The Nation's Long-Term Fiscal Outlook

September 2008 Update

Interpreting Long-term Simulations

- Long-term simulations provide illustrations--not precise forecasts--of the relative fiscal outcomes associated with alternative policy paths.

- These simulations are not predictions of what will happen in the future as policymakers would likely take action to prevent damaging out-year fiscal consequences.

Key Drivers of the Long-Term Fiscal Outlook

- The key drivers of the long-term outlook are spending on Social Security, Medicare and Medicaid.

- GAO uses two different sources for long-term projections for these programs.

  - 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, GAO uses CBO's projections for Social Security, Medicare and Medicaid.

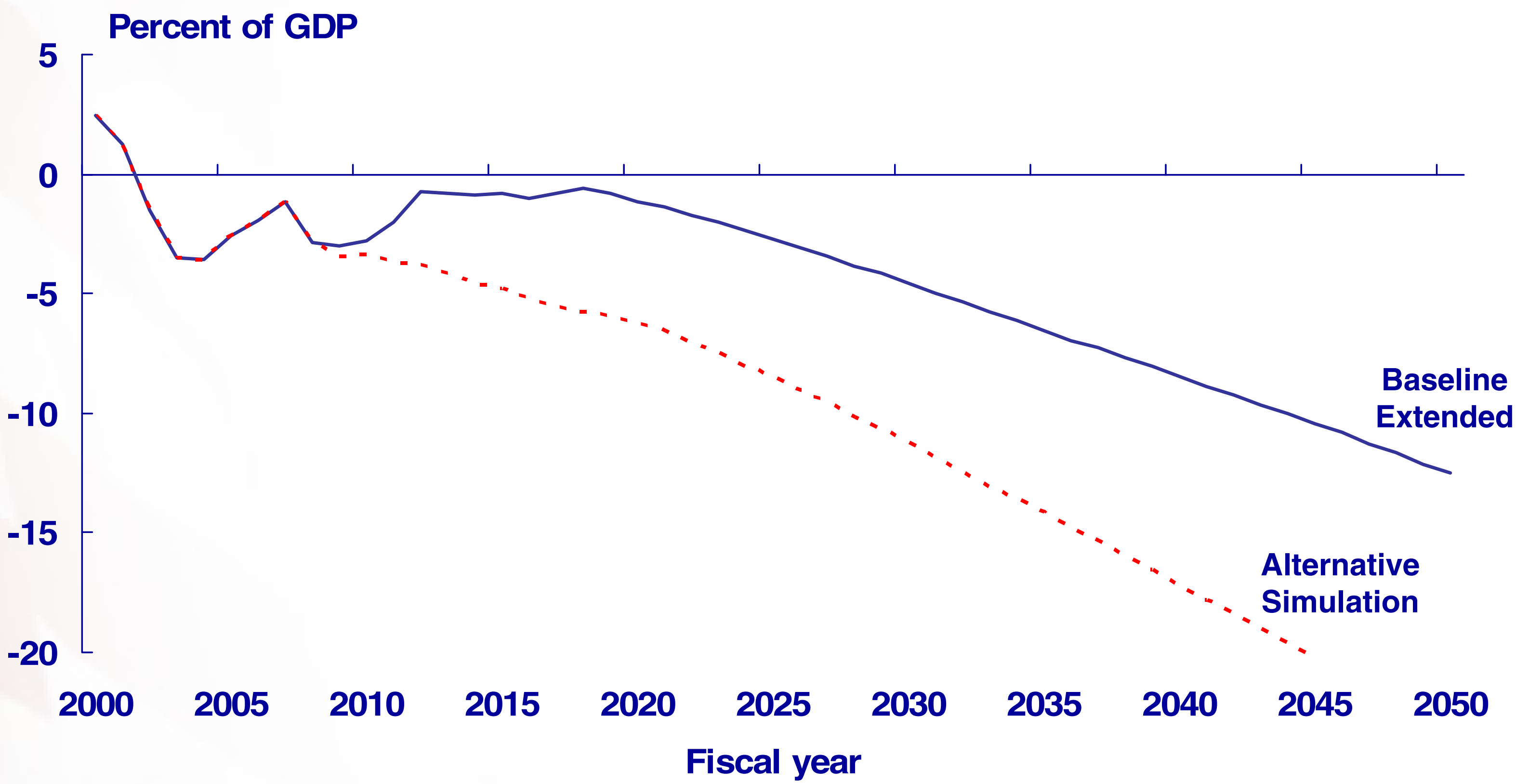
- Under either set, the long-term outlook is unsustainable.

