The Federal Government's Long-Term Fiscal Outlook

Spring 2015 Update

GAO

Why Does GAO Prepare Long-Term Fiscal Simulations?

Since 1992, GAO has published long-term fiscal simulations showing federal deficits and debt under different sets of policy assumptions. These simulations:

- provide illustrations—not precise forecasts—of the relative outcomes associated with different sets of broad fiscal policy assumptions.
- provide context for consideration of different policy options.
- are *not* predictions of what will happen in the future, as policymakers are likely to take action to prevent damaging out-year fiscal consequences.

What Do GAO's Long-Term Fiscal Simulations Show?

GAO simulations illustrate:

- a fundamental imbalance between revenue and spending over the long term leads to continuous growth in debt as a share of gross domestic product (GDP), which is unsustainable.
- increases in spending are largely driven by an aging population and rising health care costs along with increased net interest costs on federal debt.
- delaying action to address the long-term outlook increases the size of actions needed, and the risk that the eventual changes will be disruptive and destabilizing to the economy and individuals.

Overview of GAO's Simulations: Near-Term Assumptions (2015 to 2025)

GAO runs two simulations, which differ in the near term in the following ways:

- The **Baseline Extended** simulation follows the Congressional Budget Office's (CBO) January 2015 baseline projections, which generally reflect current law. Discretionary spending reflects the caps and automatic enforcement procedures in effect through 2021 under current law; from 2022 to 2025 discretionary spending grows with inflation.[1] The Baseline Extended simulation also assumes that, as provided under current law, tax provisions that are scheduled to expire, such as the expansion of the earned income tax credit, do so and that payment rates for physicians treating Medicare patients are cut in future years as scheduled under the sustainable growth rate (SGR) system consistent with CBO's January 2015 Baseline.

- In the **Alternative** simulation, changes are made to the following assumptions to reflect historical trends.
  1. Discretionary and other mandatory spending is adjusted to exclude the effects of the automatic enforcement procedures established by the Budget Control Act and revised by subsequent legislation.
  2. Expiring tax provisions are extended.
  3. Medicare spending is based on the Centers for Medicare & Medicaid Services Office of the Actuary's (CMS Actuary) projections that assume that physician payment rates grow by 0.6 percent annually rather than being cut as scheduled under the SGR system and that other policies that would restrain Medicare cost growth begin to phase out after 2019.

[1]The Budget Control Act (BCA) established discretionary spending limits for 2012 through 2021. The BCA also established the Joint Select Committee on Deficit Reduction, which was tasked with proposing legislation to reduce the deficit by at least $1.2 trillion by fiscal year 2021. The Joint Committee did not enact legislation, which triggered downward adjustments to discretionary spending caps and reductions to nonexempt mandatory spending programs to achieve the spending reductions. These are collectively referred to here as the automatic enforcement procedures. Subsequent legislation extended reductions of nonexempt mandatory spending programs through 2024.

Overview of GAO's Simulations: Longer-Term Assumptions (2026 to 2089)

GAO runs two simulations, which differ over the longer term in the following ways:

- In the **Baseline Extended** simulation, discretionary spending remains constant at the 2025 level–5.1 percent of gross domestic product (GDP) (lower than at any other point over the past 50 years). Revenue is held constant as a share of GDP at the 2025 level of 18.3 percent—implicitly assuming that action is taken to offset increased revenue from real bracket creep, tax-deferred retirement accounts, and an excise tax on high cost employer-sponsored health plans. Long-term Social Security spending is based on intermediate projections by the Social Security Trustees. Long-term Medicare spending is based on current law projections by the Medicare Trustees. Long-term spending on Medicaid, the Children's Health Insurance Program (CHIP), and exchange subsidies is consistent with CBO's long-term assumptions for the number and age composition of enrollees and the Medicare Trustees' intermediate assumptions for excess cost growth.

- Several of the **Alternative** simulation's assumptions differ from those used in the Baseline Extended, including:
  1. Discretionary spending as a share of GDP gradually rises to the 20-year historical average of 7.2 percent after 2021.
  2. Revenue is held constant as a share of GDP at the 2025 level of 18.1 percent.
  3. Medicare spending is based on the CMS Actuary projections that assume physician payment rates are not reduced as scheduled and that policies intended to restrain Medicare cost growth phase out over time.
  4. Other mandatory spending is held constant as a share of GDP at the 2025 level of 2.4 percent.

In both simulations, we assume that Social Security and Medicare benefits are paid in full regardless of the amounts available in the trust funds.

