



# The Nation's Long-Term Fiscal Outlook

## April 2007 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's simulations were updated with new estimates for Social Security and Medicare spending. GAO also modified its alternative simulation so that Medicare spending follows a more realistic path and revenues return to historical levels.

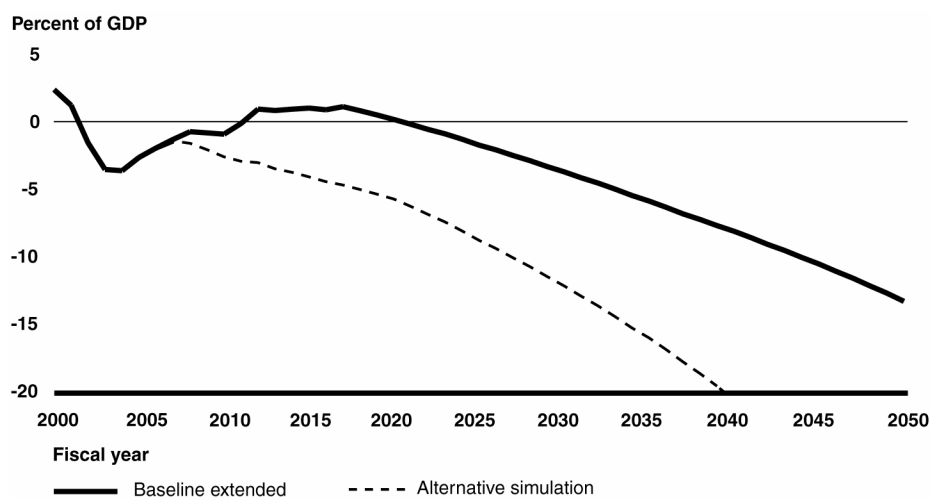
GAO updates its simulations three times a year as new estimates become available from:

- CBO's Budget and Economic Outlook (January),
- Social Security and Medicare Trustees Reports (spring), and
- CBO's Budget and Economic Outlook: An Update (late summer).

This product responds to congressional interest in receiving updated simulation results. Additional information about the GAO model, its assumptions, data, and charts can be found at <http://www.gao.gov/special.pubs/longterm/>. For more information, contact Susan J. Irving at (202) 512-9142 or [irvings@gao.gov](mailto:irvings@gao.gov)

## The Bottom Line: Federal Fiscal Policy Remains Unsustainable

**Figure 1: Unified Surpluses and Deficits as a Share of GDP under Alternative Fiscal Policy Simulations**



Source: GAO's April 2007 analysis.

As in previous updates, GAO's current long-term simulations show ever-larger deficits resulting in a federal debt burden that ultimately spirals out of control. Figure 1 shows two alternative fiscal paths. The first is "Baseline extended," which extends the Congressional Budget Office's baseline estimates beyond the 10-year projection period, and the second is an alternative based on recent trends and policy preferences. For this update we modified the alternative simulation to reflect a return to historical levels of revenue and a more realistic Medicare scenario for physician payments. Although the timing of deficits and the resulting debt build up varies depending on the assumptions used, both simulations show that we are on an unsustainable fiscal path.

By definition, what is unsustainable will not be sustained. The question is how and when our current imprudent and unsustainable path will end. At some point, action will be taken to change the Nation's fiscal course. The longer action to deal with the Nation's long-term fiscal outlook is delayed,

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the greater the risk that the eventual changes will be disruptive and destabilizing. Acting sooner rather than later will give us more time to phase in gradual changes, while providing more time for those likely to be most affected to make compensatory changes.

Simulations are not forecasts or predictions. They are designed to ask the question “what if?” GAO’s “what ifs” include that discretionary spending may grow slower (as in Baseline extended) or faster (as in the alternative), and tax cuts may be allowed to expire (as in Baseline extended) or be extended (as in the alternative), but in both cases, the Nation’s long-term fiscal future is at risk. Under both sets of expectations about future spending and revenues, the risks posed to the Nation’s future financial condition are too high to be acceptable.

