NATIONAL CENTER FOR POLICY ANALYSIS

THE R.E.A.L. FEDERAL DEFICIT

Pick up a newspaper, a news magazine, or even the official federal budget and you'll read that the 1983 deficit is expected to be about $208 billion. Aside from the challenge of trying to comprehend the enormity of this number, you may think that this $208 billion figure represents the amount of money the federal government will have to borrow this year. If so, you're wrong.

This year total direct and indirect borrowing by the federal government will reach $324 billion--over $100 billion more than what is reported by the "official" federal deficit. Through various forms of accounting gimmickry, government accountants are failing to record in the official budget a huge amount of borrowing and lending activity.

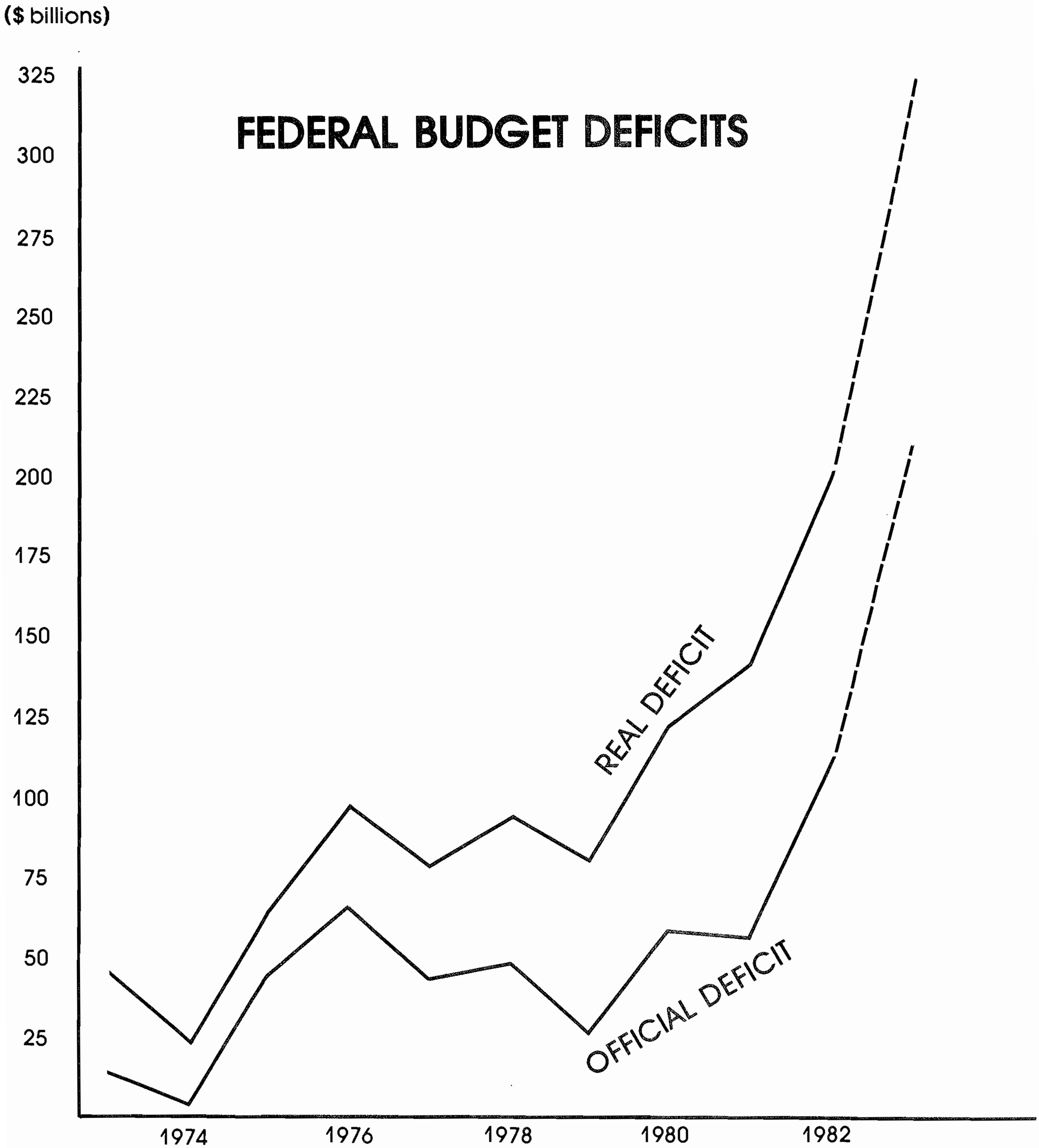
In order to get a more accurate picture of the federal government's role in U.S. credit markets, the NCPA proposes a new deficit concept: the Real Effect on the Allocation of Loans (R.E.A.L.) deficit. The REAL deficit measures the total number of dollars the federal government diverts from the private credit market each year. The REAL deficit therefore measures total government borrowing, both direct and indirect, both on-budget and off-budget.

