United States Government Accountability Office

GAO

The Federal Government's Long-Term Fiscal Outlook

Fall 2011 Update

GAO's Long-Term Fiscal Simulations

Since 1992, GAO has published long-term fiscal simulations showing federal deficits and debt under different sets of assumptions. GAO developed its long-term model in response to a bipartisan request from members of Congress concerned about the long-term effects of fiscal policy. GAO's simulations provide context for consideration of policy options. They are not intended to suggest particular policy choices but rather to help facilitate a dialogue on this important issue.

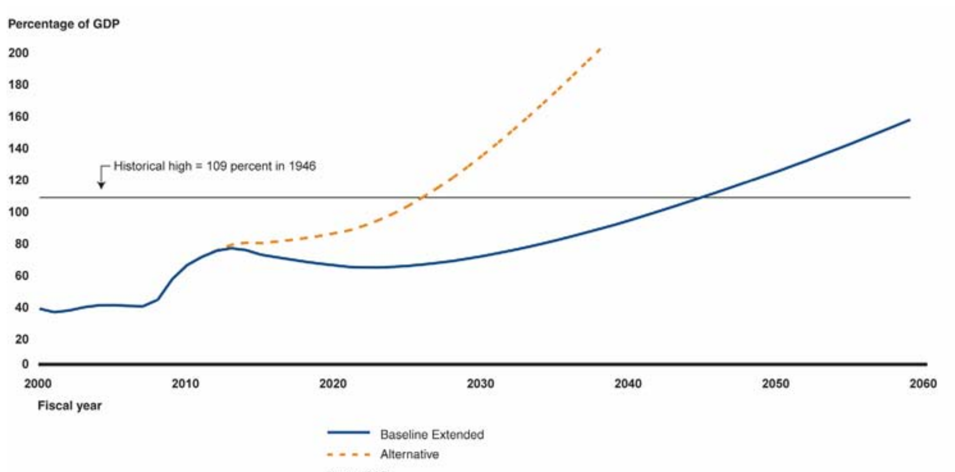
GAO regularly updates its simulations as new data become available from the Congressional Budget Office (CBO) and the Social Security and Medicare Trustees (Trustees). This update incorporates provisions of the Budget Control Act. As in the past, GAO shows two simulations:

The **Baseline Extended** simulation follows CBO's August 2011 baseline for the first 10 years and then holds revenue and spending other than interest on the debt and large entitlement programs (Social Security, Medicare, and Medicaid) constant as a share of gross domestic product (GDP). Revenue as a share of GDP over the entire period is higher than the historical averages; discretionary spending is below average.

In the **Alternative** simulation, expiring tax provisions other than the temporary Social Security payroll tax reduction are extended to 2021 and the alternative minimum tax (AMT) exemption amount is indexed to inflation through 2021; revenues

The federal government's fiscal outlook has improved since GAO's last report, largely due to provisions in the Budget Control Act of 2011.[1] This Act requires at least $2.1 trillion in deficit reduction from 2012–2021. Nevertheless, GAO's simulations continue to underscore the need to address the longer-term outlook as soon as possible while still recognizing the current weakness in the economy (see fig. 1). Rising health care costs and the aging of the U.S. population continue to create budgetary pressure. The oldest members of the baby-boom generation are already eligible for early Social Security retirement benefits and become eligible for Medicare this year. The Social Security program, which historically ran large cash surpluses that helped reduce the need to borrow from the public to finance other programs, is now projected to pay more in benefits than it receives in tax income each year into the future. Budgetary pressure will increase in coming decades as more members of the baby-boom generation retire and become eligible for federal health programs.

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



Note: Data are from GAO's Fall 2011 simulations based on the Trustees' assumptions for Social Security and the Trustees' and the CMS Actuary's assumptions for Medicare.

The timing of the debt buildup varies depending on the assumptions used: debt held by the public increases less rapidly in the Baseline Extended simulation than under the Alternative simulation. However, even with the improvement from the Budget Control Act, debt held by the public under the Alternative simulation exceeds the post-World War II high of 109 percent of GDP by 2027.

[1]GAO, *The Federal Government's Long-Term Fiscal Outlook: January 2011 Update* (GAO-11-451SP, Mar. 18, 2011)

are then brought back to the historical average as a share of GDP; discretionary spending follows CBO's baseline for the first 10 years and thereafter gradually increases to the historical average.