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## What Drives Our Nation’s Bleak Long-Term Fiscal Outlook?

The long-term fiscal outlook results from a large and persistent gap between expected revenues and expected spending.

The spending that drives the outlook is primarily spending on the large federal entitlement programs (i.e., Medicare, Medicaid, Social Security). The retirement of the baby boom generation is one key element of this. In 2008 the first boomers will be eligible to draw Social Security early retirement benefits, and in 2011 the first boomers will become eligible for Medicare. In the succeeding 2 decades America’s population will age dramatically, and relatively fewer workers will be asked to support ever larger costs for retirees.

Although Social Security is a major part of the fiscal challenge, it is far from our biggest challenge. Spending on the major federal health programs (i.e., Medicare and Medicaid) represents a much larger and faster growing problem. In fact, the federal government’s obligations for Medicare Part D alone exceed the unfunded obligations for Social Security. Over the past several decades, health care spending on average has grown much faster than the economy, absorbing increasing shares of the Nation’s resources, and this rapid growth is projected to continue. For this reason and others, rising health care costs pose a fiscal challenge not just to the federal budget but to American business and our society as a whole.

In their April 2007 report, the Medicare Trustees for the first time issued a Medicare funding warning of projected “excess general revenue funding” in the Medicare program. As required under the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, issuance of the warning will require the President to submit to Congress, within 15 days after the release of the Fiscal Year 2009 Budget, proposed legislation to

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respond to the warning. Congress is then required to consider the legislation on an expedited basis.<sup>1</sup>

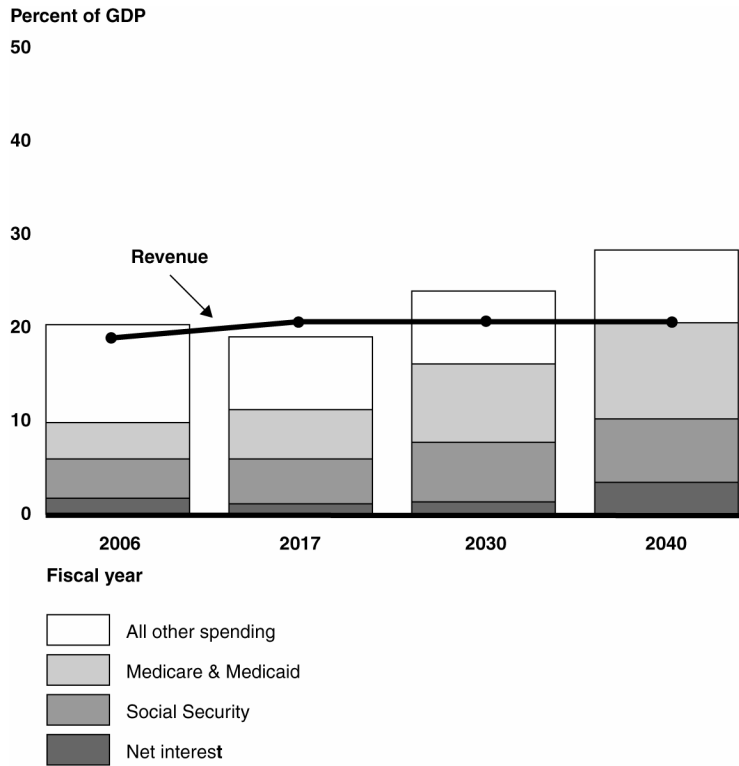
Figures 2 and 3 look behind the deficit path to the composition of federal spending under the two scenarios. Both figures show that the estimated growth in the major entitlement programs leads to an unsustainable fiscal future—whether revenues as a share of GDP are above historical levels over the past 20 or 40 years, as in Baseline extended, or at about historical levels as in the alternative simulation.

