Formal Publication 4

7-1-1975

Federal Finances and Inflation

Murray L. Weidenbaum
Washington University in St Louis

Publication No. 4 July 1975

FEDERAL FINANCES AND INFLATION

by

MURRAY L. WEIDENBAUM

CENTER FOR THE STUDY
OF AMERICAN BUSINESS
WASHINGTON UNIVERSITY/ST. LOUIS

Federal Finances and Inflation

MURRAY L. WEIDENBAUM

Through its revenue-raising, expenditure-disbursement, and related financial activities, the federal government takes a wide variety of actions that influence the rate of inflation experienced by the American economy. Some of these actions are deliberate and highly visible; others occur by default or escape public attention. In still other cases, the federal influence may be less direct, but have considerable effect. Confusion could result from this multiplicity of ways in which government fiscal policy affects the overall economy and especially the inflation rate. This essay will analyze the many aspects of the question.

The inflation that the United States now faces had its origin in deficit spending during the Vietnam war. The inflation has been accelerated and extended by many other factors, ranging from wage-cost push to food and energy shortages. Yet the federal fiscal policy continues to aggravate the inflation problem. Between 1965 and 1974, federal spending more than doubled; the cumulative budget deficit exceeded $100 billion, and it continues to increase.

To begin with, an excess of government outgo over income increases the purchasing power available to the private sector. For a technical reason—the absence of "saving" by the government—even a balanced budget tends to be mildly stimulative (as explained in the standard theorem of the "balanced budget multiplier"). Also, the revenues raised to cover expenditures, to the extent that they come out of funds that would otherwise be used for investment, have an adverse effect because the nation loses the anti-inflationary benefits of a larger supply of goods and services.

To some extent, the federal deficit is financed through sales of savings bonds and other securities to individuals and nonfinancial institutions.

The result will likely be some reduction in the funds available for consumption, which helps offset the inflationary pressures resulting from the deficit spending. But to the extent that the purchases of federal securities reduce the funds that are available to finance private investment, the result may be a smaller increase than would otherwise occur in the stock of productive capital.

However, a large proportion of the federal budget deficits is financed in a different way, through sales of Treasury debt to the banking system. This is inflationary because it provides a direct basis for the multiple expansion of the money supply. Issuing more Treasury debt also exerts an upward pressure on interest rates as the government is not simultaneously increasing the supply of savings available for investment.

It should be noted that it has become fashionable to downplay the role of federal fiscal policy and point to the power of monetary policy. Without entering the esoteric debate between "monetarists" and "fiscalists," one should note an important development in the recent work of monetary theorists that focuses on the underlying causes of changes in the money supply.

According to the Federal Reserve Bank of St. Louis, three related factors account for the progressive rise in the average growth of the money stock and, hence, a progressive rise in inflation: (1) the sharp rise in the growth of government spending, (2) the resultant deficit financing and its accompanying upward pressure on interest rates, and (3) the response of the Federal Reserve System by increasing the money supply to soften the rise in interest rates. Although the relationship between fiscal policy and monetary policy may be more complex than that, this type of analysis surely underscores the need to be concerned with federal fiscal policy in facing the overall question of inflation.

Budgetary Subterfuges

The analysis of federal fiscal policy has become especially difficult because the government has increasingly resorted to subterfuges whereby certain categories of federal activity do not appear in the budget. It is pertinent but distressing to note that the official unified budget covers a shrinking part of federal spending. Students of federal budgeting, unfortunately, will not be surprised. The unified budget itself was developed because of the erosion of the old "administrative" or "conventional" budget, which came to omit the social security trust funds and ultimately the federal-aid highway program.

The current pressure to slow down the growth of federal spending has given a renewed impetus to efforts to "protect" a given government program by making it less visible by excluding it from the budget totals. The phenomenon of the "off-budget" federal agencies is of recent origin. The term was first introduced in January 1974 in the federal budget for the fiscal year 1975. It deserves some attention, because it is weakening the effectiveness of the unified budget as a comprehensive indicator of federal finance.

