United States Government Accountability Office

GAO

The Nation's Long-Term Fiscal Outlook

March 2009 Update

GAO's Long-Term Fiscal Simulations

Since 1992, GAO has published long-term fiscal simulations of what might happen to federal deficits and debt levels under varying policy assumptions. GAO developed its long-term model in response to a bipartisan request from Members of Congress who were concerned about the long-term effects of fiscal policy.

GAO runs two simulations:

- Baseline Extended follows the Congressional Budget Office's (CBO) baseline estimates for the first 10 years and then 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 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, and expiring tax provisions, except for those enacted in the American Recovery and Reinvestment Act (Recovery Act), are extended until 2019 and then revenue is brought back to about its historical level.

Recovery Act provisions are included in both simulations but are assumed to be temporary.

GAO updates its simulations as new estimates become available from CBO and the Social Security and Medicare Trustees. This update incorporates CBO's March 2009 baseline projections. Additional information can be found at: http://www.gao.gov/special.pubs/longterm/.

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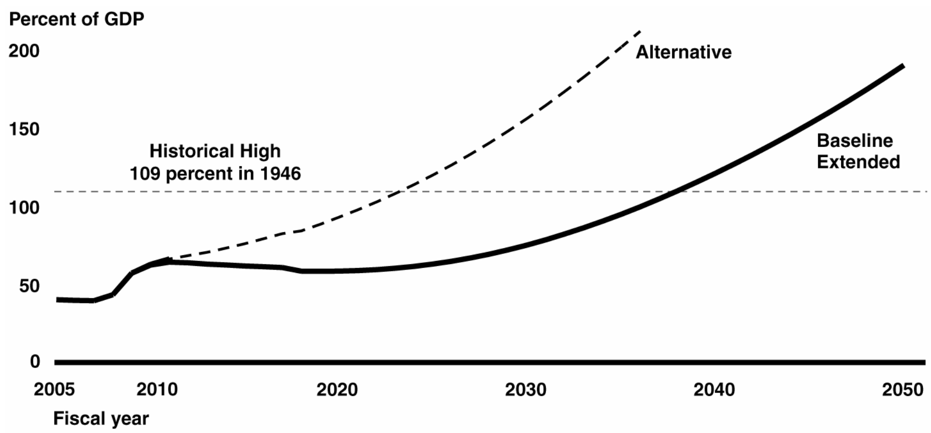
The new President, the new Congress, and the American people have been understandably focused on addressing problems with financial markets and responding to the economic downturn. However, the nation will need to apply the same level of intensity to the nation's long-term fiscal challenge. As shown in the figure below and the attached charts, GAO's updated simulations continue to show escalating and persistent debt that illustrates the long-term fiscal outlook is unsustainable. By 2025, debt held by the public under the Alternative simulation exceeds the historical high reached in the aftermath of World War II.

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



Source: GAO.

Note: Data from GAO's simulations based on the 2008 Trustees' assumptions for Social Security and Medicare. We also run simulations using CBO's Social Security and Medicare projections; the results are not materially different.

GAO's updated simulations reflect the effects of policies undertaken to stabilize the financial markets and stimulate the economy through mid-March 2009. According to CBO's March 2009 estimates, the actions taken to date and the weakened economy will produce a surge in debt held by the public in fiscal year 2009.

While the factors driving the near-term outlook can be and have been quite volatile, the long-term fundamentals have not changed. Health care costs are still growing faster than the economy and the nation's population continues to age. GAO's long-term simulations show that absent policy actions aimed at reforming the key drivers of our structural deficits—health spending and Social Security—the federal government faces unsustainable growth in debt. The longer that action to deal with the federal government's long-term fiscal outlook is delayed, the greater the risk that the eventual changes will be disruptive and destabilizing.

