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**The Long Term Budget Outlook
June 29, 2009**

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Last week, the Congressional Budget Office (CBO) released its Long-Term Budget Outlook. The reports suggests a brief window in which deficits subside a bit, after which the effects of health care cost growth and population aging will drive them rapidly upward and bring the national debt to unprecedented and intolerable levels.

Under current law, CBO projects debt held by the public will rise from less than 40 percent of GDP before the economic crisis to nearly 100 percent by 2040 and 300 percent by 2083. If current policies are continued, CBO projects the debt will rise to 100 percent by the early 2020s, to 200 percent before 2040, and eventually to 750 percent.

CBO points out that the economy cannot bear these levels of debt:

CBO's long-term budget projections raise fundamental questions about economic sustainability.... Large budget deficits would reduce national saving, leading to more borrowing from abroad and less domestic investment, which in turn would depress income growth in the United States. Over time, the accumulation of debt would seriously harm the economy... In addition, a worsening fiscal situation might put pressure on monetary policy, potentially endangering the Federal Reserve's ability to keep inflation low and stable. If the budget continued along the path of rising debt, serious concerns about fiscal solvency would arise.

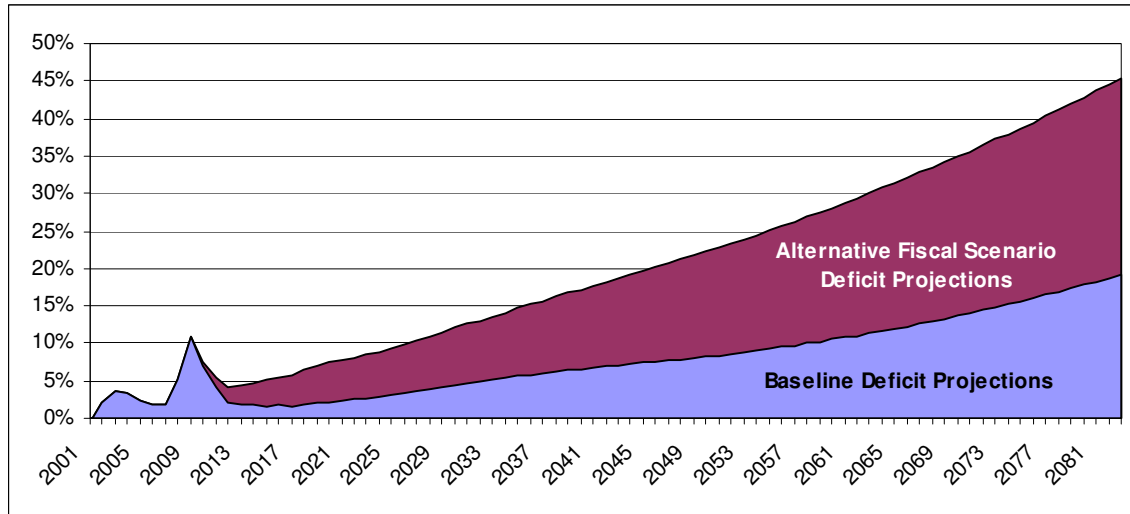
Ultimately, revenue increases and/or spending cuts will be necessary to prevent "a vicious cycle in which the government had to issue ever-larger amounts of debt in order to pay ever-higher interest charges." As interest payments grow from 4 percent of spending in 2009 to 12 to 15 percent by 2020, an unanticipated uptick in interest rates -- which could easily result from fiscal pressures -- would further erode the budget situation.

Given the severity of both the short and long-term outlook, we strongly advise policy makers to act promptly to put measures in place to slow the accumulation of our mounting debt. Failure to act could result in a full-blown fiscal crisis and an erosion of the U.S. economy.

Ever-Growing Deficits

If we continue on our current path, according to the CBO, deficits will persist and grow, driving public debt to untenable levels. The CBO makes two sets of long-term projections: the “extended baseline scenario,” which essentially assumes current law, and the “alternative fiscal scenario,” which assumes policy makers continue a number of current practices such as maintaining physicians payments in Medicare, continuing to patch the Alternative Minimum Tax, renewing the 2001/2003 tax cuts, and allowing discretionary spending to grow with GDP rather than inflation over the next decade.

