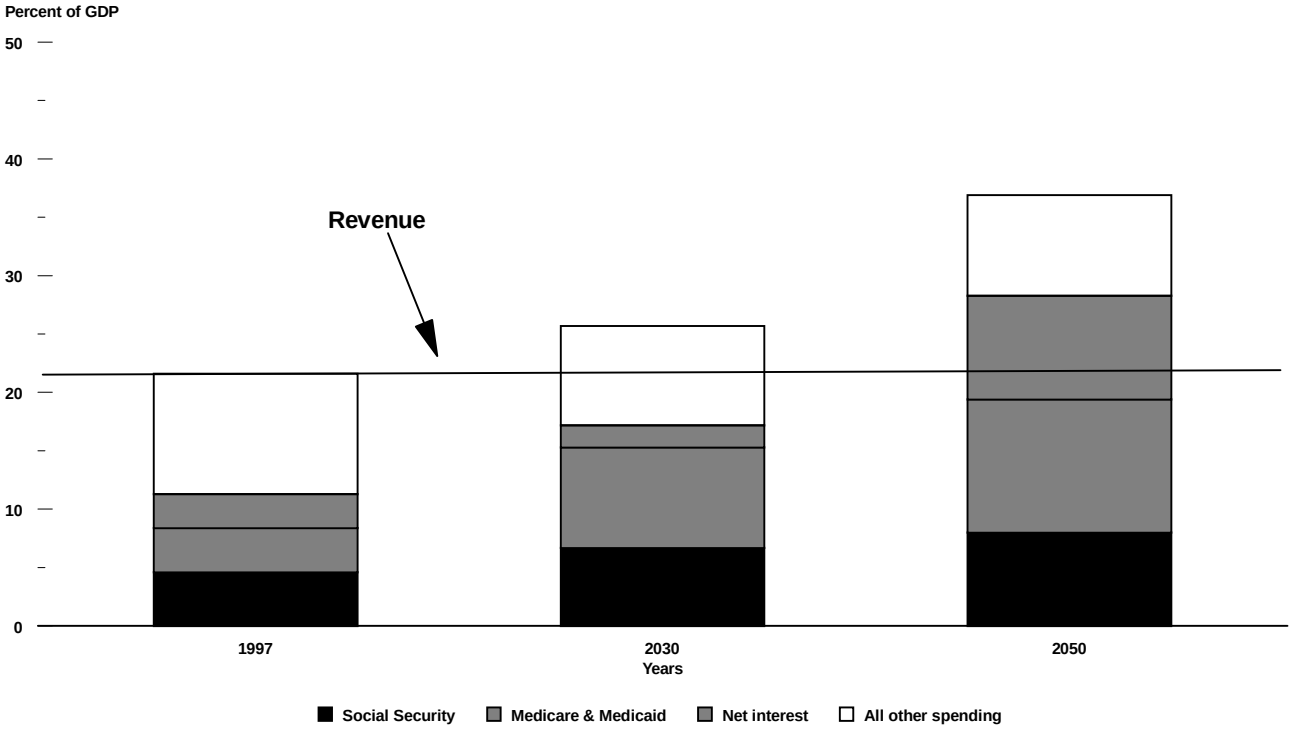


Figure II.3: Alternative Deficit/Surplus Paths

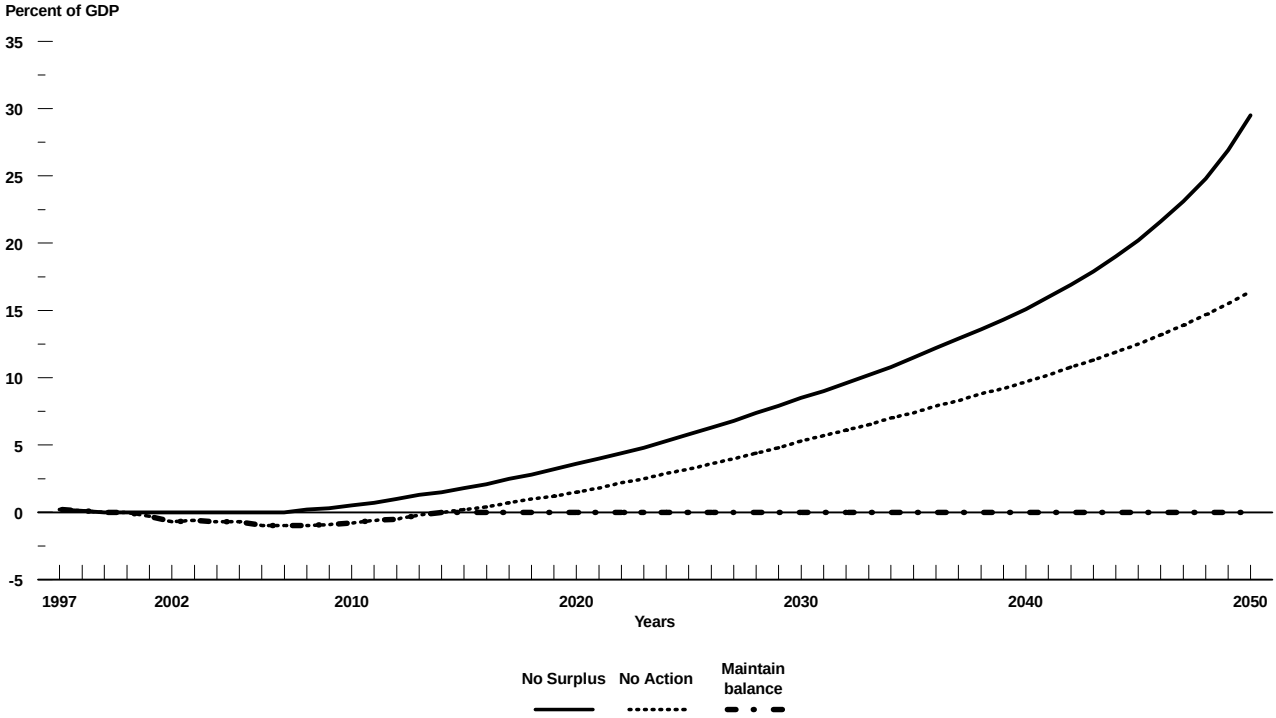


Figure II.4: Net Interest as a Share of Total Spending in 2050 Under GAO's Three Fiscal Policy Simulations