Alternative Fiscal Policy Simulations

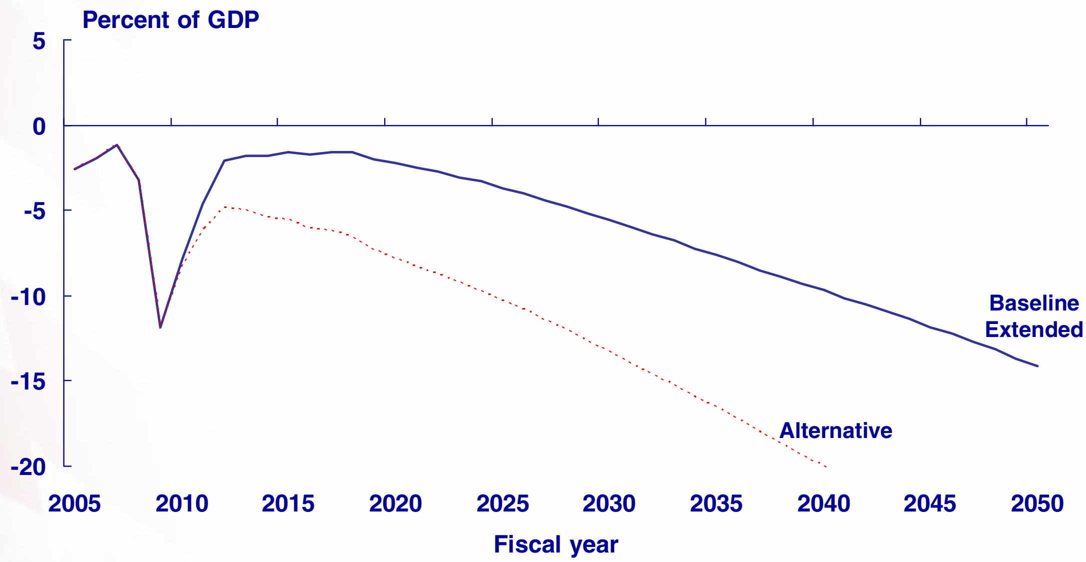
- **Baseline Extended** follows CBO's March 2009 10-year baseline projections that assume discretionary spending authority, except that enacted in the Recovery Act, grows with inflation; Recovery Act provisions are included but assumed to be temporary. Tax provisions scheduled to expire will actually do so. After 2019, discretionary spending is assumed to grow with the economy and revenue is held constant as a share of GDP at the 2019 level of 20.3 percent—implicitly assuming that action is taken to offset increased revenue from real bracket creep, the alternative minimum tax (AMT), and tax-deferred retirement accounts. Medicare spending is based on projections assuming the continuation of current law under which fees for physicians treating Medicare patients would be cut in future years.

- The **Alternative** simulation follows Baseline Extended except for changes to the assumptions for three variables. Discretionary spending other than Recovery Act provisions grows with the economy after 2009; Recovery Act provisions are included but assumed to be temporary. Expiring tax provisions are extended, except for expiring provisions enacted in the Recovery Act.[1] After 2019, revenue is brought back to its 40-year historical average level of 18.3 percent of GDP plus expected revenues from deferred taxes (i.e., taxes on withdrawals from retirement accounts). Throughout the simulation period, Medicare spending is based on projections assuming that physician payments are not reduced as specified under current law.

[1]The 1-year extension of the increased exemption amount for the AMT that is part of the Recovery Act was not extended because updated estimates were not available. While extending the AMT could reduce revenue by over $600 billion over the first 10 years, it would not affect the long-term outlook in our simulation because we assume that revenue/GDP returns to its historical average over the long term.

Note: CBO's projections are from *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook* (March 2009).

Unified Deficits as a Share of GDP
Under the Two Fiscal Policy Simulations



Source: GAO.