Alternative Fiscal Policy Simulations

- **Baseline extended** follows CBO's September 2008 10-year baseline projections which assume that discretionary spending authority grows with inflation and tax provisions scheduled to expire will actually do so including the temporary increase in the alternative minimum tax (AMT) exemption amount. After 2018, discretionary spending is assumed to grow with the economy, and revenue is held constant as a share of GDP at the 2018 level of 20.4 percent—implicitly assuming that action is taken to offset increased revenue from real bracket creep, the AMT, and tax-deferred retirement accounts. Medicare spending is based on the 2008 Trustees' intermediate projections that assume the continuation of current law under which fees for physicians treating Medicare patients would be cut in future years.

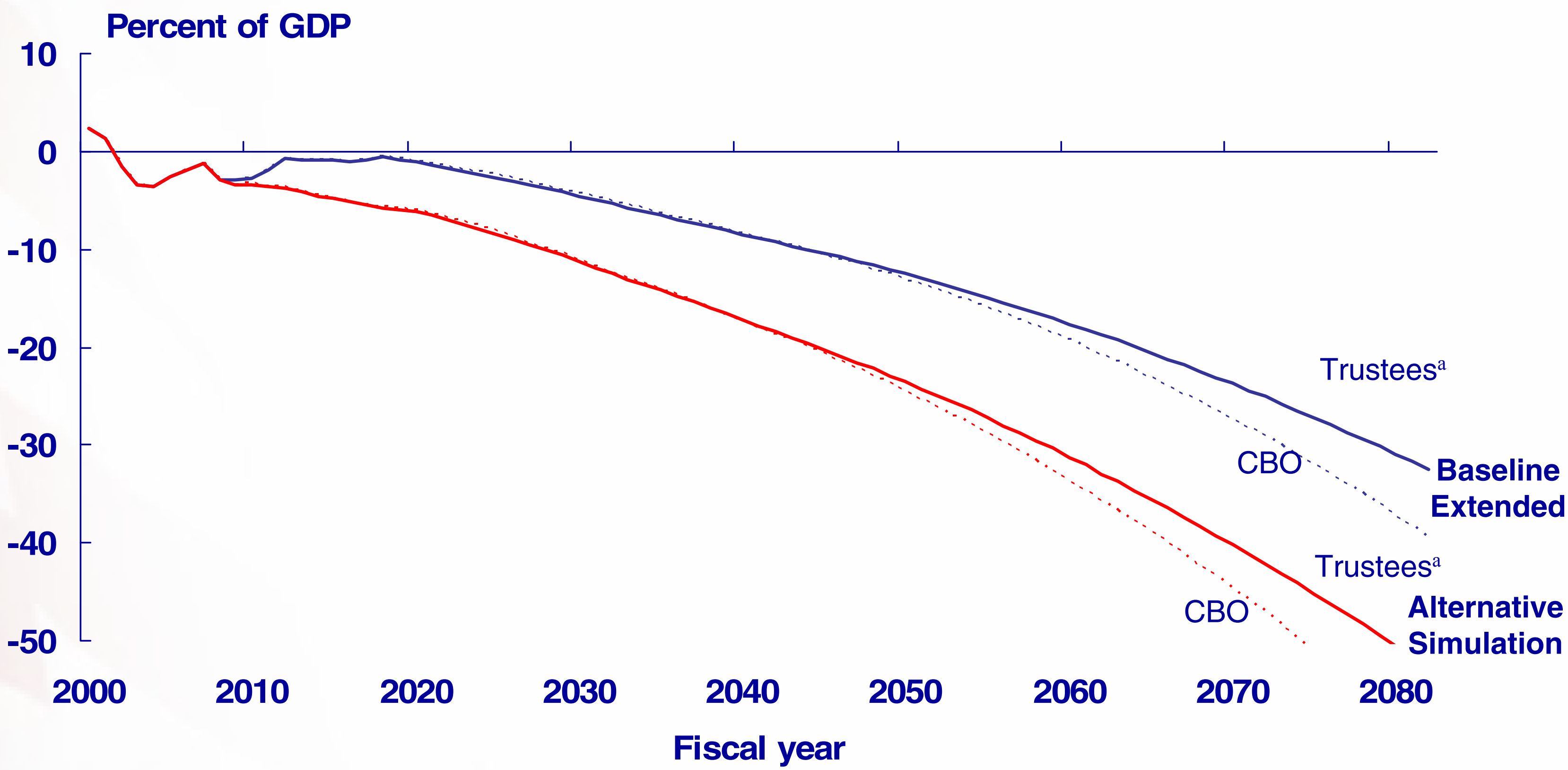
- **Alternative simulation** follows baseline extended except for changes to the assumptions for three variables. Discretionary spending grows with the economy after 2008 and all expiring tax provisions are extended including the 2007 AMT exemption amount. After 2018, revenue is brought back to its 40-year 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 the 2008 Trustee's intermediate projections adjusted for CMS's alternative assumption that physician payments are not reduced as specified under current law.