Fig. 1: Deficit Projections (percent of GDP)



In either case, the budget is on an unsustainable path, but the situation is far worse if we continue current policies (illustrated in the alternative fiscal scenario). Under its baseline scenario, CBO projects deficits will briefly drop below 2 percent of GDP in the next decade before rising to above 5.5 percent in 2035, 8 percent in 2050, and over 19 percent by the end of the 75-year window. Under its alternative scenario, deficits would never drop below 4 percent of GDP, would hit 15 percent by 2035, and would surpass 45 percent of GDP by the end of the 75-year period.

In part because of the effects of the economic crisis, the long-term outlook has significantly worsened since CBO last made these projections in late 2007. The fiscal gap, which measures the present-value of the disparity between revenue and outlays over a given period of time, is considerably larger in the current report than it was at that time.

Fig. 2: Fiscal Gap as Measured by CBO in 2007 and 2009 (percent of GDP)

Projection Period	Extended Baseline		Alternative Scenario	
	2009	2007	2009	2007
25 Years	2.1%	-0.7%	5.4%	2.8%
50 Years	2.6%	0.6%	6.9%	5.2%
75 Years	3.2%	1.7%	8.1%	6.9%

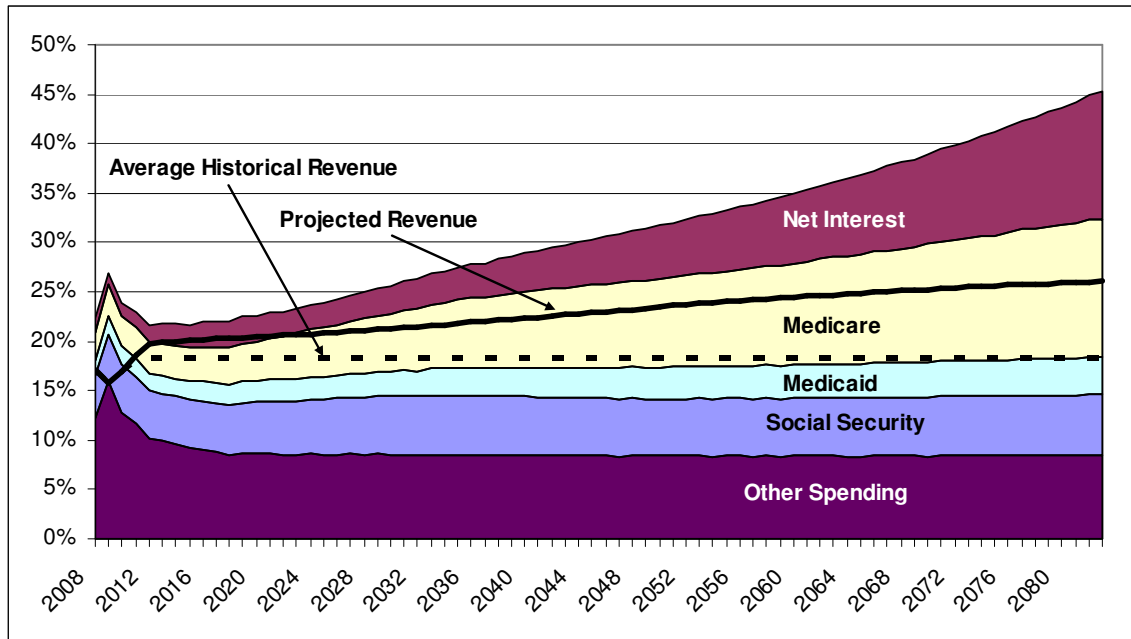
Sources of Rising Deficits

Over the long-term, both spending and taxes are estimated to grow well beyond their historical averages. Rising deficits are caused by spending growing considerably faster than revenue. CBO's baseline scenario projects spending to more than double as a percent of GDP over the next 75 years, while revenues increase by approximately 40 percent. Under the alternative scenario, spending would more than triple while revenues would grow by around 20 percent.

Projected spending increases come mainly from the growth of Medicare and Medicaid, and to a lesser extent Social Security. The Social Security program is projected to grow from 4.8 percent to 6 percent of GDP over the next two decades, without much change in the magnitude of its dedicated revenue source. Medicare and Medicaid, meanwhile, are projected to grow from 5 percent of GDP today to 8.5 percent by 2030, over 12 percent by 2050, and nearly 18 percent by the end of 75-year window.

