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CBO's Long Term Budget Outlook
July 1, 2010

Yesterday, the Congressional Budget Office (CBO) issued its Long Term Budget Outlook. Under CBO's "Extended-Baseline Scenario," the long-run fiscal picture has slightly worsened over the next twenty years, compared to last year, but significantly improved over the longer run – due largely to the impact of health care reform on spending and especially revenues. However, CBO's overall analysis shows the budget to be on an unsustainable path, with debt moving to unprecedented and cripplingly high levels.

Under current law, CBO projects that public debt will rise from 62 percent of GDP this year, to 84 percent by 2040, and to 107 percent by 2080. This scenario is highly optimistic, since it assumes that all the 2001/2003 tax cuts will expire this year as scheduled, there will be no AMT patches or doc fixes, all of the savings in the health care bill will be sustained over the next two decades, and revenues will eventually exceed 30 percent of GDP.

Under CBO's Alternative Fiscal Scenario, which does not make these assumptions, debt will rise to 87 percent by 2020, 233 percent by 2040, and to 854 percent by 2080.

Markets would not permit such high levels of debt accumulation, though. As Herbert Stein once said, "If something can't go on forever, it will stop." Yet there is a corollary – it matters how. Enacting gradual tax and spending adjustments today, on our own terms, is far more beneficial than waiting for a fiscal crisis to occur to force change. Therefore, as the Peterson-Pew Commission on Budget Reform has recommended, policymakers should act immediately to put in place a credible plan to stabilize the debt gradually as the economy recovers.

Some of our other main takeaways from this week's CBO reports are:

- Healthcare cost growth continues to be a major threat to the budget and additional changes to Medicare and Medicaid will be necessary.

- Population aging is the most important driver of spending growth over the next several decades. Programs affected by aging will have to be reformed to control spending.

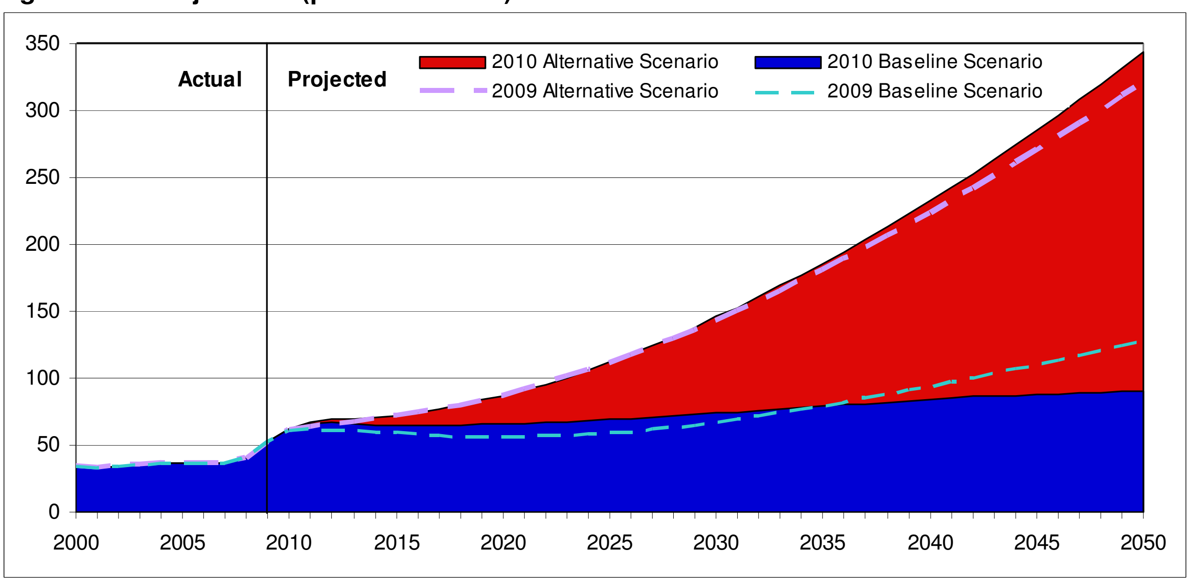
- Under CBO's Alternative Fiscal Scenario, interest costs are projected to grow ten-fold as a share of the economy - from 1.4 percent of GDP this year to over 16 percent of GDP by 2050.

