

January 27, 1984

UNDERSTANDING THE FEDERAL DEFICIT PART 2: THE FIGURES HIDE THE TRUTH

INTRODUCTION

Predictions of twelve-digit deficits for years to come dominate the budget debate. Yet policy makers should hesitate before allowing projections of federal budget deficits to influence economic policy. First, there is the sticky problem of estimating future budget deficits. As Part I of this series explains, private and government forecasters have a dismal record when it comes to predicting the deficit.¹ Second, even if deficits actually materialize as predicted, there is no agreement about how they will affect the domestic and international economy. Finally, controversy surrounds even the definition of the budget deficit. Indeed, if policy makers are to have an accurate measure of the government's financial burden on the credit markets, they at least must understand what the deficit is.

In a simple sense, the budget deficit is government outlays minus government revenues. This is the amount the government must borrow in the capital markets. According to this conventional measure, the federal budget deficit climbed to an all-time high of \$195.4 billion in 1983, consuming 6.1 percent of the nation's Gross National Product (GNP).

A more appropriate measure of government borrowing requirements, however, is the dollar value of all government activities--of which the federal sector is just one part. Such a measure provides a better idea of the total impact of the public sector

¹ This study is the second of a four-part series examining the nature and effects of the federal deficit. Part I explored the problem of forecasting the deficit; Part III will analyze the deficit's impact on the domestic economy, and Part IV will examine the trade impacts of the deficit.

on the credit market. Using this approach, the conventional federal budget deficit, in some important respects, exaggerates total borrowing. The following important pair of factors, for instance, must be considered when measuring total government borrowing.

1. 1984 state and local budget surpluses of over \$50 billion will help offset federal borrowing. Much of the state and local surplus, in fact, is invested by law in Treasury bills, notes, and bonds.
2. The federal government will hold an estimated 22 percent of its own new debt in 1984. This effectively cancels out about \$44 billion of the 1984 deficit. The interest and principal payments on this debt are merely a transfer of money from one government agency to another with no net impact on the capital markets.

These two factors should effectively cut the FY 1984 budget deficit from nearly \$200 billion to \$100 billion. Similarly, anticipated cumulative budget deficits from 1984 to 1988 would be cut by more than half.

To obtain a better picture of the true budget deficit, the federal government should adopt the procedure used in Great Britain: a Public Sector Borrowing Requirement (PSBR). The PSBR provides a more complete account of public sector credit activities. This measurement would include not only the normal federal budget deficit, but the state and local deficit or surplus, the debt held by government agencies, and the annual cost of off-budget debt. If the federal deficit were corrected in this way to give a more accurate picture of government's true borrowing needs, the net requirement for FY 1984 could turn out to be as low as \$142 billion, compared with the deficit estimate of nearly \$200 billion. And the PSBR for 1984 through 1988 could be \$667 billion, compared with the mid-1983 forecast of \$1,063 billion.

A yearly statement of the anticipated PSBR would be a major step toward an accurate calculation of government's demand for credit. If Congress does not even know the total government borrowing, it can hardly be expected to develop sensible policies to remedy the deficit problem.

THE UNDERGROUND BUDGET

Although the official federal budget deficit receives nearly all the publicity, many government activities are carried "off-budget" (that is, they are not included in the regular budget statement). This "underground" federal economy is racing out of control, increasing 1.5 times faster, since 1976, than the budget deficit. The off-budget has mushroomed because it allows lawmakers to grant preferential access to credit markets to select groups, while proclaiming the need for fiscal discipline.

The regular budget is only the tip of the iceberg. A full picture of federal involvement in the credit markets would have to include off-budget items, such as the following:

- 1) Off-budget agencies: The costs of off-budget agencies, including the Federal Financing Bank, postal service agency, and the Strategic Petroleum Reserve, have doubled between 1976 and 1984, reaching \$14 billion in net loans outstanding (see Chart 1).

CHART 1
Federal Borrowing Activities
(in billions of dollars)

	Fiscal Year	Regular Revenues	Budget Outlays	Regular Budget Deficit	Off-Budget Deficit	Total	Net Borrowing of Government Sponsored Enterprises
(1)	1976	\$298.1	\$364.5	\$66.4	\$7.3	\$73.7	\$4.1
(2)	1977	355.6	400.5	44.9	8.7	53.6	12.0
(3)	1978	399.6	448.4	48.8	10.4	59.2	21.4
(4)	1979	463.3	491.0	27.7	12.5	40.2	21.9
(5)	1980	517.1	576.7	59.6	14.2	73.8	21.4
(6)	1981	59.3	657.2	57.9	21.0	78.9	34.8
(7)	1982	617.7	728.4	110.7	17.3	128.0	43.8
(8)	1983	600.5	795.9	195.4	12.4	207.8	53.5
(9)	1984E	668.4	848.1	179.7	14.0	193.7	55.0

Source: President's Private Sector Survey on Cost Control

- 2) Government sponsored enterprises: Borrowing by organizations that are privately owned but government sponsored, such as the Federal Home Loan Bank Board and Farm Credit Administration, registered the largest percentage increase in these "underground" items, up from \$4.1 billion in 1976 to \$55 billion in 1984--an increase of over 1,200 percent.