Unified Surpluses and Deficits as a Share of GDP Under Alternative Fiscal Policy Simulations



Source: GAO's September 2008 analysis based on the Social Security and Medicare Trustees' assumptions.

Unified Surpluses and Deficits Under Alternative Social Security, Medicare, and Medicaid Assumptions



[a] Some adjustments are made to Trustees assumptions.

Source: GAO's September 2008 analysis.

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

Total Federal Revenue and Discretionary Spending as Shares of GDP: Historical Averages and GAO's Simulations after 2018

(percent)	20-year historical average	40-year historical average	GAO's Baseline Extended Simulation	GAO's Alternative Simulation
Total Revenue	18.4	18.3	20.4	18.6[a]
Discretionary spending	7.6	9.1	6.8	7.9

[a]Average over the period from 2019-2082. Represents a return to 40-year historical average level of revenue of18.3 percent of GDP plus expected revenues from deferred taxes (i.e. taxes on withdrawals from retirement accounts).

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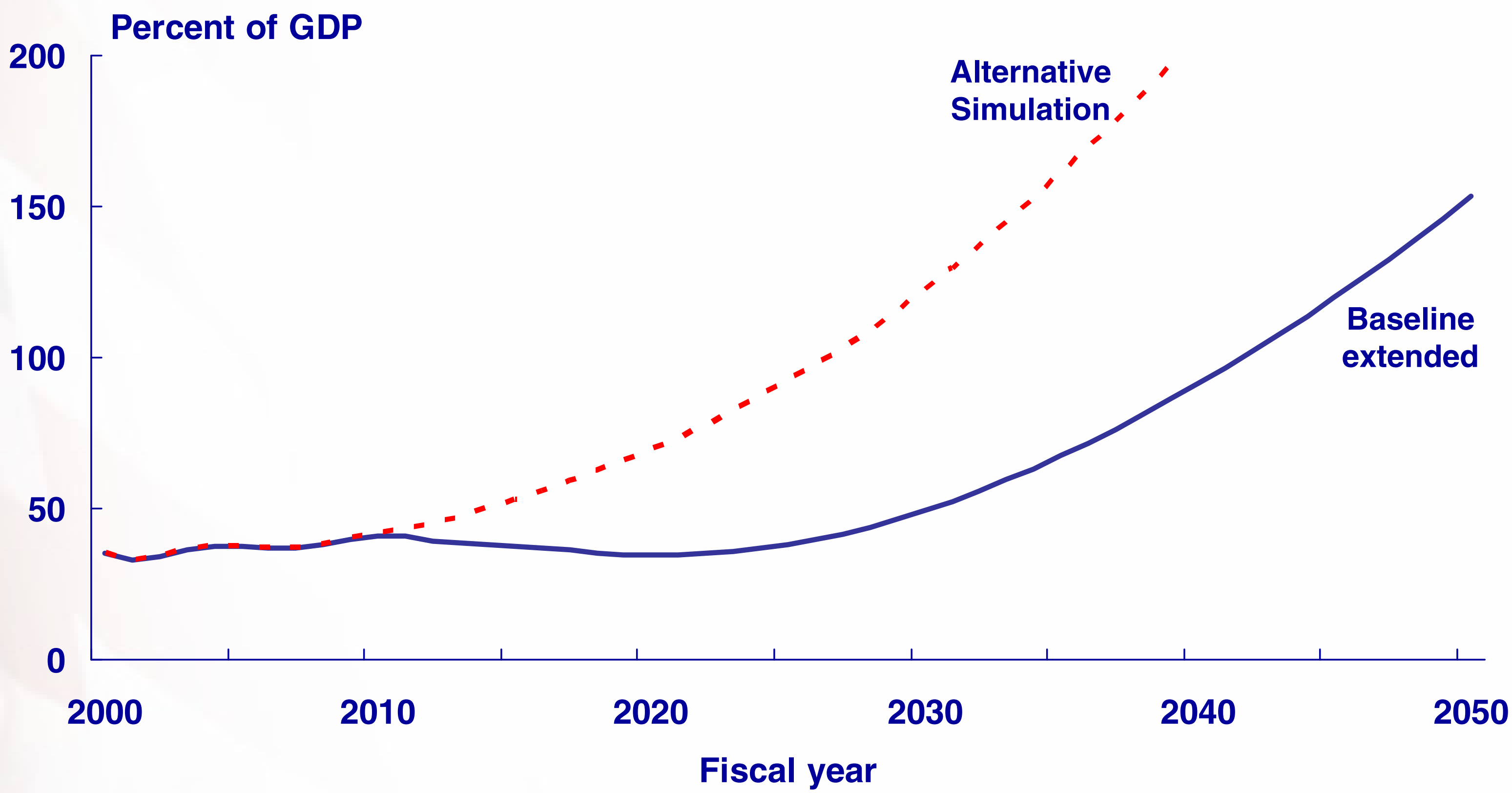
Source: Congressional Budget Office and GAO.