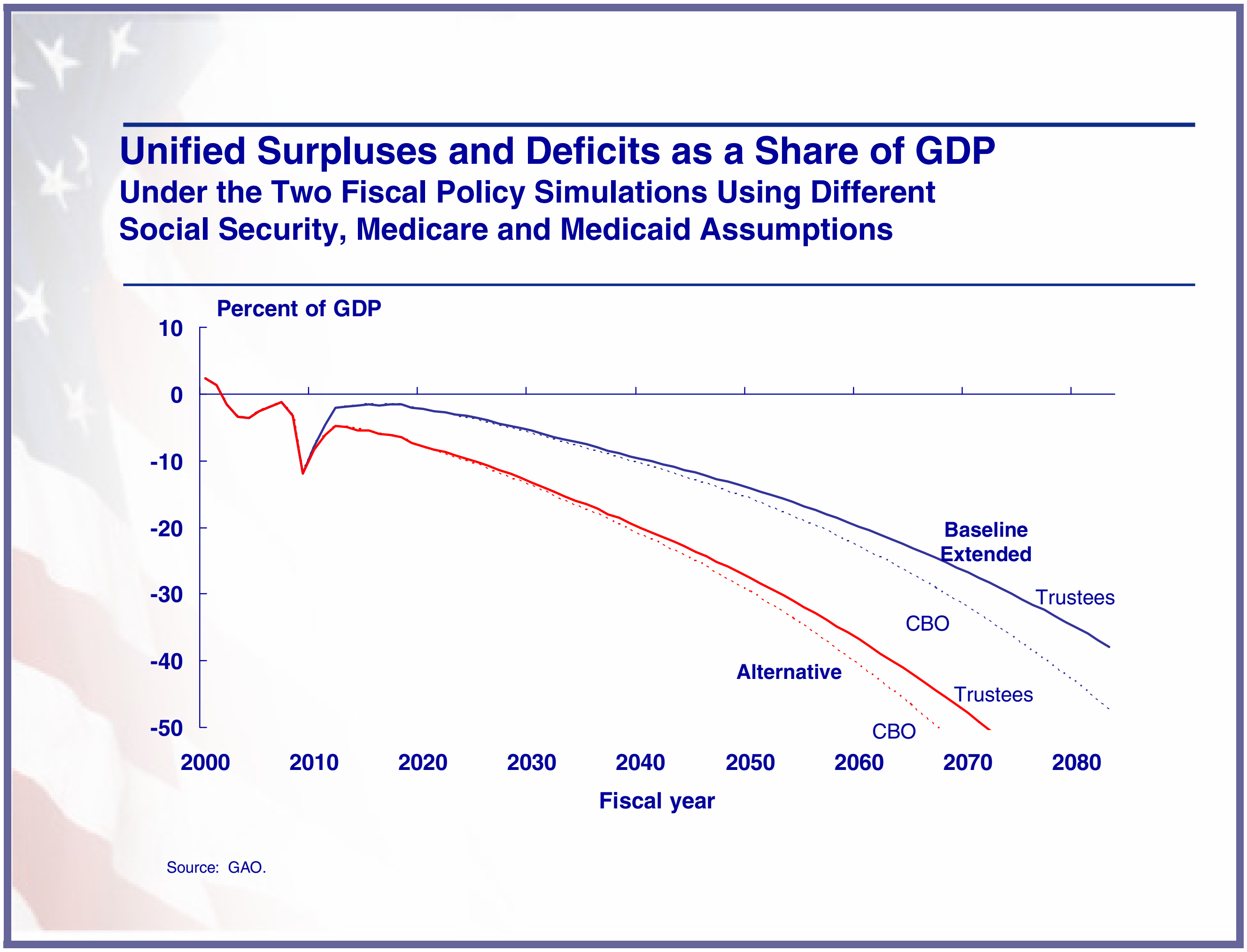
Notes: Based on simulations using the Trustees' Assumptions for Social Security and Medicare. We also run simulations using CBO's projections for Social Security and Medicare; as shown on page 5, the results are not materially different.