In both simulations, deficit reduction resulting from provisions in the Budget Control Act related to the Joint Select Committee on Deficit Reduction is applied to total annual deficits evenly from 2013 to 2021. It remains a constant share of GDP thereafter.

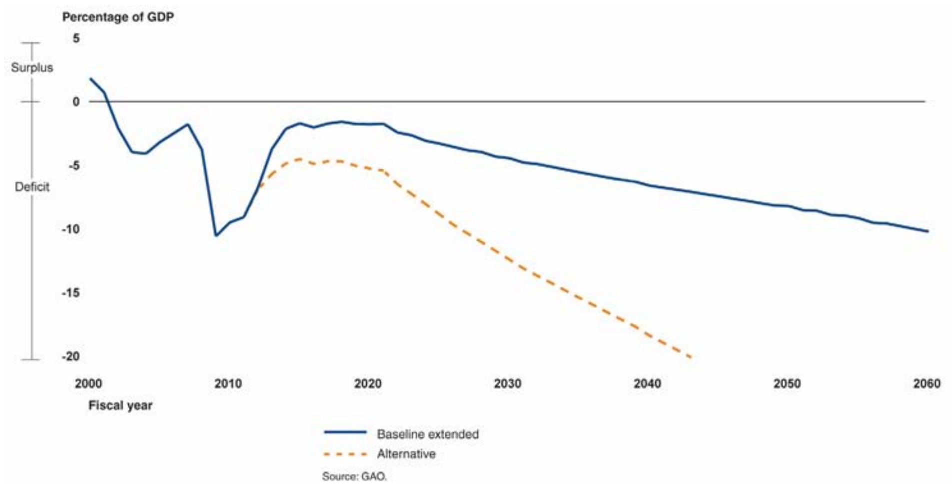
In Baseline Extended, GAO uses the Trustees' 2011 intermediate projections and CBO's June 2011 long-term projections for Medicaid adjusted to reflect excess cost growth consistent with the Trustees' projections. In the Alternative, major health entitlement programs are based on the Centers for Medicare & Medicaid Services Office of the Actuary's (CMS Actuary) alternative projections that assume reductions in Medicare physician rates do not occur as scheduled under current law and that certain cost containment mechanisms intended to slow the growth of health care cost are not sustained over the long term. We also show the outlook using CBO's long-term projections for Social Security and the major health entitlements; the results are consistent with our other simulations.

Additional information on the fiscal outlook and federal debt is available at www.gao.gov/special.pubs/longterm/.

For more information, contact Susan J. Irving at (202) 512-6806 or irvings@gao.gov or Thomas J. McCool, at (202) 512-2642 or mccoolt@gao.gov.

The Budget Control Act set limits on discretionary spending for fiscal years 2012–2021 and created the Joint Select Committee on Deficit Reduction. Under the enacted discretionary spending limits, discretionary spending as a share of the economy would be lower in 2021 than at any point in the last 40 years. The Act also provides for an additional $1.2 trillion in deficit reduction over the period—either through enactment of recommendations made by the Joint Select Committee or through automatic procedures that would reduce spending. Since the Joint Select Committee may allocate the deficit reduction between changes in tax and spending law as it deems appropriate, savings are applied to the total deficit in the simulations shown in this report. The simulations also assume that the savings as a share of GDP are maintained throughout the simulation period. To do this would require a sustained commitment extending beyond the time horizon and the goals specified in the Budget Control Act. As figure 2 shows, however, based on our simulations even this level of deficit reduction is not sufficient to ensure sustainability.

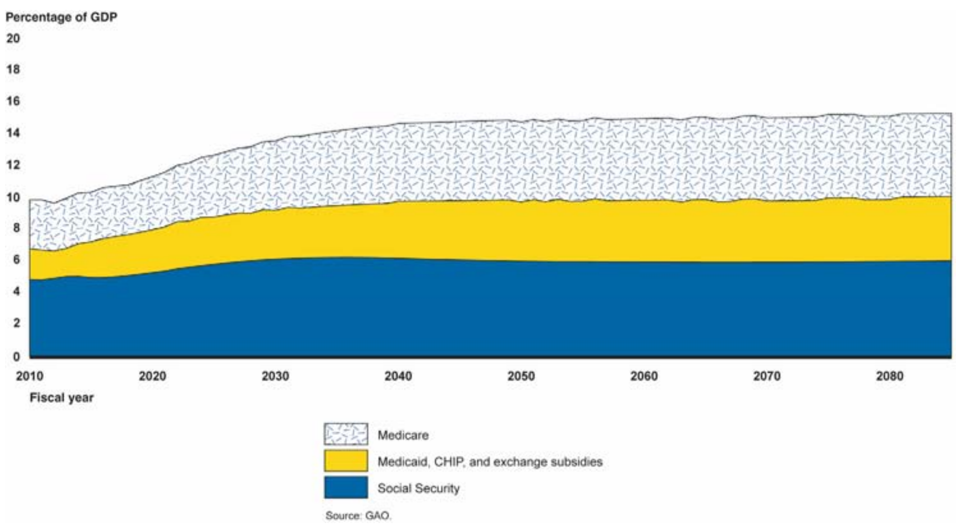
Figure 2: Federal Budget Surpluses and Deficits under Two Fiscal Policy Simulations