The magnitude of this deficit is enormous:

- Official federal deficits over the last decade add up to $494 billion. But total direct and indirect borrowing by the federal government over that period was $972 billion.
- On the average, the REAL federal deficit has been about twice the size of reported deficits.

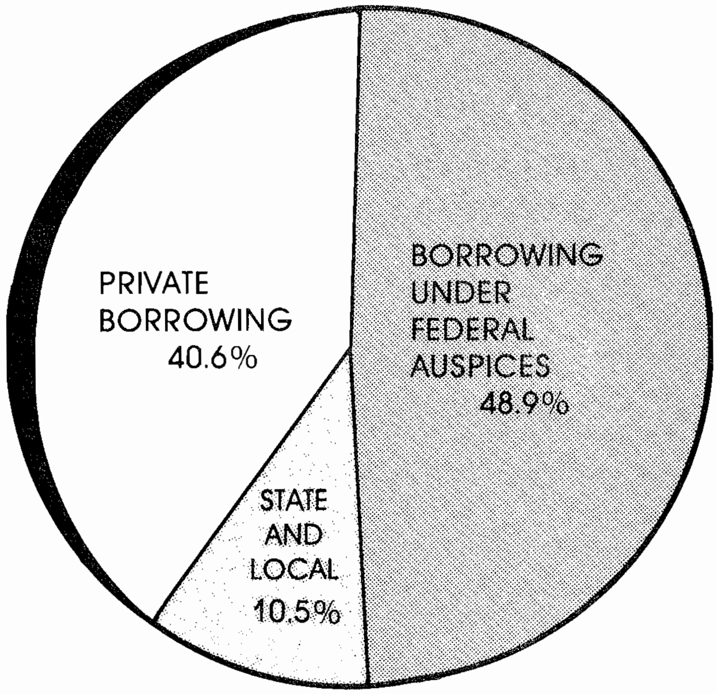
In a sense the REAL deficit is not a deficit at all. For example, it is not an accurate accounting of liabilities being created for future taxpayers to bear. But for that matter, neither is the "official" deficit an accurate accounting of those liabilities. What the REAL deficit does tell us, much more accurately than the official deficit, is how the federal budget is affecting the private credit market.

The purpose of this report is to introduce and explain the concept of a REAL deficit, to investigate methods of calculating it, and to compare it with the official deficit as reported in the Unified Budget of the United States Government.

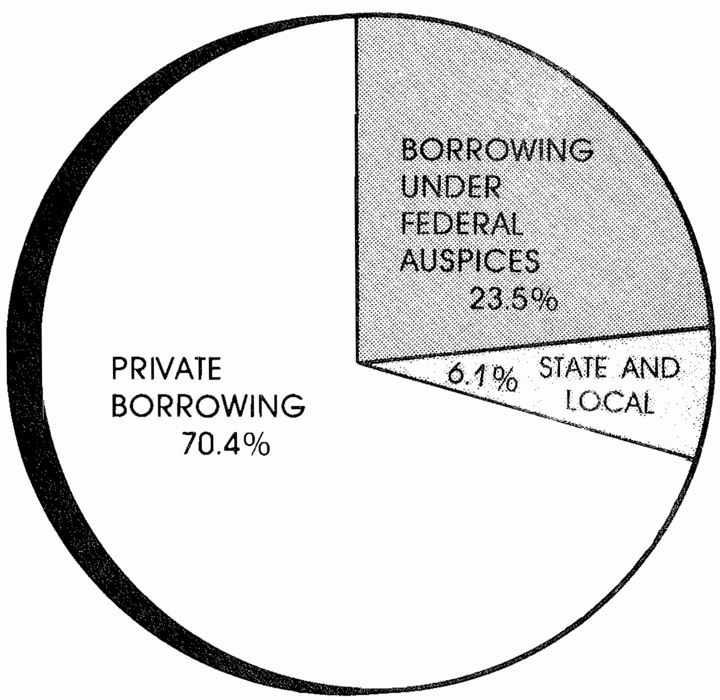


Source: National Center for Policy Analysis (---estimate)