Federal Budget Path is Unsustainable over the Long Term

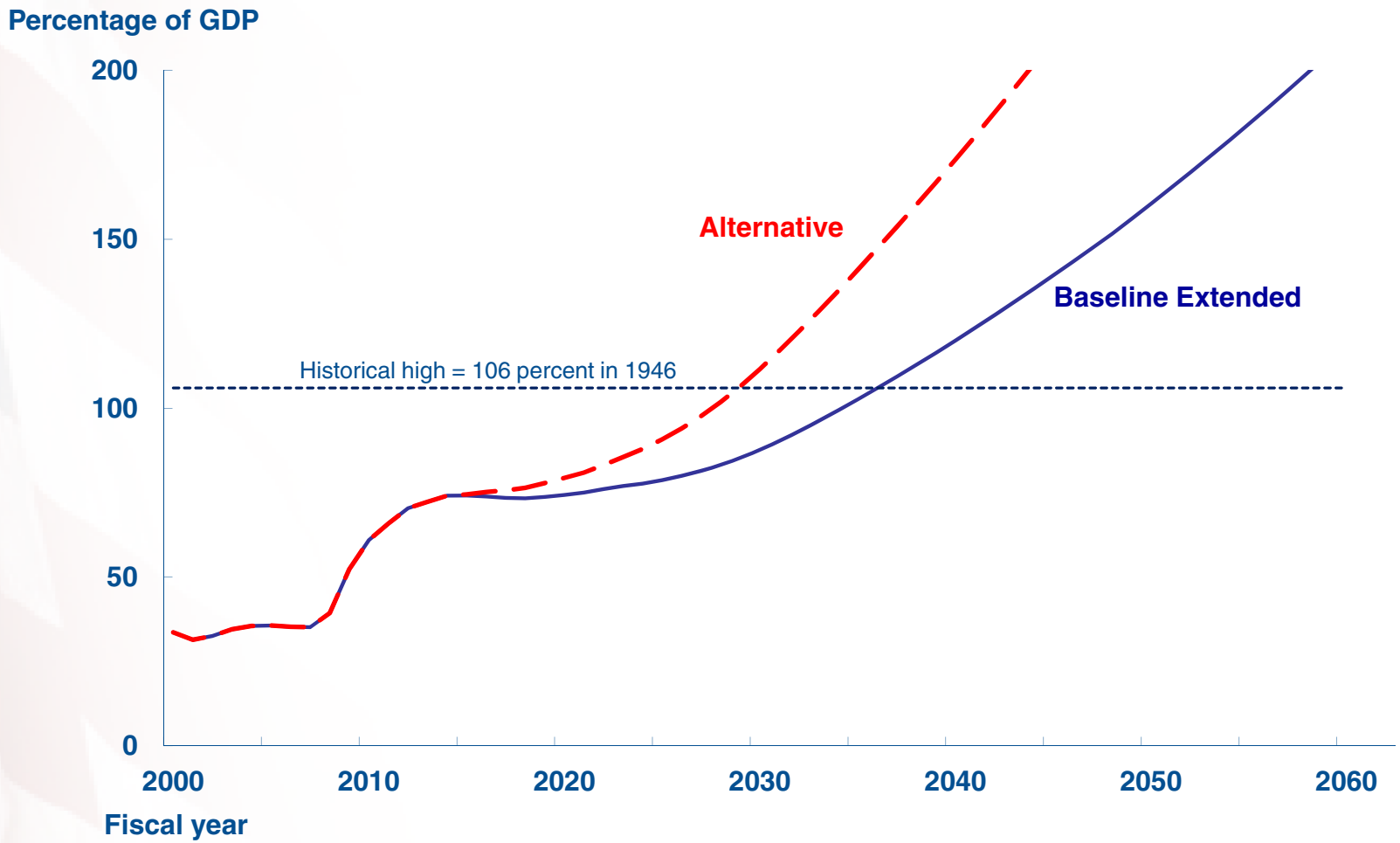
The timing and the pace of the build-up of federal debt held by the public—and therefore the size of action needed to address it—depend on the specific assumptions used.

- In the **Baseline Extended** simulation federal debt as a share of gross domestic product (GDP) declines in the short term before turning up again.
- In the **Alternative** simulation federal debt as a share of GDP grows throughout the period.
- These simulations show that, without policy changes, debt held by the public will surpass its historical high within the next 15-25 years.

The growing gap between revenue and spending will further limit the federal government's flexibility to address future challenges.