Notes: Data are from GAO's Fall 2011 simulations based on the Trustees' assumptions for Social Security and the Trustees' and CMS Actuary's alternative assumptions for Medicare. Discretionary spending is based on discretionary caps in Title I of the Budget Control Act through 2021. Additional deficit reduction resulting from provisions related to the Joint Select Committee on Deficit Reduction is allocated evenly from 2013 to 2021 and remains a constant share of GDP thereafter.

One of the key drivers of the federal government's long-term fiscal imbalance is federal health care spending, which has been growing faster than the overall economy. Several provisions under current law, including provisions in the Patient Protection and Affordable Care Act (PPACA)[2] were designed to control the growth of health care costs. The full implementation and effectiveness of these cost-control provisions, which are reflected in the Baseline Extended simulation, would slow the growth in federal health care spending over the long term. Under the Baseline Extended simulation, spending on Social Security and major health care entitlements grows from a little less than 10 percent of GDP in 2010 to 13.5 percent by 2030 (see fig. 3).

Figure 3: Spending on Social Security, Medicare, Medicaid, Children's Health Insurance Program (CHIP), and Exchange Subsidies under the Baseline Extended Simulation



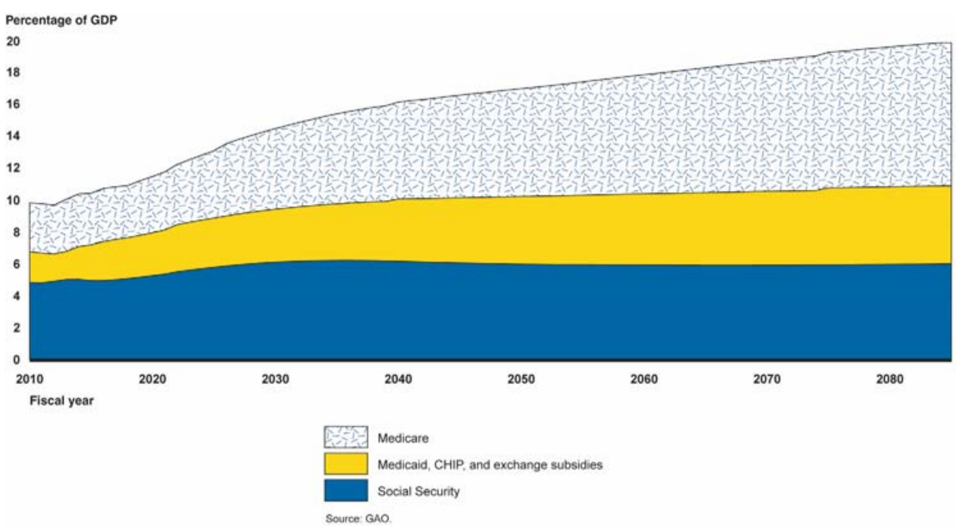
Note: Social Security and Medicare projections are based on CBO's August 2011 baseline through 2021 and the Trustees' 2011 intermediate assumptions thereafter. Projections for Medicaid, the Children's Health Insurance Program (CHIP), and state health insurance exchange subsidies are based on CBO's short-term estimates (from August 2011) and long-term projections (from June 2011) of outlays for those programs, adjusted to reflect excess cost growth consistent with the 2011 Trustees intermediate assumptions. This figure does not take into account any changes to these programs that may result from the provisions in the Budget Control Act related to the Joint Select Committee on Deficit Reduction.

