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THE LONG-TERM FISCAL OUTLOOK IS BLEAK
Restoring Fiscal Sustainability Will Require Major Changes to Programs, Revenues, and the Nation's Health Care System

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Summary

This report updates the Center on Budget and Policy Priorities' projections of federal spending, revenues, deficits, and debt through 2050. These projections — like the projections the Center issued in January 2007 and the projections by other institutions such as the Congressional Budget Office (CBO), Government Accountability Office, and Office of Management and Budget — show that without changes in current policies, federal deficits and debt in coming decades will grow to unprecedented levels that will threaten serious harm to the economy.

We are *not* suggesting that the long-term budget problem should take precedence over short-term steps to stabilize financial markets and the economy. Such steps — even if deficits exceed $1 trillion this year and next — are necessary to help avert a deep and prolonged recession. In fact, one important conclusion of this analysis is that the increases in the deficit caused by the current recession and various measures to bring it under control will have only a small effect on the long-term deficit problem, assuming that the severity of the recession does not greatly exceed current expectations.

This conclusion should not be surprising. The costs related to the recession will have only a small budgetary impact on the long-term deficit problem, because they are temporary. *Temporary* costs — even if very large in the short run — add much less to the long-term fiscal gap than *permanent* costs (such as extending the tax cuts) because their total costs are small relative to the total size of the economy over the long-run. Also, short-term economic weaknesses have little impact on the major drivers of the long-term fiscal imbalance: rising health care costs and the aging of the population.

Nevertheless, policymakers should keep the long-term budget problem in mind as they take the necessary steps to stabilize financial markets and the economy. While the long-term problem should not deter policymakers from dealing with the short-term crisis, policymakers will need to demonstrate to the public and the lenders who finance our short- and longer-term borrowing needs that they are prepared to move the budget toward a sustainable long-run path when the economy improves.

In addition, in designing policies to deal with the short-term problems, policymakers should consider policies that could serve "double duty" by helping to spur the economy in the short term while also laying the groundwork for measures to restore fiscal responsibility in the longer term. This includes measures such as investments in health information technology that hold promise for contributing to efforts to stem the rapid growth of health care costs over time.

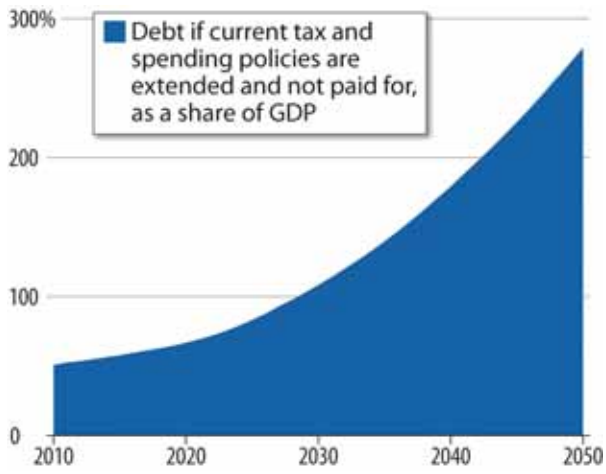
The report's principal findings are:

- **Deficits and debt are headed for dangerously high levels.** If we continue current policies, the federal debt will skyrocket from a projected 46 percent of the gross domestic product (GDP) at the end of fiscal year 2009 to 279 percent of GDP in 2050. That would be more than two and a half times the existing record (which was set when the debt reached 110 percent of GDP at the end of World War II) and would threaten serious harm to the economy. (See Figure 1.) In addition, under current policies, the annual budget deficit is projected to reach approximately 21 percent of GDP by 2050.

  Deficits and debt are projected to grow this much because expenditures will rise as a share of GDP between now and 2050, while revenues will fall. Without policy changes, we project that program expenditures will increase from 19.2 percent of GDP in 2008 to 24.6 percent in 2050. We project that revenues will decline to 17.2 percent in 2050 — well below the average for the last 30 years (which is 18.4 percent of GDP). Moreover, the federal budget was balanced only four times in those 30 years, and in each of those years, revenues were between about 20 percent and 21 percent of GDP.

FIGURE 1

Debt Will Explode Under Current Policies



Source: CBPP projections based on CBO data and CBPP assumptions about the impact of the recession on the federal budget.

- **Preventing a debt explosion will require difficult choices.** The "fiscal gap" — or the average amount of program reductions or revenue increases that would be needed over the next four decades to stabilize the debt at its 2009 level, as a share of the economy — equals 4.2 percent of projected GDP. Eliminating that gap would require the equivalent of an immediate and permanent *24 percent* increase in tax revenues or an immediate and permanent *20 percent* reduction in expenditures for *all* federal programs. Given the size of the fiscal gap, some combination of revenue increases and program cuts will be needed.

- **Rising health care costs are the single largest cause of rapidly rising expenditures.** The main sources of rising federal expenditures over the long run are rising costs throughout the U.S. health care system (both public and private) and the aging of the population. Together, these factors will drive up spending for the "big three" domestic programs: Medicare, Medicaid, and Social Security.

Health care costs are by far the biggest single factor. For the past 30 years, costs per beneficiary throughout the health care system have been growing approximately 2 percentage points faster per year than per-capita GDP, and our projections assume this pattern will continue through 2050. Limiting health care cost growth to 1 percentage point faster than per-capita GDP growth would shrink the fiscal gap by more than one-third (to 2.7 percent of GDP). If health care costs could be constrained to grow only at the same rate as per-capita GDP — a daunting and probably unachievable goal — the fiscal gap would shrink by more than two-thirds, to just 1.2 percent of GDP.