Note: Simulation values represent GAO's ultimate assumptions (year 10 and beyond).

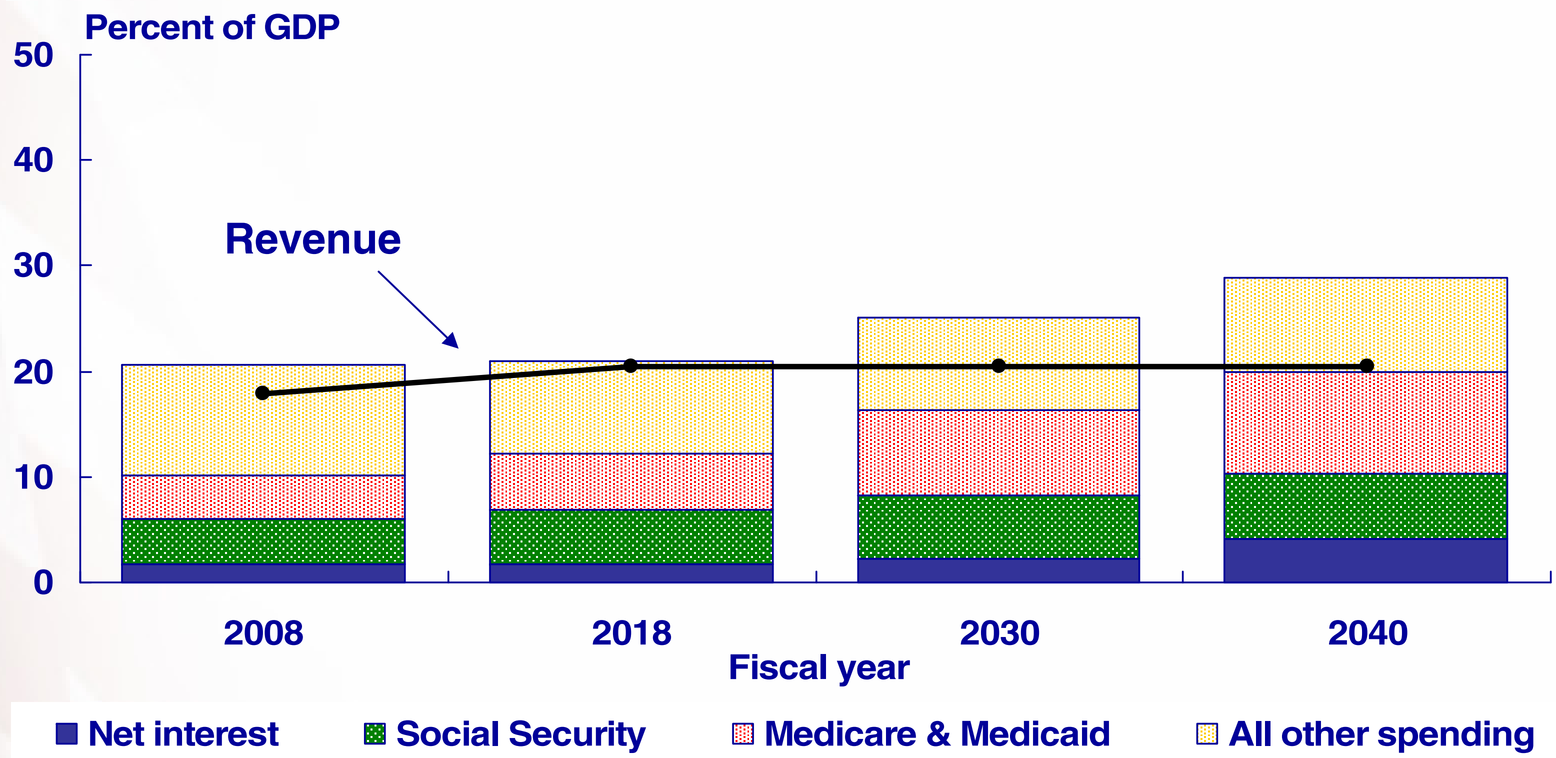
Debt Held by the Public as a Share of GDP Under Alternative Fiscal Policy Simulations