First of all, this category does not include many items that seem to fit the title. It does not cover the government-chartered enterprises, such as the Federal Land Banks and the Federal National Mortgage Association, which have become privately owned in recent years. Since 1967, when the federal government adopted the recommendations of the President's Commission on Budget Concepts, these privately owned but government-sponsored enterprises have been properly excluded from the federal budget.

In contrast, the new category of "off-budget agencies" is limited to enterprises that are entirely federally owned and controlled. That is, the "off-budget agencies" are truly part of the federal government. They generally are staffed by civil servants and subject to all other federal operating procedures. The only thing that separates them from the agencies that are included in the budget is that Congress has passed laws which arbitrarily move their financial transactions out of the federal budget.

The result is clear: both the total of federal expenditures and the budget deficit are lower than they would be if this arbitrary change had not occurred. It is noteworthy that when the Treasury reports the federal government's total borrowings from the public, the financial requirements of these off-budget agencies are included.

One characteristic that accompanies the achievement of "off-budget" status is expansion. For example, the first off-budget agency was the Export-Import Bank, which was excluded by statute as of August 17, 1971. In the fiscal year 1972, its lending totaled $249 million. The volume more than doubled to $630 million in 1973 and is estimated to exceed $1.3 billion in 1975. This upward trend contrasts with another wholly federal enterprise that has remained in the budget, the Tennessee Valley Authority. TVA's net outlays declined from $448 million in 1972 to $367 million in 1973 and are estimated to be $458 million in 1975.

Since 1972, the Post Office (now the Postal Service) and the lending activities of the Rural Electrification Administration (now the Rural Telephone Bank and the Rural Electrification and Telephone Revolving Fund) were removed from the budget. In fiscal 1973, the REA's net outlays were $528 million. By 1975 its net lending—now outside of the budget—is estimated to reach $784 million; in addition, $19 million of administrative costs continue to appear in the budget.

Several new wholly federal activities have been established since 1972 —the Environmental Financing Authority, the Federal Financing Bank, and the U.S. Railway Association—and their finances will be "off-budget."

Except in the case of the Postal Service, the excluded outlays of the off-budget agencies are for loan programs. These programs are similar in all substantive effects to the direct loan programs that are in the budget. Pending legislation would set up additional off-budget agencies, some in the lending area and others to make transfer payments or direct purchases of goods and services. One version of a proposed national health insurance program (the Kennedy-Mills bill) would operate under a new off-budget trust fund in the neighborhood of $30 billion a year.

It is more difficult to obtain detailed information about the current and prospective operations of off-budget agencies than of agencies which are included in the budget. Table 1 brings together the data on off-budget agencies that are currently dispersed over a variety of special analyses which accompany the budget document. When the Railway Association gets under way, it is likely that its disbursements will push the total outlays of the off-budget agencies well beyond $3 billion a year.

If any forecast on federal finance can be made with some confidence, it is that the number of the "off-budget agencies" and the size of their outlays will continue to grow rapidly in the future. Unless Congress sees the danger of this apparently painless way of government financing, the unified budget will become a less complete measure of the total flow of revenues and expenditures between the federal government and the public.

TABLE 1

Outlays of Off-budget Federal Agencies
(fiscal years, in millions of dollars)

Agency	Amount Excluded from the Budget 1970	1972	1975
Export-Import Bank	0	$249	$1,250
Postal Service[a]	0	0	733
Rural Electrification Administration	0	0	463
Environmental Financing Authority	0	0	240
Rural Telephone Bank	0	0	135
Total[b]	0	$249	$2,821

Source: Compiled by the author from various budget documents.
[a]Net after receipt of subsidy of $1,533 million from budget funds.
[b]Estimates not yet available for Federal Financing Bank and U.S. Railway Association.

Federal Credit Programs

Credit programs are a second type of federal activity excluded from the budget. Programs in this group are loan guarantees, operations of federally sponsored enterprises, and similar uses of the government's credit power. So long as they are excluded from the budget, there is a strong incentive to convert federal spending to these indirect techniques, and this is being done on an increasing scale. Thus it is important to note the relationship between federal credit programs and the problem of inflation.

