



October 4, 2011

Honorable Chris Van Hollen
Ranking Member
Committee on the Budget
U.S. House of Representatives
Washington, DC 20515

Dear Congressman:

This letter responds to your September 27, 2011, request for an estimate of the portion of the federal deficit that is due to the current underutilization of capital and labor resources in the economy. The Congressional Budget Office (CBO) estimates that if those resources were not underutilized—that is, if the economy was operating at its potential level—the projected federal deficit under current law in fiscal year 2012 would be about a third lower, or roughly \$630 billion instead of the \$973 billion projected in CBO’s most recent baseline. That deficit would be equal to about 4.0 percent of gross domestic product (GDP), compared with the 6.2 percent deficit projected for 2012 in CBO’s baseline. If the economy was operating at its potential, the deficit would be lower because incomes and, therefore, revenues would be higher, while the rate of unemployment and, therefore, outlays for certain government programs would be lower.

How CBO Developed Its Estimate

CBO calculated its estimate of the portion of the deficit attributable to those “cyclical” factors, about \$340 billion, using the same methodology that the agency uses to estimate the so-called automatic stabilizers—the automatic responses of revenues and outlays to changes in real (inflation-adjusted) output and unemployment.¹ Specifically, CBO estimated what taxable income would be if output equaled its potential; under those circumstances, taxable income (as measured in the national income and product accounts maintained by the Department of Commerce’s Bureau of Economic Analysis) would exceed the taxable income currently projected by about \$850 billion (or by about 7½ percent). CBO translated that difference into an estimate of how much higher revenues would be in the absence of cyclical factors.

¹ See Congressional Budget Office, *The Effects of the Automatic Stabilizers on the Federal Budget* (April 2011).

For outlays, CBO estimated what unemployment would be if output equaled its potential and the recession's temporary effects on unemployment did not occur; under those circumstances, the unemployment rate would be 5.2 percent. Then, CBO translated the difference between that number and the 8.8 percent average unemployment rate for 2012 that the agency projected in August into an estimate of how much lower spending for unemployment insurance benefits and other income support programs would be in the absence of cyclical factors.²

CBO's estimate does not include the effect of economic factors that are not directly cyclical—such as inflation and interest rates—even though they affect the budget and can be influenced by the rate of economic growth. For example, a higher rate of inflation would raise the dollar amount of taxable income and thus boost federal tax receipts. In addition, spending that is indexed for inflation (Social Security benefits, for example) would increase. If interest rates also rose, federal interest payments would be higher as well.

How This Estimate Differs from Other Types of Estimates

The portion of the deficit attributable to cyclical factors differs from estimates that might be derived using CBO's "rules of thumb" that describe how the budget balance would differ if certain economic outcomes were different from the projections.³ The estimates in this letter (based on the methodology used to estimate the automatic stabilizers) are meant to capture temporary cyclical effects on the budget. The rules of thumb showing the budgetary effects of different economic outcomes illustrate the budgetary impact of sustained changes in the rate of growth of GDP and other economic variables.

Similarly, the estimate of the portion of the deficit stemming from cyclical factors differs from the changes in receipts and outlays that occur in CBO's baseline budget projections as output is projected to rise toward its potential over the next several years and unemployment falls to a corresponding rate. Revenues are projected to rise as a share of GDP for a number of reasons aside from those accounted for by the automatic stabilizers. For example, the expiration of various tax provisions, changes that are independent of the business cycle in the shares of national income attributable to various income sources, and "real bracket creep" in the individual income tax all affect the change in receipts as a share of GDP over time. In addition, corporate income tax receipts remain below the amount

² In its *The Budget and Economic Outlook: An Update* (August 2011), CBO projected an average unemployment rate of 8.8 percent during fiscal year 2012, compared with 5.2 percent in the absence of the temporary effects of the recession. Hence, CBO's estimate that the cyclical portion of the deficit in 2012 is about \$340 billion implies that the deficit would decline by about \$95 billion for each 1 percentage-point decline in the unemployment rate. That dollar amount depends on the level of potential GDP; CBO estimates that, on average, over the past 50 years, the budget's automatic responses to a 1 percentage-point reduction in the unemployment rate would have reduced the deficit by about ½ percent of potential GDP.

³ See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021* (January 2011), Appendix B.

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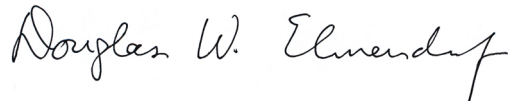
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that can be explained by currently available data on profits, and CBO expects that the factors generating that disparity will gradually disappear and that receipts will rise to more closely match their historical relationship to profits. The degree to which that projected increase in receipts represents cyclical versus other effects is not readily apparent.

Likewise, certain sorts of outlays are projected to decline as a share of GDP for reasons aside from those accounted for by the automatic stabilizers. For example, factors other than the rate of unemployment affect baseline outlays for unemployment insurance by affecting the number of beneficiaries and the amount and duration of benefits. Those factors include, for example, recent changes to state laws that govern those benefits, the growth of the labor force and average wages, and the average duration of unemployment.

I hope that you find this information useful. If you have any questions, please feel free to contact me or CBO staff. The primary staff contact for this analysis is Frank Russek.

Sincerely,

A handwritten signature in cursive script that reads "Douglas W. Elmendorf".

Douglas W. Elmendorf
Director

cc: Honorable Paul Ryan
Chairman