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<sup>1</sup>The 2003 act requires the President to submit a proposal to Congress for action if the Medicare Trustees determine in 2 consecutive years that the general revenue share of Medicare spending is projected to exceed 45 percent during a 7-year period. For the purpose of this Medicare trigger, general revenue is defined as the difference between program outlays and dedicated financing sources (that is, Hospital Insurance (HI) payroll taxes, the HI share of income taxes on Social Security benefits, state transfers for Part D prescription drug benefits, premiums paid under Parts A, B, and D, and any gifts received by the trust funds). For more information on trigger mechanisms such as the one in the 2003 legislation and the sustainable growth rate, which governs the formula used to update physician fees, see *Mandatory Spending Using Budget Triggers to Constrain Growth*, GAO-06-276 (Washington, D. C.: January 31, 2006).

**Figure 2: Potential Fiscal Outcomes Under Baseline Extended**

**Revenues and Composition of Spending**

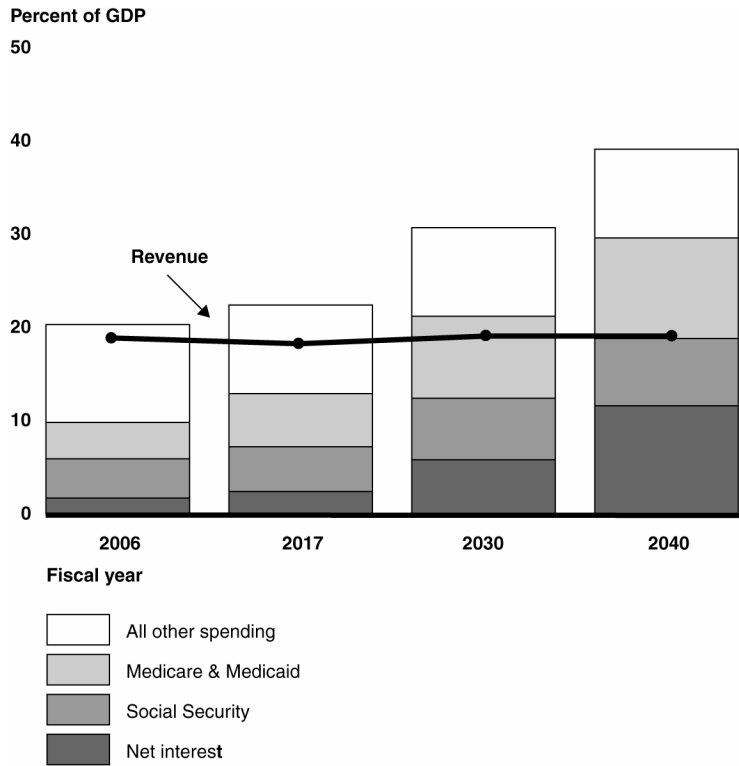


Source: GAO's April 2007 analysis.

Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2017 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2017, revenue as a share of GDP is held constant.

**Figure 3: Potential Fiscal Outcomes Under Alternative Simulation**

**Revenues and Composition of Spending**



Source: GAO's April 2007 analysis.

Note: Discretionary spending grows with GDP after 2007. AMT exemption amount is retained at the 2006 level through 2017 and expiring tax provisions are extended. After 2017, revenue as a share of GDP returns to its historical level of 18.3 percent of GDP plus expected revenues from deferred taxes, i.e. taxes on withdrawals from retirement accounts.

In these figures the category “all other spending” includes much of what many think of as “government”—discretionary spending on such activities as national defense, homeland security, veterans health benefits, our national parks, highways and mass transit, foreign aid, plus mandatory spending on the smaller entitlement programs such as Supplemental Security Income, Temporary Assistance for Needy Families (TANF), and

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farm price supports.<sup>2</sup> The growth in Social Security, Medicare, Medicaid, and interest on debt held by the public dwarfs the growth in all other types of spending.

