United States Government Accountability Office

GAO

The Nation's Long-Term Fiscal Outlook

September 2006 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.

In 1992 GAO said: *"The federal budget is structurally unbalanced. This will do increasing damage to the economy and is unsustainable in the long term. Regardless of the approach chosen, prompt and meaningful action is essential. The longer it is delayed, the more painful it will be."* These words are as relevant today as when GAO first published them.

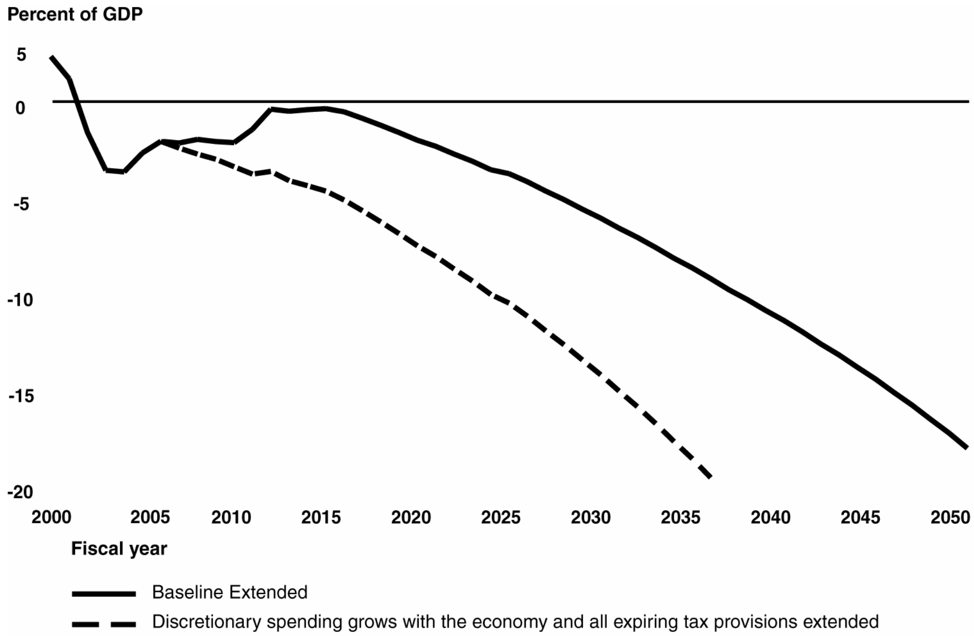
GAO updates its simulations three times a year as new estimates become available from:

- CBO's *Budget and Economic Outlook* (January),
- Social Security and Medicare Trustees Reports (early 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

The Bottom Line: Today's Fiscal Policy Remains Unsustainable

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



Source: GAO's August 2006 analysis.

GAO's current long-term simulations continue to show ever-larger deficits resulting in a federal debt burden that ultimately spirals out of control. The timing of deficits and the resulting debt build up varies depending on the assumptions used, but under either optimistic ("Baseline extended") or more realistic assumptions, current fiscal policy is unsustainable.

Simulations are not forecasts or predictions. They are designed to ask the question "what if?" GAO's "what ifs" are that discretionary spending may grow faster or slower, and tax cuts may be renewed or allowed to expire – but in both cases, the Nation's long-term fiscal future is "at risk." Under any reasonable set of expectations about future spending and revenues, the risks posed to the Nation's future financial condition are too high to be acceptable.

By definition, what is unsustainable will not be sustained. The question is how our current imprudent and unsustainable path will end. At some point, action will be taken to change the Nation's fiscal course. The sooner appropriate actions are taken, the sooner the miracle of compounding will begin to work for the federal budget rather than against it. Conversely, 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. 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.

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.