All of this is compounded by the continued accumulation of debt, resulting in higher net interest payments. Although a relatively small portion of our budget today at 1 percent of GDP, interest on the debt would grow to consume 12 percent of GDP by 2080 under CBO's baseline scenario or 30 percent under its alternative scenario. Of course, even the baseline scenario displayed below would be unlikely to occur, since investors and lenders would not allow the United States to accumulate such high levels of debt. But this projection represents the magnitude of the gap that must be closed.

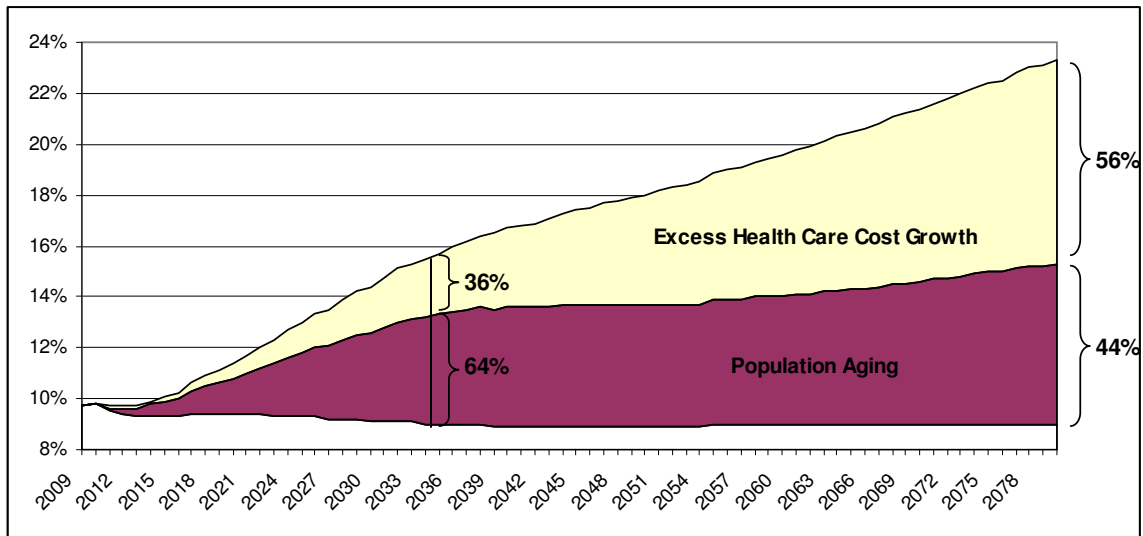
Fig. 3: Spending Growth by Category under Extended-Baseline Scenario (percent of GDP)



Drivers of Entitlement Growth

Growing entitlement costs are driven by a combination of population aging and growth in health care costs. As the baby boomers begin to retire, life expectancy increases and fertility remains around replacement, the population as a whole is getting older. The result is greater collection of Social Security and Medicare benefits and higher costs for Medicaid. At the same time, overall health care costs have been growing around 2.5 percent faster than the economy each year (this is referred to as “excess cost growth”), resulting in higher costs for Medicare and Medicaid.

Fig. 4: Factors Impacting Growth of Medicare, Medicaid, and Social Security (percent of GDP)



When CBO allocates the interaction effects of the two causes proportionally, population aging is projected to have driven 64 percent of entitlement growth (including 44 percent of Medicare and Medicaid growth) in 2035. Over time, excess cost growth in health care is projected to overtake population aging, accounting for 56 percent of entitlement growth (and 70 percent of Medicare and Medicaid growth) in 2080. (See <http://www.usbudgetwatch.org/budgetblog/2009/aging-health-costs-and-long-term-budget-outlook-650> for a discussion of CBO’s measurements of their relative effects).

To address excess cost growth, policy makers must enact policies to reduce overall health care costs from their current trajectory. However, given the role of demographics in driving entitlement growth – especially over the next few decades – health care reform will not be sufficient to control the deficit.

Some actions can be taken to address aging, of course, including enacting policies to increase the size of the labor force, encourage longer work lives, or increase national savings and investment. But ultimately, the long-term budget outlook will necessitate serious tax and spending changes. Absent such changes, we face the real threat of a fiscal and economic crisis more severe than what we’ve already endured.