Debt Held by the Public

Under Two Fiscal Policy Simulations



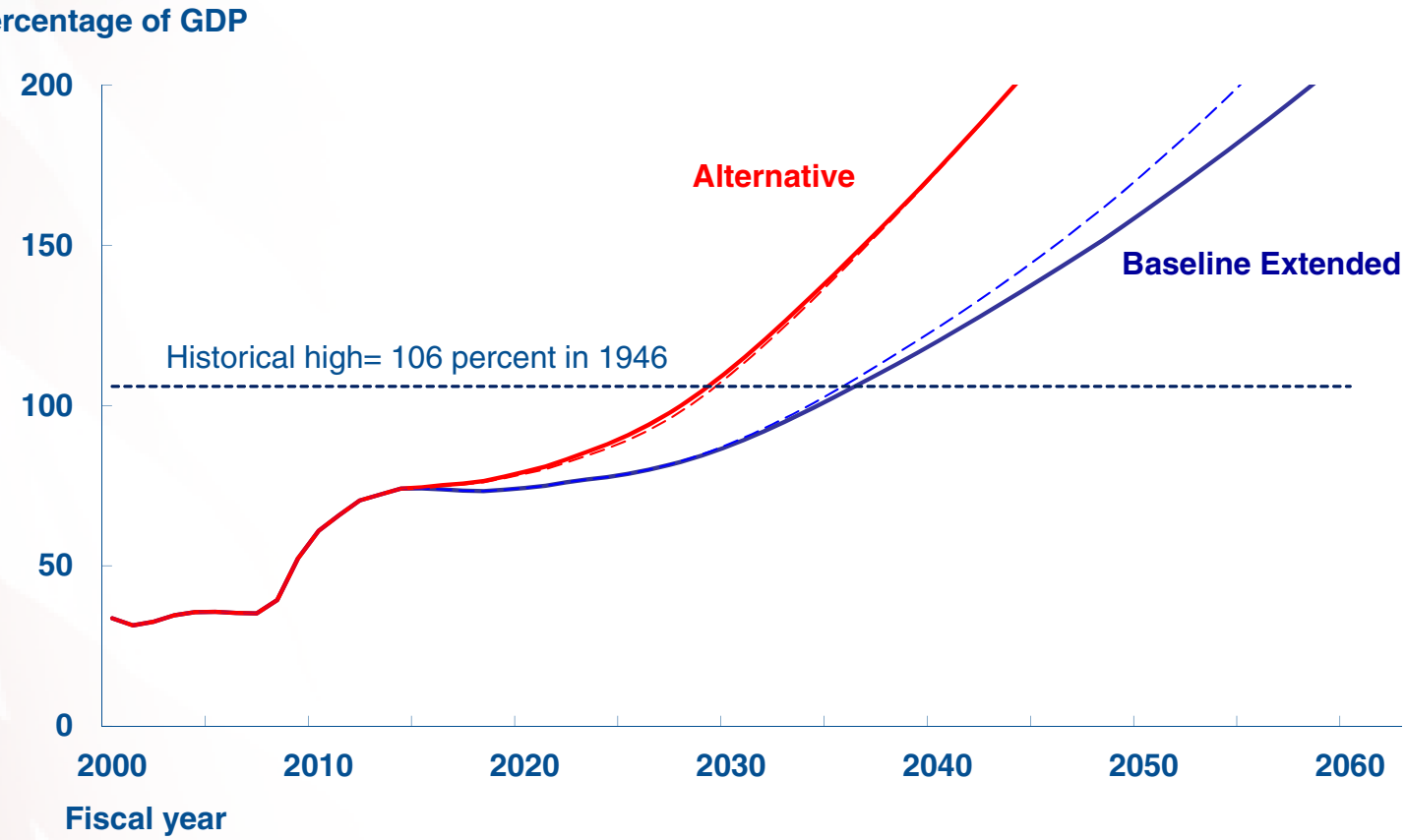
Source: GAO.

Note: Data are from GAO's Spring 2015 simulations based on the Trustees' assumptions for Social Security and the Trustees' and CMS Actuary's assumptions for Medicare.

Since the amount of spending in GAO's simulations depend largely on what is assumed about growth in spending for large entitlement programs, GAO also shows the **Baseline Extended** and **Alternative** simulation using the Congressional Budget Office's estimates for long-term spending on Social Security and major health entitlement programs (Medicare, Medicaid, and others).

The results are largely the same. The outlook under either set of assumptions is unsustainable.

Debt Held by the Public Under Two Sets of Fiscal Policy Simulations
with Different Assumptions for Major Entitlement Programs



Baseline Extended based on the Trustees' intermediate assumptions for Social Security and current law assumptions for Medicare

Alternative based on the Trustees' intermediate assumptions for Social Security and CMS Actuary's illustrative alternative assumptions for Medicare

Baseline Extended based on CBO's assumptions for Social Security and Medicare

Alternative based on CBO's assumptions for Social Security and Medicare

Source: GAO.