Budget Assumptions after the First 10 Years

- GAO uses two different sources for long-term projections for Social Security, Medicare, and Medicaid:
  - In the first set of simulations, Social Security and Medicare are based on the Trustees' 2008 estimates. Medicaid spending is based on CBO's projections but adjusted to reflect excess cost growth consistent with the Trustees.
  - In the second set of simulations, Social Security, Medicare, and Medicaid are based on CBO's most recent long-term projections.

- In both sets of simulations, we assume the following:
  - Social Security and Medicare benefits are paid in full after the trust funds are exhausted through borrowing from the general fund to meet any payroll tax shortfall.
  - Other mandatory spending is held constant as a share of GDP at the 2019 level.

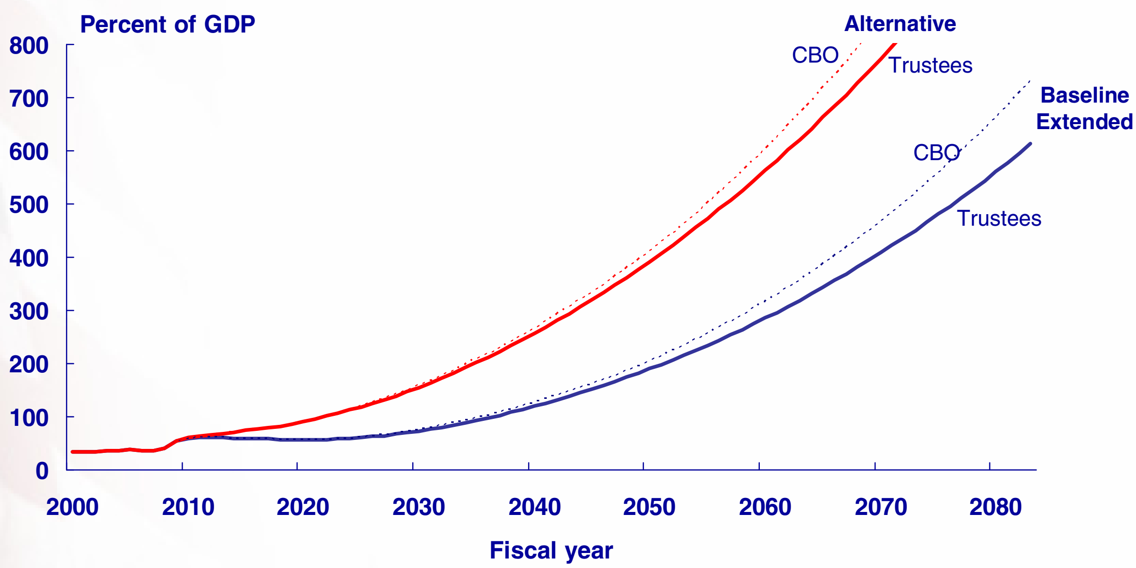
Notes: The Trustees' 2008 estimates are from T*he 2008 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* and *2008 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* that were both issued on March 25, 2008. CBO's estimates are from *Updated Long-Term Projections for Social Security* (August 2008) and *The Long-Term Budget Outlook* (December 2007).



