United States Government Accountability Office

GAO

The Federal Government's Long-Term Fiscal Outlook

Fall 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. 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.

GAO runs two simulations:

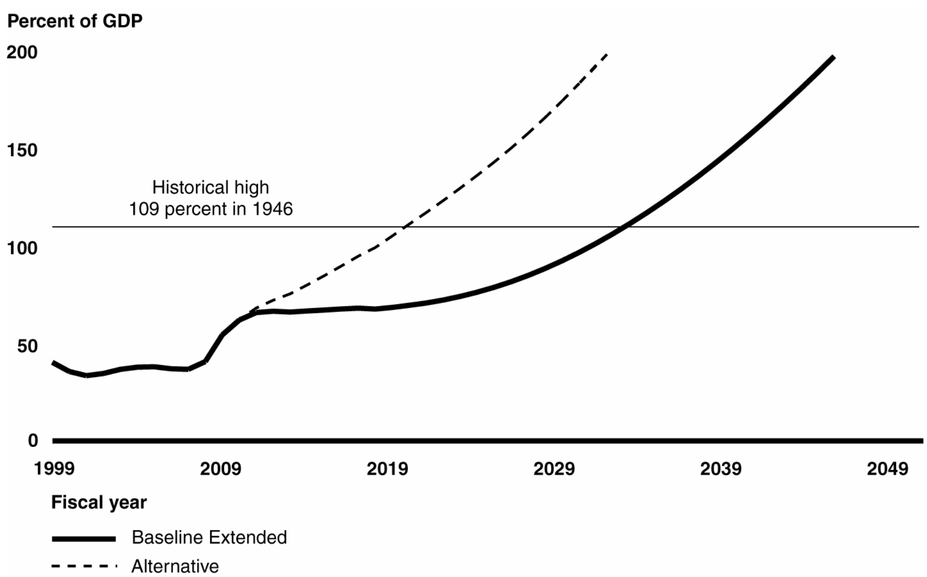
- "Baseline Extended" follows the Congressional Budget Office's (CBO) August baseline estimates for the first 10 years and then simply holds revenue and spending other than large entitlement programs constant as a share of gross domestic product (GDP).
- The "Alternative" simulation is based on historical 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 2019, and beginning with this update, the alternative minimum tax (AMT) exemption amount is indexed to inflation through 2019; revenues are then brought back to their historical level.

This update incorporates the most recent projections from the Social Security and Medicare Trustees, and from CBO.

This product responds to congressional interest in receiving updated simulation results. For more information, contact Susan J. Irving at (202) 512-6806 or irvings@gao.gov.

Weaknesses in the economy and financial markets—and the government's response to them—have contributed to near-term increases in federal deficits, which reached a record level in fiscal year 2009. While a lot of attention has been given to the recent fiscal deterioration, the federal government faces even larger fiscal challenges that will persist long after the return of financial stability and economic growth. As shown in figure 1, GAO's simulations continue to show escalating levels of debt that illustrate that the long-term fiscal outlook remains unsustainable. In little over 10 years, debt held by the public as a percent of GDP under our Alternative simulation is projected to exceed the historical high reached in the aftermath of World War II and grow at a steady rate thereafter.

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



Source: GAO's Fall 2009 analysis based on the Trustees' assumptions for Social Security and Medicare.

