97th Congress
2d Session

JOINT COMMITTEE PRINT

THE UNDERGROUND FEDERAL ECONOMY: OFF-BUDGET ACTIVITIES OF THE FEDERAL GOVERNMENT

A STAFF STUDY

PREPARED FOR THE USE OF THE

SUBCOMMITTEE ON MONETARY AND FISCAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

APRIL 20, 1982

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

92-362 O WASHINGTON : 1982

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402

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LETTER OF TRANSMITTAL

APRIL 6, 1982.

Hon. HENRY S. REUSS,
Chairman, Joint Economic Committee,
Congress of the United States,
Washington, D.C.

DEAR MR. CHAIRMAN: I am pleased to transmit herewith a staff study prepared for the Joint Economic Committee entitled "The Federal Underground Economy: The Off-Budget Activities of the Federal Government," prepared by Dr. Richard K. Vedder of the committee staff. Dr. Vedder acknowledges useful comments made by Christopher Frenze of the committee staff and by Dr. Marvin Phaup of the Congressional Budget Office. The manuscript was typed by Doris Irwin, and research assistance was provided by Thomas Ulrich. The views expressed reflect the views of the author and not necessarily those of the Joint Economic Committee or its members.

The staff study shows that a large amount of activity carried on by the Federal Government is not reflected in the unified budget. As a consequence, the oft-cited budget deficit is not an adequate indicator of the Federal impact on the credit markets. The reduction in some forms of "off budget" activity from 1981 to 1983 should largely offset the impact of the increase in the unified deficit on credit markets. As a consequence, the study argues that it is inappropriate to alter the President's economic recovery program on the basis of projections of rising deficits.

Sincerely,

ROGER W. JEPSEN,
Chairman, Subcommittee on Monetary and Fiscal Policy.

FOREWORD

By Senator Roger W. Jepsen

In the past several years a rapidly growing amount of Federal Government activity has been carried on outside the budget. I have long viewed this as a deceptive and essentially dishonest practice. It reflects an unwillingness on the part of the Nation's public policymakers to face the consequences of their own decisions and it enables special interest groups to derive governmental benefits without appropriate congressional or sometimes even executive branch scrutiny.

This study details various ways in which activities are carried on outside the unified budget, showing how off-budget activities have grown substantially. It then shows how subsidies implicit in much off-budget activity can lead to a misallocation of resources, contributing to the recent productivity slowdown and sluggish economic growth.

I concur in the study's indictment of off-budget activities, such as the practice of allowing agencies to borrow from the Federal Finance Bank "off budget." The study makes a good case for reforming the budget to make it more informative and accurate, more comprehensive, and more subject to control by our elected lawmakers.

Perhaps the most interesting conclusion of the study is that most of the impact of the increase in the unified deficit on credit markets projected in 1982 and 1983 (compared with 1981) is offset by a reduced amount of off-budget activity. This suggests that concerns about the rising budget deficit are largely misplaced. In particular, this study reinforces my strong conviction that it would be a tragic mistake to roll back or dilute the major provisions of the Economic Recovery Tax Act of 1981, the singlemost important piece of incentive and growth-inducing legislation passed by any recent Congress.

It is time to get the Government off the backs of the people. Bad budgeting practices have deliberately hidden much of the growth in Federal involvement in our lives, and the reforms suggested in this study would be an important step in reversing this unfortunate trend toward bigger government.

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THE UNDERGROUND FEDERAL ECONOMY: OFF-BUDGET ACTIVITIES OF THE FEDERAL GOVERNMENT

By Richard K. Vedder [1]

I. INTRODUCTION

Just as the private sector has a booming underground economy that developed in large part to evade rising levels of taxation, so the Federal Government has developed its own underground economy, a host of activities that are carried on outside the confines of the Federal unified budget. While the Federal "underground" economy is a "legal" economy (since the Government writes the laws) and is somewhat less hidden than its private sector counterpart, it shares some of the negative characteristics of the private hidden economy. Like its private counterpart, the Federal underground economy exists because deception and secrecy can be highly profitable to some interests.

The Federal underground economy is defined as that variety of Federal activities whose fiscal or economic impact are not reflected in the Federal Government's most comprehensive economic document, its unified budget. It consists of some conventional programs operated directly by the Federal Government, but is primarily a massive credit operation involving loans and interest rate subsidies to a variety of customers. The volume or economic impact of this activity is difficult to ascertain, which is the primary reason that it exists. While there are some cases where "off-budget" activity is justified for legitimate reasons, the primary reason most activity is undertaken outside the Federal "unified" budget is that it reduces the political liabilities associated with the growth in certain forms of governmental activity. The motivation for the growth of this activity is almost entirely political, but the emergence of the underground Federal economy has caused some growing economic problems.

The whole concept of off-budget activity can be criticized on at least four grounds. First, off-budget financing imposes significant information costs on decisionmakers and analysts who formulate and evaluate governmental programs. If off-budget financing of governmental related activities were put on budget, for example, a more accurate perception of the Government's impact on key economic variables such as inflation, interest rates, and employment can be ascertained. The size of the Government deficit, for example, varies extensively with the method of accounting used with respect to off-budget activities. Excluding such activities from the

[1] Richard K. Vedder is an economist on the staff of the Joint Economic Committee.

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unified budget makes it more difficult (costly) to measure the impact of governmental activity. Consequently, decisions with respect to macroeconomic policies may be distorted by merely evaluating the unified budget which excludes significant activity that involves the allocation of resources.

Off-budget activities have completely distorted current discussions about the Federal deficit. "Conventional wisdom" is that the Reagan administration's 1983 budget incorporates a large increase in the budget deficit over 1981 levels. According to this view, the rising deficit will be inflationary and/or crowd out needed investment by forcing up interest rates. This, in turn, will aggravate unemployment.

This conventional view is wrong for a variety of reasons, including the fact it ignores the growth in the savings pool resulting from the Economic Recovery Tax Act of 1981, it ignores the longrun lack of relationship between budget deficits and inflation, etc.

While this view may be logically and empirically valid, it is in a sense irrelevant. The Reagan administration's 1983 budget does not contemplate a large increase in the deficit from current (1981) levels as it should be measured, incorporating off-budget activities. Including the underground Federal economy, the "deficit" as a proportion of total credit available will be lower in fiscal year 1983 than fiscal year 1981, the last Carter budget. Off-budget activities completely distort the budgetary picture, and in so doing can lead to highly inappropriate budgetary responses (e.g., a large tax increase).

A second argument is that off-budget financing is deceptive and dishonest, and has been adopted in an attempt to hide some of the growth in governmental activity from the taxpaying public. The growth in off-budget financing has led to a deliberate underestimation of what many would view as an irresponsible growth in deficit spending. We have been "cooking the books."

Third, much of the off-budget activity has brought about a distortion in the allocation of resources that is undesirable. The distortion is not merely the result of the fact that we have engaged in an inappropriate accounting of governmental activity. Rather, some highly uneconomic forms of subsidization have been allowed to occur that would not have been politically expedient if they were measured as involving direct Federal outlays. For example, government-guaranteed loan programs have lowered interest rates paid to borrowers in a manner that probably has led to some "crowding out" of other investments with a higher social rate of return than provided on the investments with loan guarantees. This, in turn, has lowered productivity and our rate of economic growth.

The fourth argument is that under current statutory provisions, off-budget activities are not completely under the control of Congress. Agencies can and do engage in off-budget activities without explicit congressional approval. The move to adopt a credit budget (adopted in 1981) is a step toward controlling this practice, but Federal-directed expenditures still are made without what is generally viewed as an appropriate review of their microeconomic efficacy and the overall macroeconomic impact. Participatory democracy implies that government resource allocation decisions are made by elected officials rather than by nonelected administrators not accountable to the public in any meaningful fashion.

II. TYPES OF OFF-BUDGET ACTIVITY

While the term "off budget" is widely used, there is no universally accepted definition as to what activities are off budget in nature. We might offer as a working definition of "off-budget activity": the dollar value of any allocation of resources (costs) and revenues (benefits) that results from Federal Government action but which is not reflected in the unified budget of the Federal Government. This definition is broader than that used in most of the current discussions of the issue. For example, Government regulations force private businesses to allocate billions of dollars in resources to various purposes, but most statistics on "off-budget" activity exclude these amounts, possibly because there are major conceptual and methodological problems.[1] Following convention, therefore, we will exclude such regulatory impacts from this discussion. This in no way, however, is meant to imply that the incorporation of a regulatory budget into the Federal budget process is undesirable or unworthy of analysis. Indeed, such a regulatory budget has considerable merit. In this connection, it can be argued that all private costs associated with governmental regulations and even laws should be budgeted in some manner. This could go beyond conventional economic regulation to include the costs of, say, the 55-mile-per-hour national speed limit or, in earlier times, of military conscription (the ultimate and original form of off-budget financing).