Over the years, many credit programs have been established by the federal government. Since most of these activities do not appear in the federal budget, they seem to be a painless way of achieving national objectives. In the main, the federal government is "merely" guaranteeing private borrowing or sponsoring ostensibly private institutions, albeit with federal aid. Examples include the federal land banks and the federal home loan banks.

Yet upon closer inspection one finds that this use of the governmental credit power does result in substantial costs to the society. First of all, these programs do little to increase the total pool of capital available to the economy. They result in a game of musical chairs. By preempting a major portion of the annual flow of savings, the government-sponsored credit agencies reduce the amount of credit that can be provided to unprotected borrowers (mainly consumers), state and local governments, and private business firms.

During periods of tight money, it is difficult for unassisted borrowers to attract the financing that they require. They are forced to compete against the government-aided borrowers (a federal loan guarantee reduces the riskiness of lending money to the borrower who is so aided). The result of that uneven competition is still higher interest rates as investment funds are bid away from the unprotected sectors.

This phenomenon occurs for a variety of reasons. The total supply of funds is broadly determined by household and business saving and the ability of banks to increase the money supply. The normal response of financial markets to an increase in the demand for funds by a borrower, such as that represented by a new federal credit program, is an increase in interest rates to balance the demand for funds with the supply of saving. But the federal government's demand for funds is "interest-inelastic" (the Treasury will generally raise the money that it requires regardless of the interest rate) and the interest-elasticity of saving is relatively modest. Thus weak and marginal borrowers will be "rationed" out of financial markets in the process, while the Treasury and other borrowers pay higher rates of interest.

There are also extra costs associated with introducing new government credit agencies to the capital markets. Their issues are often smaller than those of the Treasury itself, and they only approximate the characteristics of direct government debt. As a result of such considerations, the market normally charges a premium over the interest cost on direct government debt of comparable maturity. That premium ranges from 0.25 percent on the well-known federally sponsored agencies, such as the Federal National Mortgage Association, to more than 0.5 percent on such exotic issues as New Community Bonds.

The very nature of federal credit assistance is to create advantages for some groups of borrowers and disadvantages for others. The literature provides clear answers on who will tend to be rationed out in the process. It is unlikely to be the large well-known corporations or the United States government. It is more likely to be state and local governments, medium-sized and smaller businesses, private mortgage borrowers not under the federal umbrella, and consumers. This is bound to contribute to additional economic and financial concentration in the United States.

The competition for funds by the rapidly expanding federal credit programs also increases the cost to the taxpayer by raising the interest rate at which the Treasury borrows its own funds. As shown in table 2, there

TABLE 2

Impact on Credit Markets of Federal and Federally Assisted Borrowing
(fiscal years, in billions of dollars)

Category of Credit	*1960*	*1965*	*1970*	*1971*	*1972*
A. Federal borrowing	$ 2.2	$ 4.0	$ 5.4	$ 19.5	$ 19.4
B. Federally assisted borrowing (off-budget)[a]	$ 3.3	$ 6.8	$15.1	$ 18.2	$ 19.2
C. Total federal and federally assisted borrowing (A + B)	$ 5.5	$10.8	$20.5	$ 37.7	$ 38.6
D. Total funds advanced in credit markets	$43.4	$69.6	$89.0	$120.0	$145.6
E. = (C) ÷ (D)	12.7%	15.5%	23.0%	31.4%	26.5%

Source: Federal Reserve System and U.S. Department of Treasury.

[a]Obligations issued by government-sponsored agencies or guaranteed by federal agencies.

has been a massive expansion in the size and relative importance of federal government credit demands over the past decade. In 1960, the federal share of funds raised in private capital markets, based on the Federal Reserve System's flow-of-funds data, was 12.7 percent. By 1970, the government's share had risen to 23 percent, and has continued to grow.