Under **Baseline extended** we follow the Congressional Budget Office (CBO) baseline for the first 10 years: tax provisions that are scheduled to expire are assumed to do so (including the temporary increase in the alternative minimum tax (AMT) exemption amount) and discretionary spending is assumed to grow with inflation. At the end of the 10-year period, revenues in Baseline extended are several points above the 20-year historical average and discretionary spending is several points below the 20-year historical average. For the remainder of the simulation period, revenues and discretionary spending are held constant as shares of the economy, and for Social Security and Medicare, we use the Trustees' April 2007 intermediate estimates. The Medicare estimates assume the continuation of current law, under which fees for physicians treating Medicare patients would be cut in future years.<sup>3</sup>

Under the **alternative scenario** in the first 10 years we assume that all expiring tax provisions are extended, and the 2006 exemption amount for the alternative minimum tax is continued but not indexed for inflation. After the first 10 years revenues are allowed to return to their historical share plus expected revenues from deferred taxes, i.e. taxes on withdrawals from retirement accounts. Discretionary spending grows with the economy throughout the simulation period. Over the long term, levels of discretionary spending are slightly under the 20-year historical average. The alternative scenario uses Medicare estimates developed by the Centers for Medicare and Medicaid Services (CMS) that assume payment rates to physicians will not be reduced as specified under current

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<sup>2</sup> Discretionary spending refers to spending based on authority provided in annual appropriations acts. Mandatory spending refers to spending that Congress has authorized in legislation other than appropriations acts that entitles beneficiaries to receive payment or that otherwise obligates the government to make payment.

<sup>3</sup> The Trustees noted in their April 2007 report that Medicare expenditures "are substantially understated because projected current-law physician payment updates are unrealistically reduced under the sustainable growth rate system [the statutory formula that governs fee updates] by about 10 percent in 2008 and 5 percent in each subsequent year through 2016. In practice, Congress is virtually certain to prevent some or all of the scheduled reductions through new legislation, as it has for 2003 through 2007."

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law.<sup>4</sup> As in Baseline extended, after the first 10 years the alternative scenario uses the Trustees' intermediate estimates for Social Security.

These figures also show that waiting makes the size of the problem worse. For example, even under GAO's Baseline extended scenario—under which revenues rise to about 20 percent of GDP and discretionary spending falls to below 6 percent of GDP—waiting until 2040 to balance the budget would require drastic change. Taxes as a share of GDP would have to increase by about 40 percent or noninterest spending cut by about a third in order to balance the budget in that year. If changes in personal income taxes were the sole means used to balance the budget, these would increase by about 75 percent. Sudden, drastic changes of either kind—and revenues at such a level—are outside post-World War II historical experience in this country.

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## The Fiscal Gap— Another Way to Measure the Challenge

Many ways exist to measure the long-term fiscal challenge. One quantitative measure is called “the fiscal gap.” The fiscal gap is the amount of spending reduction or tax increases needed to keep debt as a share of gross domestic product (GDP) at or below today's ratio. Another way to say this is that the fiscal gap is the amount of change needed to prevent the kind of debt explosion implicit in figure 3. The fiscal gap can be expressed as a share of the economy or in present value dollars. (See table 1.)

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<sup>4</sup> This reflects the fact that Congress has generally acted to prevent payment rates from being reduced. CMS developed two illustrative Medicare estimates that vary from the intermediate estimates. One set of estimates assumes a 0.0 percent update to physician fees; the other assumes updates for medical inflation. GAO's alternative simulation uses the 0-percent update estimates. For more information on these estimates, see CMS' April 2007 memorandum “Projected Medicare Part B Expenditures under Two Illustrative Scenarios with Alternative Physician Payment Updates,” available at [http://www.cms.hhs.gov/ReportsTrustFunds/05\\_alternativePartB.asp](http://www.cms.hhs.gov/ReportsTrustFunds/05_alternativePartB.asp)

**Table 1: Fiscal Gap 2007-2081**

	Fiscal Gap		Change Required to Close Gap		
	Trillions of 2007 Dollars	Share of GDP	Percentage Increase in Revenue	Percentage Increase in Individual Income Taxes	Percentage Decrease in Non-Interest Spending
<b>Baseline</b>	\$27.2	3.7%	19.9%	44.0%	20.3%
<b>Alternative</b>	\$54.5	7.4%	40.0%	88.1%	40.7%

Source: GAO analysis.