The bulk of Federal "off-budget" activities (aside from regulatory effects) involves credit. There is some direct expenditure not recorded in the unified budget. For example, while Postal Service subsidies are recorded in the budget, gross receipts and expenditures of the Postal Service are not. Several other Federal enterprises that produce goods or services for sale to the public are in this category. A notable recent case of Federal expenditure being placed "off budget" was the Strategic Petroleum Reserve. Expenditures for this item were placed "off budget" for fiscal year 1982 in the historic debates over the budget in 1981, and that "off budget" designation has been maintained in the President's proposed 1983 budget. There is no defensible economic rationale for excluding this expenditure from the unified budget while other purchases of tangible assets are included. There are four major forms of Federal involvement in credit activities:[2]

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[1] Also, as discussed below, the budget excludes certain liabilities not requiring current cash outlays, such as depreciation on governmental capital or unfunded liabilities of the Social Security System.

[2] This draws heavily on Herman B. Leonard and Elisabeth H. Rhyne, "Federal Credit and the 'Shadow Budget' ", The Public Interest, Fall 1981. There are a number of other good accounts of the growth in off-budget financing: Stephen H. Pollock, "Off-Budget Federal Outlays," Federal Reserve Bank of Kansas City Monthly Review, March 1981; Beth Brophy, "Cutting the Off-Budget, Too," Forbes, October 26, 1981; statement of Lawrence A. Kudlow at hearings before the House Budget Committee, October 29, 1981; Congressional Budget Office, "Federal Credit Activities: An Analysis of President Reagan's Credit Budget for 1982" (Washington: Congressional Budget Office, April 1981); Timothy B. Clark, "Reagan's Assault on Federal Borrowing—Making

(1) Direct loans,
(2) Loan guarantees,
(3) Lending by government-sponsored enterprises, and
(4) Tax exemptions for interest payments on much State and local debt.

Direct loans are the most straightforward form of Federal participation in the credit market. Some activity has been carried on within the unified budget, but much of it is "off budget," financed almost entirely by the off-budget Federal Financing Bank (FFB), an agency that began operation in 1974 that is discussed below. The FFB participates in direct loans in two fashions. First, it purchases loan assets sold by Federal agencies, most importantly the Farmers Home Administration (FMHA) but also the Rural Electrification Administration (REA), and some other agencies.

Second, the FFB effectively makes direct loans to borrowers, where the loans are guaranteed by an agency of the Federal Government. The largest loans in this category are to rural electric cooperatives (guaranteed by the REA) and to foreign countries (arms sales guaranteed by the Department of Defense). Of lesser importance are Department of Education guaranteed loans to the Student Loan Marketing Association (Sallie Mae), and Tennessee Valley Authority (TVA) guaranteed loans to the Seven States Energy Corporation. The FFB also makes loans to some Federal agencies, including the Export-Import Bank, TVA, etc.

Loan guarantees are made by Federal agencies. They, in effect, guarantee the repayment of the principal and interest on loans made by private firms. Thus, the lender is insured by the Federal Government, which assumes legal liability for payments. The most famous loan guarantees recently were made to Chrysler Corporation, but other guarantees are quantitatively far more important, such as those made by the Government National Mortgage Association (Ginnie Mae), and the Export-Import Bank.

A third form of credit extended under Federal auspices are the loans made by federally sponsored enterprises not owned by the Federal Government but at least partially federally controlled. The oldest of these institutions, the Federal Reserve System, is usually excluded from mention (for reasons not altogether clear), but the major lenders in this category are seven enterprises created in recent decades, including the Federal National Mortgage Association (Fannie Mae).

A fourth category is exemption from Federal income taxes of interest earned on municipal bonds issued by State and local governments to promote industrial development, investment in pollution control, housing construction and other activities. Interest rates on these bonds are substantially lower because the tax exempt feature raises the return on investment relative to taxable securities. This interest rate subsidy is a "tax expenditure" unrecorded in the unified budget but which significantly influences the allocation of credit.

Room for the Private Sector," National Journal, November 17, 1981; Irwin L. Kellner, "The Tip of the Iceberg," Manufacturers Hanover Economic Report, November 1981. An older, but still useful document is U.S. Senate, Committee of the Budget, "Off-Budget Agencies and Government-Sponsored Corporations" (Washington, D.C.: Government Printing Office, March 23, 1977).

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An important, but hard to answer, question is how one should treat government-sponsored agencies for budgetary purposes. Consider Fannie Mae. Until 1968, it was a Federal agency. The reason it was made private was that "its large borrowings made the Federal budget look bad." [3] Yet it *is* privately owned, its stock is sold on the New York Stock Exchange, and private stockholders share in its profits and losses and elect directors. Nonetheless, it is by no stretch of the imagination a private firm in the conventional sense of the word. "Quasi-governmental" is a more appropriate term. Three major forms of Federal involvement are worth noting. First, the President of the United States appoints 5 of Fannie Mae's 15 directors. Second, certain actions of Fannie Mae require approval of the Secretary of Housing and Urban Development. Third, the corporation, by law, has the right to sell over $2 billion of its debt to the Treasury. This Treasury tie gives it government agency status that allows it to sell its debt at interest rates only modestly greater than Treasury securities and far below the interest rate that would exist without the Federal tie.

The status of some other agencies is even more complex. Consider the Federal Home Loan Mortgage Corporation, known to its friends (and it has many) as "Freddie Mac." Created by the Emergency Home Finance Act of 1970 (Public Law 91-351), Freddie Mac's stock is entirely owned by the Federal Home Loan Banks (FHLB). Who owns the Federal Home Loan Banks? Officially, the Nation's savings and loan associations in much the same way the Federal Reserve is "owned" by its member banks. In reality, the banks are supervised by the Federal Home Loan Bank Board, whose board members are *all* appointed by the President. There is congressional committee oversight of the Board, GAO audits of its activities, certain Treasury Department controls over its financing, a right on the part of the Board to borrow from the Treasury and exemption of its securities from State and local taxes. The bond market quite accurately accords "Federal agency" status to both Freddie Mac and its corporate parent.

Should the activities of these government-sponsored agencies be included in the budgetary documents of the Federal Government? Some observers would say no, citing their private ownership and, in some cases, partial private control. At the same time, however, excluding them leads to a misstatement of the role of the Federal Government in economic activity, since these organizations derive tremendous advantages from their quasi-public status, which in turn they pay for by relinquishing partial control to policymakers in the Government. While complete recording of all the financial activities of these agencies in the unified budget might lead to some overstatement of Federal involvement in the economy, it is even worse to exclude them completely from both the unified and the credit budgets. No one really believes the Federal Reserve System is a private organization, and to treat similar entities like Freddie Mac as if there were no Federal connection leads to a clear understatement of the Federal role in resource allocation.

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[3] Allan Sloan, "Saving Fannie," Forbes, October 26, 1981.

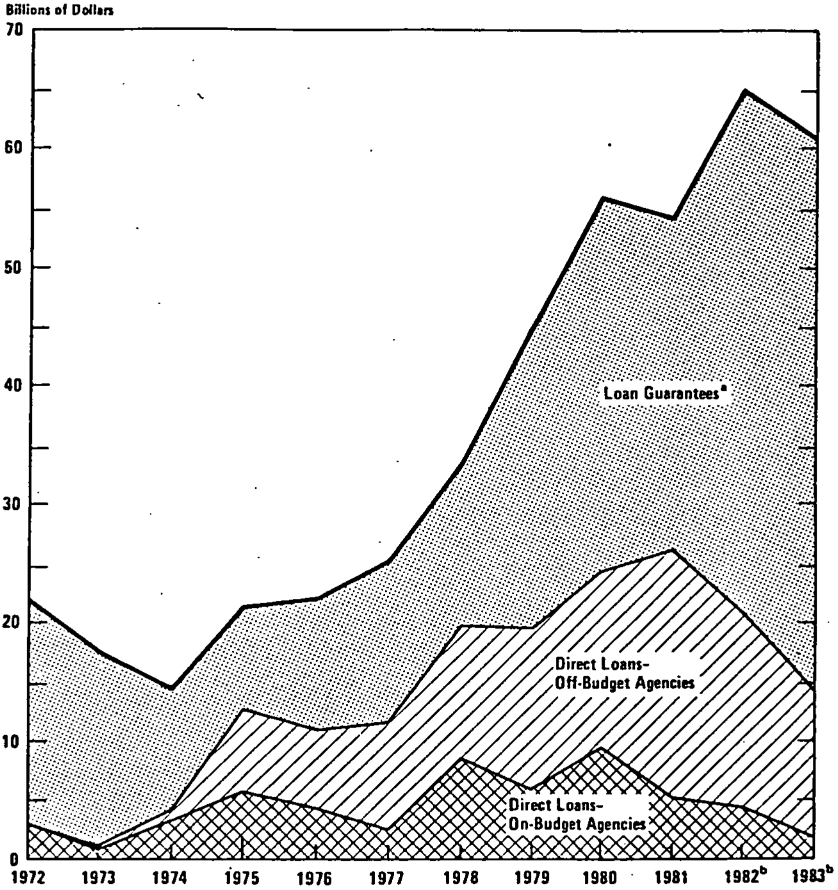
III. THE GROWTH IN OFF-BUDGET ACTIVITY

Some forms of "off-budget" activity of the Federal Government have existed since the beginning of the Republic, particularly if nonfinancial forms of governmental involvement in resource allocation are included, such as regulatory activity and military conscription. The explosive growth in off-budget activities, however, is a product of the last decade or so.

