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PUTTING OFF-BUDGET FEDERAL SPENDING BACK ON THE BOOKS

INTRODUCTION

The Office of Management and Budget (OMB) recently proposed putting all federal off-budget spending back on the books. Federal off-budget spending is spending or lending that, by law, is not counted as part of the regular budget and thus does not appear in "the deficit." Since 1973, off-budget spending has ballooned, having grown from \$100 million in 1973 to \$21 billion in 1981, a 21,000 percent increase. In fiscal year 1985, off-budget spending, it is estimated, will be in the range of \$15 billion, and there is now nearly \$150 billion in off-budget debt outstanding.

Off-budget spending, in short, is a tool used to disguise the true cost of government programs. As a result, U.S. taxpayers forfeit a degree of control over the process of government. The OMB proposals to place off-budget spending back on the books would afford an important step toward fiscal responsibility.

WHAT IS OFF-BUDGET SPENDING?

Off-budget spending is federal spending or lending that, by law, is not counted as part of the regular federal budget,¹ and as such, is isolated from the normal appropriations processes and public debate surrounding on-budget spending. Since 1973, Congress has enacted legislation to place various agencies off the books. The U.S. Railway Association, the Rural Electrification and Telephone Revolving Fund, and the Rural Telephone Bank were

¹ For a detailed discussion of off-budget spending at the federal, state, and local levels of government, see James T. Bennett and Thomas J. DiLorenzo, Underground Government: The Off-Budget Public Sector (Washington, D.C.: Cato Institute, 1983).

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placed off-budget in 1973. The U.S. Postal Service Fund and the Pension Benefit Guaranty Corporation were placed off the books in 1974. Off-budget spending seemingly is nonpartisan, for it was the Reagan Administration that in 1981 placed the Strategic Petroleum Reserve off-budget.

Table 1 shows recent off-budget outlays by agency. The entity responsible for most off-budget spending is the Federal Financing Bank (FFB), which was created in 1974 as part of the Treasury Department. Its primary activity is the purchase of agency debt from funds obtained by borrowing directly from the Treasury. By law, any federal agency can place some of its spending or lending off the books by dealing with the FFB, since FFB borrowing is not included as part of the Treasury's outlays--although interest payments from the FFB to the Treasury are counted as deductions from Treasury outlays.

Table 1

Outlays of Off-Budget Federal Entities
(in billions of dollars)

Off-budget Federal Entity	1983	1984 estimate	1985 estimate
Federal Financing Bank	10.4	12.7	10.2
Rural Electrification and Revolving Fund	*	-	-
Rural Telephone Bank	0.1	0.2	0.2
Strategic Petroleum Reserve	1.6	2.2	1.7
Postal Service Fund	0.3	1.2	2.8
U.S. Railway Association	-	-	-
Synthetic Fuels Corporation	-	-	-
Total	12.4	16.3	14.8

*\$50 million or less.

Source: Budget of the United States Government, FY 1985 (Washington, D.C.: U.S. Government Printing Office, 1984), pp. 6-11.

There are two ways in which the FFB serves as a conduit through which federal spending is placed off the books: FFB purchase of loan assets and its purchase of guaranteed loans issued by federal agencies. Outstanding FFB holdings in these three categories, from 1976 to 1983, are shown in Table 2. By 1983, there were \$60.5 billion in loan assets and \$46.3 billion in guaranteed loan purchases for a total of \$106.8 billion in debt outstanding.

Table 2

Outstanding Federal Financing Bank Holdings, Fiscal Years 1976-1983
(billions of dollars)

<u>Fiscal Year</u>	<u>Loan Assets</u>	<u>Direct Loans*</u>
1976	9.2	3.1
1977	16.0	6.6
1978	23.3	10.5
1979	32.7	14.4
1980	40.4	21.5
1981	51.8	31.8
1982	57.2	39.3
1983	60.5	46.3

*That is, purchases of loans guaranteed by agencies.

Source: Special Analyses, Budget of the U.S. Government (Washington, D.C.: U.S. Government Printing Office, Fiscal Years 1978-1985).