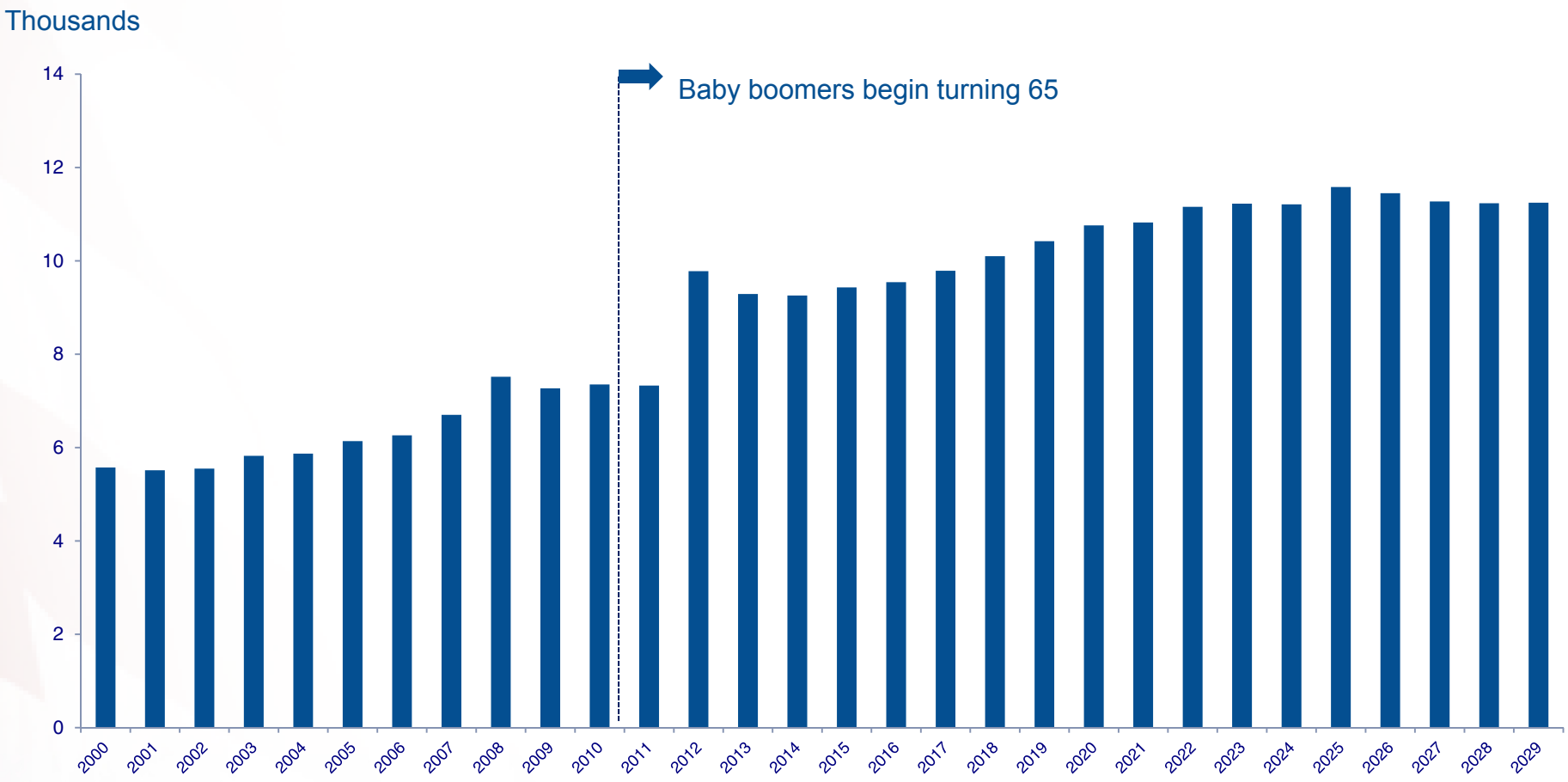
Note: Data are from GAO's Spring 2015 simulations.

Increases in Spending in GAO's Simulations are Driven by an Aging Population and Rising Health Care Costs

In both simulations spending for the major health and retirement programs will increase as a share of GDP in coming decades, putting greater pressure on the rest of the federal budget.

Over the first few decades, this spending is driven largely by the aging of the population. The oldest members of the baby-boom generation are already eligible for Social Security retirement benefits and for Medicare, and, the number of baby boomers turning 65 is projected to grow in coming years.

Daily Average Number of People Turning 65 Each Year



Source: GAO analysis of U.S. Census Bureau data.