The growth in net Federal credit over time is indicated in Figure 1. That figure is a conservative statement of the growth of Federal credit in that it excludes the federally sponsored but privately owned enterprises as well as interest rate subsidies on State and local debt issues. Even this conservative statement of Federal credit activity indicates a more than quadrupling of Federal intervention in the credit markets in the past decade and perhaps a doubling in real terms.

Table 1 looks at total Federal involvement in credit markets, including Treasury financing of on-budget deficits. Total annual federally related borrowing grew ninefold from the late 1960's to 1981, or at an annual compound rate of 17.2 percent a year. Direct Federal borrowing generally was less than total borrowing under Federal auspices. The most explosive growth was borrowing by federally sponsored enterprises totally excluded from the budget process. The Federal unified budget deficit explains only a minority of Federal Government-related debt in recent times and the relationship between "the deficit" and Federal credit needs is unstable. Thus, in 1981 the "deficit" declined but borrowing under Federal auspices rose dramatically. The notion that the Federal budget deficit is a reliable indicator of Federal impact on credit markets and interest rates is simply not supported by the evidence.

Figure 1.
Components of Net Federal Credit, Fiscal Years 1972-1983



[a] Primary guarantees: excluding secondary guarantees and guaranteed loans acquired by on- and off-budget agencies.
[b] Estimates

SOURCE: *Budget of the United States Government, Fiscal Year 1983,* Special Analysis F, Federal Credit Programs.

TABLE 1.—FEDERAL ACTIVITY IN CREDIT MARKETS; YEARLY AVERAGES [1]

	1965–69	1970–74	1975–79	1980	1981 [2]
Direct Federal borrowing	$6.4	$13.0	$56.0	$70.5	$78.8
Federally guaranteed loans	5.2	14.4	14.8	32.4	48.0
Borrowing by Government created enterprises	1.0	5.0	12.9	21.4	27.7
Additional tax exempt borrowing	7.3	12.8	19.7	19.5	27.7
Total borrowing for Federal and federally assisted purposes	19.9	45.2	103.5	143.8	182.2
Unified budget deficit	8.5	13.7	46.5	59.6	57.9
Deficit as percent of federally related borrowing	42.7	30.3	44.9	41.4	31.8

[1] All dollar amounts in billions.
[2] Partly estimated.

Source: Office of Management and Budget; Timothy B. Clark, "Reagan's Assault on Federal Borrowing—Making Room for the Private Sector," National Journal, November 17, 1981, p. 1860.

The total impact of Federal borrowing (broadly defined) is better indicated in Table 2, which relates total borrowing to the total amount of borrowing in U.S. credit markets. The table indicates a steady progression in the proportion of total credit absorbed by federally related entities, so that by 1981 the proportion had reached half of total borrowings—equaling private sector borrowing. Very little of this growth is revealed by looking at the Federal unified budget deficit. Borrowing under Federal auspices in 1981, for example, was up $162.3 billion from 1965–69 average annual borrowing, but the deficit had risen by only $49.4 billion, less than one-third as much, further evidence that the much discussed budget deficit is a poor indicator of the impact of the Federal Government on credit markets.

TABLE 2.—FEDERAL GOVERNMENT RELATED BORROWING AS PERCENT OF TOTAL BORROWING IN U.S. CREDIT MARKETS [1]

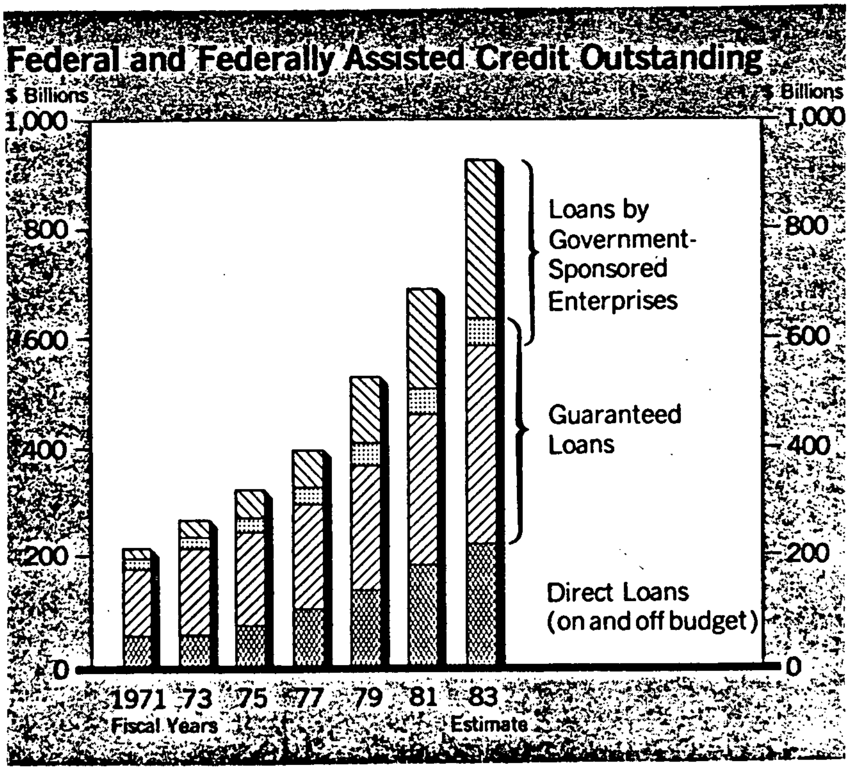
Year or period	Annual Federal borrowing	Total borrowing	Federal as percent of total
1965 to 1969 [2]	$19.9	$80.6	25
1970 to 1974 [2]	45.2	156.9	29
1975 to 1979 [2]	103.5	309.4	33
1980	143.8	344.7	42
1981 [3]	182.2	361.0	50

[1] In billions of dollars.
[2] Average annual figures.
[3] Estimated.

Source: National Journal, Nov. 17, 1981.

The discussion to this point has dealt with only annual flows of credit activity, not with the accumulated stock of that activity over time. Figure 2 shows that the accumulated amount of credit issued with some Federal involvement has soared, so that by 1983 it will approach $1 trillion, compared with slightly over $200 billion in 1971. This, of course, excludes the Federal debt that represents an accumulation of previous budget deficits, which exceeds another trillion dollars.

FIGURE 2



Source: 1983 Budget of the U.S. Government, Special Analysis F, "Federal Credit Programs" (Washington, D.C.: Office of Management and Budget, 1982), p. 9.

IV. THE FEDERAL FINANCING BANK

Before the end of 1982, the largest bank in the United States likely will be the Federal Financing Bank (FFB). The FFB began operation in 1974 and was designed to provide a cheaper and more efficient means for Federal agencies to borrow from the public. Prior to 1974, individual agencies issued their own debt instruments. Because the market was not as familiar with the various agencies as it was with the Treasury, their debt sold for a healthy premium over Treasury debt. The intent of the FFB was merely to save money by having a single institution issue and service agency debt. As then Under Secretary of the Treasury Paul Volcker put it, the FFB "would neither add to nor subtract from existing Federal credit assistance programs." [1] It was not a gimmick to increase government spending without legislative review or without the political consequences associated with the deficit created by additional spending.

The FFB was given the power to issue $15 billion of its own notes. Wall Street, however, continued to place an interest rate premium on FFB obligations, so it was perceived to be cheaper for the FFB to borrow from the Treasury, which it could do without regard to the $15 billion limit. As a consequence, the FFB has far surpassed the legislative intent and by the end of fiscal year 1981 had outstanding holdings of $107.3 billion in Federal credit, nearly a 30 percent increase from the 1980 figure of $83.0 billion.[2]

The FFB, which operates with a handful of employees out of the Department of the Treasury, has three major forms of activity: the purchase of agency debt, the purchase of loan assets of Federal agencies by issuing "certificates of beneficial ownership" (CBO's), and the making of direct loans to guaranteed borrowers. Table 3 indicates the magnitudes of three major forms of activities as of September 30, 1981. When created, it was anticipated that the FFB would be primarily involved in servicing agency debt, but that activity is actually the least important of the three functions of the FFB. Besides the Export-Import Bank and the Tennessee Valley Authority, other agencies to use the FFB include the Postal Service, the National Credit Union Administration, and the U.S. Railway Association.