Source: GAO's September 2008 analysis based on the Social Security and Medicare Trustees' assumptions.

Potential Fiscal Outcomes Under Baseline Extended

Revenues and Composition of Spending as a Share of GDP

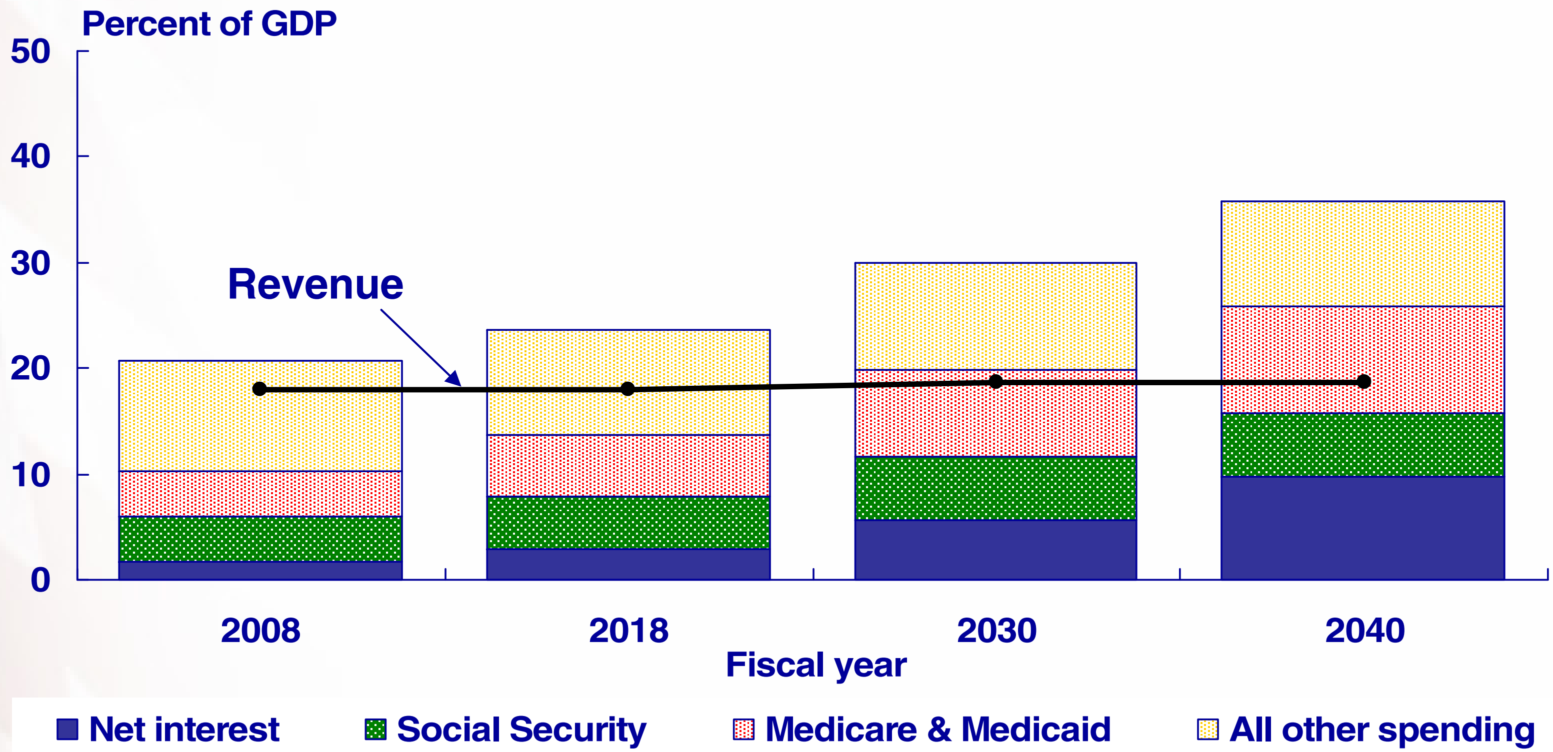


Source: GAO's September 2008 analysis based on the Trustees' assumptions for Social Security and Medicare.

Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2018 because of (1) real bracket creep, (2) more taxpayers becoming subject to the alternative minimum tax (AMT), and (3) increased revenue from tax-deferred retirement accounts. After 2018, 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.

Potential Fiscal Outcomes Under Alternative Simulation

Revenues and Composition of Spending as a Share of GDP