The most important source of off-budget FFB financing, however, is the purchase of loan assets. Federal agencies are permitted to "sell" their direct loan obligations to the FFB. These sales are treated as repayments of the loans as far as the budget is concerned. Converting on-budget direct loans into off-budget loans in this way gives the taxpayer the erroneous impression that debts are being repaid. In addition, the agencies then can make even more loans since they have more funds available due to the sale. The net effect is a gross understatement of the amount of federal lending activity. For example, in 1981 the Farmers Home Administration (FmHA) extended more than \$9 billion in new loans, but the federal budget actually recorded a net reduction in loans outstanding to the tune of \$900 million, suggesting that loan repayments exceeded new loans. But this impression was misleading because the FmHA simply had converted almost \$7 billion in new on-budget loans to off-budget loans by selling them to the FFB. Accordingly, the recorded federal budget deficit was "reduced," in an accounting sense, by that amount.

The second way in which the FFB helps disguise federal spending is by purchasing loans (from the borrowers) guaranteed by other agencies, thereby converting the guaranteed on-budget loans into off-budget loans. For example, there are Department of Defense programs that guarantee the principal and interest on loans made before fiscal year 1985 to foreign governments to finance their purchases of military equipment. A foreign government can take the loan guarantee to the FFB, which may purchase it for the full amount of the guaranteed loan principal. Thus the borrower has received the funds, in the form of a direct loan, from the federal government. And since loan guarantees are

not considered to be budgetary outlays, none of the loan activity is charged to the budget of the Defense Department. In 1984, Congress amended the law, such that new guarantees issued under these military programs will appear in the budget.

Since the FFB is an off-budget agency, its direct loans are not included in the budget totals. As shown in Table 2, the Bank's purchases of loan guarantees have ballooned in recent years, more than doubling between 1980 and 1983, a period when on-budget spending programs grew much more slowly. The spending that has expanded because of this activity includes foreign military sales (\$14.3 billion in debt outstanding in 1983), Rural Electrification Administration programs (\$18.9 billion), the Student Loan Marketing Association (\$5 billion), and, to a lesser degree, federal public housing programs, Department of Transportation railroad programs, and the Tennessee Valley Authority.²

When the FFB was established, the argument was made by the Treasury Department that such a bank would reduce financing costs by pooling agency borrowing. But in reality the FFB increased the borrowing costs to the government, because FFB borrowing from the Treasury increased the overall interest rate on federal debt. This more than offset the minimal savings to federal agencies that take advantage of the slightly lower Treasury borrowing rate (approximately one-eighth of one percent). Agency debt appeals to a different market than does Treasury debt, as the difference in interest rates attests. And when the Treasury issues more debt (to finance the FFB), it puts pressure on the market segment to which its issues appeal, and that forces rates up on Treasury debt. Indeed, this effect invalidates the entire economic--but unfortunately not the political--rationale for the FFB.

The Federal Financing Bank and other off-budget mechanisms, therefore, are used to hide the true costs of federal spending programs from those who must ultimately pay for them--U.S. taxpayers. Dozens of agencies participate in the "laundering" of funds through the FFB, which enables their spending programs to continue growing outside the direct view of the taxpaying public.

OFF-BUDGET SPENDING AND THE POLITICAL PROCESS

Off-budget spending is the epitome of fiscal irresponsibility and governmental hypocrisy. OMB's proposal to include off-budget outlays as part of the budget should be welcomed by all those who are seriously concerned about budgetary control. The political role of off-budget spending is to allow politicians to preach fiscal responsibility and to practice political profligacy. It is a way of telling U.S. voters that they can have something for nothing--that the government can provide them with benefits at no

² Executive Office of the President, Special Analyses: Budget of the United States Government (Washington, D.C.: U.S. Government Printing Office, 1983), p. F-69.

cost. A brief look at the origins of federal off-budget spending makes this clear.

In 1974, U.S. News and World Report praised the Congressional Budget and Impoundment Control Act as "a revolutionary budget reform intended to give Congress a tighter grip on the nation's pursestrings."³ The Budget Act of 1974 emerged from a recognition that existing budgetary procedures generated a bias toward overspending and budget deficits. Before 1974, the total amount of federal spending was the product of many individual appropriations decisions; no explicit limit was ever placed on the total amount of public expenditure. Every Congressman had then, as now, a strong incentive to maximize spending for his own constituency, but no Congressman was required to take responsibility for the total amount of federal spending. So for the first time in the history of Congress, lawmakers were required to stand up and be counted--they had to vote for a budget package. The Budget Act also created a budget committee in each House of Congress, responsible for setting overall targets for revenues, expenditures, and deficits.