FUNDS LENT IN U.S. CREDIT MARKETS



1982



1973

Source: National Center for Policy Analysis

ACCOUNTING FOR THE DEFICIT

What is the true deficit of the federal government? It is difficult to say because there is no "right" way to calculate the government's deficit. In fact, there are a number of ways to calculate the deficit, each designed to answer a different set of questions.

Since World War II economists and financial experts have generally agreed that the federal government's budget is different in kind from the budget of a household, a profit-making enterprise, a non-profit institution, and even the budgets of state and local governments. The federal government's budget affects the economy as a whole in ways which no other budget does.

Historically, there have been three principal questions raised with respect to the government's budget: (1) What obligations are being created for future taxpayers? (2) What is the budget's effect on total spending in the economy? and (3) What is its effect on credit markets? The answers to each of these questions require different methods of accounting.

1. **Liabilities for Future Taxpayers.** The traditional concern of economists regarding the federal deficit has been the total liabilities being created for taxpayers. If government spends more than it collects in tax revenues, it must borrow from the private credit market to finance the excess spending. This borrowing takes the form of government bonds and treasury bills--government pledges to pay back lenders at some point in the future.

There is a widespread belief that the "official" deficit (the unified budget deficit) of the federal government measures the liabilities which will fall on future taxpayers. Similarly, there is a widespread belief that the national debt represents the sum of deficits that have been created up to now. These are popularly held impressions of what the deficit and the debt represent. In reality, however, nothing could be further from the truth.

Take the national debt, for example. In 1982, it stood at a little over one trillion dollars. But what few people realize is that over 30 percent of this debt is held by federal agencies.[1] In other words, the federal government owes a large portion of this debt to itself. Theoretically we could wipe out over 30 percent of the national debt simply by cancelling what one government agency owes to another.

1. "The Federal Debt: On-Budget, Off-Budget and Contingent Liabilities," Joint Economic Committee, Congress of the United States, June 8, 1983, p. 3.

A more serious problem is that neither the official deficit nor the official national debt reflects spending commitments which Congress has made for future budget periods. When Congress legislates an increase in Social Security benefits, for example, it makes a commitment to spend money in the future. Yet these commitments are not reflected in the official deficit. In addition, the official deficit does not reflect the government's potential liability for private debts. If the federal government guarantees a student loan, for example, the taxpayers will become liable if the loan is defaulted.

When commitments for future spending are considered, including probable spending that will arise from potential liabilities, the true national debt is about three and one-half times more than the official national debt--more than $15,000 for every man, woman and child in the country.[2]

2. **Effects on Total Spending.** In the 1950's and early 60's, Keynesian economic theory became the most influential theory to guide economists and the federal government. And with this theory's rise to dominance came a shift in focus--from the traditional concern over future taxpayer liabilities to a new-found concern with the effects of government finance on total spending within the economy. So complete was this shift that Congress today gives very little attention to calculating future taxpayer liabilities. In fact, there is no generally recognized and accepted method of performing such calculations.

In the Keynesian view, the primary focus and concern is with total spending on goods and services. Government deficits are important to the Keynesians because of the belief that when government borrows from the credit market it spends money that otherwise might not be spent.

To see what effect this view has on budget accounting procedures, take again the example of a guaranteed student loan. The fact that the government guarantees the loan gives the student an advantage over other borrowers in the market. It does not necessarily affect the total amount of lending in the economy, however. In addition, the fact that the student spends the loan mainly on living expenses (consumption) and that the funds might otherwise have financed the purchase of capital goods (investment) is irrelevant. What counts for the Keynesians is total spending, not its composition.

3. **Effects on the Credit Market.** The 1970's saw a decline in the influence of Keynesian economic theory. With that decline came a concomitant rise in a new view toward the effects of the government deficit on the economy: Government borrowing in the credit market "crowds out" private borrowing, slows the rate of private investment, and thus stifles economic growth.