- **Fundamental health care reform must be part of any solution.** Rising costs throughout the health care system exacerbate the long-term budget problem in *two* ways. They increase federal spending by raising the per-person cost of providing health care through Medicare and Medicaid. (Per-person costs are rising in these programs at about the same rate as in the health care system as a whole, including the public and private sectors.) In addition, rising health care costs shrink federal revenues by increasing the share of the nation's income that is exempt from taxation. Employer-provided health benefits are excluded from taxable income, and various other provisions of the tax code allow individuals to pay some health care costs from pre-tax income. Thus, when health care costs grow faster than the economy, the share of total income that is exempt from taxation increases.

  A major effort is needed to expand our currently limited knowledge about ways to reduce the rate of growth in heath care costs in the public and private sectors alike, while improving the quality of care system-wide. Medicare can play an important role in these efforts, and policymakers should promote initiatives that both restrain cost growth in Medicare and serve as a model for reforms applicable to the system as a whole. Examples include eliminating the large overpayments that Medicare makes to private insurance companies that participate in the Medicare Advantage component of the program, altering Medicare's payment systems to reward quality and efficiency, and strengthening primary care and care coordination.

- **Upcoming tax policy decisions will have a major impact on the size of the problem.** Policymakers could shrink the fiscal gap by almost half — from 4.2 percent of GDP to 2.3 percent — by allowing the 2001 and 2003 tax cuts to expire as scheduled at the end of 2010 or by offsetting the cost of extending those tax cuts they choose to extend. This is because the budgetary benefits would start almost immediately (in 2011), and those benefits would reduce projected interest payments on the national debt by a growing amount over time. But even if Congress were to allow the tax cuts to expire or to offset the full cost of extending them — steps that are extremely unlikely — the budget would still remain on an unsustainable long-run path.

- **The recession and other government programs are not major long-term factors.** The current recession will enlarge the long-term fiscal imbalance only very modestly. Our projections take into account the substantial expenditures that Congress has approved or is expected to approve to help revive financial markets and to stimulate the economy. They also take into account the fact that this recession, like previous ones, will reduce tax revenues and cause automatic increases in expenditures for programs such as unemployment insurance. Yet *96 percent* of the projected long-term fiscal problem would exist even without these added costs.

  Also of note, total spending for all federal programs other than Medicare, Medicaid, and Social

Security — as well as total spending for all federal *entitlement* programs other than these three — are projected to *shrink* as a share of the economy in coming decades. Since these programs will consume a smaller share of the nation's resources in 2050 than they do today, they do not contribute to the long-term fiscal problem. Statements that we face a *general* "entitlement crisis" thus are mistaken.

The bottom line is that, as the economy recovers, policymakers should begin to implement a balanced approach to addressing the nation's long-term imbalance, through a combination of reform of the U.S. health care system, reductions in federal expenditures, and increases in federal tax revenues.

Current Budget Policies Are Unsustainable

The nation's budget policies are unsustainable.[1] Our projections show that the deficit will rise from 3 percent of the gross domestic product (GDP) in 2008 to 21 percent of GDP in 2050 if current budget policies are continued and health care costs rise in the public and private sector by the average rate that CBO projects Medicare and Medicaid will increase. (This projection assumes that a number of provisions scheduled to expire under current law — the 2001 and 2003 tax cuts, various other temporary tax provisions, relief from the Alternative Minimum Tax (AMT), and relief from scheduled reductions in the fees that Medicare pays to physicians — are extended without their costs being offset.)

Under these assumptions, the national debt will climb from 46 percent of GDP in 2009 to 279 percent of GDP by 2050, or more than two and a half times the size of the U.S. economy.[2] (See Figure 1 on page 2. The box on page 5 describes the assumptions about the budgetary effect of the current recession. The final section of this paper explains in detail the other assumptions that underlie these projections.)

Debt-to-GDP ratios of this size are unprecedented in the United States, even after major wars. (The debt peaked at roughly 110 percent of GDP at the end of World War II.) While budget projections — especially those that extend 40 years — necessarily involve a high degree of uncertainty, the conclusion that current policies are unsustainable over the long term seems inescapable.

If current policies are continued, the high levels of resulting debt will risk serious damage to the economy and place severe strains on the federal budget. For example, by 2050, simply paying interest on the national debt would cost 80 percent of projected federal revenues.

Another way of measuring the size of the problem is to examine the long-term *fiscal gap*, or the average amount of program reductions or revenue increases that would be needed over the next

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[1] See "The Long-Term Budget Outlook," Congressional Budget Office, December 2007; Alan J. Auerbach, William G. Gale, and Peter R. Orszag, "New Estimates of the Budget Outlook: Plus Ça Change, Plus C'est la Même Chose," February 15, 2006; Government Accountability Office, "The Nation's Long-Term Fiscal Outlook," September 2006; Jagadeesh Gokhale and Kent Smetters, "Fiscal and Generational Imbalance: An Update," August 2005.

[2] In this paper we use the "debt held by the public," net of the financial assets that the government has acquired.

Current Recession and Recovery Efforts Have Little Impact on Long-Term Projections

Although our estimate of a fiscal gap through 2050 equal to 4.2 percent of GDP derives from projections the Congressional Budget Office issued in September 2008, we have added costs to reflect the further deterioration in the financial markets and the economy since CBO finalized its September projections. We have assumed $500 billion in costs for rescue efforts for the nation's financial institutions, and an additional $500 billion for an economic recovery package. We have also assumed $400 billion in additional deficits resulting from the revenue losses and increases in unemployment compensation and other "automatic stabilizers" that occur when the economy weakens, even without any additional legislation.

If we had *not* added these costs to CBO's projection, the fiscal gap would have been slightly more than 4.0 percent of GDP, rather than 4.2 percent. In other words, virtually the entire long-term fiscal gap — 96 percent of it — would exist even without the recent bad economic news. The long-term fiscal gap that we project is overwhelmingly the result of budgetary policies and other factors that were already in place last summer — the increased expenditures and lost revenues resulting from rapid growth in health care costs, the aging of the population, and the expensive tax cuts enacted in 2001 and 2003.