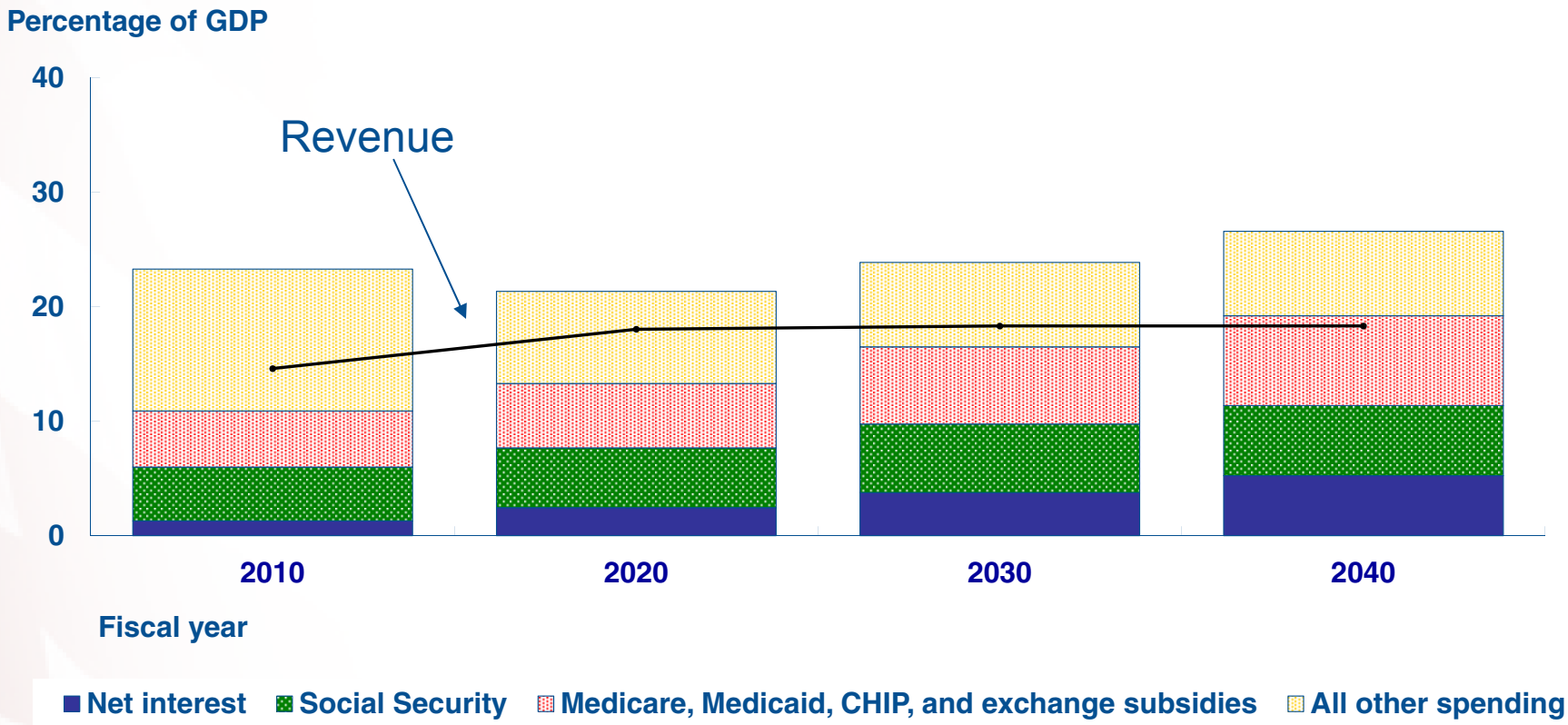
Addressing the Long-Term Fiscal Outlook will Require Difficult Trade-offs

Both the **Baseline Extended** and **Alternative** simulations show spending on interest, Social Security, and the major health programs absorbing increasing shares of revenue over time.

This leaves little room for "all other spending," which includes national defense, homeland security, veterans' health care, mass transit, education, and basic research for future economic growth.

