THE LONG-TERM OUTLOOK FOR THE FEDERAL BUDGET

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SUMMARY

The budget outlook, for both the coming decade and beyond, is daunting. The retirement of the baby-boom generation portends a significant and sustained increase in the share of the population receiving benefits from Social Security, Medicare, and Medicaid. Moreover, per capita spending for health care is likely to continue rising faster than spending per person on other goods and services for many years (although the magnitude of that gap is very uncertain). Without significant changes in government policy, the Congressional Budget Office (CBO) projects that those factors will boost federal outlays sharply relative to gross domestic product (GDP) in coming decades under any plausible assumptions about future trends in the economy, demographics, and health care costs. As the economy recovers and the policies adopted to counteract the recession and the financial turmoil phase out, budget deficits will probably decline markedly in the next few years. However, under CBO's projections, federal debt held by the public as a share of the economy, already at its highest level since shortly after World War II, will continue to grow.

ALTERNATIVE SCENARIOS FOR THE LONG-TERM BUDGET OUTLOOK

In *CBO's 2011 Long-Term Budget Outlook* (June 2011), CBO issued long-term budget projections under two scenarios that embody different assumptions about future policies governing federal revenues and spending.[1] The extended-baseline scenario reflects the assumption that current laws do not change, and the alternative fiscal scenario, which incorporates several changes to current law that are widely expected to occur or that would modify some provisions of law that might be difficult to sustain for a long period, maintains what some analysts might consider "current policy" as opposed to current law (table 1).

The extended-baseline scenario follows CBO's most recent baseline budget projections for the next decade and then extends the baseline concept beyond that 10-year window.[2] The current-law assumption of the extended-baseline scenario implies that many adjustments that lawmakers have routinely made in the past—such as changes to the Alternative Minimum Tax (AMT) and to the Medicare program's payments to physicians—will not be made again.[3] The alternative fiscal scenario embodies several changes to current law that would continue certain tax and spending policies that people have grown accustomed to (because the policies are in place now or have been in place recently). Versions of some of the changes assumed in the scenario—such as those related to the tax cuts originally enacted in 2001, the AMT, certain other tax provisions, and Medicare's payments to physicians—have regularly been enacted in the past and are widely expected to be made in some form over the next few years.

Both sets of projections understate the size of the budgetary shortfalls that would be likely to occur. In order to clearly illuminate long-term budgetary trends, as distinguished from the resulting economic effects, CBO generally assumes stable economic conditions after 2021. In particular, economic variables such as GDP growth and interest rates are assumed to be the same as if federal debt remained at 76 percent of GDP, the level it reaches in 2021 in CBO's baseline projections. In actuality, if debt grew faster than GDP, economic growth would slow and real interest rates would rise. Most of CBO's budget projections also omit the impact of changes in effective marginal tax rates.

THE EXTENDED-BASELINE SCENARIO

Under CBO's current-law scenario, primary (noninterest) spending would drop relative to GDP

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Table 1

Assumptions About Spending and Revenues Underlying CBO's Long-Term Budget Scenarios