It may be useful to note that projected GDP through 2050 exceeds $500 trillion (in "present value" terms). That is why the addition of even a significant amount of extra debt, such as $1 trillion, adds so little to the fiscal gap as a share of GDP. Put differently, this is why *temporary* costs, even if very expensive in the short run, are much less significant than *permanent* costs such as making some or all of the 2001 and 2003 tax cuts permanent or enacting the 2003 Medicare prescription drug program.

four decades to ensure that the debt is no larger in 2050 than it will be at the end of 2009, measured as a share of the economy. Under our projections, the fiscal gap equals 4.2 percent of projected GDP through 2050.[3] This means that the nation's finances could be stabilized through 2050 by enacting tax increases or budget cuts averaging 4.2 percent of GDP per year. (To appreciate the size of the fiscal gap, one might note that in 2010, 4.2 percent of GDP will equal $652 billion.)

Eliminating a fiscal gap equal to 4.2 percent of GDP would be extremely difficult. Even so, some readers may wonder how it is that the nation could reduce the debt in 2050 from our projection of 279 percent of GDP to 46 percent of GDP (the projected level at the end of 2009) simply by instituting annual spending reductions and tax increases equal to 4.2 percent of GDP. This could be done if the changes started immediately. If we began to institute these revenue increases or program reductions in fiscal 2010, we would begin running surpluses rather than deficits in the near term, which would decrease the national debt. The reductions in the debt, in turn, would reduce interest costs (relative to current projections) in every year from 2010 through 2050, bringing "the miracle of compound interest" to bear on the long-term budget problem.

To be sure, deficit reduction of this, or any, magnitude in 2009 or 2010 is not only politically unimaginable but also unwise. Deficit-reduction measures should *not* go into effect while the economy is in recession or just beginning to recover. The right prescription now is for substantial

[3] Our projected fiscal gap has increased relative to our January 2007 projection of 3.2 percent of GDP through 2050 largely because we have followed CBO in including the federal revenue loss resulting from increasing private health care costs. See page 13 for more detail.

fiscal stimulus — i.e., for *increased* deficits — in order to infuse more demand into the slumping economy and ameliorate what threatens to be the most severe recession in at least a quarter century.

But measures to put the nation on a sustainable long-term fiscal path will be needed when the economy recovers. If little or no deficit reduction is enacted for a number of years, the deficit reduction required in subsequent decades will be even more massive than the $652 billion figure cited above indicates. Due to the power of compound interest, there is great disadvantage in delaying deficit reduction too far into the future.

Given the magnitude of the deficit reduction that ultimately will be needed, policymakers will almost certainly need to enact multiple deficit-reduction packages over several decades. At the same time, a number of pressing national and international problems will also demand attention, including global warming, disease and extreme poverty in a number of the world's poorest countries, the millions of uninsured Americans, levels of poverty and inequality in the United States that are very high for a western industrialized nation, and the need for investments in infrastructure, basic research, and education and training systems to boost U.S. competitiveness.

Main Causes of Rising Expenditures Are Health Care Costs and Demographic Changes

The main sources of rising federal expenditures are rising costs throughout the U.S. health care system and demographic changes, with health care costs playing the predominant role. Together, these two forces will cause the "big three" domestic programs — Medicare, Social Security, and Medicaid — to grow considerably faster than the economy. Collectively, these three programs now cost 9 percent of GDP; by 2050, they are projected to cost 19 percent of GDP.

Total spending for all other programs, including all domestic programs other than the "big three," is projected to grow *more slowly* than the economy in coming decades, so other programs do not contribute to the projected rise in deficits and debt. Of particular note, even aggregate spending for all entitlement programs outside of the "big three" is projected to grow more slowly than the economy. Common pronouncements that the nation's fiscal problems result from a general "entitlement crisis" are thus mistaken.

Tax Policy Choices Will Have a Major Impact on the Long-Term Problem

Tax policy decisions that Congress will make in the near future will have large implications for the size of the long-term fiscal problem. Allowing the 2001 and 2003 tax cuts to expire as scheduled would increase revenues by about 2 percent of GDP each year, reducing the fiscal gap through 2050 by almost half — from 4.2 percent of GDP to 2.3 percent.[4]

Stated another way, making the tax cuts permanent without paying for them would make the fiscal gap through 2050 more than 85 percent larger than it would otherwise be. If the fiscal gap

[4] If Congress offset the costs of *all* tax and spending policy changes enacted — including the costs of extending the 2001/2003 tax cuts and certain other temporary tax provisions, relief from the Alternative Minimum Tax, and relief from scheduled reductions in Medicare fees for doctors — the fiscal gap would shrink further, to 1.3 percent of GDP.

were measured over a period that extended beyond 2050, extending the tax cuts without paying for them would increase the size of the problem by a smaller, but still quite substantial, percentage.

These tax policy decisions have such a pronounced effect on the long-term fiscal outlook because they will be made very soon. Paying for some or all of the tax cuts that Congress chooses to extend would begin to reduce projected deficits, debt, and interest payments immediately, and those changes would compound over time.

Some observers discount the importance of the tax cuts, arguing that the long-term growth projected in the cost of federal health care programs is vastly more significant. True, the tax cuts cost about 2 percent of GDP while the growth of Medicare and Medicaid is projected to add more than 8 percent of GDP to federal program costs by 2050. But that growth in health care costs will occur gradually over 40 years, while paying for any extension of the 2001 and 2003 tax cuts would start improving the budget outlook almost immediately and have a powerful compounding effect on debt and interest payments over the next four decades.

At the same time, however, there is virtually no chance that policymakers will agree to pay for all of the tax cuts they extend. In addition, such a course would fall well short of what is needed to place the nation on a sustainable long-term fiscal path. If the tax cuts expired or were fully offset, debt in 2050 would still stand at 171 percent of GDP. Even if Congress fully offset the cost of extending *all* tax and spending policy changes that we assume will be continued — including the 2001 and 2003 tax cuts as well as relief both from the AMT and from the scheduled reductions in the fees that Medicare pays to physicians — debt would still reach 117 percent of GDP by 2050 and continue to mount after that.