- The very large difference between the Extended-Baseline Scenario and the Alternative Fiscal Scenario emphasizes the critical point that fully offsetting the costs of extending any expiring policies (or not extending them) and sticking to the planned healthcare savings is extremely important in controlling the growth of the debt.

The Long-Term Debt Outlook

The CBO produces two sets of long-term projections. Under the "Extended-Baseline Scenario," the CBO assumes that future spending and revenue levels generally continue as under current law. Under the "Alternative Fiscal Scenario," CBO assumes that lawmakers will continue to enact new legislation in order to maintain certain policies currently in place. In the near term, this includes continued AMT patches; renewal of the 2001/2003 tax cuts, except for high earners; and future "doc fixes" to avoid cuts in Medicare payments to physicians. The alternative scenario also assumes faster growth in spending other than for Social Security and health care. Beyond 2020, the Alternative Fiscal Scenario assumes that revenues stay fixed as a share of GDP, and that several policies to control health care cost growth would not stay in effect.

Fig. 1: Debt Projections (percent of GDP)



Though the Alternative Fiscal Scenario is a much closer representation of current policy in the near-term, there is a considerable amount of uncertainty with regards to the long-term. In some ways, these two scenarios can be thought of as upward and downward bounds of what is possible under a variety of current policy scenarios.

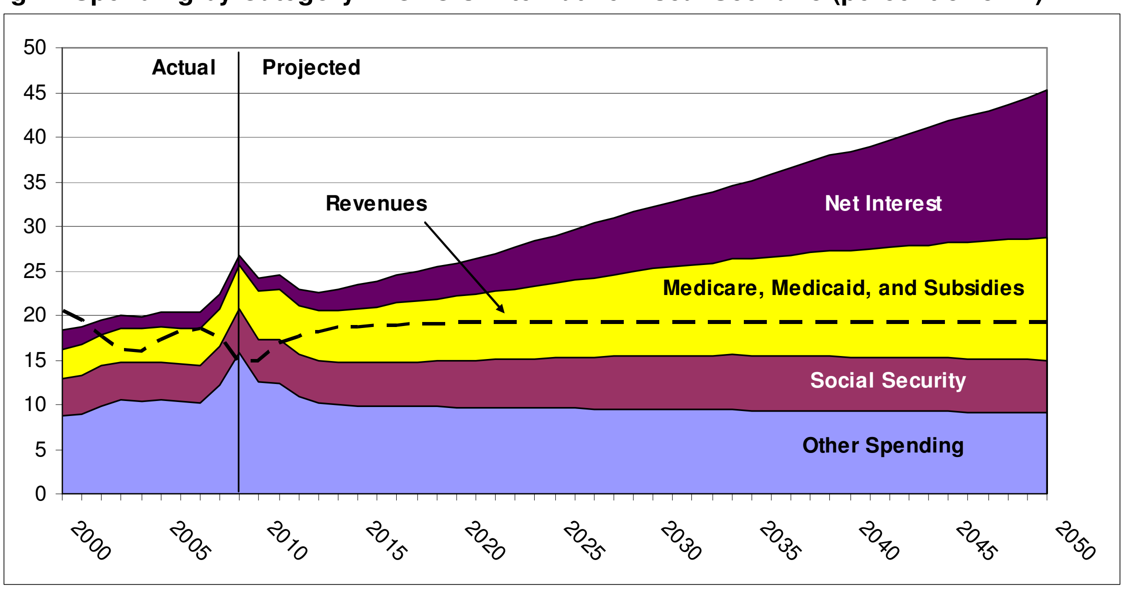
Under the baseline scenario, public debt is set to slowly grow as a share of the economy over the next 75 years, breaching 100 percent in 2074. Under the alternative scenario, debt would reach that level by 2023, and soar to unsustainable and unimaginable levels thereafter. Even if the savings from revenue and spending components of the health care act were allowed to continue, as under current law, this would still be the case.

Spending and Revenues

Over the long-term, spending is projected to grow well beyond historical averages – and well above revenues. Under the Alternative Fiscal Scenario, spending will reach 35 percent of GDP by 2035, and 75 percent of GDP by 2080 – primary (non-interest) spending would exceed 26 percent and 34 percent of GDP, respectively. Primary spending is only 3 or 4 percent of GDP lower under CBO's Extended-Baseline Scenario (the difference is largely due to the "doc fix" and other primary growth).