- 3) Unfunded liabilities: The unfunded liabilities in government pension, disability, and Social Security programs are a measure of committed future expenditures above projected receipts, but they do not appear on the budget. The U.S. government has made spending commitments, in excess of projected revenues, totalling

\$3.05 trillion (see Chart 2). If the present trend continues, by 1990 the accumulated unfunded liability will reach almost \$7 trillion, and almost \$28 trillion by the year 2000.

(4) Loan Guarantees: Loan guarantees are another form of off-budget financing that channels capital resources to favored activities at the expense of the general public. The effect of loan guarantees is to increase the demand for credit, and at the same time, to reduce the amount of credit to unfavored borrowers. Loan guarantees, therefore, expand the government's control over the allocation of resources and distort the market allocation of capital away from the most highly valued and productive areas.

The estimated volume of government loan guarantees in 1984 is \$428.4 billion, up from \$194.4 billion in 1976. The average annual increase in loan guarantees was 13.3 percent between 1976 and 1982, but slowed to 5.7 percent between 1981 and 1984.

(5) Insurance: The largest contingent liability facing the federal government is insurance, estimated for 1984 at \$2.3 trillion. This includes commitments made by the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC), and other federal institutions.

It would not be sensible, however, to include in the budget the total volume of loans, guarantees, insurance obligations, or unfunded liabilities, since they will not fall due for many years to come. Moreover, the probability is slim that all these commitments will ever come due. Many would be exercised only in an extreme emergency or default. Yet their cost is not zero--which the current method of accounting presumes. Some guaranteed loans will go into default, for instance, forcing the government to appropriate funds. And loan guarantees also impose inefficiencies on the capital markets by enabling certain borrowers to be more attractive than their situation would otherwise suggest--even if there is no direct cost to the government.

MEASURING THE TRUE COST OF LOANS

A method, therefore, needs to be found to estimate the true cost of the government's financial commitments. Some of these obligations should be accounted for like a mortgage. The government has liabilities, just as the house purchaser has a liability that he figures into his annual budget as mortgage payments. The government should calculate the annual cost of many of its liabilities in a similar fashion. Other commitments are like insurance premiums. A soundly managed insurance company assesses the risk associated with its business and figures the total annual cost it must cover with premiums. The government should apply this process to many off-budget loan and insurance programs.

CHART 2

U.S. Government Pension
Social Security Liabilities

	<u>Unfunded Pension And Social Security Liabilities In \$Trillions</u>
1976	\$1.011
1977	1.211
1978	1.646
1979	1.896
1980	2.206
1981	2.475
1982	2.700
1983	2.801
1984E	3.051
Average Annual Percentage Increase 1976-1984E	14.8%
<hr/>	
<u>Extrapolated At 1976-1984E Growth Rates</u>	
1990	\$6.984
2000	\$27.766

Source: President's Private Sector Survey on Cost Control.

A full accounting of the government's annual borrowing needs should include annual cost assessments of this type. Various methods have been suggested for making this calculation, some of which involve a different method of handling federal financial activities.

One technique, called the "market plan,"² has been developed to assign the actual cost of loan guarantees, direct loans, and interest subsidies to the agencies that provide these benefits. The plan requires that all agencies, or government banks empowered to do it for them (1) sell their loans immediately to private investors in an open auction and (2) purchase guarantees from private suppliers.

Because most agency loans are provided at lower than market interest rates, they would sell only at a significant discount over the face amount, thereby resulting in a loss over the funds advanced. This loss would be a true measure of the current value of the interest rate subsidy or other special preference extended to the borrower. Similarly, the cost of a loan guarantee purchased from a private supplier would be equal to the current value of loan insurance. Agencies would then be charged for the true cost of the guarantees and loan concessions, and necessary appropriations legislation put before Congress.

Under this market plan, the total volume of agency borrowing would not be included in the PSBR or deficit. The agencies, however, would have to account for the annual cost of loan guarantees and subsidize them out of their budgets. Financing costs would therefore be explicit and on budget. The estimated subsidy implicit in prospective government credit programs, according to proponents of the market plan, would be \$38 billion in 1984. This estimate includes a \$30 billion yearly cost of direct loan subsidies and an \$8 billion cost of government loan guarantees.