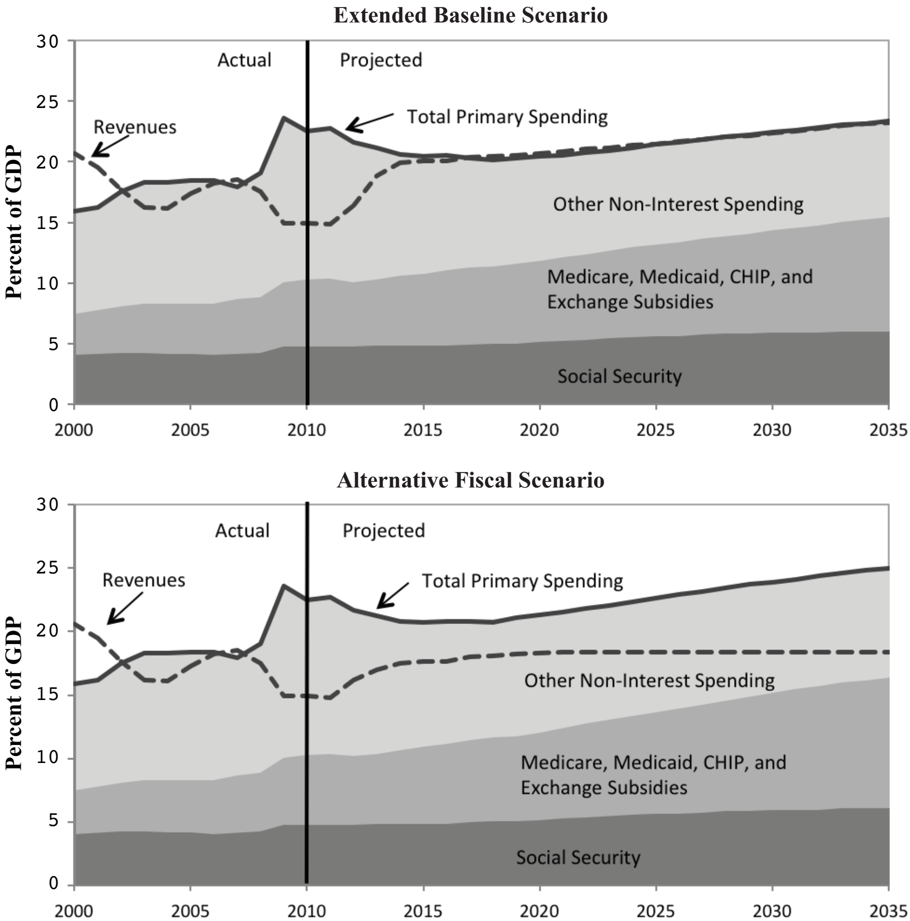
	Extended-Baseline Scenario	*Alternative Fiscal Scenario*
		Assumptions About Spending
Medicare	As scheduled under current law	As scheduled under current law, except that payment rates for physicians are maintained at the 2011 levels through 2021 (rather than at the lower rates of the sustainable growth rate mechanism) and that, after 2021, several policies that would restrain spending growth are assumed not to be in effect
Medicaid	As scheduled under current law	As scheduled under current law
Exchange Subsidies	As scheduled under current law	As scheduled under current law, except that a policy that would slow the growth of per-participant subsidies for health insurance coverage is assumed not to be in effect and eligibility thresholds are assumed to be modified to maintain the share of the population eligible for subsidies
CHIP	As projected in CBO's baseline through 2021; remaining constant as a share of GDP thereafter	As projected in CBO's baseline through 2021; remaining constant as a share of GDP thereafter
Social Security	As scheduled under current law	As scheduled under current law
Other Noninterest Spending	As projected in CBO's baseline through 2021; remaining at the 2021 level as a share of GDP thereafter, except that some refundable tax credits, Medicare premiums, and certain payments by states to Medicare are as scheduled under current law	As projected in CBO's baseline through 2021, except that all discretionary appropriations grow at the same rate as nominal GDP through 2021, and discretionary appropriations are further adjusted by assuming that the number of troops deployed for certain types of military operations is reduced to 45,000 by 2015; thereafter, spending remains at the 2021 level as a share of GDP, except that Medicare premiums and certain payments by states to Medicare are consistent with the projections of Medicare spending in this scenario
		Assumptions About Revenues
Individual Income Taxes	As scheduled under current law	All provisions scheduled to expire in the next 10 years are extended through 2021, including the income tax reductions and AMT relief temporarily extended in the 2010 tax act; revenues remain constant as a share of GDP thereafter
Payroll Taxes	As scheduled under current law	As scheduled under current law
Corporate Income Taxes	As scheduled under current law through 2021; remaining constant as a share of GDP thereafter	All provisions scheduled to expire in the next 10 years are extended through 2021; revenues remain constant as a share of GDP thereafter
Excise Taxes	As scheduled under current law	All provisions scheduled to expire in the next 10 years are extended through 2021; revenues remain constant as a share of GDP thereafter
Estate and Gift Taxes	As scheduled under current law	The 2012 tax rates and exemption amount (adjusted for inflation) continue through 2021; revenues remain constant as a share of GDP thereafter
Other Sources of Revenue	As scheduled under current law through 2021; remaining constant as a share of GDP thereafter	All provisions scheduled to expire in the next 10 years are extended through 2021; revenues remain constant as a share of GDP thereafter

Source: Congressional Budget Office. *CBO's 2011 Long-Term Budget Outlook* (June 2011).

Notes: The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2021 and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period.

CHIP = Children's Health Insurance Program; GDP = gross domestic product; AMT = alternative minimum tax; 2010 tax act = Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312).

Figure 1: **Revenues and Primary Spending, by Category, Under CBO's Long-Term Budget Scenarios**



Source: Congressional Budget Office, *CBO's 2011 Long-Term Budget Outlook* (June 2011).

Notes: Primary spending refers to all spending other than interest payments on federal debt.