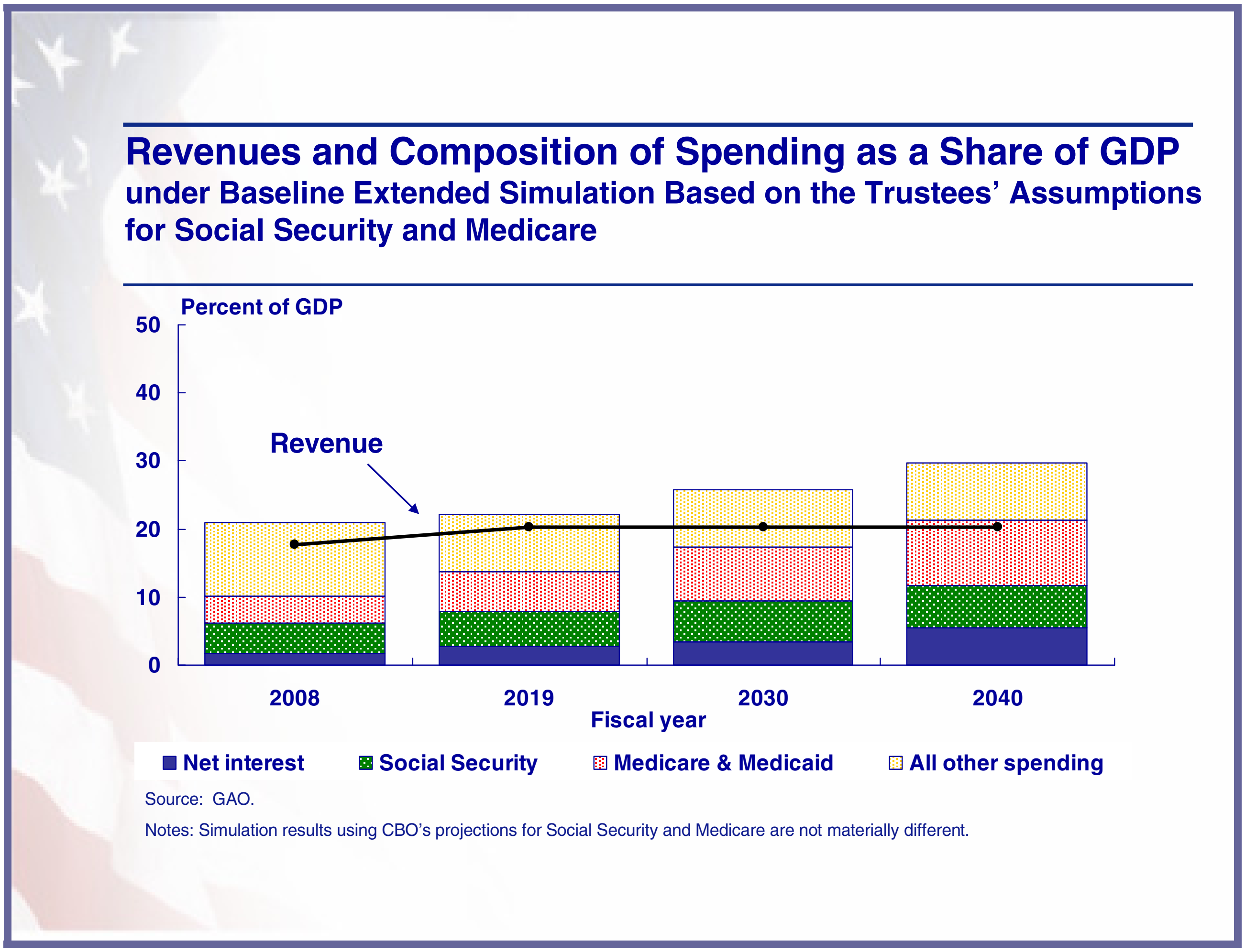
Unified Surpluses and Deficits as a Share of GDP
Under the Two Fiscal Policy Simulations Using Different
Social Security, Medicare and Medicaid Assumptions
Percent of GDP
10
0
-10
-20
-30
-40
-50
2000
2010
2020
2030
2040
2050
2060
2070
2080
Fiscal year
Baseline
Extended
Trustees
CBO
Alternative
Trustees
CBO
Source: GAO.