Potential Fiscal Outcomes

Revenues and Composition of Spending in the Baseline Extended Simulation

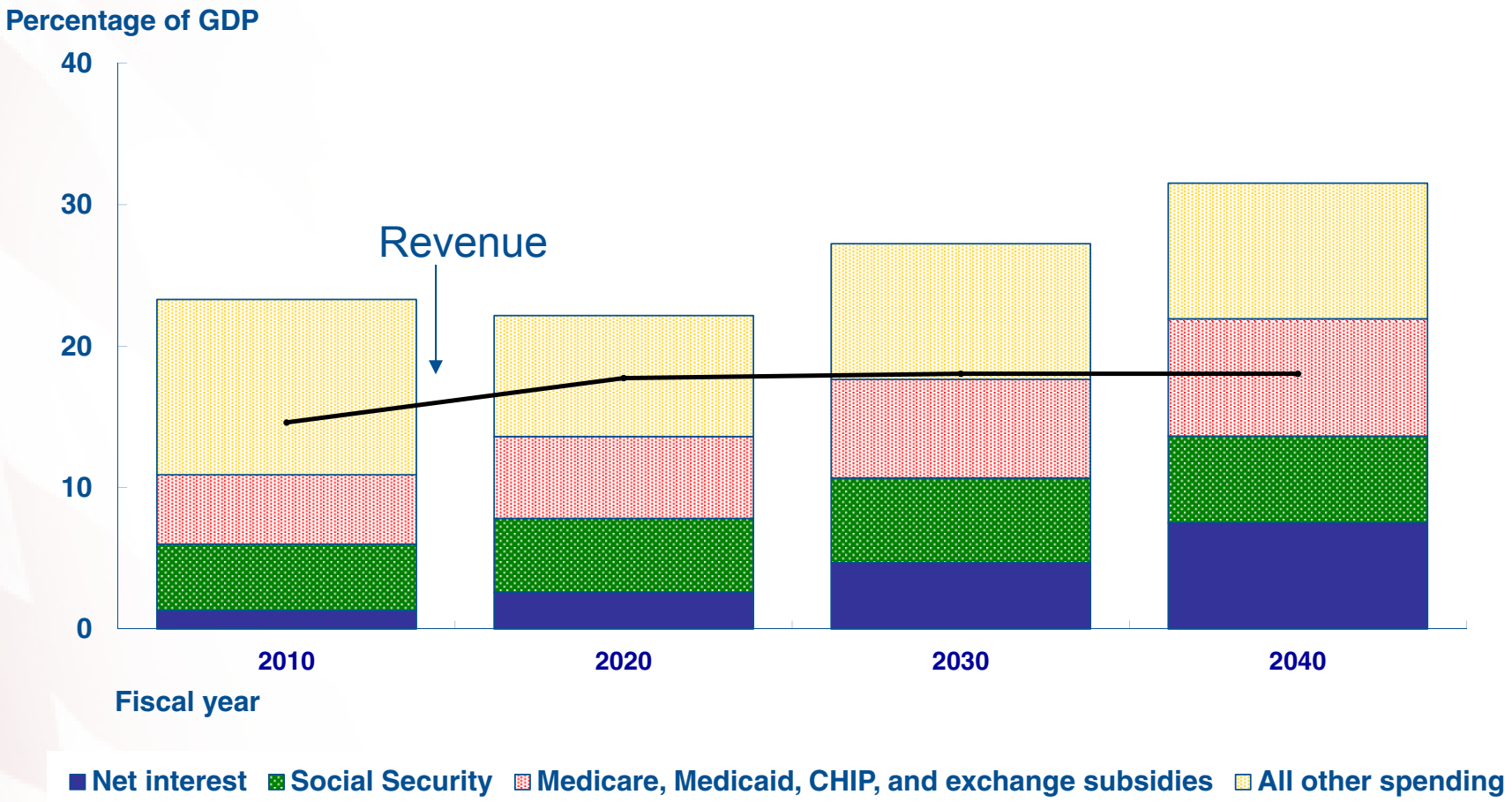


Source: GAO.

Note: Data are from GAO's Spring 2015 simulation based on the Trustees' intermediate assumptions for Social Security and current law assumptions Medicare.

Potential Fiscal Outcomes

Revenues and Composition of Spending in the Alternative Simulation



Source: GAO.

Note: Data are from GAO's Spring 2015 simulations based on the Trustees' intermediate assumptions for Social Security and CMS Actuary's illustrative alternative assumptions for Medicare.

The Longer that Action is Delayed, Increases the Size of Actions Needed in the Future

One measure of the challenge over the long term is the "**fiscal gap**." The fiscal gap represents the difference, or gap, between revenue and noninterest spending over a certain period, such as 75 years, that would need to be closed in order to achieve a specified debt level at the end of the period.

Closing the gap will require tax increases, spending reductions, or, more likely, a combination of the two.

Delaying action increases the size of actions needed and the risk that the eventual changes will be disruptive and destabilizing to the economy and individuals.

Federal Fiscal Gap (2015 to 2089)

	Fiscal gap	Average percentage change required to close gap			
		If action is taken today		If action is delayed until 2025	
	Percentage 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	3.6	19.9	16.9	23.3	19.4
Alternative	6.7	37.0	27.4	43.2	31.0

Source: GAO.