The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2021 and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period.

CHIP = Children's Health Insurance Program.

in the next few years, level out for the rest of the decade, and grow significantly in later decades (see top panels of figure 1 and table 2). The severe recession and financial turmoil, as well as federal policies implemented in response to them, pushed primary outlays to 24 percent of GDP in 2009, the highest level since World War II. (Unless otherwise indicated, the years referred to in this paper are federal fiscal years.) CBO projects that such outlays will remain above 22 percent of GDP in 2011. As the economy recovers and the budgetary effects of those recent policies diminish, primary spending is projected to decline to 20 percent of GDP and stay near that level through 2021. In later years, primary spending would follow a gradual upward path, reaching 23 percent of GDP in 2035.[4]

If current law continued, revenues would also rise considerably; by the 2020s, they would reach higher levels relative to the size of the economy than ever recorded in the nation's history. Under current law, revenues would jump from about 15 percent of GDP now to 19 percent in 2013 as the economic recovery increased taxable income, as the tax cuts enacted since 2001 expired in 2012 and 2013 as scheduled, and as the reach of the AMT expanded greatly. In later years, revenues would continue to rise relative to GDP, causing marginal tax rates to increase and federal revenues to grow faster than the economy, reaching 23 percent of GDP in 2035.

Even with revenues rising to those projected levels, the federal government would still experience substantial budgetary shortfalls. By 2035, the deficit (including interest costs) would equal about 4 percent of GDP under the extended-baseline scenario, and federal debt held by the public would equal 84 percent of GDP. In later years, debt would grow at approximately the same rate as the economy, as both revenues and spending increased relative to GDP; therefore, debt would continue to be a much larger percentage of GDP than has been seen in most of U.S. history.

THE ALTERNATIVE FISCAL SCENARIO

Under CBO's alternative fiscal scenario, primary spending would be 1.1 percentage points higher as a share of GDP in 2021 than under current law (see bottom panels of figure 1 and table 2). That difference would grow in later years. The higher primary spending stems from several assumptions of the alternative scenario: that through 2021 lawmakers will act to prevent Medicare's payment rates for physicians from declining; that lawmakers will not allow various restraints on the growth of Medicare costs and health insurance subsidies to have their full effect after the first decade of the projections; and that, as a percentage of GDP, federal spending for things other than Social Security, major mandatory health programs, and interest payments will be close to the level experienced during much of the past decade.[5]

On the revenue side, the alternative fiscal scenario incorporates the assumption that almost all expiring tax provisions will be extended through 2021 (the end of CBO's 10-year baseline projection period). Most important, CBO assumes for that scenario that the cuts in individual income taxes enacted since 2001, and most recently extended in 2010, will be extended through 2021; that relief from the AMT will continue through 2021; and that the 2012 parameters of the estate tax will apply through 2021. Thereafter, revenues are assumed to remain at their 2021 level of 18.4 percent of GDP, just above the average of the past 40 years.

That revenue path, combined with the spending policies described above, would produce a deficit equal to 15 percent of GDP in 2035. It would also push federal debt held by the public to more than 100 percent of GDP by 2021 and soon afterward to levels unprecedented in the United States, reaching almost 190 percent by 2035.

THE OUTLOOK FOR MAJOR HEALTH CARE PROGRAMS AND SOCIAL SECURITY

Federal spending for mandatory programs has accounted for a sharply rising share of primary outlays in the past few decades. Most of that growth has been concentrated in the three largest entitlement programs—Social Security, Medicare, and Medicaid. Together, federal outlays for those three programs made up 46 percent of primary spending, on average, over the past 10 years, up from 27 percent in 1975.

Under CBO's two scenarios, all of the projected growth in primary spending as a share of GDP over the long term stems from increases in mandatory spending, particularly in outlays for the government's major health care programs: Medicare, Medicaid, the Children's Health Insurance Program (CHIP), and insurance subsidies that will be provided through the exchanges created by the March 2010 health care legislation.[6] Under both scenarios, total outlays for those health care programs would grow much faster than GDP, increasing from 5.6 percent in 2011 to about 9 percent or 10 percent in 2035.[7] Spending on Social Security would rise much more slowly, from almost 5 percent of GDP in 2011 to about 6 percent in the 2030s and beyond. Despite differing growth rates, under both scenarios, the trust funds for Social Security and for Part A of Medicare would be exhausted over time.[8] However, to measure the imbalance between the revenues for those programs and the outlays for benefits currently specified in law, CBO assumes for these projections that the two programs will continue to pay benefits as now scheduled.