Unfortunately for the taxpayer, while federal politicians were congratulating themselves on becoming more fiscally responsible, the lawmakers were simultaneously placing various agencies off budget. They also were busy establishing the Federal Financing Bank so that spending and borrowing by all agencies could be placed off budget.⁴ In short, off-budget spending allowed politicians of all persuasions to continue to win the political support of special interests, at taxpayers' expense, while denying to taxpayers that the subsidies were costing them anything. It has enabled Congress to suggest that there is such a thing as a free lunch after all. Examples: the Export-Import Bank can continue to subsidize big business with off-the-books loans; the Tennessee Valley Authority can subsidize the utility bills of businesses and residents of the southeastern states; the Farmers Home Administration and Rural Electrification Administration can continue to grant low-interest loans and other subsidies to Americans in rural areas; the Department of Defense can subsidize exports by weapons contractors; and students can receive low interest loans. Beginning in 1992, even the Social Security system will be placed off-budget. This will not, of course, restore the financial stability of the Social Security system, but politicians hope it will make the federal deficit (and deficit projections) look better, at least on paper.

³ Cited in James M. Buchanan and Richard E. Wagner, Democracy In Deficit: The Political Legacy of Lord Keynes (New York: Academic Press, 1977), p. 156.

⁴ Bennett and DiLorenzo, in Underground Government, provide a more detailed analysis of the political economy of off-budget finance. For a discussion of local government off-budget finance, see James T. Bennett and Thomas J. DiLorenzo, "Off-Budget Activities of Local Government: The Bane of the Tax Revolt," Public Choice, Fall 1982, pp. 333-342.

There is one question that should be posed to those who favor off-budget spending: If all these programs are in the public interest, why then are they so well hidden from the public? If these programs are part of government's legitimate function, why not finance them on budget rather than off budget? The real answer is that many of these programs could not survive politically, at least not at the levels at which they are currently funded, in the normal democratic process where voters can have a reasonably clear perception of the benefits and costs of federal programs.

Off-budget spending provides Congressmen with greater latitude than is available with regular on-budget spending, since the latter is subject to various checks and balances, however imperfect. When in 1979 the Chrysler Corporation was granted its widely publicized loan guarantee by the federal government, for instance, the on-budget guarantee was criticized sharply by both conservatives and liberals objecting to government bailouts of big business, or "corporate welfare." Similarly, on-budget loan guarantees to New York City in the late 1970s were vigorously debated. In each case, the on-budget status of the loan guarantees meant that they went through the normal appropriations process and received widespread public attention. These well-publicized loan guarantees, however, pale in comparison to the billions of dollars of off-budget loans administered by the FFB--loans that usually receive only minimal congressional debate and almost no public attention.

Subsidies to big business, defense contractors, affluent college students and professors, and even more affluent corporate farm businesses are partially hidden when granted in the form of on-budget guaranteed loans rather than direct cash grants.⁵ If these subsidies were in the form of cash grants, the voting public doubtless would balk at many of them, once they realized how much they cost. Keeping these programs off-budget, however, hides them from public scrutiny and so enables their supporters to obtain more benefits than the taxpaying public would otherwise permit. This is bad politics and a bad way of setting priorities for use of the nation's resources. If the defense budget should be bigger (or smaller) than it is, the issue should be decided openly by the electoral and political process, which in a democracy includes the opinions of voter-taxpayers. Similarly, the issue of a larger (or smaller) welfare state also should ultimately be

⁵ Guaranteed loans are loans to individuals or governments in which the federal government guarantees the principal and interest in case of default. The major economic impact of guaranteed loans is not the dollar amount of defaulted loans, but rather the allocative effects. There were approximately \$125 billion in new federal guaranteed loans issued in 1983. The effect is to allocate credit according to political rather than economic criteria. Unsubsidized, nonguaranteed borrowers get crowded out of the market. See James T. Bennett and Thomas J. DiLorenzo, "Credit Allocation and Capital Formation: The Political Economy of Indirect Taxation," in Dwight Lee, ed., Taxation and Capital Formation (San Francisco: The Pacific Institute, 1985).

decided through the electoral and political process. The problem with off-budget spending is that it encourages the excessive expansion of all types of spending by sidestepping the normal democratic process as it distorts budgetary priorities and disguises the cost of governmental activity. Eliminating off-budget spending, as OMB has proposed, would be an important first step toward fiscal responsibility and an improved democratic process.