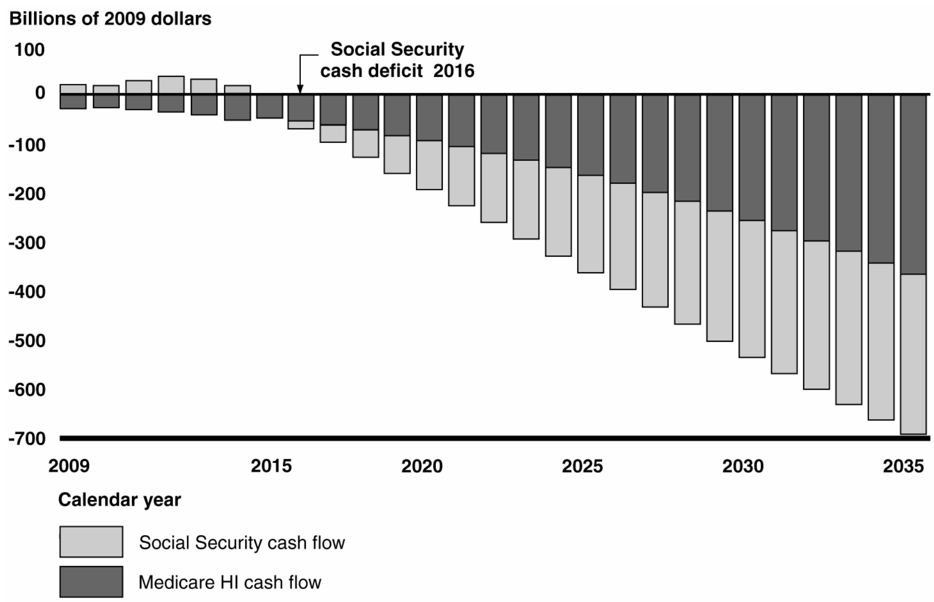
Note: Some of the increase in debt has been used to purchase financial assets as part of programs to stabilize financial markets and stimulate the economy. The value of these financial assets has not been subtracted from the total debt held by the public in our simulations.

These fiscal challenges are driven by health care cost growth and demographic trends. Absent reform, Social Security, Medicare, and Medicaid will account for a growing share of the economy in coming years. The longer action to deal with the nation's long-term fiscal outlook is delayed, the larger the changes will need to be, increasing the likelihood that they will be disruptive and destabilizing.

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

Health care cost growth and demographic trends that were once thought of as long-term challenges are already having a negative impact on the federal budget in the near term. The oldest members of the baby-boom generation are now eligible for Social Security retirement benefits and will be eligible for Medicare benefits in less than 2 years. Meanwhile, Medicare's Hospital Insurance (HI) Trust Fund began running cash deficits in 2008; that is, program expenses exceed dedicated revenue. Social Security cash surpluses, which have been used to help finance other government activities, are projected to turn to cash deficits by 2016 (see fig. 2).[1] This will put additional pressure on the rest of the budget.

Figure 2: Social Security and Medicare's Hospital Insurance Trust Funds Cash Deficits based on the Trustees' 2009 Projections



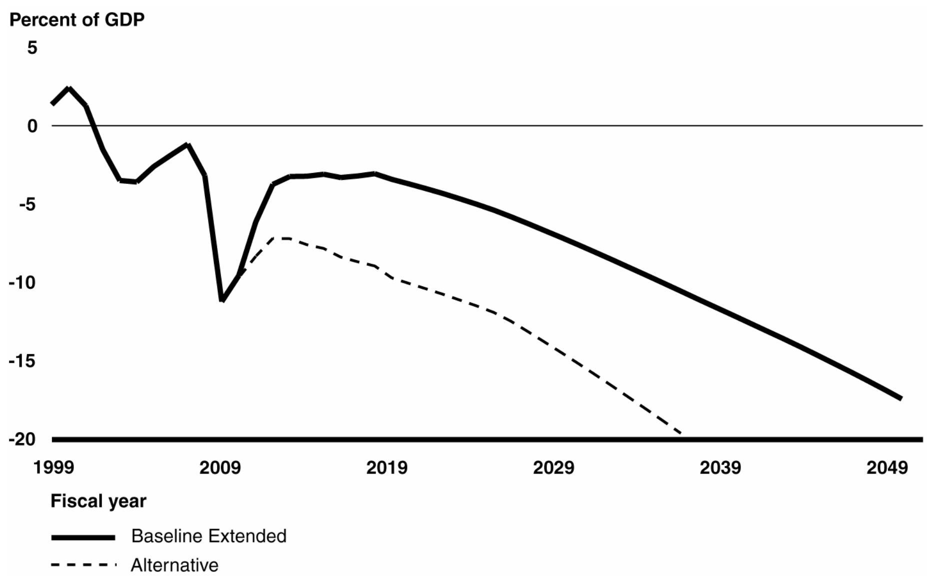
Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration and Office of the Actuary, Centers for Medicare & Medicaid Services.