To close the fiscal gap under Baseline extended would require revenue increases or programmatic spending cuts (i.e., in all discretionary spending and spending on federal entitlement programs) equal to about 20 percent each and every year over the next 75 years. Under GAO’s alternative simulation, the required action would be even more dramatic—about 40 percent. These annual tax increases and spending cuts would exceed the fiscal year 2006 deficit of 1.9 percent of GDP. Delaying action would make things worse. Under our alternative simulation, waiting even 10 years would require a revenue increase of about 50 percent or non-interest spending cuts of about 45 percent.

This gap is too large for us to grow our way out of the problem. It would require decades of double-digit real economic growth, but the U.S. has not had a single year of double-digit real economic growth since World War II. To be sure, additional economic growth would certainly help the Nation’s financial condition and our ability to address our fiscal gap, but it will not eliminate the need for action.

Other ways to think about the size of the long-term challenge may also be found in <http://www.gao.gov/cghome.htm>



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## What Is Assumed in GAO's Simulations?

GAO's two simulations project current policies on revenue and spending forward. The first, **Baseline extended**, takes the 10-year baseline estimates<sup>5</sup> of the Congressional Budget Office (CBO) and extends them over a 75-year period and the second, **Alternative simulation**, is based on recent trends and policy preferences. As CBO recognized in its January 2007 *Budget and Economic Outlook*, its baseline estimates incorporate some very problematic assumptions that we adjust for in our alternative simulation as summarized below.

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<sup>5</sup> The Balanced Budget and Emergency Deficit Control Act of 1985, which established rules that govern the calculation of CBO's baseline, expired on September 30, 2006. Nevertheless, CBO continues to prepare baselines according to the methodology prescribed in that law.

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**Table 2: Assumptions for Baseline Extended and Alternative Simulations**

<b>Model inputs</b>	<b>Baseline Extended</b>	<b>Alternative Simulation</b>
<b>Revenue</b>	CBO's January 2007 baseline through 2017; thereafter remains constant at 20.1 percent of GDP (CBO's projection in 2017)	All expiring tax provisions are extended through 2017; thereafter equal to 40-year historical average of 18.3% of GDP plus CBO's estimate of revenue from tax-deferred retirement plans
<b>Social Security spending (OASDI)</b>	CBO's January 2007 baseline through 2017; thereafter based on 2007 Social Security Trustees' intermediate projections	Same as Baseline Extended
<b>Medicare spending</b>	CBO's January 2007 baseline through 2017, thereafter based on 2007 Medicare Trustees' intermediate projections	Throughout simulation period, CMS's intermediate projections with alternative assumption of zero percent physician payment updates
<b>Medicaid spending</b>	CBO's January 2007 baseline through 2017; thereafter based on CBO's December 2005 long-term projections under Scenario 2 that assume per enrollee Medicaid spending grows with GDP per capita plus 1 percent over the long term	Same as Baseline Extended
<b>Other mandatory spending</b>	CBO's January 2007 baseline through 2017; thereafter increases at the rate of economic growth (i.e., remains constant as a share of GDP)	Same as Baseline Extended
<b>Discretionary spending</b>	CBO's January 2007 baseline through 2017; thereafter increases at the rate of economic growth	Increases at the rate of economic growth starting in 2007

Source: GAO.

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## What Changed in This Update?

Despite some improvement in the near-term projections for Social Security and Medicare, the long-term outlook has not changed: it remains unsustainable.

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GAO's simulations were updated using estimates from the Social Security and Medicare Trustees. The Trustees' April 2007 reports can be accessed at

<http://www.ssa.gov/OACT/TR/index.html>

This product is based on GAO's work on the long-term fiscal challenge, including reports and testimonies. These efforts were conducted in accordance with generally accepted government auditing standards.