ECONOMIC IMPLICATIONS OF OFF-BUDGET SPENDING

The problems associated with off-budget spending are not solely political. Off-budget spending is an accounting gimmick used to reduce the perceived cost of government programs. When the Federal Financing Bank receives funds from the U.S. Treasury, the funds may not show up in the federal budget, but the economic costs of these expenditures are nonetheless real. The Treasury must either tax or borrow to obtain the funds so that ultimately they come from either taxpayers or at the expense of those who otherwise would have borrowed those funds to finance cars, homes, and businesses. The cost of off-budget spending, like all government spending, is the sacrifice of private sector spending. Since much off-budget activity is in the form of credit marketing activity, such as subsidized loans and loan guarantees, the credit markets are distorted to the extent that government allocates credit to economically inefficient (albeit politically popular) uses. In 1980, for instance, a 20 percent prime rate and 16 percent consumer loan rate contributed to the bankruptcy of scores of small businesses, yet the Rural Electrification Administration began a new program to provide 35-year loans at 5 percent to finance rural cablevision stations; rural home mortgages were available at 3.3 percent; and student loans went for 7 percent.⁶ In each case, resources were diverted from one use to another, simply because certain groups enjoyed federally subsidized credit facilities.

OMB's proposal to put off-budget spending into the regular budget has been criticized by some as increasing the federal deficit. But this objection is a red herring. Off-budget spending is a problem because it hides the true cost of government programs and therefore allows government spending to be higher than it otherwise would be. The true cost to society of higher spending is foregone private sector economic activity, regardless of whether the spending is on budget or off budget. If the federal government spends \$900 billion, for example, it will have essentially the same effect on the nation's resources whether all of it appears on the official budget accounts or not. But because off-budget credit reduces the perceived cost of governmental programs--since the costs are passed on to future generations--it therefore increases the demand for them.⁷ Such deficit financing,

⁶ Bennett and DiLorenzo, Underground Government, p. 144.

⁷ James T. Bennett and Thomas J. DiLorenzo, "The Ricardian Equivalence Theorem: Evidence From the Off-Budget Public Sector," Public Finance/Finances Publique, vol. 2, 1983, pp. 309-316.

the mainstay of off-budget spending, causes total government spending to be higher than it otherwise would be. This leads to greater crowding out of private sector economic activity. By disguising the true costs of government, off-budget spending encourages deficit and allows government to take a larger proportionate share of national income at the expense of private sector production, consumption, and employment.

What many who object to the OMB proposals are really saying is that they prefer a relatively larger governmental sector and a smaller private sector. To object to the proposals on grounds of fiscal responsibility, stemming from an alleged concern over the deficit, is economic nonsense. The published deficit may well go up in the short run, as hidden spending is put on the books. But Congress then would be held more fully responsible for its actions, and increased public scrutiny would foster greater incentives for genuine budgetary restraint and deficit reduction.

CONCLUSION

The legal provisions that exclude off-budget entities from unified budget totals should be repealed by Congress. An alternative would be for Congress to revise the budgetary treatment of loan assets and direct loans to guaranteed borrowers. Redefining loan asset sales as agency borrowing, for instance, would keep on-budget loans from being given off-budget status. A similar approach could be applied to FFB purchases of loan guarantees made by on-budget agencies. By treating these as loans made by the agency issuing the guarantee and redefining the FFB transaction as agency borrowing, agency budgets would accurately reflect outlays associated with FFB-financed loans and enable the public to see exactly what these loans cost.

Eliminating federal off-budget spending would be a long overdue reform. The implicit subsidies embodied in off-budget spending and loan programs are not only economically inefficient; they are also inequitable since they are comprised almost entirely of subsidies to those in the middle- and upper-income brackets. Perhaps this is why they are so well hidden from the public. Opposition to off-budget spending spans the political spectrum, for regardless of their political persuasion, most Americans prefer a government that is aboveboard and open, not underground and off the books.

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