The FFB activities that have served to reduce the meaningfulness of the Federal unified budget deficit, however, are loan asset sales and direct loans to guaranteed borrowers. "Loan asset sales"

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[1] Quoted in John J. Fiakla, "Obscure U.S. Lender, Bigger Than Citibank, Irks Budget Watchers," Wall Street Journal, December 15, 1981.

[2] The best single study of the Federal Financing Bank is Congressional Budget Office, "The Federal Financing Bank and the Budgetary Treatment of Federal Credit Activities" (Washington, D.C.: Government Printing Office, January 1982). A shorter account is "The Federal Financing Bank: A Department of the Treasury," International Currency Review, vol. 12, No. 5, 1980.

are not really that. The Farmers Home Administration (primarily) will sell the FFB CBO's. The Farmers Home Administration, however, retains possession of the loan instrument, retains responsibility for servicing the loans, and retains all the risk, guaranteeing full payment of interest and principal. As the Congressional Budget Office put it, "In reality, an agency selling a CBO is borrowing from the CBO purchaser."[3] Budgetarily, by treating CBO sales as asset sales (inappropriately), the Farmers Home Administration can transfer enormous outlays off-budget.

The creation of a means to convert on-budget outlays into off-budget activity was a great boon to the Farmers Home Administration and to a lesser extent to other agencies. As Figure 3 indicates, Farmers Home Administration loans increased fivefold in the first 5 years after the establishment of the FFB.

TABLE 3.—FFB OUTSTANDING HOLDINGS, BY TYPE OF ACTIVITY

[End of fiscal year, in billions of dollars]

Activity	1980	1981
Agency debt:		
Export-Import Bank	10.1	12.4
Tennessee Valley Authority	8.9	10.9
Other	2.1	1.6
Subtotal, agency debt	21.1	24.9
Loan assets: [1]		
Farmers Home Administration	38.0	48.8
Rural Electrification Administration	1.9	2.6
Other	0.5	0.4
Subtotal, loan assets	40.4	51.8
Direct loans to guaranteed borrowers:		
REA guaranteed loans to rural electric cooperatives	8.4	12.3
DOD guaranteed loans for foreign military sales	7.2	9.1
Other	5.9	9.2
Subtotal, direct loans to guaranteed borrowers	21.5	30.6
Total, FFB outstanding holdings	83.0	107.3

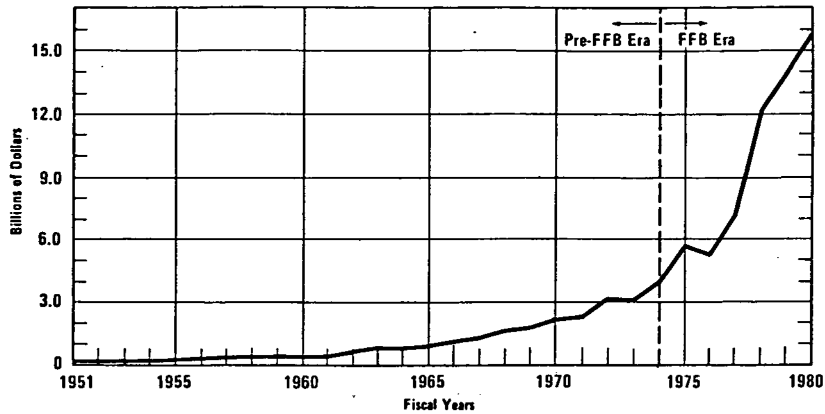
[1] Primarily certificates of beneficial ownership.

Sources: Budget of the U.S. Government, fiscal year 1982, "Special Analysis on Credit"; and Department of the Treasury, Federal Financing Bank News, September 1981 Report (Oct. 26, 1981); Congressional Budget Office.

[3] The Federal Financing Bank . . ., op. cit., p. xiii.

FIGURE 3

New Direct Loans by the Farmers Home Administration, Fiscal Years 1951-1980 (End of year)



SOURCE: *Budget of the United States Government,* Fiscal Years 1952-1982, Special Analyses on Credit.

The FFB buys the entire issue of securities issued by non-Federal enterprises that are guaranteed by a Federal on-budget agency. This practice is growing, rapidly as Table 4 indicates, and is practiced by diverse governmental agencies. Effectively, a direct Federal loan is being made off-budget, and there is no budgetary consequence to the agency that initially made the guarantee. It has been a "low cost" program in a political sense in that it allows Federal largesse to be extended without a perceived budgetary consequence and it also gives bureaucrats greater freedom from resource restraints.

TABLE 4.—OUTSTANDING FFB LOANS TO GUARANTEED BORROWERS, FISCAL YEARS 1980–82

[In billions of dollars]

Agency and borrower	1980	1981	1982 [1]
REA guaranteed loans to rural electric cooperatives	8.4	12.3	16.5
DOD guaranteed loans for foreign military sales	7.2	9.1	11.1
Department of Education guaranteed loans to Student Loan Marketing Association	2.3	4.3	5.3
HUD guaranteed loans to low-rent public housing	.1	.9	3.5
TVA guaranteed loans to Seven States Energy Corp	.7	.9	1.2
Other	2.8	3.1	3.9
Total, loans outstanding	21.5	30.6	41.5

[1] Estimates.

Sources: "Budget of the U.S. Government, Fiscal Year 1982, Special Analysis on Credit"; Department of the Treasury, Federal Financing Bank News, September 1981 Report (October 26, 1981); and estimates based on Mid-Session Review of the Budget, July 1981; Congressional Budget Office.

The exclusion of FFB-financed CBO sales and direct loans to guaranteed borrowers from the unified budget serves to not only understate the true deficit but also to give wrong signals as to the direction Federal fiscal activity is moving with respect to credit market impact. This is indicated in Table 5. The deficit in 1981 was reported to have fallen, but in reality it rose if FFB-financed off-budget outlays were included.

TABLE 5.—EFFECT OF FFB INCLUSION IN UNIFIED BUDGET, 1980-81 [1]

	1980	1981
Reported budget deficit	$59.6	$57.9
FFB-financed CBO sales and loans	14.3	21.0
Deficit, including FFB	73.9	78.9
Change in reported deficits, 1981		−1.7
Change in deficit, including FFB, 1981		+5.0

[1] All dollar amounts in billions of dollars.

Source: Congressional Budget Office.

V. ECONOMIC CONSEQUENCES OF OFF-BUDGET ACTIVITIES

The growth of off-budget activity can be rightly attacked on moral grounds as being a manifestation of essentially dishonest bookkeeping. Only persons extremely well versed in governmental procedures and budgetary practice know the extent of Federal activity carried on off-budget, and the relatively hidden nature of this activity has lowered the political costs of the activity to politicians and made life easier for some bureaucrats, but at a significant cost to taxpayers. It is deceptive financial practice, a "budgetary Watergate." Similarly, the off-budget activities are legitimately criticized on political grounds, namely, that it subverts the constitutional practice of providing legislative oversight and control of the purse-strings of government.

The major concern in this report, however, is with the economic consequences of contemporary Federal budgetary practice. There are two major problems created by the off-budget credit programs. First, the understatement of the budget situation potentially can lead to poor macroeconomic decisions. As discussed above, the impact of Federal activities on credit markets has been quite different than what the unified deficit indicates. Generally speaking, in the late Carter years Federal credit market intrusion was far greater than the deficit indicated, thus partially disguising the need for fiscal policy responses that would reduce the debilitating impact on productivity of the crowding out of private investment. An opposite danger exists now. Because the Reagan administration is restricting the growth and actually reducing some of the operations of the underground Federal economy in the credit area, focusing on the unified deficit can lead to policies dealing with non-problems, such as increased crowding out of private investment. While the apparent large deficit signals the need for deficit reduction, the inclusion of the underground government in the totals leads one to conclude that the proportion of borrowing carried on under Federal auspices likely will decrease in fiscal year 1983 over fiscal years 1981 or 1982, a point discussed in greater detail below.