It is clear that a more complete accounting of the federal budget deficit is essential for a proper estimate of the impact of government borrowing on credit markets. In developing such a new measure, it should be remembered that the on-budget deficit is only one part of total government borrowing and financial involvement. Lawmakers should spend at least as much time on the off-budget deficit, loan guarantees, and other government financial commitments.

THE PUBLIC SECTOR BORROWING REQUIREMENT (PSBR)

The government would do much to clarify the debate on the budget by publishing an annual Public Sector Borrowing Requirement

² Marvin Phaup, draft paper for discussion purposes only, "A New Approach to the Budgetary Treatment of Federal Credit Activity," July 20, 1983.

(PSBR), as the British government does. This would indicate the net borrowing needs of all levels of government and government enterprises. The Administration should also announce the creation of a task force, drawing on officials from the Office of Management and Budget, the Treasury, and the Congressional Budget Office, to determine which credit activities should be on-budget and counted in the PSBR, and which can be properly excluded. The task force should also examine the possibility of enacting a "market plan," under which the budget of each agency would be charged for the interest subsidies it receives.

Publishing a PSBR, in other words, would mean adjusting the federal deficit by:

- a) the total surplus or deficit resulting from state and local government activities;
- b) the debt held by the federal government itself; and
- c) the annual cost of loans, guarantees, and similar liabilities.

Chart 3 provides an indication of how the Public Sector Borrowing Requirement, adjusted for the above factors, would compare with the mid-1983 OMB forecasts of the federal deficit until 1988. Necessarily, the cost of government credit activities must be a very rough estimate--and will remain so until accurate techniques are developed to measure the cost of credit activities.

Nevertheless, even these approximate figures indicate the disparity between the published federal deficit and the true extent of borrowing by all government--even though policy makers generally believe that the federal deficit provides them with an accurate picture of the borrowing requirement.

CONCLUSION

One of the thorniest and most confusing issues surrounding budget deficits is the problem of definition. The current budget deficit numbers provided to Congress and the American people are a flawed indicator of the federal government's impact in the credit market, and so the policy debate takes place amid false impressions of the true problem. In certain ways, the published deficit figure exaggerates the government's borrowing, by failing to account for inflation, government holdings of its own debt, and state and local surpluses. Accounting for these factors would cut the public sector's borrowing needs by more than half. On the other hand, the federal government also is involved in an enormous range of credit assistance, which cannot be easily or accurately accounted for in the budget. The implicit yearly subsidy involved in credit programs adds an estimated \$38 billion to the total government borrowing needs.

CHART 3

The Public Sector Borrowing Requirement (PSBR)
(in billions of dollars)

	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>TOTAL</u>
Mid-1983 estimates of current services deficits	\$200	\$206	\$219	\$228	\$210	\$1,063
Projected state and local surpluses	-52	-45	-48	-57	-62	-264
Estimated debt held by federal government*	-44	-56	-68	-80	-74	-322
Estimated cost of government credit programs**	38	38	38	38	38	190
<hr/>						
Net adjusted deficit on midyear basis (PSBR)	142	143	141	129	112	667
<hr/>						

Source: Paul Craig Roberts, Business Week, January 9, 1984 (primary source).

Data: Office of Management and Budget.

*Estimated by author, based on historical trends and agency estimates.

**This estimate measures only the subsidy implicit in prospective government loans and loan guarantees, not the subsidy in the current stock of loans. The estimate assumes new direct loans of \$50 billion a year and that 60 percent of the direct loan volume is equal to the present value of the subsidy. Loan guarantees are assumed to grow by \$100 billion a year and the present value of the guarantee is estimated at 8 percent of the contingent liability. The total cost is, therefore, \$30 billion for the interest subsidy (\$50 billion x 60 percent) and the loan guarantee cost is \$8 billion (\$100 billion x 8 percent). The existing loan portfolio could also be sold off under the market plan, generating a net revenue gain to the government or to off-budget agencies.

These off-budget credit activities shield a massive component of government intervention from congressional and public scrutiny. This financing cost should be brought on-budget, so that the true extent of government borrowing can be assessed. Congress and the Administration should carefully examine the federal government's credit activities and develop methods to calculate their true annual cost.

Lawmakers should devise a more encompassing measure of the financial burden imposed by the government than is indicated by the federal deficit. If a Public Sector Borrowing Requirement were published annually with the budget, it would prove a useful and meaningful benchmark of government financial transactions. Ideally, the PSBR should include the effects of inflation, government holdings of debt, state and local surpluses, and the cost of off-budget credit as well. By utilizing this more accurate measure of the borrowing needs of government, Congress could proceed to develop economic policy, free of the mistaken impression that the federal deficit indicates the extent of public sector pressure on the capital markets.

Thomas M. Humbert
Senior Policy Analyst and
Walker Fellow in Economics