Note: These projections are based on the Trustees' intermediate assumptions and are adjusted from current to constant dollars using the Consumer Price Index.

[1]The Trustees project that the Social Security trust fund will be exhausted in 2037, 4 years earlier than estimated last year. This is largely due to the economic downturn. The date when the Medicare HI trust fund is expected to be exhausted was also moved forward by 2 years to 2017. The long-term projections of spending, however, are not materially different from our last update.

As a result of these trends, annual budget deficits are expected to increase continuously under both our Baseline Extended and Alternative simulations (see fig. 3). 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. Although the timing of deficits and the resulting debt buildup varies depending on the assumptions used, both simulations show that the federal government is on an unsustainable fiscal path.

Figure 3: Federal Surpluses and Deficits under Two Fiscal Policy Simulations

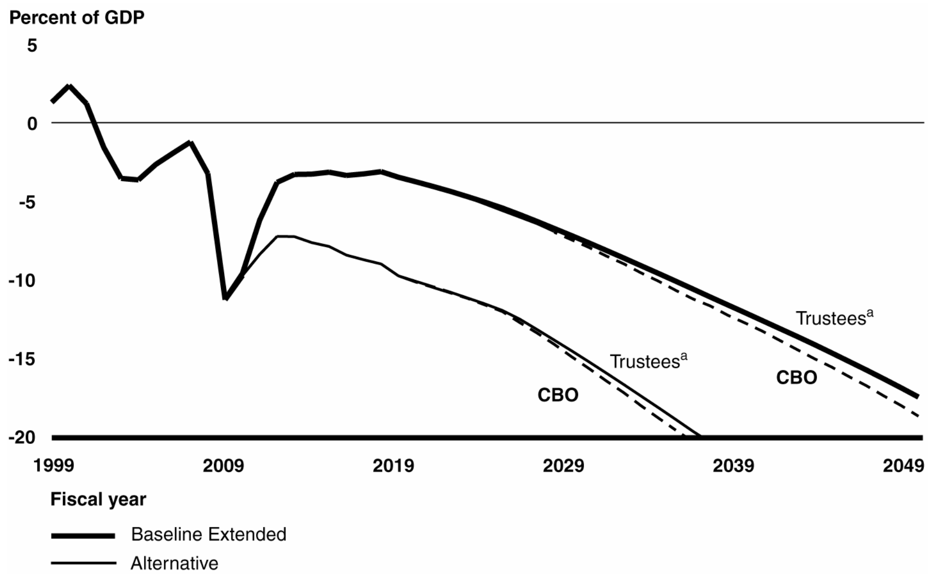


Source: GAO's Fall 2009 analysis based on the Trustees' assumptions for Social Security and Medicare.

While this is similar to the results of previous simulations, the sense of urgency has increased. Beginning in 2009, our Alternative simulation shows persistent annual budget deficits in excess of 7 percent of GDP—levels not seen since the aftermath of World War II.

As in previous updates, we compare the long-term outlook under our two simulations using two different sources for long-term Social Security, Medicare, and Medicaid projections. The key difference between them 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.” The first set of simulations are based on the Trustees’ projections for excess cost growth, while the second set are based on CBO’s projections for excess cost growth, which are slightly higher on average than the Trustees’ over the long term.[2] Despite the different assumptions, the results of these simulations are not materially different (see fig. 4).