Two factors account for the projected increases in outlays for the government's large entitlement

Table 2
Projected Spending and Revenues Under CBO's Long-Term Budget Scenarios
(Percentage of gross domestic product)

	2011	2021	2035
	Extended-Baseline Scenario		
Spending			
Primary spending			
Social Security	4.8	5.3	6.1
Medicare[a]	3.7	4.1	5.9
Medicaid, CHIP, and exchange subsidies	1.9	2.8	3.5
Other noninterest spending	12.3	8.3	7.8
Subtotal, primary spending	**22.7**	**20.5**	**23.3**
Interest spending	1.4	3.4	4.1
Total Spending	**24.1**	**23.9**	**27.4**
Revenues	14.8	20.8	23.2
Deficit (-) or Surplus			
Primary deficit or surplus	-7.9	0.3	-0.1
Total deficit	-9.3	-3.1	-4.2
Debt Held by the Public[b]	69	76	84
	Alternative Fiscal Scenario		
Spending			
Primary spending			
Social Security	4.8	5.3	6.1
Medicare[a]	3.7	4.3	6.7
Medicaid, CHIP, and exchange subsidies	1.9	2.8	3.7
Other noninterest spending	12.3	9.1	8.5
Subtotal, primary spending	**22.7**	**21.5**	**25.0**
Interest spending	1.4	4.4	8.7
Total Spending	**24.1**	**25.9**	**33.9**
Revenues	14.8	18.4	18.4
Deficit			
Primary deficit	-7.9	-3.1	-6.6
Total deficit	-9.3	-7.5	-15.5
Debt Held by the Public[b]	69	101	187

Source: Congressional Budget Office, *CBO's 2011 Long-Term Budget Outlook* (June 2011).

Notes: Primary spending refers to all spending other than interest payments on federal debt. The primary deficit or surplus is the difference between revenues and primary spending.

The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2021 and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period.

CHIP = Children's Health Insurance Program.

a. Spending for Medicare reflects gross amounts. Beneficiaries' premiums and certain other receipts used to offset a portion of spending for Medicare are included in other noninterest spending.

b. At the end of the year.

programs: aging of the population and rapid growth of health care spending per capita. In the case of Social Security, the aging of the population drives the projected growth of spending as a percentage of GDP. In the case of the major mandatory health care programs, both aging and rapid growth of per capita health care spending are responsible for the projected rise in federal spending as a share of GDP. CBO projects that aging accounts for 64 percent of the total projected growth in spending on Social Security and the major mandatory health care programs by 2035, and excess cost growth accounts for 36 percent.

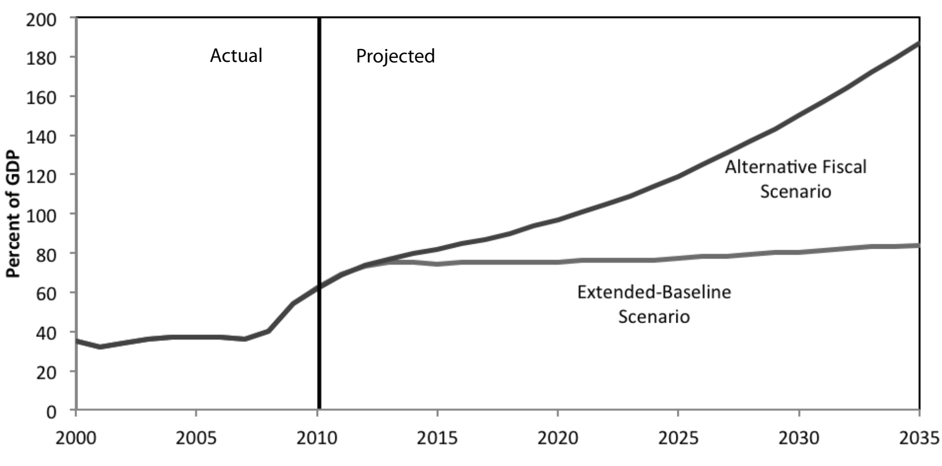
THE ACCUMULATION OF FEDERAL DEBT

A useful barometer of the federal government's financial position is the amount of federal debt held by the public relative to annual economic output. Such debt stood at 40 percent of GDP at the end of 2008, a little above the 40-year average of 37 percent. Since then, large deficits have caused debt held by the public to increase sharply—to 62 percent of GDP at the end of 2010 and, CBO projects, to 69 percent by the end of this year (figure 2). Debt has exceeded 60 percent of GDP during only one other period in U.S. history: between 1943 and 1952, because of a surge in federal spending during World War II.