Tough Changes, Including Health Care Reform, Will Be Required

These projections indicate that sooner or later, difficult choices will have to be made.

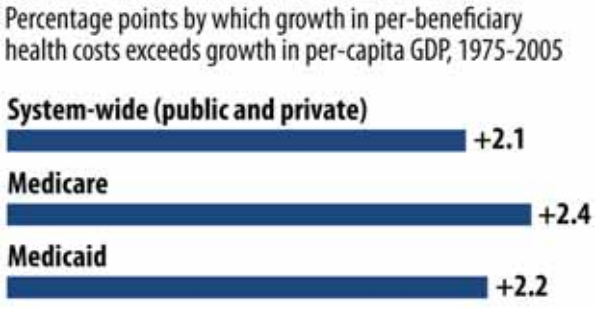
It would be both politically implausible and inadvisable on policy grounds to try to eliminate the fiscal gap solely by raising taxes or solely by cutting programs. Eliminating a fiscal gap of 4.2 percent of GDP would require the equivalent of an immediate and permanent 24 percent increase in tax revenues or an immediate and permanent 20 percent reduction in all programs, including Social Security, Medicare, defense and anti-terrorism activities, education, veterans' benefits, law enforcement, border security, environmental protection, and assistance to the poor. Thus, it is crucial that *both* sides of the budget — revenues and expenditures — be on the table when serious conversations about deficit reduction begin.

Addressing the nation's fiscal problem will also require fundamental reforms to the U.S. health care system, for two reasons. First, rising Medicare and Medicaid costs, the single largest contributor to the long-run budget problem, are largely driven by cost growth in the U.S. health care system as a whole, including private-sector health care. For the past 30 years, the average annual rate of increase in Medicare costs per beneficiary has essentially tracked the average rate of increase in per-capita health care costs system-wide, as Figure 2 shows. (The aging of the population also contributes to rising Medicare and Medicaid costs, but to a much smaller degree, and these demographic effects will level off after several decades. See Figure 3 on page 8.)

Second, rising private-sector health care costs depress federal revenues. A substantial portion of health care spending is non-taxable: employer-provided health benefits are excluded from taxable income, and various other provisions of the tax code allow individuals to pay some health care costs from pre-tax income. As a result, when health care costs grow faster than the economy, the share of total income that is exempt from taxation rises, and revenues fall below what they would otherwise be.

FIGURE 2

Cost Growth in Medicare and Medicaid Mirrors Health Care System as a Whole



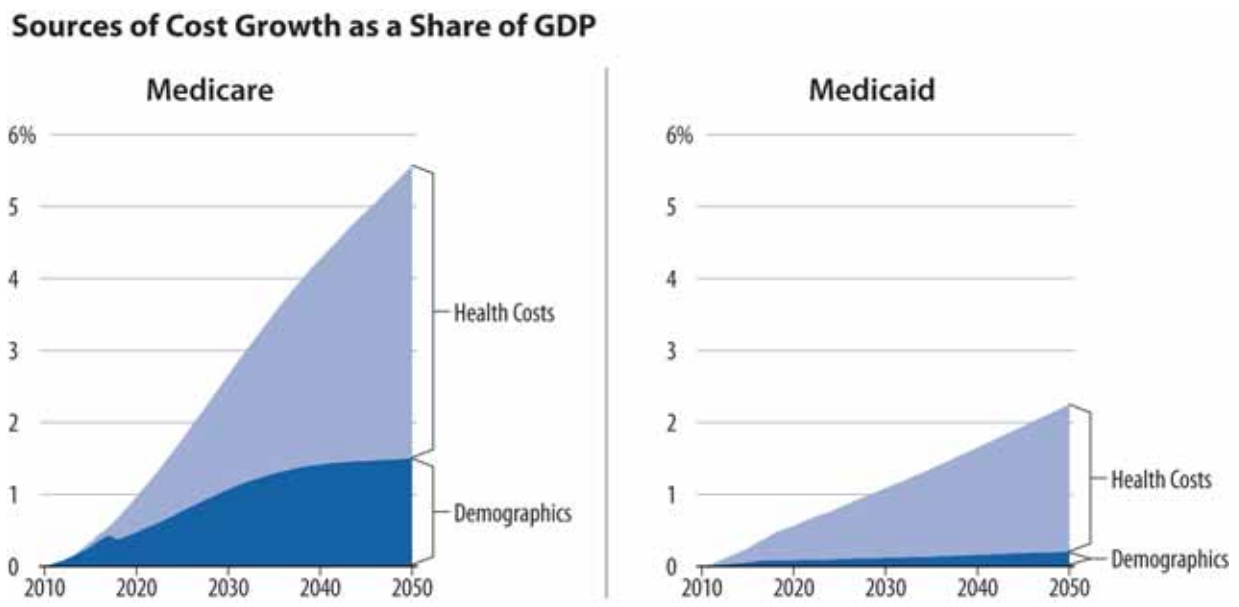
Source: CBO Long-Term Projections, December 2007

Slowing cost growth in the entire health care system will thus have the double benefit of decreasing federal health care spending and limiting the erosion of federal revenues caused by rising private-sector health costs.

In contrast, trying to slow rising health care costs in the public sector but *not* the private sector would require draconian cuts in Medicare and Medicaid that ultimately would have severe effects on the poor, the elderly, and people with serious disabilities. Moreover, such cuts would, to some extent, simply shift public-sector health care costs on to the private sector, for instance by forcing

FIGURE 3

Health Care Costs, Not Demographics, Are Main Drivers of Medicare and Medicaid Growth



Source: CBPP calculations based on CBO data

Note: "Demographics" denotes the program cost growth that would occur solely due to demographic changes if per-beneficiary health costs merely rose with per-person GDP. "Health costs" denotes the additional cost growth due to the fact that per-beneficiary health costs are growing faster than per-person GDP.

health care providers to give greater amounts of uncompensated care. (Providers would then pass these costs on to private-sector employers, employees, and patients.)