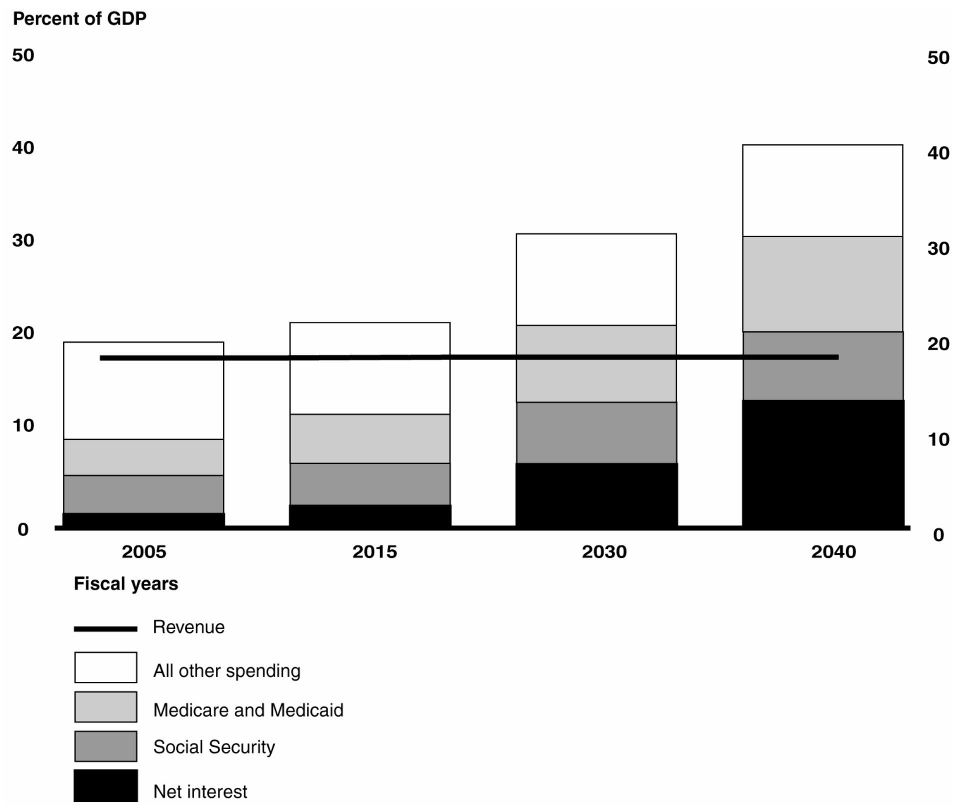
The spending that drives the outlook is primarily spending on the large federal entitlement programs (i.e., Social Security, Medicare, Medicaid). The retirement of the baby boom generation is one key element of this. In 2008 the first boomers will be eligible to draw "early retirement" Social Security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

Although Social Security is a major part of the fiscal challenge, contrary to popular perception, 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. 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 figures 2 and 3 below, 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, TANF, and farm price supports.[1] The spending increases for all these types of spending taken together are dwarfed by the growth in spending for Social Security, Medicare, Medicaid, and interest on debt held by the public. Figure 2, which shows results from GAO's more realistic simulation, is a visual depiction of how the magic of compounding will work against us if a gap between revenues and spending is allowed to continue to grow.

Figure 2: Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP After 2006 and All Expiring Tax Provisions are Extended



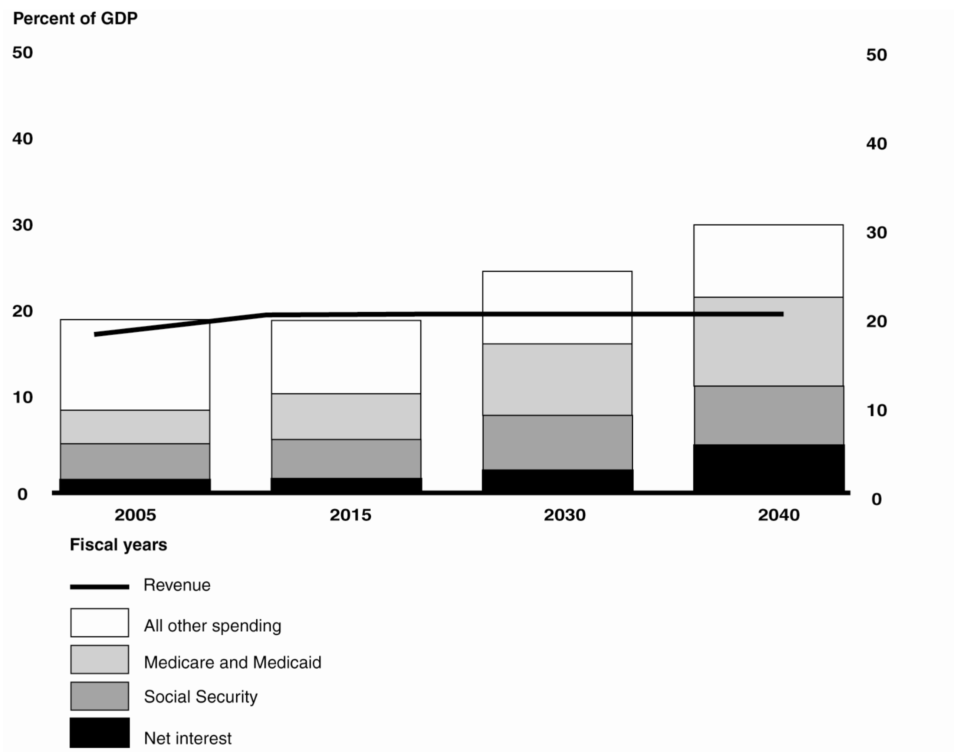
Source: GAO's August 2006 analysis.