Additional information and related products can be found at

<http://www.gao.gov/special.pubs/longterm/longtermproducts.html>

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## Appendix: Update of GAO's January 2007 Alternative Simulation

GAO periodically revises the assumptions of its alternative simulation to better illustrate a fiscal path that embodies recent trends and policy preferences. For the April update, as described earlier in this report, we revised the revenue and Medicare assumptions from those used in January. Had we not made these revisions, the updated simulation would have looked as shown in Figure 4. A comparison with the corresponding January 2007 chart (fig. 5) shows that the substitution of the Trustees 2007 Social Security and Medicare estimates for their 2006 estimates did not materially affect the long-term fiscal outlook.

**Figure 4: Potential Fiscal Outcomes Under Alternative Simulation: GAO's April 2007 Analysis**

**Revenues and Composition of Spending Assuming Discretionary Spending Grows with GDP After 2007 and All Expiring Tax Provisions Are Extended**

Percent of GDP

50

40

Revenue

20

10

0

2006

2017

2030

2040

Fiscal year

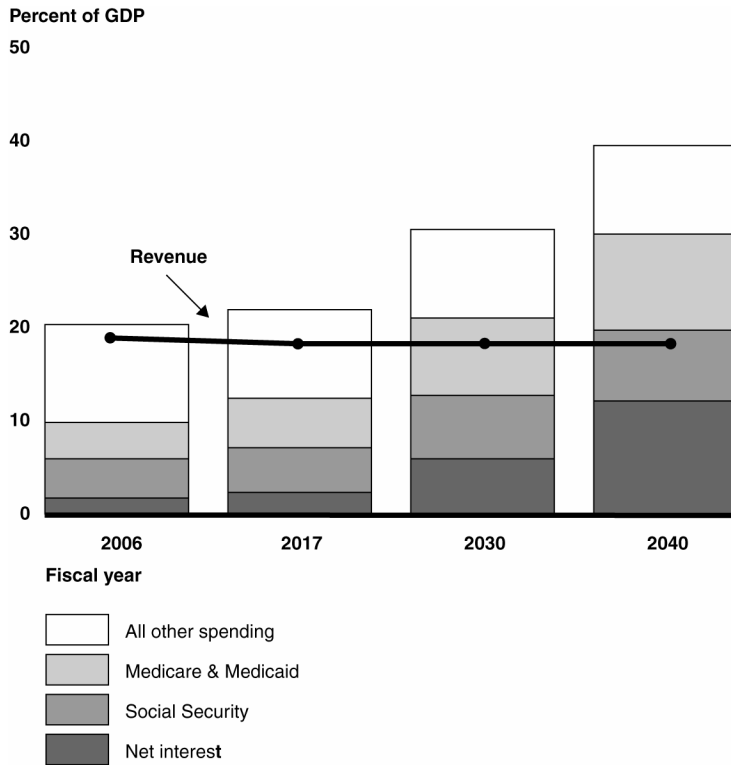
- All other spending
- Medicare & Medicaid
- Social Security
- Net interest

Source: GAO's April 2007 analysis.

Notes: AMT exemption amount is retained at the 2006 level through 2017 and expiring tax provisions are extended. After 2017, revenue as a share of GDP is held constant—implicitly assuming that action is taken to offset increased revenue from real bracket creep, the AMT, and tax-deferred retirement accounts.

**Figure 5: Potential Fiscal Outcomes Under Alternative Simulation: GAO's January 2007 Analysis**

**Revenues and Composition of Spending Assuming Discretionary Spending Grows with GDP After 2007 and All Expiring Tax Provisions Are Extended**



Source: GAO's January 2007 analysis.

Notes: AMT exemption amount is retained at the 2006 level through 2017 and expiring tax provisions are extended. After 2017, revenue as a share of GDP is held constant—implicitly assuming that action is taken to offset increased revenue from real bracket creep, the AMT, and tax-deferred retirement accounts.

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