Most off-budget credit activity implicitly involves subsidies to various borrowers. This serves to distort the market-determined allocation of credit. Let us illustrate by using an example involving Federal loan guarantees. Suppose the "risk-free" interest rate is 12 percent and there are two borrowers who are not completely creditworthy; lending to them entails some risks. Suppose the market interest rate for loans to them (including the risk premium) is 16 percent. Suppose firm A expects a rate of return on a housing investment of 13 percent and firm B expects a rate of return on a machinery investment of 15 percent. Without loan guarantees neither will borrow to invest, since the interest costs are greater than the expected rate of return. However, if firm A gets a guaranteed loan that allows him to borrow at 12 percent, he will do so as the investment now yields an anticipated profit. The housing project will be built even though its perceived rate of return is less than on the machinery purchase; the latter investment will not occur (as there is no loan guarantee). Only if there are some social benefits or "positive externalities" of the housing investment can this scenario be justified. The current off-budget financing arrangements provide a political motivation to promote loan guarantees, increasing the probability that more low yielding (in a real social sense) investments will take place that cannot be justified in terms of externalities or "spillover effects."

The Wall Street Journal recently succinctly described the effects of federally determined credit allocation on the economy as a whole: [1]

> * * * the point of allocating credit is to give credit to enterprises which fail the test of the marketplace on the premise that the social benefits outweigh the costs. This is a nice way of saying that credit allocation channels funds away from projects earning risk-adjusted market rates. Credit allocation, by design, misallocates credit from productive uses to less productive uses.
>
> All this works together to keep interest rates high, productivity low and economic growth slow. And it all works together largely unseen and unevaluated by anyone but agency bureaucrats and lobby groups of the sectors favored by cheap government credit.

The reallocation of credit is justifiable if only special positive spillover effects exist. The current budgetary arrangement provides no incentives for government decisionmakers to weigh the economic costs of interest rate subsidies against their alleged benefits. Government policies that have restricted the supply of credit have received much attention, but the budgetary process that exists has diverted attention from the unproductive fashion in which the Federal Government has altered the demand for loanable funds.

[1] "Careening Credit," Wall Street Journal, November 17, 1981, p. 26.

VI. FEDERAL BUDGETING PROCEDURES: THE NEED FOR REFORM

The previous discussion indicates beyond a shadow of doubt that the Federal Government's budgeting procedures are in need of substantial reform. While recognition of the problem is important, the solution to the problem is less obvious. As a basic proposition it appears the solution is to eliminate virtually all "off-budget" activity so as to make the unified budget truly comprehensive. While this is clearly the direction in which to move, there are a variety of sticky accounting issues involved. Moreover, the "optimal" budgetary format will vary with the perceived purpose(s) of Federal budgeting.

The Federal budget serves multiple functions. To some, the budget is a measure of the cash flow of the Federal Government, designed to provide information on revenues and receipts and changes in Federal indebtedness, or as one budget document put it, the budget "is a report to Congress and the people on how the Government has spent the funds entrusted to it. . . ." [1] The budget serves another function; namely, to reduce information costs to public policymakers seeking to improve resource allocation. According to this view, the budget is "an economic document" that "proposes all allocations of resources between the private and public sectors and within the public sector." [2]

The treatment of certain off-budget financial items might well vary with the relative importance of different budgetary functions. Some off-budget activity does not involve explicit cash outlays of large amounts (e.g., loan guarantees) but involves large subsidies. From the narrow perspective of recording cash payments, the exclusion of these activities from the unified budget is not terribly objectionable. To the extent the budget is to provide information in measuring governmental impacts on resource allocation, however, the exclusion of loan guarantees is a serious deficiency.

All of this suggests that perhaps a single budget document is not adequate to meet disparate uses to which the budget is put. It is in recognition of that possibility that in recent years Congress has begun experimentally providing for a credit budget separate from the unified budget that essentially records cash flows. Even if one accepts the concept of a Federal credit budget separate from the unified budget, it is clear that numerous problems certainly remain with the existing budgets.

There is no question that the unified budget should include the off-budget outlays of the Federal Financing Bank and some lesser

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[1] Executive Office of the President, Office of Management and Budget, "Special Analyses, Budget of the U.S. Government, Fiscal Year 1981" (Washington, D.C.: Government Printing Office, 1980), p. 47.

[2] Ibid.

government agencies. A very good case can be made that implicit subsidies should be put on budget at their approximate market value. Loan guarantees are currently not budgeted, except for payments actually made on defaulted loans. Much better, the present value of future subsidies for each new loan guarantee should be included in the budget as a measure of the value to the recipients of governmental resource reallocation. Similarly, the value of tax exempt status on newly issued municipal bonds should be similarly recorded. Merely adding FFB off-budget bank outlays and an estimate of subsidies implicit in loan guarantee programs increases the 1981 deficit from a reported $57 billion to slightly more than $100 billion. Adding in the tax exemption related subsidies raises the figure still higher. Doing so, the budget would be converted into a document that records not only cash flows but also the value of subsidies not involving cash outlays. In doing so, the budget would more accurately measure the resource allocation effects of Federal activities.

Making the suggested changes in the unified budget suggested above would help provide a measure of the allocative effects of Federal activity, but would not fully explain how those activities impact on credit markets; the reported "deficit" would not equal an amount that the Treasury must borrow, nor would it reflect the full value of loans extended on a guaranteed basis. A credit budget would provide information on federally related debt issued during a given period. It would record the purchase of Treasury securities necessary to cover cash flow deficit of the Federal Government, including off-budget outlays financed primarily through the FFB, as well as new private loans financed with governmental assistance via loan guarantees. The credit budget would include an estimate of total credit funds available in the economy, and the size of nongovernmental borrowings (total borrowings minus Federal borrowings).

As Alice Rivlin of the Congressional Budget Office has testified, a good credit budget depends on three principles: "Congressional control, comprehensive coverage, and accuracy of information." [3] While the recent credit budgets have incorporated some congressional control, full control is lacking; most notably loan guarantees are essentially uncontrolled. Complete congressional control is necessary. Recent legislative proposals (e.g., H.R. 2372, the Mineta-Bethune bill) are designed to strengthen credit budgeting, and are a welcome step forward.

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[3] Hearings before the Task Force on Enforcement, Credit and Multiyear Budgeting of the Committee of the Budget, House of Representatives, October 28, 1981, p. 15.

VII. FIVE ACCOUNTING ISSUES IN BUDGETARY REFORM

This brief survey of Federal budgeting procedures by necessity has not dealt with several sticky issues that need resolution. While this study does not purport to suggest a comprehensive and detailed reform of the budget, it needs to address some of the more serious difficulties with contemporary accounting practice. Five of the major issues are outlined below:

1. IS CASH ACCOUNTING APPROPRIATE?

"Ironically, government entities are not generally bound by accounting standards as stringent as those which the private sector imposes on itself or is required to follow by law." [1] So wrote one commentator on the Federal budget deficit.

The Federal Government fails to budget future liabilities in the year incurred, unlike private firms. This study has mentioned unfunded liabilities related to loan guarantees, but other things could be mentioned. For example, there is no provision for depreciation on government-owned capital, except to the extent new buildings or renovations are included in the budget. More fundamentally, the unfunded liabilities of the Social Security System are completely left out of the budget. In 1977, for example, these liabilities increased by $269 billion, several times the size of the unified deficit.[2] The Federal budgetary process needs to make some account of unfunded future liabilities so that the budget records future consequences of current budget action.

While unfunded future liabilities are largely unrecorded, the real value of some recorded liabilities are altered by inflation. For example, government expenditures may be partly financed through monetary expansion. The resulting inflation lowers the real value of the public debt, lowering the real liabilities of the Government. Our present system of accounting ignores this dimension of Federal activity. Moreover, the financing of debt by sales to the Federal Reserve System is not even explicitly acknowledged in budget documents even though it has profound economic consequences.

2. HOW SHOULD GOVERNMENT-SPONSORED AGENCIES BE BUDGETED?

The activities of government-sponsored but privately owned agencies are currently completely excluded from both the unified and credit budgets. For example, there is no mention of "Fannie Mae" in the budget, even though it implicitly receives billions of dollars of subsidies because of the "Federal agency" debt status. It is probably true that it would overstate the "Federal" nature of

[1] R. David Ranson, "Toward a Broader Picture of the Budget Deficit," Policy Review, Winter 1978, p. 38.