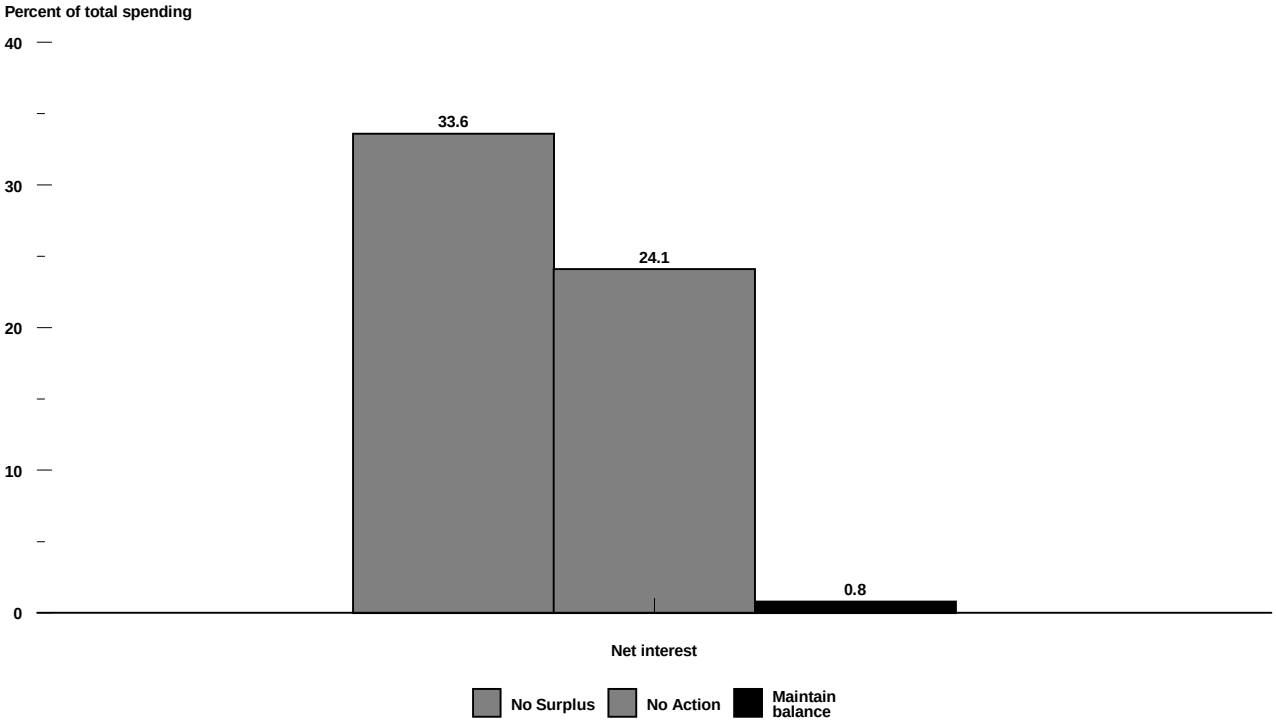
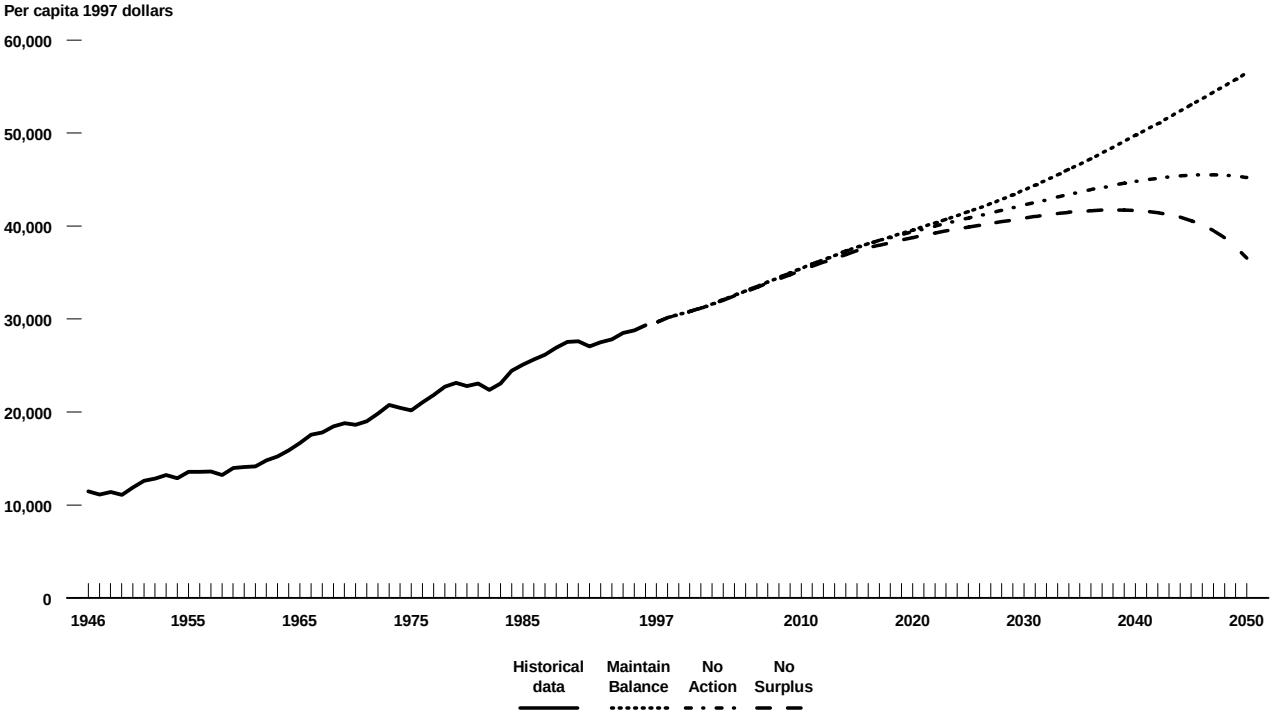


Figure II.5: GDP Per Capita Projected Under GAO's Three Fiscal Policy Simulations



Source: GAO analysis of 1946-1996 historical data, GAO's GDP simulations, and Social Security Administration population projections.

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