As former U.S. Comptroller David Walker has stated, "[F]ederal health spending trends should not be viewed in isolation from the health care system as a whole. For example, Medicare and Medicaid cannot grow over the long term at a slower rate than costs in the rest of the health care system without resulting in a two-tier health care system."[5] Similarly, Peter Orszag, former CBO Director and President-elect Obama's nominee for head of the Office of Management and Budget, has explained that

> Many analysts believe that significantly constraining the growth of costs for Medicare and Medicaid over long periods of time, while maintaining broad access to health providers under those programs, can occur only in conjunction with slowing cost growth in the health care sector as a whole. Ultimately, therefore, restraining costs in Medicare and Medicaid requires restraining overall health care costs.[6]

In short, system-wide reform of health care financing and delivery is essential to controlling federal health care spending — and federal expenditures generally.

Changes in Medicare and Medicaid need not be put off, however, until broader health reforms are implemented. For instance, Congress could act immediately to adopt the unanimous recommendation of its expert Medicare Payment Advisory Commission (MedPAC) to eliminate the large overpayments that Medicare makes to private insurance companies participating in the Medicare Advantage component of the program. In addition, policymakers should try to identify steps that could slow the growth of costs in Medicare through incentives for greater efficiency, rewards for quality, and elimination of excessive payments to providers. Changes such as these could serve as a model for efforts to slow the growth of costs in the rest of the health care system.[7]

Congress should also lay the groundwork now for more far-reaching efforts to control health care costs in the future. It should establish a vigorous research program on the comparative effectiveness of different health care treatments and procedures, a step MedPAC has also endorsed. And it should promote the adoption of electronic medical records and other forms of health information technology (IT). Although health IT will increase costs in the near term, it has the potential to reduce administrative expenses and duplicative procedures, improve the quality of health care, and generate data that can be used to identify more effective and less costly treatments.

Such comparative effectiveness analysis will not do much to reduce health care costs, however, unless the economic incentives to provide health care services are changed. For example, Medicare payments could be adjusted to encourage use of the most effective or most efficient treatment, and

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[5] David Walker, "Long-Term Fiscal Issues: The Need for Social Security Reform," testimony before the Committee on the Budget, U.S. House of Representatives, February 9, 2005, p. 18.

[6] Peter Orszag, "Health Care and the Budget: Issues and Challenges for Reform," testimony before the Committee on the Budget, U.S. Senate, June 21, 2007, p. 9.

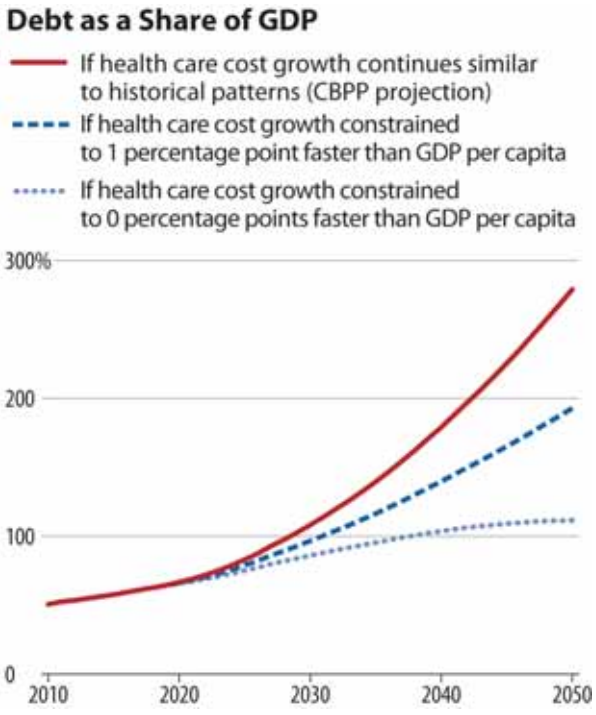
[7] See also Paul N. Van de Water, "Medicare Changes Can Complement Health Reform," Center on Budget and Policy Priorities, July 30, 2008, http://www.cbpp.org/7-31-08health.htm.

Medicare could make more extensive use of its demonstration authority to test approaches that link payments to cost and quality of care.

Dampening the growth in health care costs would improve the long-term fiscal outlook considerably. Over the past 30 years, costs per beneficiary in the health care system as a whole have grown about 2 percentage points faster than GDP per person, on average. Our long-term budget projections assume that this pattern will largely continue over the next 40 years. If instead, the growth of health care costs is limited to just 1 percentage point faster than the growth of GDP per capita, the projected fiscal gap would be closed by more than one-third—reduced from 4.2 percent to 2.7 percent of GDP. And if health care costs grew only at the same rate as GDP per capita, more than two-thirds of the fiscal gap would disappear, leaving a gap of 1.2 percent of GDP. (See Figure 4 for the growth in debt under these alternative scenarios.)

FIGURE 4

Health Care Cost Containment Would Shrink Debt Growth



Source: CBPP calculations based on CBO data CBPP assumptions about the impact of the recession on the federal budget.

The latter growth path of health care costs is almost certainly unachievable, however, even with major reforms. While the U.S. health care system contains significant inefficiencies that raise its costs, the growth in health care costs is driven largely by medical advances that tend to improve health and lengthen lifespans but also increase costs. Americans will doubtless want to avail themselves of the medical breakthroughs that will occur in the decades ahead, even if those advances entail significant costs.

Furthermore, ongoing economic growth will raise real (inflation-adjusted) incomes in coming decades, and Americans may choose to invest a growing share of that increase in income in securing better health and longer lives. The challenge therefore is to pursue major reforms that eliminate inefficiencies in the health care system and restrain cost growth to the greatest extent possible without unduly constraining medical progress or compromising health care quality (and without fostering new inequities in health care access).