2. "The Federal Debt," p. 8.

It is widely believed that the official deficit accurately measures the impact the federal budget has on the private credit market. This belief is wrong.

OFF-BUDGET BORROWING: THE GROWTH OF UNDERGROUND GOVERNMENT

The difference between the amount borrowed by the federal government as reported in the unified budget and the amount borrowed in reality is accounted for by activities classified as "off-budget".[3] These activities have become of increasing concern to those who view with alarm the ever-larger share of credit which is being siphoned away by the federal government.

One way in which this federal borrowing is conducted is through activities of government agencies which have been removed from the official budget. Before 1973 none of the activities of federal agencies were conducted off-budget. But that changed with passage of the Congressional Budget and Impoundment Act of 1974. For the first time Congress was required to project revenues and expenditures and to commit itself to the resulting deficit. Unwilling to take full responsibility for the deficits that were being projected, Congress responded simply by removing agency after agency from the official budget.

The list of federal agencies which have been taken off-budget since 1973 includes the U.S. Postal Service, the Pension Benefit Guarantee Corporation, the Federal Financing Bank, the Rural Electrification and Telephone Revolving Fund, the Synthetic Fuels Corporation, and more recently the Strategic Petroleum Reserve.

The tendency to place federal agencies off-budget appears to have no bounds. The recent Social Security Reform Act provides that the Social Security Administration will be pulled off-budget in 1992.

Since 1973, outlays of off-budget agencies have skyrocketed:

- Over the last decade, spending by off-budget agencies has increased 17,000 percent.

3. See James Bennett and Thomas DiLorenzo, Off-Budget Spending: The Growth of Underground Government, (Dallas, Texas: National Center for Policy Analysis, 1983) and James Bennett and Thomas DiLorenzo, Underground Government: The Off-Budget Public Sector (Washington, D.C.: CATO Institute, 1983).

Another way in which federal borrowing is conducted off-budget is through an accounting trick which converts on-budget federal loans to off-budget federal loans. For example, on-budget agencies which make loans to the public can sell the loans to the Federal Financing Bank (FFB), which is an off-budget entity. This removes the loan from the official budget and gives the agency funds to lend again. The FFB finances these activities by borrowing from the Treasury. However, Treasury outlays to the FFB are not counted in the official budget.[4]

Yet another way in which the activities of the federal government are conducted off-budget is through government guaranteed loans. These loan guarantees, as in the case of the student loan, do not show up in the budget and therefore are not reflected in the deficit. Yet they divert money away from the private credit market to specially priviledged borrowers.

Because guaranteed loans do not show up in the official budget, and because direct loans can often be converted to off-budget loans through various forms of federal bookkeeping gimmickry, the growth of federal credit activities has been alarming. Since the passage of the Congressional Budget Act in 1974,[5]

- Direct loans by the federal government have soared by 300 percent.

- Primary loan guarantee commitments have grown by 260 percent.

Moreover, the extent to which these activities are conducted off-budget is astonishing:[6]

- In 1981, the federal government entered into $133.7 billion in direct loan obligations and primary loan guarantee commitments. Of this amount only $5.2 billion, less than 4 percent, was reflected in the offical budget.

- This means that $129 billion of lending activity--more than twice the official deficit that year--was conducted off-budget.

Not only do these activities escape the official budget review process, but in many cases, (veterans' mortgage guarantees, for example) there is literally no limit to the amount of federally sponsored lending:

4. See "Report of the Temporary Subcommittee on Federal Credit," Committee on the Budget, U.S. Senate, December, 1982; and Bennett and DiLorenzo, Underground Government, Chapter 7.

5. "Report of the Temporary Subcommittee on Federal Credit," p. 19.

6. Congressional Budget Office, Baseline Projections for Fiscal Years 1984-1988, A Report to the Senate and House Committees on the Budget, Part II, February, 1983, p. 60.

- Approximately 26 percent of loan guarantees and 62 percent of all direct loans are not subject to appropriations limitations.[7]

- In 1982, approximately $44 billion in direct loans and loan guarantees were not subject to congressional appropriations controls.[8]

Finally, a fourth way in which government activities are conducted off-budget is through "government sponsored enterprises." The major ones are the Federal National Mortgage Association (FNMA), the Farm Credit Administration (FCA), the Federal Home Loan Bank (FHLB), the Federal Home Loan Mortgage Corporation (FHLMC), and the Student Loan Marketing Association (SLMA).