Source: GAO's September 2008 analysis based on the Trustees' assumptions for Social Security and Medicare.

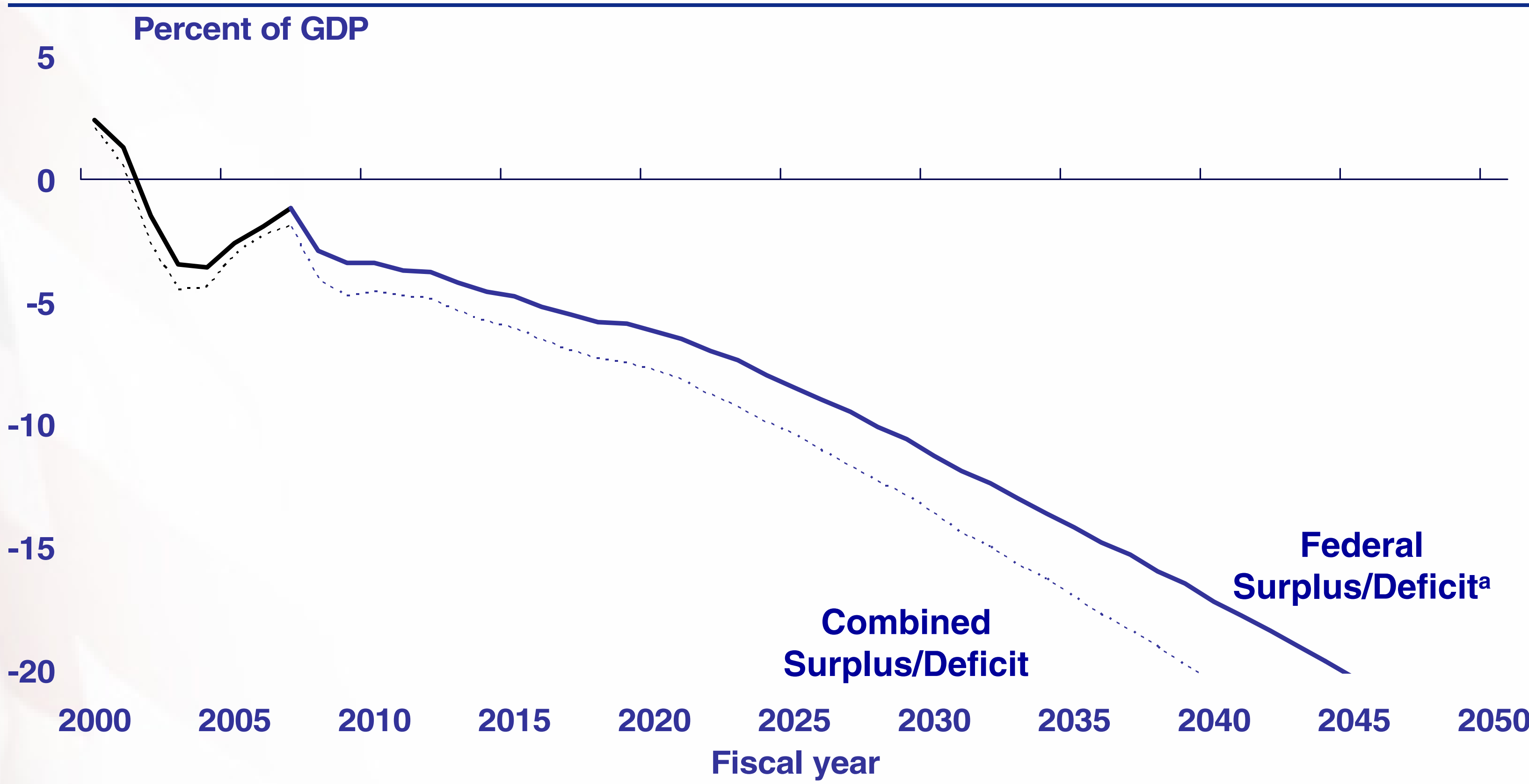
Notes: Discretionary spending grows with GDP after 2008. AMT exemption amount is retained at the 2007 level through 2018 and expiring tax provisions are extended. After 2018, revenue as a share of GDP is brought to its 40-year historical average of 18.3 percent of GDP plus expected revenues from deferred taxes, (i.e. taxes on withdrawals from retirement accounts). Medicare spending is based on the Trustees' 2008 intermediate projections adjusted for the Centers for Medicare & Medicaid Services alternative assumption that physician payments are not reduced as specified under current law.