If, as seems very likely, Americans conclude that better health and longer lives merit a somewhat larger share of their income in the future, it will be necessary to pay for these added costs, rather than simply pile up ever-mounting levels of debt. In terms of the federal budget, this means that the increases in federal health care costs as a share of GDP that occur even after health care reforms are instituted will need to be financed by increased revenues (including possibly new sources or types of revenues), reductions in projected expenditures for other programs, or a combination of the two.

In sum, solving the nation's long-term budget problems will require that political leaders enact program reductions and revenue increases *plus* extensive system-wide health care reform.

Our Projections

The projections presented here of expenditures and revenues through 2050 rest on estimates by CBO and our estimates of the fiscal impact of the recession and policy responses to it. In brief, we rely on CBO's September 2008 budget projections through 2018, the final year covered by those projections.[8] We adjust CBO's ten-year projections to account for the anticipated fiscal impacts of the recession and the financial crisis (see box on page 5) and for alternative policy assumptions that we make in certain cases. For years after 2018 we draw on CBO's December 2007 report on the long-term budget outlook, again adjusting those projections to reflect different assumptions about certain policies, as explained below.[9]

Budget projections necessarily reflect a great deal of uncertainty. We therefore find it inadvisable to entrust much confidence in estimates that project well beyond 40 years. We outline below the assumptions that underlie our projections and discuss the outcomes that would result from different assumptions. Our assumptions about health care cost growth largely drive our results, yet the future trajectory of health care costs is extremely uncertain — surely more so than the trajectory of federal expenditures in other areas of the budget. Nevertheless, our projections provide a guideline for understanding the long-term fiscal implications of the major choices that policymakers will face in coming years.

Methodology for Projections Through 2018

As noted, we base our expenditure and revenue projections through 2018 on CBO's September 2008 baseline budget projections, adjusted by CBO's projections of alternative policy scenarios and our estimates of the budgetary impact of the recession and the federal response to the financial and economic crises.[10] More precisely, we adjust baseline revenues to account for full extension of the 2001 and 2003 tax cuts and other temporary tax provisions (except for those contained in the temporary economic stimulus measures enacted in February 2008).[11] We also assume that the AMT will be indexed for inflation.[12] We adjust projected war expenditures to reflect a reduction in total troop levels in Iraq and Afghanistan to 75,000 by 2013, in accordance with one of CBO's two Iraq phase-down scenarios. (The other scenario assumes a phase-down more rapid than is likely to occur, especially given conditions in Afghanistan.)

We also assume that the substantial reductions slated in Medicare payments to physicians will continue to be cancelled, but that any increase in payment rates will be offset by savings elsewhere in

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[8] Congressional Budget Office, "The Budget and Economic Outlook: An Update," September 2008.

[9] Congressional Budget Office, "The Long-Term Budget Outlook," December 2007. These are the most recent long-term projections CBO has issued.

[10] Congressional Budget Office, "The Budget and Economic Outlook: An Update," September 2008, Table 1-8.

[11] Congress has enacted numerous tax provisions — including the corporate research and experimentation tax credit, the deduction of local and state taxes, and the deduction of expenses for classroom teachers — as "temporary measures" scheduled to expire after one or two years but then regularly extends them.

[12] This assumption is consistent with the alternative scenario provided by CBO.

the federal budget. After 2018, the projections assume that total payments to physicians will grow at the same rate as other Medicare spending.

Finally, deficit and debt projections for 2009 and subsequent years take into account the likely costs from government action to stabilize financial markets, including net government costs from the Troubled Assets Relief Program (TARP), and additional economic recovery measures expected to be enacted in early 2009. We use a round estimate of $500 billion for the net government losses from financial bailouts and another $500 billion for economic recovery (stimulus) legislation. Our projections also reflect the likelihood that the current recession will be deeper than CBO assumed in its September 2008 forecast.[13]

Expenditure Projections After 2018

Our long-term projections use the 2018 levels of spending and revenues from CBO's September 2008 budget projection, adjusted by the factors described above, as the starting point for years following 2018. We then apply what we believe are appropriate growth rates to the various categories of spending and revenues.

For instance, we project the growth of Social Security costs after 2018 in accordance with CBO's long-term budget projections.[14] We project that both Medicare and Medicaid will grow at the same rate as CBO's long-term projections show for the combined costs of the two programs.[15] (Because we use a composite growth rate, our projections for Medicare cost growth are slightly lower than CBO's and our projections for Medicaid are slightly higher, but our net federal health care growth rate exactly matches CBO's.)

In the cases of defense and domestic programs other than Social Security, Medicare, and Medicaid, we assume that overall costs will increase after 2018 at the rate of inflation plus population growth. This approach essentially assumes that these programs will continue providing the same real level of per-person services in the future as they do under CBO's baseline projections for 2018. This approach is consistent with the last 30 years of historical experience, during which programs other than the "big three" have, taken together, risen at a rate very close to the rate of inflation plus population growth.

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[13] In its September projections, CBO assumed that the economy would fall short of its potential by 3.3 percent of GDP in 2009, that this "output gap" would shrink gradually in subsequent years, and that it would largely disappear by 2012. (Potential output is the maximum sustainable — or "full-employment" — level of output.) Consistent with recent more pessimistic forecasts from Goldman Sachs (and others), we assume that the output gap will be larger, growing to about 5.0 percent of GDP in 2009. Like CBO, we assume the gap will shrink gradually thereafter. Also like CBO, we assume that the increase in the deficit caused by such a large output gap equals about two-fifths of the gap itself, consistent with the relationship observed during recent recessions.