Originally chartered by the federal government, these are now private entities. However, they are both regulated and subsidized by the federal government. Many of their board members are appointed by the President, and many of their decisions must be cleared by government agencies such as the Treasury Department. As James T. Bennett and Thomas J. DiLorenzo, two students of off-budget activity have observed, "federally sponsored enterprises are private in name only, and are yet another way in which the federal government directs billions of dollars of credit without being subject to the federal budget review process."[9]

Spending by these enterprises has grown by leaps and bounds over the last decade:

- Since 1973, borrowing by government sponsored enterprises has increased over 500 percent.

THE "REAL" DEFICIT CONCEPT

There seems to be no valid reason for treating some loans of government agencies as on-budget and other loans as off-budget. This fact was recognized by the President's Commission on Budget Concepts, which recommended that sales of loan assets to the FFB by government agencies be treated as "borrowing" rather than "sales of assets."[10] In addition, there seems to be no defensible reason for treating guaranteed loans different from direct loans.

7. Congressional Budget Office, Federal Credit Activities: An Overview of the President's Credit Budget for Fiscal Year 1983, March, 1982, pp. XIV-XV.

8. Office of Management and Budget, Budget of the United States, Fiscal Year 1984, Special Analysis F, p. 11.

9. Bennett and DiLorenzo, Off-Budget Spending, p. 18.

10. OMB, Budget of the United States, Fiscal Year 1984, Special Analysis F, p. 21.

Suppose the federal government guarantees a $100 loan to an individual. This has the same economic effect that would have occurred had the government simply borrowed the $100 on-budget and lent it to the borrower directly. In either case, if the borrower defaults the taxpayers are out $100. Current accounting practices therefore seem largely indefensible, regardless of the purpose for which the budget is constructed.

As we noted at the outset of this study, the correct way to calculate the federal deficit depends upon the question one wants to answer. Today the primary interest in the federal deficit stems from concern over the federal budget's impact on the credit market. For this reason the NCPA proposes a new deficit concept that is consistent with this interest. It is called the Real Effect on the Allocation of Loans, or the REAL deficit.

The REAL deficit measures the total number of dollars the federal government diverts from the credit market each year. As such it encompasses not only borrowing to finance the official deficit, but also off-budget borrowing by the Treasury and by off-budget entities, borrowing by federally sponsored enterprises, and guaranteed loans.

MEASURING THE REAL DEFICIT

Exact measurement of the REAL deficit is no easy task. For the most part the information necessary to calculate an exact measurement does not exist. Ideally, the REAL deficit should measure the total number of dollars which the federal government diverts away from potential borrowers who otherwise would have borrowed those funds. It is possible that some part of federal credit outlays in fact do not divert funds from one potential borrower to another. They may instead merely reduce the interest payments of borrowers who otherwise would have obtained a loan for the same amount in the private credit market, without the federal government's help.

When the government guarantees a student loan, for example, the student is able to borrow at a lower interest rate than the rate he would have been charged without the guarantee. This reduction in interest rates is actually a subsidy to the student who gets the loan. The interest subsidies created by federal government intervention are quite large.

- During 1983, new federal loans and loan guarantees will provide $14 billion in interest subsidies to borrowers.[11]

11. CBO, Federal Credit Activities, p. 6.

In addition, it is difficult to know to what extent the federal government indirectly promotes borrowing by state and local governments due to federal taxes, regulations and revenue sharing programs. For example, by making credit to state and local governments tax-exempt, the government encourages, i.e. subsidizes, state and local borrowing relative to other borrowing. In addition, high marginal tax rates encourage the demand for tax-exempt securities among upper-income individuals.

The federal government also encourages state and local governments to borrow by requiring them to find local matching funds in order to participate in certain federal programs.[12] In addition, through a variety of devices, the federal government has encouraged the proliferation of off-budget entities at the state and local level. These entities, which now number over 26,000, have been created to circumvent constitutional restrictions on state and local borrowing. They are able to borrow at tax-exempt rates in the private credit market.[13]

No one knows the extent to which federal government policies have encouraged state and local borrowing, both on and off-budget. But the growth of this borrowing has been enormous:[14]

- Over the last decade, tax-exempt credit has grown by 352 percent.
- In 1982, over 10 percent of all funds borrowed were tax-exempt credit.