Notes: Data are from GAO's Spring 2015 simulations based on the Trustees' assumptions for Social Security and the Trustees' and CMS Actuary's illustrative assumptions for Medicare. The fiscal gap is the amount of spending reductions or tax increases on average over the 75-year period to keep debt held by the public as a share of GDP in 2089 from exceeding its level at the beginning of 2015 (roughly 74.1 percent of GDP).

Appendix I:

Assumptions Underlying GAO Simulations

Total Federal Revenue and Discretionary Spending:

Historical Averages and GAO's Long-Term Assumptions

Percentage of GDP

	20-year historical average	40-year historical average	Baseline Extended Assumptions	Alternative Assumptions
Total revenue	17.2	17.3	18.3	18.1
Total discretionary spending	7.2	8.2	5.1	7.2

Sources: CBO and GAO.

Note: The Baseline Extended revenue and spending assumptions are both held constant from year 2025 through the end of the simulation period. The Alternative revenue assumption is also held constant after 2025, while the Alternative discretionary spending assumption is gradually phased in from 2021 through 2030 and then held constant as a share of GDP through the remainder of the simulation period.

Key Budget Assumptions

Model inputs	Baseline Extended simulation	Alternative simulation
Revenue	CBO's January 2015 baseline that assumes tax provisions expire as scheduled under current law and growth of real income causes a greater proportion of taxpayers' income to be taxed in higher brackets through 2025; thereafter remains constant at 18.3 percent of GDP (CBO's projection in 2025)	CBO's estimates that assume expiring tax provisions are extended through 2025; thereafter remains constant at 18.1 percent of GDP
Discretionary spending	CBO's January 2015 baseline through 2015, which reflects the caps and automatic enforcement procedures established by the Budget Control Act and revised by subsequent legislation; thereafter remains constant at 5.1 percent of GDP (CBO's projection in 2025)[a]	Follows the caps established by the Budget Control Act and revised by subsequent legislation through 2021 but not the lower caps triggered by the automatic enforcement procedures; thereafter it gradually phases up to 7.2 percent of GDP (the 20-year historical average)[a]
Other mandatory spending	CBO's January 2015 baseline through 2025, which incorporates the reductions in spending scheduled to occur under the automatic enforcement procedures established by the Budget Control Act and revised by subsequent legislation; thereafter remains constant at 2.3 percent of GDP (CBO's projection in 2025)[a]	CBO's January 2015 baseline adjusted to exclude the effects of the automatic enforcement procedures established by the Budget Control Act and revised by subsequent legislation through 2025; thereafter remains constant as a share of GDP at 2.4 percent (the level reached in 2025)[a]

Source: GAO.

Notes: CBO's projections are from *The Budget and Economic Outlook: 2015 to 2025* (Jan. 26, 2015).

[a]The Budget Control Act established discretionary spending limits for 2012 through 2021. The BCA also established the Joint Select Committee on Deficit Reduction, which was tasked with proposing legislation to reduce the deficit by at least $1.2 trillion by fiscal year 2021. The Joint Committee did not enact legislation, which triggered downward adjustments to discretionary spending caps and reductions to nonexempt mandatory spending programs to achieve the spending reductions. These are collectively referred to here as the automatic enforcement procedures. Subsequent legislation extended reductions of nonexempt mandatory spending programs through 2024.

Key Budget Assumptions (continued)

Model inputs	Baseline Extended simulation	Alternative simulation
Social Security spending	CBO's January 2015 baseline through 2025; thereafter phases into the 2014 Social Security Trustees' intermediate projections	Same as Baseline Extended
Medicare spending	CBO's January 2015 baseline through 2025 that assumes cuts in physician payment rates will occur as scheduled under current law at the time[a] and the automatic enforcement procedures established by the Budget Control Act and revised by subsequent legislation reduce spending;[b] thereafter phases into the 2014 Medicare Trustees' current law projections in which cost containment mechanisms, including those enacted in the Patient Protection and Affordable Care Act, reduce excess cost growth to 0.2 percentage points on average over the long term[c]	Based on CMS Actuary's alternative scenario that assumes physician payment rates grow by 0.6 percent annually over the next 10 years[a]; Medicare physician spending growth then gradually transitions to a long-term growth rate equal to the per capita increase in overall health spending; spending reductions scheduled under current law do not occur[b] and policies that would restrain Medicare cost growth are applied fully through 2019 but begin to phase out thereafter; excess cost growth averages 0.6 percentage points over the long term[c]
Medicaid, the Children's Health Insurance Program (CHIP), and exchange subsidies spending[d]	CBO's January 2015 baseline through 2025; thereafter growth in spending for these programs is consistent with CBO's July 2014 long-term assumptions for the number and age composition of enrollees and the 2014 Trustees' intermediate assumptions for excess cost growth; excess cost growth averages 0.8 percentage points over the long term[c]	Same as Baseline Extended

Source: GAO.