[14] We based our Social Security projections on CBO's December 2007 comprehensive long-term projections rather than CBO's Social Security projections issued in August 2008 in order to keep our projections consistent with the long-run economic assumptions in CBO's December report. Because the August 2008 Social Security projections incorporated population and economic assumptions that differ sharply from CBO's December 2007 long-term projections, we could not apply CBO's August Social Security assumptions to its December projections of all other areas of the budget. To maintain consistency, we therefore have relied on the December 2007 long-term projections for Social Security and for other budget figures.

[15] We derive the growth rate from CBO's Baseline Extended scenario.

Joint Chiefs of Staff Chairman Michael Mullen has suggested that defense spending should always equal or exceed approximately 4 percent of GDP.[16] Other analysts argue that defense spending should reflect the nation's actual security needs rather than some arbitrary level. If total defense spending, including supplemental funding for wars, were maintained at no less than 4 percent of GDP over the next four decades, the fiscal gap through 2050 would *increase by a quarter*, to 5.3 percent of GDP. This would markedly increase the already daunting size of the program cuts and tax increases needed to achieve fiscal sustainability**.**

Revenue Projections After 2018

We base our long-term revenue projections on CBO's long-term Alternative Fiscal Scenario projections, and we assume that the recent tax cuts, certain other temporary tax provisions, and relief from the AMT are permanently extended.[17] Our revenue projections therefore reflect the consequences of maintaining most of the *policies* currently in effect, rather than maintaining current *law* (with its scheduled expiration of many tax provisions).

Our projections also account for a decrease in revenues that stems from our projections of private-sector health care spending (discussed below). As health care costs rise, employees are likely to receive a greater share of their compensation in the form of health benefits. Since such benefits are excluded from taxation, higher private-sector health care costs reduce the amount collected in income and payroll taxes. Moreover, increases in tax-deductible premium costs result in a further reduction in tax revenues.

We do not adopt CBO's assumption that the growth rate of private-sector health care spending will slow substantially on its own (see below); instead, we project that such spending will rise at the same rate per beneficiary as public-sector health care spending. We therefore modify CBO's revenue projections to include the additional revenue losses that result from our higher projected private-sector health care costs. As a result, we project a larger decrease in tax revenues due to the growth in private health care spending than CBO does.[18]

Private-Sector Health Care Expenditure Projections After 2018

We project that private-sector health care spending will grow at the same rate as CBO projects for combined Medicare and Medicaid spending. This approach is consistent with historical data showing that health care costs in both of these programs have increased at rates very similar to health care spending nationwide. (See Figure 2 on page 8.) CBO, in contrast, assumed that the

[16] Department of Defense News Briefings, September 26, 2008 and November 17, 2008.

[17] CBO's Alternative Fiscal Scenario projects revenue growth under the assumption that recent tax cuts, certain temporary tax provisions, and relief from the AMT are permanently extended, whereas CBO's Extended Baseline scenario projects revenue growth under current law (under which these provisions expire).

[18] Prior to its December 2007 long-term budget report, CBO had not estimated the revenue losses that will result from higher private-sector health care spending. As a result, the Center on Budget and Policy Priorities' January 2007 long-term budget projections contained no such revenue-loss estimate. In this report, we have adopted CBO's new approach. We also adjusted CBO's revenue-loss estimate to reflect the fact that we have assumed faster growth in private-sector health care costs than CBO did. The inclusion of the projected decline in revenues resulting from increased private-sector health care costs is the single largest reason that our current estimate of the fiscal gap is more than 1 percent of GDP higher than our January 2007 estimate.

private sector (and to a lesser degree, state governments) will reduce the rate of growth of health care spending per beneficiary below the growth rate for Medicare.

As noted, because we project private-sector health care spending at higher levels than CBO does, our projections for federal revenues are significantly lower than CBO's.

Projection Results

We project that once the economy recovers, deficits will be in the range of 4–5 percent of GDP over the next decade but will begin to grow rapidly not long after that and will climb from 4 percent of GDP in 2019 to 21 percent of GDP in 2050. Between now and 2050, expenditures will rise as a share of GDP, while revenues will decline.

Total non-interest expenditures are projected to reach 24.6 percent of GDP in 2050, compared with 19.2 percent of GDP in 2008. (See Table 1.) Between now and 2050, expenditures for Social Security, Medicare, and Medicaid are expected to grow by 10.4 percent of GDP. All other non-interest expenditures are projected to shrink by 5.1 percent of GDP.

TABLE 1

Deficits and Debt Will Grow As a Share of GDP Through 2050

	Revenues	Program Outlays	Interest	Surplus (+)/ Deficit (-)	Debt Held By the Public
2000	20.9%	16.1%	2.3%	+2.4%	35%
2010	16.9%*	21.3%	2.4%	-6.8%	51%
2020	17.7%	19.2%	3.2%	-4.6%	67%
2030	17.8%	21.8%	5.4%	-9.4%	108%
2040	17.4%	23.4%	8.7%	-14.7%	179%
2050	17.2%	24.6%	13.7%	-21.1%	279%

* The low levels of revenues in 2010 reflect the temporary effect of the recession.

Source: CBPP calculations based on CBO data and CBPP assumptions about the impact of the recession on the federal budget. See also footnote 19 and the box on page 5.

At the same time revenues — already too low to cover current expenditures — will fall further. Revenues, which stood at 20.9 percent of GDP in 2000 (a year of budget surplus) and 18.8 percent of GDP in 2007, are projected to decline to 17.2 percent of GDP in 2050.

Budget surpluses have been present in only four of the past 30 years. In each of these years, progressive tax policies (and a strong economy) helped to generate federal revenue levels around 20 or 21 percent of GDP.