AN APPROXIMATION OF THE REAL DEFICIT

In the absence of better information, an approximation of the REAL deficit is given by the total amount of funds borrowed under federal auspices. The method of calculation and an estimate for 1983 is given in Table I. The totals for other years, based on OMB estimates, are given in the appendix.

12. See; Colin D. Campbell, James R. Fries and Rosemary G. Campbell, <u>Federal Grants-In-Aid to New Hampshire and Revenue Adequacy</u>, Business and Industry Association of New Hampshire, October 14, 1982.

13. See Bennett and DiLorenzo, <u>Off-Budget Spending and Underground Government</u>.

14. OMB, <u>Budget of the United States, Fiscal Year 1984</u>, Special Analysis F, p. 4.

TABLE I

REAL Deficit	1983 Estimate* ($ Billions)
Unified Budget Deficit	$207.7
Other Federal Borrowing	7.3
Borrowing for Guaranteed Loans	55.8
Borrowing by Government Sponsored Enterprises	53.5
Total Borrowing	$324.3

* OMB estimates

In some ways, the approximation given in Table I is a conservative one. The estimate of borrowing for guaranteed loans, for instance, is based on that portion of the loan for which the government is liable, rather than the full principal of the loan. The true number of dollars affected is the full principal, not just that portion of it which receives a guarantee.[15] In addition, the approximation ignores effects on the credit market produced by the federal government's taxation, regulation and spending policies discussed above.

On the other hand, including the full value of borrowing by government sponsored enterprises probably overstates the REAL deficit, since some of the activities of these enterprises would be carried on by the private sector even without federal government involvement. Similarly, some recipients of loan guarantees would have borrowed funds from the private credit market, even without government assistance.

On balance, then, the approximation of the REAL deficit is a very rough one, and is far from exact.

15. It is worth noting that in 1983, the President's Credit Budget began including the full value of guaranteed loans. See CBO, Federal Credit Activities, p. 11.

THE IMPACT OF THE REAL DEFICIT

What is of greatest concern to most economists and financial experts these days is the budget's impact on private investment. No one knows exactly what impact federal borrowing has on private investment. What is clear, though, is that the federal government is diverting a larger and larger share of funds out of the credit market, and that trend is alarming.[16]

- o Over the last decade, total direct and indirect borrowing by the federal government increased 700 percent.
- o In 1982, 49 percent of all funds advanced in U.S. credit markets were borrowed directly or indirectly by the federal government.
- o Direct and indirect federal borrowing plus state and local borrowing accounted for almost 60 percent of all funds raised in U.S. credit markets in 1982.

The impact of federal government finance on the private credit market is becoming so large that it threatens to become a major national crisis. In order to conduct an informed debate and consider solutions, it is vital to have accurate information, rather than budget figures which reflect accounting gimmickry. To that end the NCPA has constructed estimates of the REAL federal deficit.

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July 12, 1983

16. OMB, Budget of the United States, Fiscal Year 1984, Special Analysis F, p. 4.

APPENDIX

Federal Budget Deficits
(In Billions of Dollars)

	On-Budget	Off-Budget			Total
Date	Official Deficit	Other Federal Borrowing from the Public	Government-Sponsored Enterprises	Borrowing for Guaranteed loans	REAL Deficit
1973	14.8	4.5	10.6	16.6	46.5
1974	4.7	-1.7	10.9	10.3	24.2
1975	45.2	5.7	5.3	8.6	64.8
1976	66.4	16.5	4.1	11.1	98.1
TQ	13.0	5.0	1.4	-0.1	19.3
1977	44.9	8.6	12.0	13.5	79.0
1978	48.8	10.3	21.4	13.4	93.9
1979	27.7	5.9	21.9	25.2	80.7
1980	59.6	10.9	21.4	31.6	123.5
1981	57.9	21.4	34.8	28.0	142.1
1982	110.6	24.4	43.8	20.9	199.7
1983e	210.2	4.8	53.5	55.8	324.3
1984e	190.2	12.7	55.0	48.9	306.8

e: OMB estimate
TQ: Technical Quarter

Sources: Office of Management and Budget, Budget of the United States, Fiscal Year 1984; and Special Analysis F.