Primary spending growth will come primarily from Medicare and Medicaid, but also from Social Security. Federal health spending (Medicare, Medicaid, exchange subsidies, and SCHIP) is projected to grow from 5.5 percent of the economy today, to nearly 11 percent by 2035 (about 10 percent under the Extended-Baseline Scenario), and about 20 percent by the end of the 75-year window (18 percent under the Extended-Baseline Scenario). Social Security is expected to grow from 4.8 percent of GDP this year to 6.2 percent by 2035, and then remain around that level thereafter.

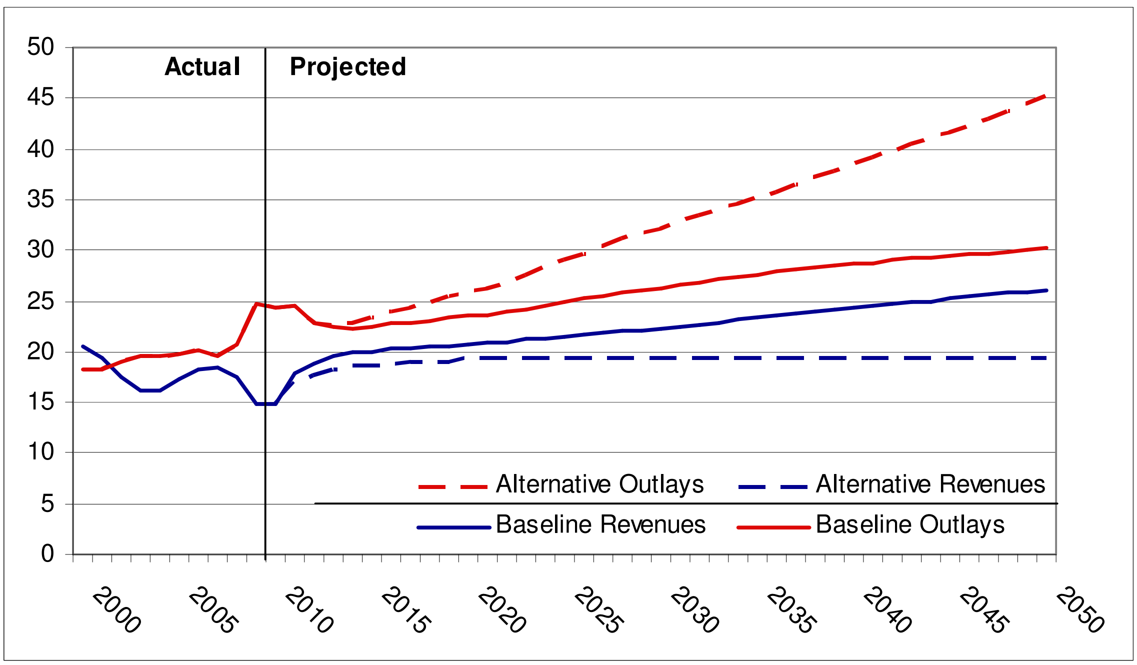
Fig. 2: Spending by Category in CBO's Alternative Fiscal Scenario (percent of GDP)



If these spending increases are not funded with higher taxes – and at least in the Alternative Fiscal Scenario they are not – they will result in massive accumulation of debt and, therefore, interest payments. Today, interest payments on debt are 1.4 percent of GDP, or less than 6 percent of the budget. Under the Alternative Fiscal Scenario, they will grow to 3.8 percent of GDP by 2020, 8.7 percent by 2035, and 41 percent by 2080.

If spending reaches these projected levels, it would represent a dramatic departure from the past, where we have historically spent about 21 percent of GDP, and never more than 23.5 percent in peace time. This is especially troubling if revenues remain at 19.3 percent of GDP (already well above historical averages of about slightly above 18 percent) after 2020.

Fig. 3: Projected Outlays and Revenues (percent of GDP)



Yet, even under the current law revenue scenario – in which all the 2001/2003 tax cuts expire at the end of this year, policymakers discontinue the annual practice of enacting AMT patches, real bracket creep continues unfettered into perpetuity, and the excise tax on high cost health care plans grows to raise an increasing amount of revenue (3 percent of GDP by 2080) – revenues will fall short of spending. And under this scenario, revenue will grow to 30 percent of GDP. That's twice as large a share of the economy as we will raise in 2010, and nearly 50 percent greater than any time in our history.