However, the Trustees, CBO, and the CMS Actuary have expressed concerns about the effective implementation of certain cost-control

[2]Pub. L. No. 111-148, 124 Stat. 119 (Mar. 23, 2010), *as amended by* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (Mar. 30, 2010).

measures over the long term. For example, they have noted that reductions in physician payment rates scheduled to occur under current law have routinely been overridden. They have also questioned whether a provision in PPACA that would restrain spending growth by reducing the payment rates for certain Medicare services based on productivity gains observed throughout the economy is sustainable over the long term. These concerns are reflected in our Alternative simulation, which, consistent with CBO's and CMS Actuary's alternative projections, assumes the Medicare physician rate reductions do not occur and that certain cost-containment mechanisms intended to slow the growth of health care costs are not sustained over the long term. As figure 4 shows, spending on health care grows much more rapidly under this more pessimistic set of assumptions, putting pressure on the rest of the federal budget. Absent changes to these programs, spending on Social Security and major health care entitlements under the Alternative simulation grows to 14.5 percent of GDP by 2030.

Figure 4: Spending on Social Security, Medicare, Medicaid, CHIP, and Exchange Subsidies under the Alternative Simulation



Note: Projections for Social Security are based on CBO's August 2011 baseline through 2021 and the Trustees' 2011 intermediate assumptions thereafter. Projections for Medicare are based on the CMS Actuary's alternative assumptions. Projections for Medicaid, the Children's Health Insurance Program (CHIP), and state health insurance exchange subsidies are based on CBO's short-term estimates (from August 2011) and long-term projections (from June 2011) of outlays for those programs, adjusted to reflect excess cost growth consistent with the 2011 Trustees intermediate assumptions. This figure does not take into account any changes to these programs that may result from the provisions in the Budget Control Act related to the Joint Select Committee on Deficit Reduction.

Concluding Observations

The United States recently suffered from the most severe recession since the end of World War II. The economic downturn along with the federal government's response to it and other actions taken to stabilize financial markets contributed to a rapid buildup in federal debt held by the public—increasing from roughly 36 percent of GDP at the end of 2007 to roughly 62 percent at the end of 2010—adding to the size and urgency of the federal government's long-term fiscal challenge. Our simulations show that the Budget Control Act of 2011 will help reduce deficits. However, the longer-term fiscal challenge remains. The Joint Select Committee has the opportunity to improve the federal budget outlook by making changes to the structural imbalance between revenues and spending. Addressing the long-term fiscal challenge will not be easy. It will likely require difficult decisions affecting both federal spending and revenue. The challenge is made greater by the need to balance the fragile economic recovery with the need to act soon to change the path.

Changes since the Last Update

Our long-term federal budget simulations were updated to incorporate the most recent estimates for Social Security and Medicare spending that were released in May 2011 and CBO's most recent budget and economic projections that were released in August 2011.[3] We also include information from *CBO's Long-Term Budget Outlook* that was released in June 2011.

CBO's recent budget estimates reflect the effects of the Budget Control Act of 2011, which enacted caps on discretionary spending for fiscal years 2012–2021. The Act also created the Joint Select Committee on Deficit Reduction and tasked it with proposing legislation that would reduce the deficit by $1.5 trillion over the period. The Act specifies that the Joint Select Committee vote on a report no later than November 23, 2011. If legislation based on the committee's proposals fails to reduce the deficit by at least $1.2 trillion, automatic procedures will reduce federal spending by the amount needed to reach this goal. Consistent with CBO's baseline, we reduce the total deficit in each simulation by the same amount from 2013 to 2021. We make no assumptions about the allocation between spending and revenues and so do not change the spending and revenue paths; rather, as CBO does, we apply the savings to the deficit. After 2021, we hold the amount of deficit reduction constant as a share of GDP in both simulations.

We also changed our method and assumptions for GDP growth in our simulations. Previously, GDP in our model was determined by growth in the labor force, capital stock, and total factor productivity after the first 10 years, and projections of Social Security spending were adjusted accordingly. Beginning with this update, our GDP growth assumption matches the Trustees' intermediate assumptions over the long term. This GDP growth assumption is more consistent with the growth in labor force, wages, and other factors underlying the Trustees' Social Security and Medicare estimates used in our simulations.

[3] These reports are available at www.ssa.gov, www.cms.gov, and www.cbo.gov.

Key Assumptions in Our Federal Simulations

Table 1 lists the key assumptions incorporated in the Baseline Extended and Alternative simulations for the simulations based on the Trustees' assumptions.