[1] "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.

Estimated growth in the major entitlement programs results in an unsustainable fiscal future regardless of whether one assumes future revenue will be somewhat below or above historical levels as a share of the economy.

These figures also show that waiting makes the size of the problem worse. For example, under GAO's more optimistic simulation shown in figure 3, waiting until 2040 means that as a share of the economy, either taxes would need to be increased by almost 60 percent or total spending reduced by a third in order to balance the budget in that year. Sudden, drastic changes of either kind—and revenues at such a level–are outside post-World War II historical experience in this country.

Figure 3: Composition of Spending as a Share of GDP Under Baseline Extended



Source: GAO's August 2006 analysis.

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 2. The fiscal gap can be expressed as a share of the economy or in present value dollars.

For GAO's "Baseline extended" simulation, closing the fiscal gap would require spending cuts or tax increases equal to 4.5 percent of the entire economy each year over the next 75 years, or a total of $34 trillion in present value terms. For GAO's more realistic simulation, the gap is 8 percent of the economy, or about $61 trillion in present value terms. To put this in perspective, if we were to invest enough today to pay off these amounts over the next 75 years, the sums needed would amount to about between $115,000 to $200,000 per person, or between about $270,000 to $485,000 for each full-time worker.

Under either set of assumptions, the size of the change we would need to make in the federal budget would be larger than last year's unified deficit—and that is just the change in the first year of the 75-year window. Waiting even 10 years to close the fiscal gap would require larger, more drastic changes. For example, under GAO's optimistic simulation the fiscal gap would grow from 4.5 percent of the economy today to 5.7 percent in 2016 simply by waiting to act.

Additional economic growth is critical and will help to ease the burden, but the projected fiscal gap is so great that it is unrealistic to expect we will grow our way out of the problem. To do so under any reasonable set of assumptions would require double-digit real economic growth for many decades to eliminate the long-term fiscal challenge. However, since the end of World War II we have not seen economic growth of this kind. 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

What Is Assumed in GAO's Simulations?

GAO's two simulations project current policies on revenue and spending forward. The first is "Baseline extended," and the second is based on more realistic assumptions given recent trends and assumed policy preferences. They vary in how they deal with the first 10 years:

- Baseline extended. This takes the 10-year baseline estimates of the Congressional Budget Office (CBO) and extends them over a 75-year period. By law, CBO is required to assume in its baseline estimates that discretionary spending grows at the rate of inflation--a slower growth rate than that witnessed in many recent years. CBO is also generally required by statute to assume no changes to today's laws. One implication of this is that CBO must assume that all tax cuts originally enacted in 2001 and 2003 expire as currently scheduled.

- Discretionary spending grows with the economy (that is, with gross domestic product) and all expiring tax reductions are extended. This simulation alters two key assumptions of CBO's baseline. First, discretionary spending is allowed to grow with the economy in the first 10 years rather than being constrained to grow with inflation. Second, all expiring tax cuts are extended permanently.

At the end of the 10-year period we take the levels of revenue and discretionary spending as shares of GDP and hold these constant for the rest of the simulation period. Since 1992 we have held revenues and discretionary spending constant as shares of GDP after the CBO estimation period so as to make no policy assumptions. In addition, after the first 10 years, both simulations use the Social Security and Medicare Trustees' 75-year intermediate estimates for those programs and assume that promised benefits will be paid in full.

What Changed in This Update?

The long-term outlook has not changed significantly since the last simulations. Although this year's deficit outlook has improved, the long-term continues to be unsustainable.

GAO's simulations were updated using CBO's 10-year baseline budget and economic estimates in its August *Budget and Economic Outlook: An Update*. CBO's report can be found at http://www.cbo.gov/showdoc.cfm?index=7492&sequence=0

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.