Drivers of Entitlement Spending Growth

Two factors are key in driving the growth of entitlement spending – health care cost growth and population aging. Despite health reform, CBO projects health care costs to grow faster than the economy over the longer term under both scenarios (details are described in the next section). This health care cost growth will drive up per-person costs for Medicare and Medicaid, as well as for exchange subsidies and other federal health programs.

Meanwhile, the combination of steadily growing life expectancy, stable fertility rates, and the retirement of the large baby boom generation means that more and more people will become eligible for Social Security and Medicare, and will draw more heavily on certain parts of Medicaid.

Through 2035, population aging will be the more dominant factor, accounting for about 63 percent of the growth in entitlement spending (when interactions are distributed proportionally), and 45 percent of the growth in federal health programs. By 2080, aging will account for 44 percent and 29 percent of growth in these spending categories, respectively, with the majority of both attributable to excess health care cost growth.

Fig. 4: Factors Explaining Future Entitlement Spending Growth

	Percent Attributable to:	
	Aging	**Excess Health Care Cost Growth**
Health Care Programs and Social Security		
2035	63%	37%
2080	44%	56%
Health Care Programs Only		
2035	45%	55%
2080	29%	71%

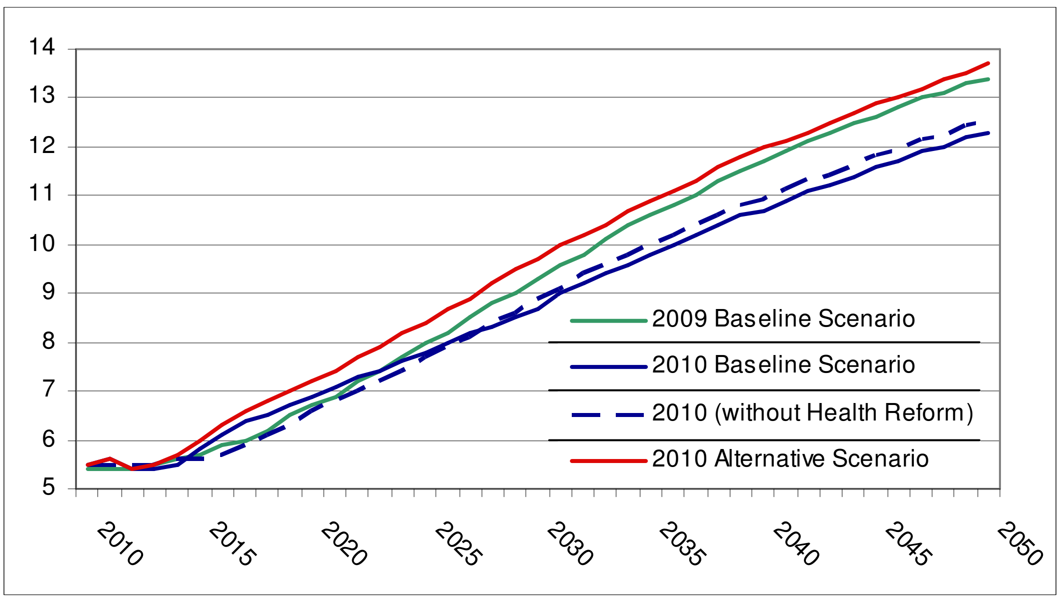
It is worth noting that aging and health care cost growth not only drive entitlement spending, they also undermine the revenue base. The former does so by reducing the proportion of tax-paying workers, and the latter does so by way of the employer-sponsored insurance exclusion which leaves compensation in the form of health insurance untaxed. (Note that the excise tax on high cost insurance plans will partially offset this second effect, having an ever greater effect over time assuming policy makers allow it to be indexed at the low rate written into the law.)

The Impact of Health Care Reform

As part of the Long-Term Outlook, CBO has updated its health care spending projections to reflect the recently-passed health care reform legislation. The legislation makes a number of changes with major budgetary consequences, including expanding Medicaid, providing insurance subsidies, enacting changes to cut the level of Medicare spending, making changes to reduce the growth of Medicare, and raising new revenues in a variety of ways.