Figure 4: Federal Surpluses and Deficits under Two Fiscal Policy Simulations with Different Entitlement Assumptions



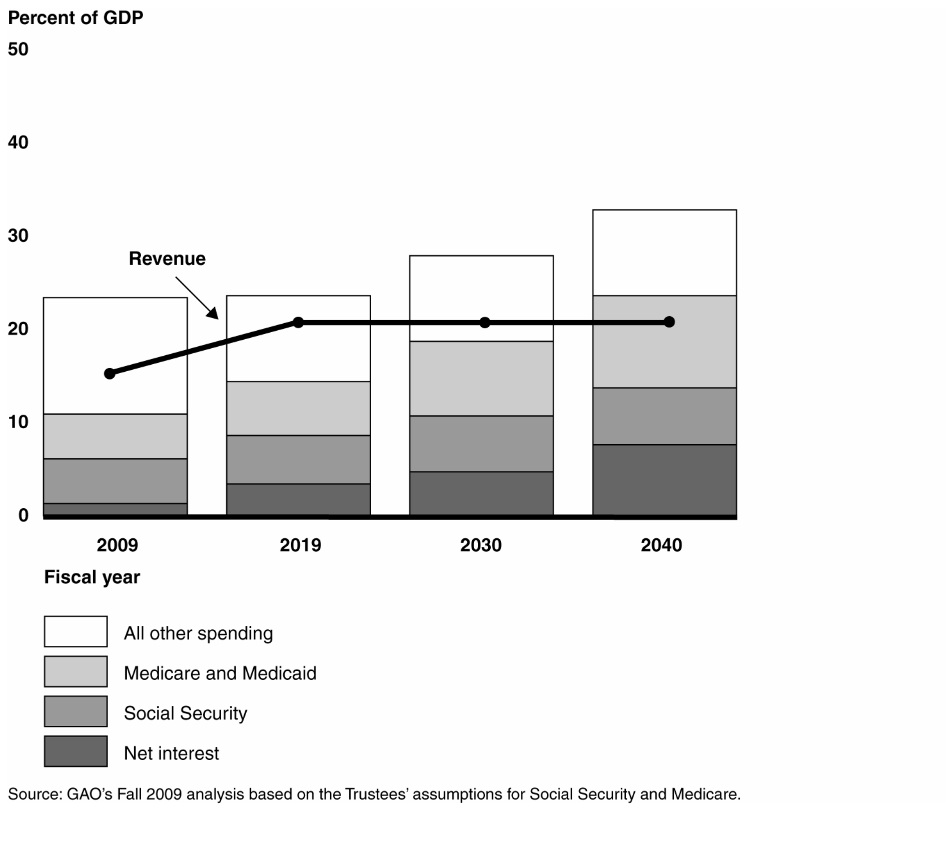
Source: GAO’s Fall 2009 analysis.

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

[2]More information on the different assumptions underlying the two sets of simulations appears on p. 10.

Figures 5 and 6 show the composition of federal spending using different revenue and spending assumptions. 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 5 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.

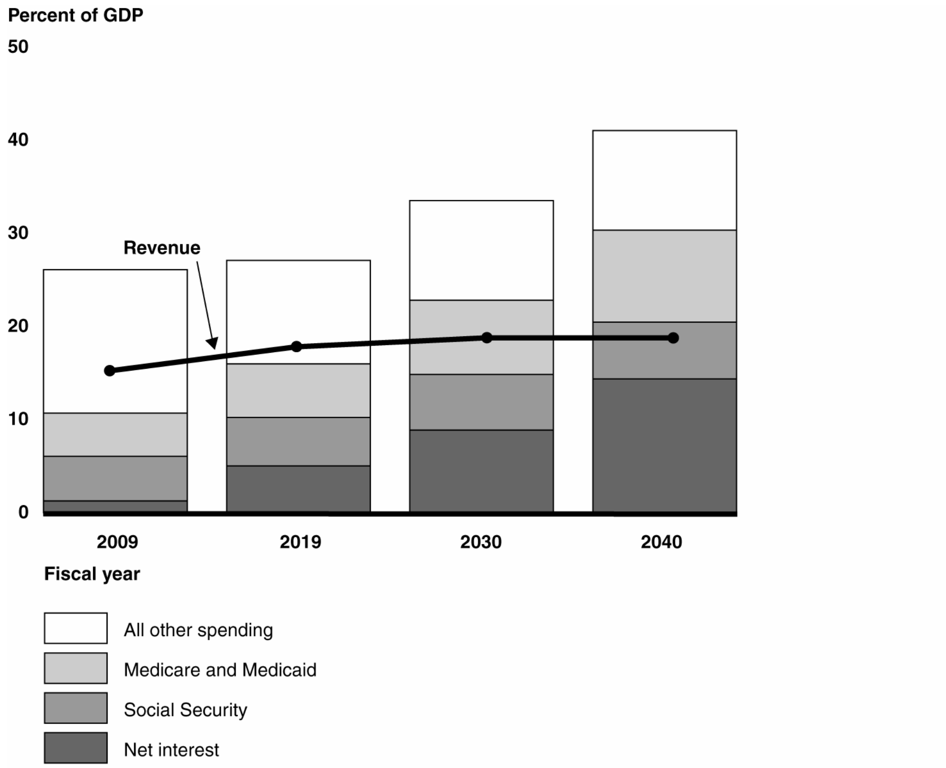
Figure 5: Potential Fiscal Outcomes under Baseline Extended: Revenues and Composition of Spending