Federal Fiscal Gap (2008-2082)

	Fiscal gap		Change required to close gap compared to today's levels		
	Trillions of present value 2008 dollars	Percent of GDP	Percent increase in today's revenue	Percent increase in today's individual income taxes	Percent decrease in noninterest spending
Baseline Extended	$31.3	3.9%	21.8%	47.7%	20.5%
Alternative	56.1	7.0	39.1	85.6	36.6

Source: GAO's September 2008 analysis based on the Social Security and Medicare Trustees' assumptions.

State and Local Fiscal Challenges Add to the Federal Government's Fiscal Challenge



Source: GAO's September 2008 analysis.

[a]Under GAO's Alternative simulation based on the Trustees' assumptions.

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

Model inputs	Baseline extended	Alternative
Revenue	CBO's September 2008 baseline through 2018; thereafter remains constant at 20.4 percent of GDP (CBO's projection in 2018)	All expiring tax provisions are extended through 2018; 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 September 2008 baseline through 2018; thereafter based on 2008 Social Security Trustees' intermediate projections	Same as Baseline Extended
Medicare spending	CBO's September 2008 baseline through 2018; 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 and Medicaid Services' alternative assumption of 0-percent physician payment updates in the first 10 years
Medicaid spending	CBO's September 2008 baseline through 2018; 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 September 2008 baseline through 2018; thereafter remains constant as a share of GDP at 2.0 percent of GDP (i.e., increases at the rate of economic growth)	Baseline Extended through 2011, then adjusted for extension of certain tax credits through 2018; thereafter remains constant at 2.1percent of GDP
Discretionary spending	CBO's September 2008 baseline through 2018; thereafter remains constant at 6.8 percent of GDP	Increases at the rate of economic growth starting after 2008 (i.e., remains constant at 7.9 percent of GDP)

Source: GAO.

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

Model inputs	Baseline extended	Alternative
Social Security spending	CBO's September 2008 baseline through 2018; 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 September 2008 baseline through 2018; 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.	CBO's projections that assume physician payment rates grow with inflation (using the Medicare economic index)[a]
Medicaid spending	CBO's September 2008 baseline through 2018; 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.

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 1950-2007)
Current account balance (percent of GDP)	From 2007-2018, 2007 share of GDP plus one-third of any change in gross national saving from 2007; thereafter equal to 2018 nominal level plus one-third of any change in gross national saving from 2007
Total factor productivity growth	1.4 percent through 2018 (CBO's September 2008 short-term assumption); 1.4 percent thereafter (long-term average from 1950-2007)
Inflation (percent change in GDP price index)	CBO September 2008 baseline through 2018; 1.9 percent thereafter (CBO's projection in 2018)
Interest rate (on publicly held debt)	Rate implied by CBO's September 2008 baseline net interest payment projections through 2018; 5.1 percent thereafter (the rate implied in 2018)

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.