CBO projects these changes will reduce deficits by $143 billion over the next decade, but beyond the first decade the impact of the health care legislation is highly uncertain. This is true for several reasons, including the natural uncertainty of the inputs which determine health spending in the first place, the additional uncertainty of estimating the effects of a variety of changes with no historical precedent, the difficultly in disentangling the effects of the legislation from changes which may have occurred absent reform, [1] and the potential unsustainability of some provisions in the bill.

Fig. 5: Federal Spending on Medicare and Medicaid (percent of GDP)



Before estimating the impact of the health reform legislation, CBO altered its methodology for projecting health care spending and as a result projects lower spending than it did in 2009. Among their changed technical assumptions, CBO assumes that excess cost growth is slower, and that it does not differ between government programs.

[1] Prior to their analysis of health reform, the CBO had already projected a gradual decline in excess health care cost growth, resulting from changes in private, state, and federal regulatory behavior. The extent to which health care reform preempted or altered any of these assumed changes is highly uncertain.

Although these changes are not related to the health care legislation, they are consistent with some of its likely effects since it would tend to slow Medicare cost growth in a way that would bring it more closely in line with Medicaid.

CBO estimates the impact of the health reform legislation differently under its two scenarios. Through 2020, both scenarios track CBO's earlier estimates of the bill – although the Alternative Fiscal Scenario assumes Congress will continue to enact "doc fixes" as they have since 2003**.** In the following decade, the Extended-Baseline Scenario uses broad growth rates to assume continuation of current law, while the Alternative Fiscal Scenario assumes policymakers will override provisions which would continue to slow Medicare cost growth and hold down growth of the new exchange subsides. Beyond 2030, under both scenarios, CBO assumes federal health spending will grow at rates consistent with its pre-reform long-term model.

Put another way, the two scenarios differ in the *level* of projected federal health spending – since the Alternative Fiscal Scenario assumes the enactment of doc fixes and the prevention of cost containment measures from health reform after 2020. However, beyond 2029, the two scenarios do not differ from each other or from pre-reform projections (except due to methodological differences) in terms of the *growth rate* of federal health spending. This does not mean that the legislation does or doesn't bend the health care cost curve, but is rather the result of the lack of any type of analytical basis for estimating the effects of reform.

Though it is entirely possible that provisions in the health reform legislation could further reduce costs, CBO and others have questioned the long-term sustainability of some provisions – particularly those which keep Medicare provider payments growing at a significantly slower rate than before. As CBO remarks, "it is unclear whether that lower rate of growth can be sustained and, if so, whether it will be accomplished through greater efficiencies in the delivery of health care or will instead reduce access to care or diminish the quality of care (relative to the situation under prior law)."

Note that the health legislation would also increase revenues – by about 0.5 percent of GDP in 2020 and 1.2 percent by 2035. By 2080, under the Extended-Baseline Scenario, the tax on high cost health plans alone is projected to raise over 3 percent of GDP; other revenue provisions would probably raise another percent or so of GDP.

Under CBO's Alternative Fiscal Scenario, revenues remain constant as a share of GDP after 2020. In that sense, one could think of health reform as permanently increasing revenue by 0.5 percent of GDP

Conclusion

Regardless of what effect health reform actually has, the long-term budget remains on an unsustainable path. If we simply continued on our current policy path through 2020, our debt will grow to 87 percent of GDP in that year, and to unprecedented levels soon after. Under any scenario, Social Security will grow by 1 to 1.5 percent of GDP and federal health spending will grow many times more.

The lower levels of debt under CBO's Extended-Baseline Scenario demonstrate the importance of paying for any renewal of the tax cuts and maintaining cost controls in the health reform bill as long as possible. But they do not exempt policy makers from further necessary changes.

Growing levels of spending and therefore debt should be tackled sooner rather than later -- through some combination of further health care changes, Social Security reform, general spending reductions, and tax reform. Though major changes should not occur until the economy has recovered, a plan should be put in place immediately.

As CBO explains: "taking those actions earlier would lead to higher output in the long run, enhance the well-being of future generations, and reduce the risk of a fiscal crisis."