Virtually every session of the Congress in recent years has enacted additional federal credit programs. Since 1960, the Federal National Mortgage Association (Fannie Mae) has been joined by the General National Mortgage Association (Ginnie Mae), the Student Loan Marketing Association (Sally Mae), and, most recently, the U.S. Railway Association (Fannie Rae). The upward trend is likely to continue. Proposals are now being seriously advanced for federal credit guarantees of private electric utility bonds and of bank deposits by local governments.

Information on federal credit programs is contained in table 3. An

TABLE 3

Major Federal Credit Programs, Fiscal Year 1974
(new commitments, in millions of dollars)

Category and Agency	*Direct Loans*	*Guaranteed Loans*	*Government Sponsored Enterprises*	*Total*
Aid to Business				
Commerce	$ 19	$ 255	–	$ 274
Interior	19	35	–	54
Transportation	50	1,143	–	1,193
General Services Administration	20	483	–	503
Emergency Loan Guarantee Board	–	60	–	60
Export-Import Bank	–	7,039	$ 1,617	8,656
Small Business Administration	249	2,703	–	2,952
Subtotal	$ 357	$11,718	$ 1,617	$13,692
Aid to Farmers				
Agriculture	$3,901	$ 2,870	–	$ 6,771
Farm credit agencies	–	–	$ 1,941	1,941
Subtotal	$3,901	$ 2,870	$ 1,941	$ 8,712
Aid to Local Governments				
District of Columbia	$ 270	–	–	$ 270
Washington Metropolitan Transit Authority	–	$ 334	–	334
Environmental Financing Authority	–	–	$ 300	300
Subtotal	$ 270	$ 334	$ 300	$ 904
Aid to Individuals				
Health, Education, and Welfare	$ 132	$ 1,671	–	$ 1,803
Housing and Urban Development	15	15,269	–	15,284
Veterans Administration	412	8,643	–	9,055
Federal Home Loan Bank Board	10	–	$ 4,995	5,005
Federal National Mortgage Association	–	–	3,354	3,354
Subtotal	$ 569	$25,583	$ 8,349	$34,501
Miscellaneous				
Funds appropriated to the president	$1,125	$ 664	–	$ 1,789
Other agencies	70	308	–	378
Subtotal	$1,195	$ 972	–	$ 2,167
Total	$6,292	$41,477	$12,207	$59,976

Source: *Special Analyses, Budget of the United States Government for the Fiscal Year 1974.*

examination of the array of programs is noteworthy. In the typical case, the area being aided is one subject to close federal regulation (transportation and agriculture) or has become, at least in part, a federal responsibility (housing and veterans assistance).

Reduced to its basics, federal credit programs really involve "putting the monkey on someone else's back." They do not increase the amount of investment funds available to the economy. Rather, they merely take capital funds away from other sectors of the economy and lead to similar requests for aid by those sectors. By raising the level of interest rates in the economy, for both private as well as government borrowers, they increase an important element of the cost of production. The pressure on interest rates in turn often forces the Federal Reserve System to increase the reserves of the banking system to supply financing to the private sector. This increase, in turn, contributes to the general inflationary condition of the economy.

Federal Procurement Activities

The specific operations of public programs can also exert inflationary pressures. Through its procurement powers, the federal government can impose extra costs on the firms that supply it with goods and services.

The magnitude of the government's procurement outlays and particularly their importance to government-oriented firms create opportunities for implementing a variety of economic and social aims through the contract mechanism. The federal government thus requires that firms doing business with it maintain "fair" employment practices, provide "safe" and "healthful" working conditions, pay "prevailing" wages, refrain from polluting the air and water, give preference to American products in their purchases, and promote the rehabilitation of prisoners and the severely handicapped. This required "social responsibility" increases the costs of goods and services that government agencies, as well as others, purchase from the private sector.

The advantage of using government contracts to promote basic social policies is apparent. Important national objectives may be fostered without the need for additional, direct appropriations from the Treasury. To a congressman, this may seem a painless and simple approach. Because restrictive procurement provisions seem to be costless, the government has been making increasing uses of them. Any disadvantages, being more indirect, receive less attention.