Table 1: 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 August 2011 baseline through 2021; thereafter remains constant at 20.9 percent of GDP (CBO's projection in 2021)	CBO's estimates assuming expiring tax provisions other than the temporary Social Security payroll tax reduction are extended through 2021 and the 2011 alternative minimum tax (AMT) exemption amount is indexed to inflation for years 2012–2021; thereafter is phased into the 40-year historical average of 18.0 percent of GDP
Social Security spending	CBO's August 2011 baseline through 2021; thereafter based on 2011 Social Security Trustees' intermediate projections	Same as Baseline Extended
Medicare spending	CBO's August 2011 baseline through 2021 that assumes cuts in physician payment rates will occur as scheduled under current law; thereafter 2011 Medicare Trustees' intermediate projections	Based on CMS Actuary's alternative scenario that assumes that physician payment rates grow with inflation (using the Medicare Economic Index [MEI])[a] and other policies that would restrain spending growth begin to phase out after 2019
Medicaid, CHIP, and exchange subsidies spending	CBO's August 2011 baseline through 2021; thereafter CBO's June 2011 long-term projections adjusted to reflect excess cost growth consistent with the 2011 Medicare Trustees' intermediate projections	CBO's August 2011 baseline through 2021; thereafter CBO's June 2011 long-term projections adjusted to reflect excess cost growth consistent with CMS Actuary's alternative scenario and CBO's alternative assumption that a policy that would slow the growth of subsidies for health insurance coverage is not in effect
Other mandatory spending	CBO's August 2011 baseline through 2021; thereafter remains constant as a share of GDP at 2.2 percent of GDP (implied by CBO's projection in 2021)	Baseline Extended adjusted for extension of certain tax credits through 2021; thereafter is phased back to 2.2 percent of GDP by 2025 (same as Baseline Extended)
Discretionary spending	CBO's August 2011 baseline through 2021, which is based on discretionary caps in Title I of the Budget Control Act; thereafter remains constant at 6.1 percent of GDP (CBO's projection in 2021)	Same as Baseline Extended through 2021; thereafter gradually phases into 7.5 percent (the 20-year historical average)
Additional deficit reduction related to the Budget Control Act[b]	Follows CBO's August 2011 baseline through 2021, which applies savings evenly from 2013–2021; does not allocate savings to revenue, discretionary or mandatory spending; thereafter deficit reduction held constant as a share of GDP	Same as Baseline Extended

Source: GAO.

Notes: CBO's projections are from *The Budget and Economic Outlook: An Update* (August 2011) and *CBO's 2011 Long-Term Budget Outlook* (June 2011). Trustees' projections are from *The 2011 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* and *The 2011 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, which were both issued on May 13, 2011. Projections from the CMS Actuary are based on "Projected Medicare Expenditures under an Illustrative Scenario with Alternative Payment Updates to Medicare Providers" (May 13, 2011). We assume that Social Security and Medicare benefits are paid in full regardless of the amounts available in the trust funds.

[a]Since 2003, Congress took a series of legislative actions to prevent reductions in physician payment rates that would otherwise occur under law. Physician fee updates set by Congress have averaged 1.0 percent per year over this period. Growth in MEI is projected to average 1.9 percent from 2012 to 2020. Thus, the assumption used by CMS implies physician payment rates will grow almost two times faster than they have since 2003.
[b]The Budget Control Act created the Joint Select Committee on Deficit Reduction and tasked it with proposing reductions that will amount to at least $1.5 trillion in budgetary savings over 10 years. If legislation based on the committee's proposals fails to reduce the deficit by at least $1.2 trillion, automatic procedures will reduce federal spending by the amount needed to reach this goal. Additional deficit reduction in our simulations is based on the latter amount—the amount tied to enforcement.

Table 2 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. Also, the interest rate on federal debt held by the public in our simulations is held constant over the long term even when deficits climb. With large budget deficits, there could be a rise in the rate of interest and a more rapid increase in federal interest payments than our simulations display.

Table 2: Key Economic Assumptions Underlying All of GAO's Long-Term Federal Simulations

Model inputs	All simulations
GDP growth	CBO's August 2011 baseline through 2021; thereafter averages 2.1 percent based on the intermediate assumptions of the 2011 Social Security and Medicare Trustees Reports
Inflation (percentage change in GDP price index)	CBO's August 2011 baseline through 2021; 2.0 percent thereafter (CBO's projection in 2021)
Interest rate (on publicly held debt)	Rate implied by CBO's August 2011 baseline net interest payment projections through 2021; 5.2 percent thereafter (based on CBO's June 2011 long-term projection)

Source: GAO.