[2] Derived from the "Economic Report of the President" (Washington, D.C.: Government Printing Office, 1982), p. 104. Chapter 4 of that Report has an excellent discussion of budget issues.

these organizations to fully record gross revenues and expenditures of these organizations in the unified budget. At the same time, it seems the dollar value of the subsidy associated with "agency status" is an expenditure of the Government, and the gross amounts of loan outlays may be appropriately included in a credit budget recording credit activities controlled or substantially influenced by Federal involvement. The amounts involved are not inconsequential. Fannie Mae alone has well over $50 billion in debt on which it pays only marginally more than Treasury interest rates to service—an implicit interest rate subsidy of perhaps $3 billion a year. New borrowings of all federally sponsored agencies have exceeded $20 billion annually for several years, an important amount in any credit budget. It is true that the demand for loanable funds with respect to interest rates is not perfectly elastic, meaning some borrowing by those agencies would occur in the absence of implicit interest rate subsidies. The current practice of ignoring them completely in budgeting, however, is clearly inappropriate. The 1967 President's Commission on Budget Concepts recommended that the budget include "all borderline agencies and transactions unless there are exceptionally persuasive reasons for exclusion."[3] The private ownership criterion was considered "an exceptionally persuasive reason" for exclusion but that decision needs reevaluation.

3. How Should the FFB Be Budgeted?

Unquestionably, the current practice of permitting the FFB to convert agency activities to off-budget status must be stopped. In a careful study of the topic, the Congressional Budget Office noted at least four different ways to approach the problem.[4] The FFB could be eliminated or put on-budget. The FFB is an efficient organization which helps organize government debt operations at low cost, so eliminating it might not be desirable. If the FFB were put on-budget, it would remove one principal cause of deficit misstatement. It would bring congressional control over FFB financed credit activities. Agencies still would not feel the financial effects of FFB activity in their budgets, and Congress would be abdicating control over rationing credit funds of the FFB to that agency rather than maintaining control. An alternative approach would be to change the budget procedures, focusing on the transactions. This could be done by making the credit budget a more meaningful document by including limitations by agency and programs on CBO's sold to the FFB or direct loans to guaranteed borrowers originated by the FFB. This, however, would leave the unified budget unaffected. It would be better to call CBO's what they are—borrowing. Agencies selling CBO's to the FFB would have these new loans recorded as agency outlays in the unified budget.

The Congressional Budget Office seems favorably disposed to putting all lending activity in the credit budget, enhancing that document's status. The Nation's budget deficit would be the sum of the deficit from operations reflected in the unified budget and net

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[3] "Report of the President's Commission on Budget Concepts" (Washington, D.C.: Government Printing Office, 1967), p. 25.
[4] The Federal Financing Bank . . . , op. cit., pp. 34–41.

lending activities (the credit budget "deficit").[5] In any case, all lending needs to be brought into budget documents disseminated among the general public.

4. Recording Gross Versus Net Lending Activity

There is a practice in the unified budget to record only *net* changes in credit activities. If an agency makes new on-budget loans of $1.5 billion while previously made loans of $1.2 billion are repaid, the unified budget lists the agency as having made $0.3 billion in loan expenditure. This implicitly assumes that the agency has the "'right" to relend any loans that are retired; once lending authority is granted, it remains in perpetuity. This is a dubious notion, reducing congressional control, hiding significant amounts of new lending activity, and possibly leading to a misallocation of resources. A strong case can be made for recording both the full amount of new loans and the amount of repayments in the unified budget, a practice followed in the credit budget.

In an excellent account of Federal credit activities, Herman B. Leonard and Elisabeth H. Rhyne conclude:[6]

> A full and integrated acounting for credit programs . . . would treat the gross flow of resources—new loans or guarantees issued in the current year as the most important measure of the scale of discretionary credit activities. It would examine and control the net flow of resources—loans or guarantees minus repayments and expirations—as the best measure of the change in the current status of Federal finances. Finally, it would present some estimate of the cost of the program to the Treasury—the present value of the interest subsidy or the present value of the expected defaults—as the best measure of the economic value of the Federal assistance.

5. Valuation of Loan Guarantees

Pursuing the last point, a sticky question is, "How should loan guarantees be handled in budgeting?" It is clearly wrong to ignore future liabilities that the guarantees pose, as is prevailing budgetary practice. However, it may be regarded as an overstatement of Federal involvement to record the face value of a loan guaranteed by the Federal Government as an outlay, as the probability is remote that the Government will be required to make a payment equal to 100 percent of the principal amount of the loan.

In terms of credit market impact, if the Government makes $80 billion in loan guarantees, it is not true that that means $80 billion in loans are being made under Federal auspices that would not have been made otherwise, unless borrowers are so interest-rate sensitive that the quantity of loanable funds demanded at a higher interest rate incorporating a risk premium is zero. The possibility that the demand for loanable funds is perfectly elastic seems extremely remote.

One way to handle the problem that represents a compromise between present practice with respect to the unified budget of almost ignoring the guarantees and the other extreme (used in the credit budget) of budgeting them at their face value would be to value the guarantees at the implicit value to the borrower of the interest

[5] Ibid.
[6] Op. cit., p. 51

rate subsidy provided by the government. Specifically, the budget would be charged the discounted present value of the sum of interest payments saved by the firm by having the loan guaranteed by the Treasury. The value of these subsidies is not trivial, estimated to be perhaps $22 billion in fiscal 1981.[7] As previously indicted, this and other omissions increases the 1981 deficit to over $100 billion.

The notion that it is difficult to estimate the size of interest rate subsidies since it is "impossible" to estimate the interest rate firms would pay in the absence of a guarantor is without foundation. As Leonard and Rhyne point out, insurance companies estimate risks like this all the time, and indeed one could sell the loan guarantee services to private insurers by competitive bidding, thus getting an identifiable cost that can be put in the budget much the same way expenditures for pencils or tanks are recorded.[8] By forcing the Government to make cash outlays, an implicit subsidy will become explicit.

The five accounting issues above are by no means exhaustive. As the Leonard and Rhyne quote points out, budgets serve a multiplicity of purposes and budget reform should acknowledge that fact. Perhaps the unified budget needs to be supplemented by a stronger credit budget. Certainly major reforms in the unified budget are necessary if it is to be a meaningful document in shaping monetary and fiscal policy.

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[7] Partially estimated by the author from a CBO estimate for fiscal year 1980.
[8] Op. cit., p. 57.

VIII. THE 1983 BUDGET AND THE TRUE "DEFICIT"

Does the Reagan budget project a larger deficit in 1983 than in 1981? [1] "Conventional knowledge" is: "Of course. That's the major failing of the President's plan." In fact, if one uses an appropriately broad definition of the budget and compares the deficit to the GNP or to the pool of available credit, a quite "unconventional" conclusion emerges.

Table 6 shows the basis for conventional view that the Federal budget deficit (as a fraction of GNP) is much larger in 1983 than in 1981. The 1983 figure is 31 percent higher than the 1981 figure (although somewhat smaller than in 1982).

TABLE 6.—THE UNIFIED DEFICIT AND GNP, 1981–83 [1]

	1981	1982	1983
Unified deficit	$57.9	$98.6	$91.5
GNP	$2,922.0	$3,160.0	$3,524.0
Deficit as percent of GNP	1.98	3.12	2.60

[1] Dollar amounts in billions.

Source: "1983 Budget of the United States" (Washington, D.C.: Government Printing Office, 1982).

Adding in the direct off-budget outlays, however, reduces the 1983 over 1981 increase. That is, off-budget outlays raise the 1981 deficit more than the 1983 deficit, as shown in Table 7. Indeed, the 1983 figure is only 12 percent larger than the 1981 figure.

TABLE 7.—DEFICITS INCLUDING DIRECT OFF-BUDGET OUTLAYS, 1981–83 [1]

	1981	1982	1983
Deficit, including off-budget	$78.9	$118.2	$107.2
GNP	$2,922.0	$3,160.0	$3,524.0
Deficit as percent of GNP	2.70	3.74	3.04

[1] Dollar amounts in billions

Source: "1983 Budget of the United States" (Washington, D.C.: Government Printing Office, 1982).

While including FFB outlays reduces the growth in the ratio of deficit to GNP, it does not change the conclusion that the 1983 deficit is bigger than that of 1981. However, FFB outlays include only a small fraction of the credit activities of the Federal Government (Table 8). A broader measure of Federal credit will further modify the verdict on the true size of the deficit.

[1] All the data regarding 1983 expenditures or deficits are derived from the "Budget of the U.S. Government: Fiscal Year 1983" (Washington, D.C., Government Printing Office, 1982).

TABLE 8.—THE CREDIT BUDGET AND GNP, 1981–83 [1]

	1981	1982	1983
Credit budget	$133.7	$143.4	$147.3
GNP	$2,922.0	$3,160.0	$3,524.0
Credit budget as percent of GNP	4.58	4.54	4.18

[1] Dollar amounts in billions

Source: "1983 Budget of the United States" (Washington, D.C.: Government Printing Office, 1982).

MEASURING THE TOTAL FEDERAL IMPACT ON FINANCIAL MARKETS

While the unified deficit including off-budget outlays suggests increased pressure on credit markets from 1981 to 1983, the total credit budget is expected to decrease as a percent of GNP. What is the net impact of Federal financing likely to be?