Yet, upon reflection, these special provisions are all burdens on the governmental procurement process. They increase overhead expenses of private contractors and federal procurement offices alike. Many of the provisions also exert an upward pressure on the direct costs incurred by the government. For example, special provisions such as the Davis-Bacon Act increase the cost of public construction projects through government promulgation of wage rates higher than those that would have resulted if the market were allowed to operate without impediment.

Federally Imposed Costs

The federal government's imposition of costs on the private sector is not limited to the case of government contractors, although that is where the phenomenon is most apparent. In part because of efforts to control the growth of government spending, the federal government now increasingly relies on mechanisms that are designed to achieve a given national objective—better working conditions or more nutritious foods—without spending much government money for the purpose. The current approach is to emphasize the alternative of influencing private decision making to achieve the same ends.

Thus, rather than the public treasury bearing the full burden of cleaning up environmental pollution, private firms are required to devote more resources to that purpose. Rather than the federal government spending large sums of money to eliminate traffic hazards, motorists are required to purchase more expensive vehicles which reduce the likelihood of serious injuries resulting from traffic accidents. At first glance, having the government impose some socially desirable requirement on the private sector appears to be an inexpensive way of achieving national objectives. It does not cost the government anything and therefore is no burden on the taxpayer. But, on reflection, it can be seen that the public does not escape paying the cost.

Every time that the Occupational Safety and Health Administration imposes a more costly, though safer, method of production, the cost of the resultant product will of necessity tend to rise. Every time that the Consumer Product Safety Commission imposes a standard that is more costly to attain, some product costs will tend to rise. The same holds true for the activities of the Environmental Protection Agency, the Food and Drug Administration, and so forth. The price of the typical new 1974 passenger automobile was about $320 higher than it would have been in the absence of federally mandated safety and environmental requirements.

The point is not the worthiness of the objectives of these agencies. Rather, it is that "there is no free lunch" for the public in following the procedure of imposing public requirements on private industry. Although the costs are not borne by the taxpayer directly, in large measure they are reflected in the higher prices of the goods and services that consumers buy. Even though most government regulation of business is designed to benefit the consuming public, it is the consumer who ultimately suffers the price increases that result. Although the manufacturer or distributor may initially bear the expense of destroying products declared hazardous, much of the added cost will inevitably be passed on to the public in the form of higher prices.

These fiscal "shortcuts"—imposing the costs of achieving national objectives directly on the private sector rather than financing them via taxation—are not part of any conscious new policy to increase the rate of inflation. But, intentionally or not, they do have that effect with the continued increase in government-mandated costs of production.

Summary and Conclusion

As this study attempts to show, the federal government can exert an inflationary force on the economy in many ways, some even unintentional. An important step in formulating more effective anti-inflationary policies is to improve the public understanding of those governmental actions that tend to make for more inflation. By way of a brief summary, the following are the different ways in which government financial actions can have an inflationary impact on the economy:

- The federal government can increase inflationary pressures by injecting more purchasing power into the economy via government spending than it withdraws via taxation.
- Specific types of government expenditures can be especially inflationary, notably procurement methods which result in increased costs of production.
- Specific types of taxation can have an adverse impact to the extent that they withdraw private funds that otherwise would have been devoted to increasing productive capacity.
- Some methods of deficit financing may be especially inflationary, to the extent that they result in sales of government securities to the banking system and provide the basis for a multiple expansion of the money supply.
- Subterfuges that underestimate the actual amount of federal spending —such as the so-called "off-budget agencies"—can lead to a more stimulating fiscal policy than is desired.
- Expanding use of the government's credit power can result in rising interest costs to both the Treasury and private borrowers and also force further increases in the money supply.
- Expanding use of the government's regulatory power can shift costs of achieving national objectives from the public sector to the private sector. Although such actions may improve the nominal state of the federal budget, the resultant higher costs of production exacerbate the underlying inflationary pressures.