Source: GAO’s Fall 2009 analysis based on the Trustees’ assumptions for Social Security and Medicare.

In our Alternative simulation, which assumes expiring tax provisions are extended through 2019 and then revenue is held constant at the 40-year historical average, roughly 92 cents of every dollar of federal revenue will be spent on the major entitlement programs and net interest costs by 2019. This is due largely to a substantial increase in interest on federal debt.

Figure 6: Potential Fiscal Outcomes under Alternative Simulation: Revenues and Composition of Spending



Source: GAO's Fall 2009 analysis based on the Trustees' assumptions for Social Security and Medicare.

The Longer Action Is Delayed, the Larger the Changes Necessary

Another way to measure the long-term fiscal challenge is the fiscal gap. The fiscal gap is the size of action needed—in terms of tax increases, spending reductions, or some combination of the two—for debt as a share of GDP to equal today's ratio at the end of a certain period, such as 75 years. For example, under our Alternative simulation, the fiscal gap is 8.5 percent of GDP (or more than $62 trillion in present value dollars) (see table 1). This means that revenue would have to increase by about 47 percent or noninterest spending would have to be reduced by 33 percent on average over the next 75 years to keep debt at the end of the period from exceeding its level at the beginning of 2009 (40.8 percent of GDP).

Policymakers could phase in the policy changes so that the tax increases or spending cuts would grow over time and allow people to adjust. 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 require a revenue increase of about 58 percent, a noninterest spending cut of about 39 percent, or some combination of the two.

Table 1: Federal Fiscal Gap under GAO's Simulations Based on the Trustees' Assumptions, 2009–2083

	Fiscal gap		Average percent change required to close gap			
			If action is taken today		If action is delayed until 2019	
	Trillions of 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	36.9	5.0	25.3	20.7	31.1	24.9
Alternative	62.1	8.5	47.4	32.8	57.9	39.4

Source: GAO's Fall 2009 analysis based on the Trustees' assumptions for Social Security and Medicare.

Changes to Assumptions Used in Our Federal Simulations

This update incorporates changes in CBO's 10-year baseline projections since March that affect our longer-term revenue and spending assumptions.[3] As CBO explains, some of the changes to its 10-year projections are the result of conventions governing how the baseline is constructed. CBO's baseline includes supplemental appropriations of $106 billion from 2009 and assumes the same amount of funding, adjusted for inflation, is provided through the end of the 10-year period. Since March, CBO added a total of $2.7 trillion to its projected deficits for 2010 to 2019 as a result of additional supplemental appropriations enacted in June as well as reductions in revenue and increased interest costs. Although this affected the long-term trajectory for both discretionary spending and revenues in our Baseline Extended simulation, it did not substantially affect the long-term assumptions in our Alternative simulation.