An answer cannot be obtained simply by adding the Federal deficit, including off-budget outlays (Table 7) and Federal credit outlays (Table 8). This would be invalid for several reasons. First, some Federal lending is included in both the unified and credit budgets, in the former as net amounts and in the latter as gross amounts.

Second, direct Federal borrowing does not precisely equal the deficit, including off-budget outlays. For example, the Government can increase or decrease its cash balances and earn seigniorage on coinage. In 1981, actual increases in the Federal debt exceeded the combined unified/off-budget deficit by $393 million, and it is anticipated that this discrepancy will be $733 million in 1982.[2] Fortunately, the actual increase in the public debt deviates from the deficit (so measured) by much less than 1 percent, a deviation so minor that in subsequent calculations the deficit figures are used in calculating direct Federal borrowing.

A third problem is that the credit budget excludes the impact of the activities of government-sponsored enterprises and the value of the subsidy provided by tax exemption of municipal bonds issued for private purposes (e.g., industrial development bonds). Fourth, the credit budget includes loan guarantees at their principal value, not at the market value of the subsidy implicit in such guarantees. As indicated earlier, this overstatement distorts the impact of loan guarantees on credit activity by implicitly assuming that no one receiving guaranteed loans would borrow by other means in the absence of the guarantee.

On this last point, it should be noted that the Reagan administration has adopted an extremely conservative accounting technique. Previously, loan guarantees were valued at the amount of the contingent liability to the Government, which in some cases was less than the full or principal value of the loan. By changing to a procedure whereby loan guarantees are valued at the full principal amount of the loan (whether or not guaranteed) the administration has increased the measure of Federal credit market participation. As Table 9 shows, the difference in contingent liability and full principal is estimated in 1982 to be $70.1 billion.

[2] This topic is discussed in greater detail in the "1983 Budget * * *, Special Analysis E, Borrowing and Debt" (Washington: Office of Management and Budget, 1982). See especially p. 7.

TABLE 9.—DIFFERENCE BETWEEN CONTINGENT LIABILITY AND FULL PRINCIPAL FOR GUARANTEED LOANS

[In millions of dollars]

	1981 actual	1982 estimate	1983 estimate
Veterans' Administration mortgage insurance:			
Contingent liability	48,758	54,609	61,359
Full principal	105,868	118,574	133,225
Federal Housing Administration mortgage insurance:			
Contingent liability	131,989	148,208	168,131
Full principal	135,445	152,210	172,840
All other loan guarantees programs:			
Contingent liability	262,249	317,600	368,749
Full principal	264,092	319,732	370,989
Total outstanding:			
Contingent liability	442,996	520,417	598,239
Full principal	505,405	590,516	677,054

Source: "1983 Budget of the U.S. Government, Special Analysis F, Federal Credit Programs" (Washington, D.C.: Office of Management and Budget, 1982), p. 8.

The 1981 Federal Budget's assessment of Federal participation in credit markets is presented in Table 10. That table shows the Federal role both in terms of the supply of loanable funds (funds advanced) and in the demand for loanable funds (funds raised). The table suggests that Federal participation on the demand side has varied widely, but has grown to over one-third of total funds raised in recent years. While the Federal participation rate for 1983 is not shown in Table 10, the 1983 figure of $204.7 billion is consistent with a "Federal participation rate" greater than the 1981 rate of 34.8 percent. This, in turn, suggests that markets would have to raise $588.2 billion in 1983, in order for the Federal participation rate to remain unchanged from the 1981 rate. This is a larger increase than is likely to occur, even considering the newly enacted tax incentives for savings. Thus Table 10 seems to add credence to those arguing that the big increase in deficits is increasing crowding out of private investment and stifling economic recovery.

TABLE 10.—FEDERAL PARTICIPATION IN DOMESTIC CREDIT MARKETS

[Dollars in billions]

	Actual											Estimates	
	1972	1973	1974	1975	1976	TQ	1977	1978	1979	1980	1981	1982	1983
Total funds advanced in U.S. credit markets [1]	151.9	198.5	186.7	174.4	241.8	65.0	310.8	378.9	412.9	342.5	407.8	([2])	([2])
Advanced under Federal auspices	22.0	26.1	25.5	27.0	26.9	6.7	36.7	58.4	72.9	79.9	86.5	114.9	113.9
Direct loans:													
On-budget	3.0	0.9	3.3	5.8	4.2	1.1	2.6	8.6	6.0	9.5	5.2	4.5	1.9
Off-budget		0.1	0.8	7.0	6.7	2.6	9.0	11.2	13.6	14.7	20.9	16.4	12.3
Guaranteed loans	18.9	16.6	10.3	8.6	11.1	−0.1	13.5	13.4	25.2	31.6	28.0	44.0	46.6
Government-sponsored enterprise loans	0.1	8.5	11.2	5.6	4.9	3.1	11.7	25.2	28.1	24.1	32.4	50.1	53.1
Federal participation rate (percent)	14.5	13.1	13.7	15.5	11.1	10.3	11.8	15.4	17.7	23.3	21.2	([2])	([2])
Total funds raised in U.S. credit markets [1]	151.9	198.5	186.7	174.4	241.5	65.0	310.8	378.9	412.9	342.5	407.8	([2])	([2])
Raised under Federal auspices	39.1	46.5	24.2	64.8	98.1	19.3	79.0	93.9	80.7	123.5	142.1	206.0	204.7
Federal borrowing from public	19.4	19.3	3.0	50.9	82.9	18.0	53.5	59.1	33.6	70.5	79.3	115.4	108.0
Borrowing for guaranteed loans	18.9	16.6	10.3	8.6	11.1	−0.1	13.5	13.4	25.2	31.6	28.0	44.0	46.6
Government-sponsored enterprise borrowing	0.7	10.6	10.9	5.3	4.1	1.4	12.0	21.4	21.9	21.4	34.8	46.6	50.1
Federal participation rate (percent)	25.7	23.4	13.0	37.2	40.6	29.7	25.4	24.8	19.5	36.1	34.8	([2])	([2])

[1] Nonfinancial sectors, excluding equities. Source: Federal Reserve Board Flow of Funds Accounts.
[2] Not estimated.

Source: "1983 Budget of the U.S. Government, Special Analysis F, Federal Credit Programs" (Washington, D.C.: Office of Management and Budget, 1982), p. 6.

Table 10 tells an incomplete story, however. To begin with, both loan guarantees and government-sponsored enterprise borrowing are over valued. The latter borrowing involves subsidies very similar in their economic impact to loan guarantees; as with loan guarantees, much of the borrowing would go on without Federal participation. A second problem with the table is that it excludes the tax loss to the Government from loans to private enterprises carried on through the issuance of tax-exempt municipal bonds by State and local governments.

Table 11 presents a modified credit budget that includes the market value of all government credit activities. This modified credit budget shows a small nominal growth in activity from 1981 to 1982 followed by a decline for 1983. Federal credit activity as a percent of expected nominal GNP declines fairly significantly in 1983 compared with the 1981 or 1982 level. The modified credit budget values direct loans at the amount of the principal, and other activities at the value of the subsidy. In the case of the tax-exempt bond subsidies, these estimates are derived by the administration.[3] The present value of loan guarantees is estimated to equal one-fourth of the principal amount (a ratio previously observed by the Congressional Budget Office). No reliable estimates of the subsidy implicit in "government sponsored" enterprise status are available, so it is assumed that the subsidy equals the average subsidy implicit in a loan guarantee, that is one-fourth the value of the loan.

TABLE 11.—A MODIFIED CREDIT BUDGET, 1981-83 [1]

Category	1981	1982	1983
New direct loans	$57.2	$56.4	$49.0
Subsidy involved in new loan guarantees	19.1	21.8	24.6
Subsidy involved in Government-sponsored enterprise borrowing	8.7	11.7	12.5
Value of tax loss, private purpose activities financed with tax-exempt bonds	9.8	13.4	15.0
Total	94.8	103.3	101.1
Total as percent of GNP	3.24	3.27	2.87

[1] All dollar amounts in billions.

Source: "1982 Budget of the United States," author's calculations.

Table 11 excludes direct Federal borrowing to finance its own operations. Table 12 adds the modified credit budget to the Federal unified deficit plus off-budget outlays (largely FFB financed) to arrive at the value of the total demand for loanable funds under Federal auspices. The Federal unified deficit is reduced slightly from the figure indicated in Table 6 to prevent double counting of some direct loan obligations. The value of Federal credit activity is related to GNP in Table 12. Note that while Federal credit as a percent of GNP rises sharply in 1982, almost all of that growth is eliminated by a decline in the Federal credit/GNP ratio in 1983.