Debt Held by the Public as a Share of GDP

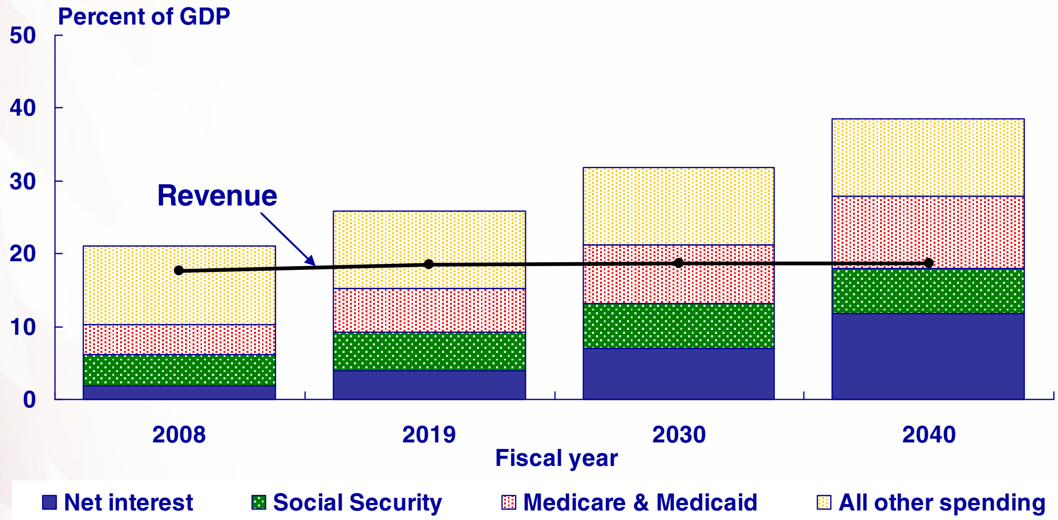
Under the Two Fiscal Policy Simulations Using Different Social Security, Medicare and Medicaid Assumptions



Source: GAO.


Revenues and Composition of Spending as a Share of GDP
under Baseline Extended Simulation Based on the Trustees' Assumptions for Social Security and Medicare
Percent of GDP
50
40
30
20
10
0
Revenue
2008
2019
2030
2040
Fiscal year
Net interest
Social Security
Medicare & Medicaid
All other spending
Source: GAO.
Notes: Simulation results using CBO's projections for Social Security and Medicare are not materially different.

Revenues and Composition of Spending as a Share of GDP under Alternative Simulation Based on the Trustees' Assumptions for Social Security and Medicare



Source: GAO.

Notes: Simulation results using CBO's projections for Social Security and Medicare are not materially different.

Federal Fiscal Gap (2009-2083)

Under GAO's Simulations Based on the Trustees' Assumptions for Social Security and Medicare

	Fiscal gap		Change required to close gap	
	Trillions of present value 2009 dollars	Percent of GDP	Percent increase in revenue	Percent decrease in noninterest spending
Baseline Extended	33.7	4.3	21.5	18.0
Alternative	62.9	8.1	43.6	30.9

Source: GAO

Notes: 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 over a certain time period, such as 75 years as shown above. Results from simulations using CBO's projections for Social Security and Medicare are not materially different.

Key Budget Assumptions

for Simulations Based on the Trustees' Assumptions for Social Security and Medicare

Model inputs	Baseline Extended	Alternative
Revenue	CBO's March 2009 baseline through 2019; thereafter remains constant at 20.3 percent of GDP (CBO's projection in 2019)	CBO's estimates assuming expiring tax provisions other than those enacted in the Recovery Act are extended through 2019; thereafter equal to 40-year historical average of 18.3 percent of GDP plus revenue from tax-deferred retirement plans
Social Security spending	CBO's March 2009 baseline through 2019; thereafter based on 2008 Social Security Trustees' intermediate projections	Same as Baseline Extended
Medicare spending	CBO's March 2009 baseline through 2019; thereafter 2008 Medicare Trustees' intermediate projections that assume per enrollee Medicare spending grows on average 1 percent faster than GDP per capita over the long term	2008 Trustees intermediate projections adjusted for the Centers for Medicare & Medicaid Services' alternative assumption of 0 percent physician payment updates in the first 10 years
Medicaid spending	CBO's March 2009 baseline through 2019; thereafter CBO's December 2007 long-term projections adjusted to reflect excess cost growth consistent with the 2008 Medicare Trustees' intermediate projections	Same as Baseline Extended
Other mandatory spending	CBO's March 2009 baseline through 2019; thereafter remains constant as a share of GDP at 2.1 percent of GDP	Baseline Extended adjusted for extension of certain tax credits through 2019; thereafter remains constant at 2.2 percent of GDP
Discretionary spending	CBO's March 2009 baseline through 2019; thereafter remains constant at 6.4 percent of GDP	Discretionary spending other than Recovery Act provisions increases at the rate of economic growth after 2009 (i.e., remains constant at 8.5 percent of GDP); Recovery Act provisions are included but assumed to be temporary

Source: GAO.