Under the extended-baseline scenario, annual budget deficits would decline to 3 percent of GDP by 2014. After that, deficits would generally equal between 3 percent and 4 percent of GDP. Debt held by the public would remain high by historical standards, growing to 84 percent of GDP in 2035 and stay fairly close to that level in later decades. Under the alternative fiscal scenario, deficits would also decline for the next few years and then grow again, but at a much faster pace. By 2021, debt would exceed 100 percent of GDP. After that, the growing imbalance between revenues and noninterest spending, combined with the spiraling cost of interest payments, would swiftly push debt to unsustainable levels. Debt would surpass its past peak of 109 percent of GDP by 2023 and would reach almost 190 percent of GDP in 2035.

Many analysts believe that the alternative fiscal scenario presents a more realistic picture of the nation's underlying fiscal policy than the extended-baseline scenario does—because, for example, it does not allow the impact of the AMT to expand substantially. The explosive path of federal debt under the alternative scenario underscores the

Figure 2: **Federal Debt Held by the Public Under CBO's Long-Term Budget Scenarios**



Source: Congressional Budget Office, *CBO's 2011 Long-Term Budget Outlook* (June 2011).

Note: The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2021 and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period.

need for major changes in current policies to put the nation on a sustainable fiscal course.

THE FISCAL GAP

How much would policies have to change to avoid unsustainable increases in government debt? A useful answer comes from looking at the fiscal gap, which measures the immediate change in spending or revenues that would be necessary to keep the debt-to-GDP ratio the same at the end of a given period as at the beginning of the period. The fiscal gap from 2011 to 2035 would amount to 0.9 percent of GDP under the extended-baseline scenario and 4.8 percent under the alternative fiscal scenario (table 3). In other words, relative to the projections of the alternative fiscal scenario, an immediate and permanent reduction in spending or increase in revenues equal to 4.8 percent of GDP—equivalent to more than $700 billion in this year's federal budget—would be needed to create a sustainable fiscal path for the next quarter century.

Waiting to close the fiscal gap would make the necessary changes larger. To illustrate the costs of delay, CBO simulated the effects of delaying action to close the fiscal gap. Those simulations indicate that postponing action would substantially increase the size of the policy adjustments needed to put the budget on a sustainable course. For example, if lawmakers wanted to close the fiscal gap through 2035 but did not begin until 2015, they would have to reduce primary spending or increase revenues over that period by 5.9 percent of GDP, rather than by 4.9 percent if they acted in 2012. If they waited until 2020 to close the fiscal gap through 2035, they would have to cut noninterest outlays or raise revenues over the remaining period by 8.1 percent of GDP.

Table 3
The Federal Fiscal Gap Under CBO's Long-Term Budget Scenarios (Percentage of gross domestic product)

	Present Value of the Future Stream of Revenues or Outlays over a Given Period		
Projection Period	*Adjusted Revenues*[a]	*Adjusted Outlays*[a]	*Fiscal Gap (Outlays minus revenues)*
		Extended-Baseline Scenario	
25 Years (2011 to 2035)	23.2	24.1	0.9
50 Years (2011 to 2060)	24.1	24.4	0.4
75 Years (2011 to 2085)	25.4	25.6	0.2
		Alternative Fiscal Scenario	
25 Years (2011 to 2035)	20.3	25.1	4.8
50 Years (2011 to 2060)	19.2	25.9	6.6
75 Years (2011 to 2085)	18.9	27.2	8.3

Source: Congressional Budget Office, *CBO's 2011 Long-Term Budget Outlook* (June 2011).

Notes: The fiscal gap is a measure of federal shortfalls over a given period. It represents the extent to which the government would need to immediately and permanently either raise tax revenues or cut spending—or do both, to some degree—to make the government's debt the same size (relative to gross domestic product, or GDP) at the end of the period that it was at the beginning of 2011.

The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2021 and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that modify some current provisions that might be difficult to sustain for a long period.

[a]To allow for the increase in the nominal value of federal debt that would occur even if that debt was maintained at its current share of GDP, outlays are adjusted by adding current debt, and revenues are adjusted by adding the present value of the target end-of-period debt. (The end-of-period debt is equal to GDP in the last year of the period multiplied by the ratio of debt to GDP at the beginning of 2011. A present value is a single number that describes a flow of future revenues or outlays in terms of an equivalent lump sum received or spent today.)