[3] See the "1983 Budget * * *, Special Analysis F, Federal Credit Programs," especially p. 49.

TABLE 12.—THE VALUE OF THE FEDERAL CREDIT PRESENCE, 1981–83 [1]

Category	1981	1982	1983
Unified deficit less net direct loans	$52.7	$94.2	$89.6
Off-budget outlays	21.0	19.7	15.7
Federal credit activities (Table 11)	94.8	103.3	101.1
Total Federal credit presence	168.5	217.2	206.4
Total as percent of GNP	5.77	6.87	5.86

[1] All dollar amounts in billions.

Source: "1983 Budget of the U.S. Government," author's calculations.

Table 13 relates the value of credit activity carried on under Federal auspices to the pool of private savings as estimated by the Council of Economic Advisers.[4] So calculated, the Federal credit presence as a proportion of total savings is lower in 1983 than in 1981, suggesting that the present unified deficit is misleading as a proxy measure for governmental presence in the credit market. Rather than more "crowding out," less crowding out should occur in 1983 than in 1981, higher unified budget deficits notwithstanding. That conclusion holds even with a much more modest estimated growth in the savings pool, to say $575 billion by 1983 ($39 billion less than the administration's estimate).

The conclusion does require a small qualification, however. First, the realism of the administration's budget might be questioned, so the actual 1983 budget deficit may be substantially larger than proposed.

Second, total public sector demand for credit, including State and local governments should be included. Doing so, however, strengthens the argument. In recent years, State and local governments have run considerable budget surpluses. For example, in 1981 public sector deficits were only $25 billion on a national income accounts basis, the Federal Government's $62 billion deficit being largely offset by a $37 billion surplus for the State and local sector.[5]

TABLE 13.—VALUE OF FEDERALLY RELATED CREDIT AS PERCENT OF PRIVATE SAVINGS, 1981–83 [1]

Category	1981	1982	1983
Federally related credit (table 12)	$168.5	$217.2	$206.4
Pool of private savings	$463.2	$516.2	$614.1
Federal credit as percent of savings	36.4	42.1	33.6

[1] All dollar amounts in billions.

Source: Author's calculations from 1983 Budget and Council of Economic Advisers' data.

Third, the administration is considering a change in the status of government-sponsored enterprises:[6]

[4] The estimates are derived from testimony of Murray L. Weidenbaum on the 1982 Economic Report to the Joint Economic Committee, February 18, 1982.

[5] "Economic Report of the President" (Washington, D.C., Government Printing Office, 1982), pp. 96–97).

[6] See "1983 Budget of the U.S. Government, Major Themes and Additional Budget Details" (Washington, D.C.: Office of Management and Budget, 1982), p. 199.

If their current links to the Federal Government are continued, the Government-sponsored enterprises should also be brought under closer scrutiny through the budget and credit budget process. The administration prefers, however, to modify the special relationship between these enterprises and the Federal Government in order to transform them into completely private organizations.

The implication is that interest rate subsidies to these agencies may be reduced or eliminated in the coming years, reducing the true "deficit" of the Federal Government (including subsidy payments), and the size of the Federal presence in financial markets.

Fourth, the above analysis ignores possible changes in foreign purchases of U.S. Government-related debt. Table 14 shows that in recent fiscal years (1979 to 1981), Federal debt holdings of foreigners increased modestly (less than $10 billion a year), but in 5 other years in the 1970's such debt purchases were more substantial. The real possibility exists, therefore, that part of the increase in the nominal size of Federal credit participation will be absorbed outside the United States. On the other hand, of course, there could also be net reductions in foreign debt purchases that would increase the strain of Federal credit activity on U.S. credit markets from the levels indicated in Table 13.

TABLE 14.—FOREIGN HOLDINGS OF FEDERAL DEBT

[In billions of dollars]

Fiscal year	Debt held by the public		Borrowing from the public		Interest on debt held by the public	
	Total	Foreign[1]	Total[2]	Foreign	Total	Foreign[3]
1965	261.6	12.3	4.1	0.3	9.8	0.5
1966	264.7	11.6	3.1	−.7	10.4	.5
1967	267.5	11.4	2.8	−.2	11.6	.6
1968	290.6	10.7	23.1	−.7	12.6	.7
1969	279.5	10.3	−1.0	−.4	14.1	.7
1970	284.9	14.0	3.8	3.8	15.6	.8
1971	304.3	31.8	19.4	17.8	16.3	1.3
1972	323.8	49.2	19.4	17.3	16.6	2.4
1973	343.0	59.4	19.3	10.3	18.5	3.2
1974	346.1	56.8	3.0	−2.6	22.4	4.1
1975	396.9	66.0	50.9	9.2	24.7	4.5
1976	480.3	69.8	82.9	3.8	28.7	4.4
TQ	498.3	74.6	18.0	4.9	7.6	1.2
1977	551.8	95.5	53.5	20.9	33.0	5.0
1978	610.9	121.0	59.1	25.5	39.2	7.9
1979	644.6	125.1	33.6	4.1	48.3	10.7
1980	715.1	126.4	70.5	1.3	60.4	11.9
1981	794.4	135.5	79.3	9.1	78.9	16.0

[1] Estimated by Treasury Department. These estimates exclude agency debt, the holdings of which are believed to be small.
[2] Borrowing from the public is defined as equal to the change in debt held by the public from the beginning of the year to the end, except to the extent that the amount of debt is changed by reclassification.
[3] Estimated by Bureau of Economic Analysis, Department of Commerce. These estimates include small amounts of interest on the debt of Government-sponsored enterprises, which are not part of the Federal Government.
Source: "1983 Budget of the U.S. Government, Special analysis E, Borrowing and Debt," p. 14.

Fifth, any forecast of future events is based on various assumptions, not all of which will be realized. One can perform "sensitivity analysis," substituting alternative assumptions about real economic growth, inflation, unemployment, the subsidy inherent in government-sponsored agency status, etc. Under some such scenarios, the conclusion that the 1983 budget of the Government leads to reduced Federal involvement in credit markets compared to those occurring late in the Carter administration will not hold. This study uses what are believed to be reasonable assumptions. Nonetheless, they are assumptions. For example, holding other factors constant, a rise in the deficit for 1983 by $15–$20 billion above the projected level would wipe out the observed decline in the ratio of the value of Federal credit activity to private savings. Under almost all scenarios, however, no significant increase in crowding out occurs.

CONTROLLING THE UNDERGROUND GOVERNMENT ECONOMY

This study concludes that rising unified deficits are not going to put a big strain on credit markets. In large part that reflects subtraction by adding; in particular, by adding the nonunified budget portions of Federal activity. The 1983 budget proposes that the underground Federal economy be brought under closer control and reduced in size. (See Table 15.) This largely offsets the growth of the above-ground or visible government economy and its deficit.

TABLE 15.—THE UNDERGROUND FEDERAL ECONOMY, 1981–83[1]

Category	1981	1982	1983
Off-budget outlays	$21.0	$19.6	$15.7
Value of off-budget credit activities (Table 11)	94.8	103.3	101.1
Total off-budget activity	115.8	122.9	116.8
As percent of GNP	3.96	3.89	3.31

[1] All dollar amounts in billions of dollars.

Source: Author's calculations from 1983 budget estimates.

IX. CONCLUSIONS

Federal budget procedures are in a mess. Large amounts of activity are hidden effectively from all but a small number of observers. The "hidden Federal economy" resulting from current budgeting procedures proceeds from dishonest and deceptive practices. It leads to a misallocation of resources since the cost of some activities are either understated or not stated. It weakens congressional control and budgetary oversight.

Most off-budget activities need to be brought on budget. In the process of doing so, the Federal budget deficit becomes much larger than at the present. Taking credit activities into account, the deficits of the Carter administration tended to be understated, and the growth in the deficit from 1981 to 1983 discussed in the media is largely a fiction—a product of a very bad budgeting procedure. Including credit activities of the Federal Government, the Governmental activity proposed by the administration for 1983 does not threaten to increase crowding out of private productive activity over levels prevailing in 1981, the last Carter budget.

Budget reform is necessary. This study outlines some ingredients needed in such reform—bringing off-budget programs on budget, increasing control over credit activities, explicitly measuring implicit subsidies and outlays. The task is complex and a new Commission on Budget Concepts is probably needed to enact longrun reform. In the short run, however, the reported unified budget deficit should not be relied on as a meaningful indicator to be used in macropolicy decisions.

Of particular concern is the fact that excessive reliance on the invalid measure of the unified budget deficit currently being used will lead to totally inappropriate policy responses that could jeopardize both short- and long-term economic growth. Clearly a reform of budgetary concepts and procedures is an important prerequisite to the adoption of improved Federal economic policies.

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