Note: CBO's March 2009 projections are from *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook* and the Trustees' projections are from *The 2008 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* and *2008 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds,* which were both issued on March 25, 2008.

Key Budget Assumptions That Change in Simulations Using CBO's Entitlement Spending Projections

Model inputs	Baseline Extended	Alternative
Social Security spending	CBO's March 2009 baseline through 2019; thereafter CBO's August 2008 projections that assume full benefits as calculated under current law are paid regardless of the amounts available in the trust funds. These projections are based on the 2008 Social Security Trustees' demographic projections and CBO's own economic assumptions.	Same as Baseline Extended
Medicare spending	CBO's March 2009 baseline through 2019; thereafter CBO's December 2007 projections based on current law. Per enrollee Medicare spending grows on average 1.7 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 March 2009 baseline through 2019; thereafter CBO's December 2007 long-term projections based on current law. Per enrollee Medicaid spending grows on average 0.9 percentage points faster than GDP per capita over the long term.	Same as Baseline Extended

Source: GAO.

Notes: CBO's projections are from *Updated Long-Term Projections for Social Security* (August 2008) and *The Long-Term Budget Outlook* (December 2007).

[a]This is slightly higher than the assumption used in GAO's alternative using the 2008 Trustees' assumptions. In the Trustees' analysis, expenditures under the Medicare Economic Index are 22.5 percent higher than current law by 2017, whereas expenditures under the 0 percent update are only 16.8 percent higher.

Federal Revenue and Discretionary Spending as Shares of GDP: Historical Averages and Assumptions after 2019 in Both Sets of GAO's Simulations

Percent of GDP

	20-year historical average	40-year historical average	Baseline Extended	Alternative
Total revenue	18.4	18.3	20.3	18.7[a]
Discretionary spending	7.6	8.9	6.4	8.5

[a]Average over the period from 2020 to 2083 represents a return to the 40-year historical revenue average of 18.3 percent of GDP plus expected revenues from deferred taxes (i.e., taxes on withdrawals from retirement accounts).

Sources: CBO and GAO.

Note: Simulation values represent GAO's assumptions for year 10 and beyond and are the same regardless of whether we use the Trustees' or CBO's projections for Social Security and Medicare.

Key Economic Assumptions Used in Both Sets of Simulations

Model inputs	All simulations
Labor: growth in hours worked	2008 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 2008)
Current account balance (percent of GDP)	From 2009 to 2019, 2008 share of GDP plus one-third of any change in gross national saving from 2008; thereafter equal to 2019 nominal level plus one-third of any change in gross national saving from 2008
Total factor productivity growth	1.4 percent through 2019 (CBO's March 2009 short-term assumption); 1.4 percent thereafter (long-term average from 1950 to 2008)
Inflation (percent change in GDP price index)	CBO March 2009 baseline through 2019; 1.6 percent thereafter (CBO's projection in 2019)
Interest rate (on publicly held debt)	Rate implied by CBO's March 2009 baseline net interest payment projections through 2019; 5.0 percent thereafter (the rate implied in 2019)

Source: GAO.

Note: GDP in GAO's simulations does not incorporate the negative effect of long-term deficits on the economy. GDP is derived using a textbook growth model in which national saving remains stable over the long term. The same GDP is used in each budget simulation.

We conducted this work from January to April 2009 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 part of a body of work on the long-term fiscal challenge. Related products and additional information about the GAO model and data can be found at: http://www.gao.gov/special.pubs/longterm/.

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