A more detailed description of the federal model and key assumptions can be found at
http://www.gao.gov/special.pubs/longterm/fed/aboutlongterm.html.

The simulation results depend largely on what is assumed about growth in large entitlement programs. As in previous updates, we also show the Baseline Extended simulation using both Trustees and CBO estimates for long-term spending on Social Security and major health entitlement programs (Medicare, Medicaid, and others). In addition, we show the Alternative simulation using different assumptions about certain health care cost-containment provisions based on CBO and CMS Actuary alternative projections. As figure 5 shows, the results under either set of assumptions are unsustainable.

Figure 5: Debt Held by the Public under Two Fiscal Policy Simulations with Different Assumptions for Major Entitlement Programs

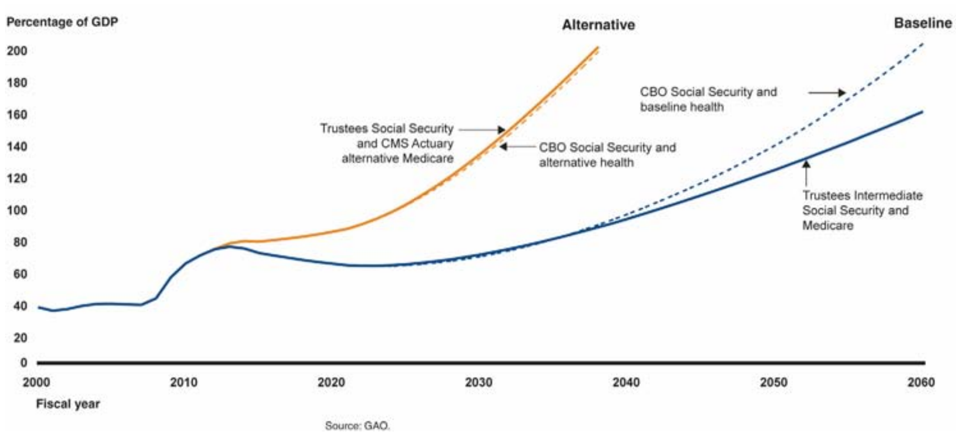


Table 3 shows the CBO assumptions incorporated into the simulations that were used in the comparison shown in figure 5.

Table 3: Key Assumptions Underlying GAO's Simulations Using CBO's Spending Projections for Major Entitlement Programs

Model inputs	Baseline Extended	Alternative
Social Security spending	CBO's August 2011 baseline through 2021; thereafter based on CBO's June 2011 long-term projections for Social Security	Same as Baseline Extended
Medicare spending	CBO's August 2011 baseline through 2021; thereafter based on CBO's June 2011 long-term projections under its extended-baseline scenario	Based on CBO's projections under its alternative fiscal scenario that assume physician payment rates are maintained at 2011 levels through 2021 and that policies to restrain growth are not in effect after 2021
Medicaid, the Children's Health Insurance Program, and exchange subsidies spending	CBO's August 2011 baseline through 2021; thereafter based on CBO's June 2011 long-term projections under its extended-baseline scenario	CBO's August 2011 baseline through 2021; thereafter CBO's June 2011 projections under its alternative fiscal scenario in which a policy that would slow the growth of per-participant subsidies for health insurance coverage is assumed not to be in effect and eligibility thresholds are assumed to be modified to maintain the share of the population eligible for subsidies

Source: GAO.

Notes: CBO's projections are from *CBO's 2011 Long-Term Budget Outlook* (June 2011). CBO assumes that full benefits are paid regardless of the amounts available in the trust funds.

This product is part of a body of work on federal debt and the long-term fiscal challenge. Related products can be found at http://www.gao.gov/special.pubs/longterm/past/.

We conducted our work from August 2011 to October 2011 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.

GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday afternoon, GAO posts on its Web site newly released reports, testimony, and correspondence. To have GAO e-mail you a list of newly posted products, go to www.gao.gov and select "E-mail Updates."

Order by Phone

The price of each GAO publication reflects GAO's actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO's Web site, http://www.gao.gov/ordering.htm.

Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537.

Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Ralph Dawn, Managing Director, dawnr@gao.gov, (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, DC 20548

Public Affairs

Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, DC 20548