Notes: CBO's projections are from *The Budget and Economic Outlook: 2015 to 2025* (Jan. 26, 2015) and CBO's *The 2014 Long-Term Budget Outlook* (July 15, 2014). Trustees projections are from *The 2014 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* and *The 2014 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, which were both issued on July 28, 2014. Projections from the CMS Actuary are based on "Projected Medicare Expenditures under Illustrative Scenarios with Alternative Payment Updates to Medicare Providers" (Aug. 28, 2014). We assume that Social Security and Medicare benefits are paid in full regardless of the amounts available in the trust funds.

[a]When CBO prepared its January 2015 baseline, physician payment rates were scheduled to be reduced by roughly 21 percent in 2015 and smaller amounts in subsequent years under the sustainable growth rate (SGR) system. Subsequently, Congress has considered legislation that would modify or repeal the SGR system. Unless offset by spending reductions or tax increases of equal size, such legislation would increase spending in the Baseline Extended simulation. We will incorporate the effects of any legislation affecting the SGR system in future updates.

[b]In addition to limits on discretionary budget authority, the Budget Control Act required reductions in nonexempt mandatory spending, including Medicare, through 2021. Subsequent legislation extended these reductions through 2024.

[c]Excess cost growth refers to the annual growth rate of health care spending per enrollee in excess of the annual growth rate of potential GDP per capita, adjusted for demographic characteristics.

[d]In March 2015, CBO released updated budget projections for 2015 to 2025 showing, among other changes, lower spending for Medicaid and exchange subsidies. These lower estimates, which are not reflected in our 2015 simulations, would affect assumptions about long-term spending for these programs.

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

Model inputs	Baseline Extended simulation	Alternative simulation
Social Security spending	CBO's January 2015 baseline through 2025; thereafter based on CBO's July 2014 long-term projections for Social Security	Same as Baseline Extended
Medicare spending	CBO's January 2015 baseline through 2025; thereafter based on CBO's July 2014 long-term projections under its extended-baseline scenario in which spending growth per beneficiary gradually moves to CBO's estimate of the underlying growth rate of 1.3 percent by 2039 before declining to 1 percent by the end of the 75-year period[a]	Based on CBO's projections under its alternative fiscal scenario that assumes physician payment rates do not decline as scheduled under current law and spending reductions under the BCA do not occur as scheduled. As in the extended-baseline scenario, spending growth per beneficiary gradually moves to CBO's estimate of the underlying growth rate by 2039
Medicaid, CHIP, and exchange subsidies spending	CBO's January 2015 baseline through 2025; thereafter based on CBO's July 2014 long-term projections under its extended-baseline scenario in which spending growth per beneficiary gradually moves to CBO's estimate of the underlying growth rate of 0.9 percent by 2039 before declining to 0 percent by the end of the 75-year period[a]	Same as Baseline Extended

Source: GAO.

Notes: CBO's projections are from *The Budget and Economic Outlook: 2015 to 2025* (Jan. 26, 2015) and CBO's *The 2014 Long-Term Budget Outlook* (July 15, 2014). CBO assumes that full benefits are paid regardless of the amounts available in the trust funds.

[a]The underlying growth rates begin with the rate of growth in health care spending in recent decades and are projected to decline gradually as people try to limit their spending for health care in order to maintain their consumption of other goods and services and as state governments, private insurers, and employers respond to the pressures of rising costs. Percentages refer the amount of excess cost growth—or the annual growth rate of health care spending per enrollee in excess of the annual growth rate of potential GDP per capita, adjusted for demographic characteristics.

Key Economic Assumptions Used in Both Sets of Simulations

Model inputs	All simulations
Real GDP growth	CBO's January 2015 baseline through 2025; thereafter averages 2.1 percent based on the intermediate assumptions of the 2014 Social Security and Medicare Trustees reports
Inflation (percentage change in GDP price index)	CBO's January 2015 baseline through 2025; 2.1 percent thereafter (CBO's projection in 2025)
Interest rate (on debt held by the public)	Rate implied by CBO's January 2015 baseline net interest payment projections through 2025; phasing to 4.7 percent by 2031 and then constant thereafter (CBO's July 2014 long-term projection)

Source: GAO.

Note: GDP in GAO's simulations does not incorporate the negative effect of long-term deficits on the economy.