As health care costs rise and the population ages in coming decades, the demand for federal revenues will increase. Even if system-wide health care reform manages to control costs in the near term and Social Security solvency is secured, health care costs will likely rise over the long run and exert continued pressure on revenues. Increased revenues will be needed to cover these growing costs. The alternative — to finance the government in future decades at *current* revenue levels —

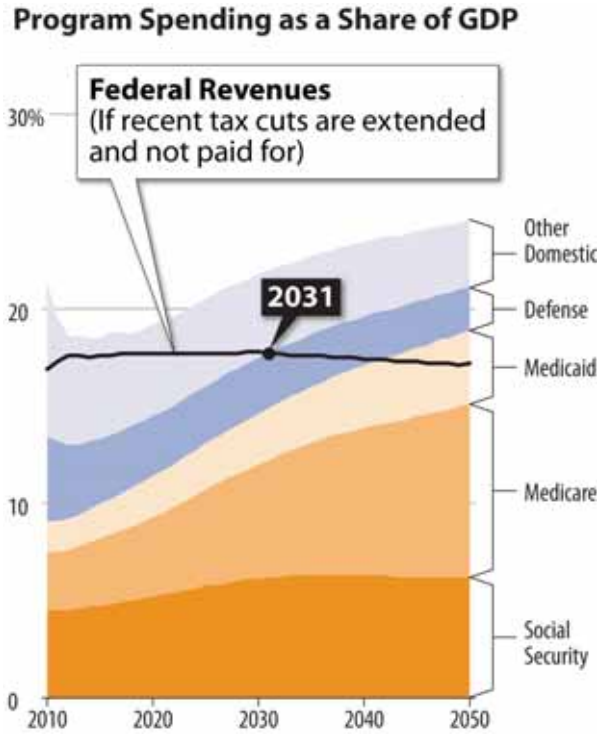
would require budget cuts so massive that they almost certainly would be unachievable politically. Cuts of this magnitude would also be undesirable from a policy standpoint.

A balanced approach consisting of reforming the U.S. health care system, raising revenues, and stemming expenditure growth will thus be critical to avoiding the crushing deficit and debt levels that we project for future decades.

In fact, the budget situation will become critical long before 2050, as Figure 5 shows. By 2031, expenditures in just four program areas — Social Security, Medicare, Medicaid, and defense — are projected to consume *all* federal revenues. The programs *not* included in these four areas — everything from education, transportation, and housing to nutrition, veterans' programs, law enforcement, international affairs, border security, environmental protection, and many others —constituted just over a third of federal program spending in 2008, or $921 billion. Those programs clearly are not about to disappear *en masse*. Moreover, Figure 5 does not show the cost of paying interest on the debt, which will grow to enormous levels without changes in fiscal policy.

FIGURE 5

By 2031, "Big 3" Programs Plus Defense Would Consume All Federal Revenue



Source: CBPP projections based on CBO data and CBPP assumptions about the impact of the recession on the federal budget.

As a result of these trends, revenues, which are already inadequate today to finance government programs and pay interest on the debt, will prove even less adequate in coming years. The federal government is projected to run large deficits every year from now through 2050 — deficits large enough to increase the debt-to-GDP ratio markedly. That, in turn, will cause interest payments to balloon, enlarging deficits still further and adding still more to the debt.

This "calamity of compound interest" will cause the federal debt to explode from a projected 46 percent of GDP at the end of 2009 to 279 percent of GDP in 2050.[19] Moreover, the interest costs

[19] We base our GDP growth and interest rate assumptions on CBO's, which do not reflect the economic impact of fiscal policies on growth rates and interest rates over the long term. If the explosion in debt and deficits outlined above actually occurred, interest rates would almost certainly rise and growth would slow. As a result, deficits and debt would increase even more rapidly as a share of the economy than we project in this analysis.

However, the main goal of analyses like ours (and those produced by CBO and others) is to determine the magnitude of the policy changes necessary to solve the nation's fiscal problems, not to determine what would happen if the nation's fiscal problems were never solved. By definition, if policy changes are made that solve the long-term problem, the fiscal calamity described would not come to pass and the negative economic effects of fiscal collapse would not materialize. Hence, when considering possible policy solutions and quantifying their effects, one should do so under economic assumptions like CBO's and ours, not under assumptions that presume economic collapse.

accompanying such a high level of debt would be huge: they would consume 14 percent of GDP, or 80 percent of projected federal revenues, in 2050.

Deficits and debt of this magnitude are widely recognized to be damaging to the economy over the long term. Persistently high levels of deficits and debt would ultimately push interest rates up and crowd out productive investment, reducing economic growth and, thereby, people's incomes. To the extent that foreign investors lend us money and so ameliorate the upward pressure on interest rates, those investors — rather than U.S. investors — will benefit from the interest payments, which would also reduce incomes in the United States. The impact of this process would be felt gradually over a long period of time.

Alternatively, the negative impact of large, sustained deficits of the type we describe in this paper could be more sudden. For example, former Treasury Secretary Robert Rubin, former CBO Director and President-elect Obama's nominee for head of the Office of Management and Budget Peter Orszag, and Wall Street economist Allen Sinai have warned that, at some future point *before* debt reaches the very high levels that we project for coming decades, "ongoing deficits [of very large magnitude] may severely and adversely affect expectations and confidence, which in turn can generate a self-reinforcing negative cycle among the underlying fiscal deficit, financial markets, and the real economy."[20]

It is important to note that the potential financial crisis Rubin, Orszag, and Sinai warn about is not the one we are currently experiencing. In the current situation, private and government investors want to hold U.S. Treasury debt because Treasury securities are regarded as less risky than any other asset. Once the current crisis is resolved, however, the specter of excessive and rising U.S. debt levels for decades to come could lead foreign investors to lose confidence in U.S. government securities, a development that would have troubling implications for the U.S. and the world economies. Failure to address the nation's long-term budget problems could thereby contribute to another international economic crisis.

[20] For more detailed discussion of how a sudden crisis could develop, see Robert E. Rubin, Peter R. Orszag, and Allen Sinai, "Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray," Brookings Institution, January 5, 2004, http://www.brookings.edu/papers/2004/0105budgetdeficit_orszag.aspx.