FURTHER CONSEQUENCES OF THE BUDGET PATH

CBO's projections understate the severity of the long-term budget problem because they do not incorporate the negative effects that additional federal debt would have on the economy, nor do they include the impact of higher tax rates on people's incentives to work and save. In particular, large budget deficits and growing debt would reduce national saving, leading to higher interest rates, more borrowing from abroad, and less domestic investment—which in turn would lower income growth in the United States. Taking those effects into account, CBO estimates that under the extended-baseline scenario, real (inflation-adjusted) gross national product (GNP) would be reduced slightly by 2025 and by as much as 2 percent by 2035, compared with what it would be under the stable economic environment that underlies most of CBO's projections.[9] Under the alternative fiscal scenario, real GNP would be 2 percent to 6 percent lower in 2025, and 7 percent to 18 percent lower in 2035, than under a stable economic environment.

Rising levels of debt also would have other negative consequences that are not incorporated in those estimated effects on output. Higher levels of debt imply higher interest payments on that debt, which would eventually require either higher taxes or a reduction in government benefits and services. Rising debt would increasingly restrict policymakers' ability to use tax and spending policies to respond to unexpected challenges, such as economic downturns or financial crises. As a result, the effects of such developments on the economy and people's well-being could be worse. Growing debt also would increase the probability of a sudden fiscal crisis, during which investors would lose confidence in the government's ability to manage its budget and the government would thereby lose its ability to borrow at affordable rates. Such a crisis would confront policymakers with extremely difficult choices. To restore investors' confidence, policymakers would probably need to enact spending cuts or tax increases more drastic and painful than those that would have been necessary had the adjustments come sooner.

To keep deficits and debt from climbing to unsustainable levels, policymakers will need to increase revenues substantially as a percentage of GDP, decrease spending significantly from projected levels, or adopt some combination of those two approaches. Making such changes while economic activity and employment remain well below their potential levels would probably slow the economic recovery. However, the sooner that medium- and long-term changes to tax and spending policies are agreed on, and the sooner they are carried out once the economy recovers, the smaller will be the damage to the economy from growing federal debt. Earlier action would permit smaller or more gradual changes and would give people more time to adjust to them, but it would require more sacrifices sooner from current older workers and retirees for the benefit of younger workers and future generations.

Notes

1 Supplementary data underlying the long-term budget scenarios are posted along with that report on CBO's Web site (www.cbo.gov).

2 See Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2012* (April 2011). CBO's baseline is a neutral reference point for measuring the budgetary effects of proposed changes to federal revenues or spending. It consists of projections of budget authority, outlays, revenues, and the deficit or surplus over 10 years calculated according to rules originally set forth in the Balanced Budget and Emergency Deficit Control Act of 1985. Those projections are not intended to be predictions of future budgetary outcomes; rather, they represent CBO's best judgment of how economic and other factors would affect federal revenues and spending if current laws did not change.

3 The AMT is a parallel income tax system with fewer exemptions, deductions, and rates than the regular income tax. Households must calculate the amount they owe under both the AMT and the regular income tax and pay the larger of the two amounts.

4 Several factors not directly included in budget totals also affect the government's need to borrow from the public. Those factors include increases or decreases in the government's cash balance as well as the cash flows reflected in the financing accounts used for federal credit programs. Changes in those factors were not modeled in this analysis.

5 Mandatory programs are programs that do not require annual appropriations by the Congress; the funding available for them is generally not limited. Most mandatory spending is for entitlement programs, in which the federal government is required to make payments to any person or entity that meets the eligibility criteria set in law. Discretionary spending, by contrast, is controlled by annual appropriation acts.

[6] That legislation was the Patient Protection and Affordable Care Act (Public Law 111-148) and the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152).

[7] Those totals for major health care programs include gross Medicare spending (that is, they do not subtract offsetting receipts, which consist mainly of premiums paid by Medicare beneficiaries).

[8] The balances of those trust funds represent the total amount that the government is legally authorized to spend on each program. For a discussion of the legal issues related to trust fund exhaustion, see Christine Scott, *Social Security: What Would Happen If the Trust Funds Ran Out?* Report for Congress RL33514 (Congressional Research Service, August 20, 2009).

[9] GNP differs from GDP primarily by including the capital income that residents earn from investments abroad and excluding the capital income that nonresidents earn from domestic investment. In the context of analyzing the impact of growing deficits and debt, GNP is a better measure because projected budget deficits would be partly financed by inflows of capital from other countries.