We made two changes to the revenue assumptions used in the Alternative simulation. First, consistent with our assumption that revenues in the first 10 years are based on historical policy preferences rather than current law, we now assume that the AMT exemption amount is indexed to inflation through 2019. This will decrease revenues in the first 10 years relative to our previous simulations because fewer households will be subject to higher tax rates. This change will have no effect on revenues after 2019, which are based on the 40-year historical average.

Second, we returned to the practice of showing the 40-year historical average without singling out individual elements in the composition of revenues. By using the 40-year historical average in the period beyond 2019, we implicitly assume that action is taken to keep total revenues at that level. There are a number of factors that can affect revenues in the future, including withdrawals from tax-deferred retirement plans, increases in revenue resulting from real tax bracket creep, and reductions in revenue from the increase in healthcare-related spending that is tax exempt. We discontinued the practice of adding revenue from tax-deferred retirement plans to the 40-year historical average level of revenue beyond 2019 to avoid placing undue emphasis on a single factor affecting future revenues.[4]

[3]CBO's August 2009 projections can be accessed at http://www.cbo.gov/budget/budproj.shtml.

[4]In addition, updated data on revenue from deferred retirement plans are not publicly available. In previous updates, revenue from tax-deferred retirement plans added an average of 0.35 percent of GDP to revenue between 2020 and 2083.

Key Assumptions in Our Federal Simulations

Table 2 lists the key assumptions incorporated in the Baseline Extended and Alternative simulations for the simulations based on the Trustees' assumptions.

Table 2: 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 2009 baseline through 2019; thereafter remains constant at 20.2 percent of GDP (CBO's projection in 2019)	CBO's estimates assuming expiring tax provisions are extended through 2019 and the AMT is indexed to inflation for years 2009-2019; thereafter phases into 40-year historical average of 18.3 percent of GDP
Social Security spending	CBO's August 2009 baseline through 2019; 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 August 2009 baseline through 2019; 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	CBO's projections are 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 August 2009 baseline through 2019; thereafter CBO's June 2009 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 August 2009 baseline through 2019; thereafter remains constant as a share of GDP at 2.1 percent of GDP (CBO's projection in 2019)	Baseline Extended adjusted for extension of certain tax credits through 2019; thereafter remains constant at 2.1 percent of GDP by 2025 (same as Baseline Extended)
Discretionary spending	CBO's August 2009 baseline through 2019; thereafter remains constant at 7.0 percent of GDP (CBO's projection in 2019)	Nonstimulus spending increases at the rate of economic growth after 2009 (i.e., remains constant at 8.6 percent of GDP); stimulus spending is included but assumed to be temporary

Source: GAO.

Note: CBO's projections are from *The Budget and Economic Outlook: An Update* (August 2009) and *The Long-Term Budget Outlook* (June 2009). CBO's projections assume that full benefits as calculated under current law are paid regardless of the amounts available in the trust funds. 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.

In the second set of simulations, we use CBO's projections for Social Security, Medicare, and Medicaid. Table 3 shows the assumptions that differ from those shown in table 2.

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

Model inputs	Baseline Extended	Alternative
Social Security spending	CBO's August 2009 baseline through 2019; thereafter CBO's August 2009 projections based on the 2009 Social Security Trustees' demographic projections and CBO's own economic assumptions	Same as Baseline Extended
Medicare spending	CBO's August 2009 baseline through 2019; thereafter based on CBO's June 2009 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 in the inputs used for physicians' services (using the Medicare Economic Index)[a]
Medicaid spending	CBO's August 2009 baseline through 2019; 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 analysis.

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 as calculated under current law are paid regardless of the amounts available in the trust funds.

[a]This is slightly higher than the assumption used in GAO's Alternative simulation using the Trustees' assumptions. In the Trustees' analysis, expenditures under the Medicare Economic Index assumption—which CBO bases its projections on—are 17.2 percent higher than current law by 2018. Expenditures under the 0 percent update used in GAO's Alternative simulation (based on Trustees' data) are only 12.2 percent higher than current law.

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

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

We conducted our work from August to October 2009 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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