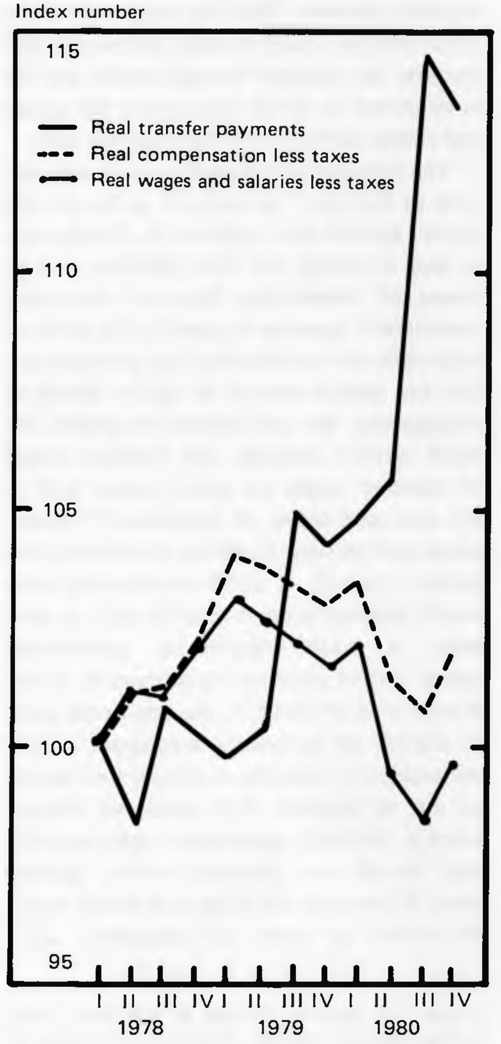
more rather than less spending. Many economists assert that financing government spending through deficits also biases outlays upward, because part of the burden of paying for current expenditures is shifted forward to future generations that would redeem or service the debt. The ability of firms or individuals to borrow in this manner is limited by their current and prospective net-worth positions, but such constraints do not apply to the U.S. government in any practical sense. While the total amount of funds available in credit markets at any particular time is limited, the market views Treasury debt as virtually risk-free. Consequently, the Treasury is a preferred borrower, and always first in the credit queue. If the Federal Reserve is unwilling to accommodate Treasury borrowing, private borrowers may be squeezed when funds are scarce.

Prior to the 1960s, deficit finance was usually associated with periods of war or business recession. Since the late 1950s, however, Treasury borrowing to finance deficits has become increasingly common. In fact, since FY 1960, the budget has been in surplus only twice. Over this period, deficits often have shown no tendency to narrow as the economy approached full employment. Consequently, new Treasury borrowing from the public has increased from an average of 1.3 percent between 1955 and 1959 to 19.0 percent between 1975 and 1979. In addition, total government-related borrowing rose from 3.2 percent to 26.7 percent of all credit-market funds over the same period, and there appears to be an increasing use of loan guarantees.

The increasing reliance on deficit finance since the late 1950s has been explained in terms of a simultaneously growing acceptance of Keynesian economics, which legitimized the use of deficit spending for countercyclical management of the economy. In addition, beginning in the mid-1960s, the focus of fiscal policy shifted to maintaining GNP at its potential, or full-employment, level instead of balancing the budget over the business cycle. In a dynamic economy, potential output and full employment are complex and somewhat ambiguous concepts that are not easily quantified. Unfortunately, the numerical measurements of capacity often ignored the ambiguities and usually indicated that the economy was operating below capacity. Fiscal policies, attuned to forcing the economy to capacity and removing the last vestiges of unemployment, produced a continuous chain of deficits regardless of the state of the business cycle.

Chart 2 Select Measures of the Growth of Purchasing Power

(1978:IQ = 100)



SOURCE: Department of Commerce, Bureau of Economic Analysis.

Trimming the Budget

Concern for the expanding size and scope of the federal government is not a new phenomenon; in fact, it is practically part of the national heritage. Nevertheless, criticisms about the growth of federal spending have been unusually vehement in recent years.

By the late 1970s, the economic malaise of high inflation, lagging productivity growth, and large wealth transfers to foreign oil producers brought real income growth to a halt. Tax burdens, however, continued to rise as inflation pushed individuals into higher tax brackets. Personal income taxes equaled 15.5 percent of personal income in 1979, a sharp increase from 15.0 percent in 1978 and 13.4 percent in 1975. Moreover, the federal government's tax and transfer-payment systems were rapidly shifting real purchasing power from wage and salary earners to transfer recipients. After-tax wages and salaries, adjusted for inflation, began declining in the second quarter of 1979, while transfer income, which is automatically adjusted for inflation, grew rapidly (see chart 2). The divergence intensified through the election year.

The public—rightly or wrongly—seems to link inflation, lagging productivity growth, and the recent declines in the real purchasing power of wages and salaries to high levels of government spending, taxing, and persistent federal budget deficits. To the extent the general public associates federal spending with the current economic malaise, the perceived costs (measured in terms of disposable income) of not opposing federal spending programs rise. The average wage and salary worker is likely to become more vocal in his opposition to spending and taxing policies. Moreover, the perceived costs to political interest groups and Congressmen of trading support on various programs will rise. Deficits, which may shift the costs of current federal spending to future generations, become less attractive when the public associates deficits with current economic problems. Moreover, the public will be more willing to reduce those federal programs that are luxury goods when its purchasing power is being strained.

The perception that spiraling government spending and persistent budget deficits have contributed to the current economic malaise provides a strong constraint against the inherent bias in government toward bigness. Today's climate bodes well for a significant reduction in federal budget growth.

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Does the Federal Government Spend Too Much?

by Owen F. Humpage

The Reagan administration has set itself to the herculean task of reducing the growth of federal spending. The administration plans to trim approximately \$5 billion from the current budget (FY 1981) and approximately \$41 billion from the FY 1982 budget. At the same time, the administration proposes to increase military spending and maintain basic services to the poor. Although the task of slowing federal spending is not insurmountable, skepticism is a natural reaction. In addition, the Reagan administration is proposing budget cuts, while weak economic activity is automatically increasing expenditures in such areas as unemployment compensation.

This *Economic Commentary* discusses the seemingly uncontrollable growth of federal spending. It asserts, however, that no budget expenditure is *uncontrollable* in any but the very narrowest, and misleading, sense of the word. Instead, this *Economic Commentary* argues that governments inherently are biased toward "more" rather than "less" spending. This bias stems from a large number of factors that are institutional, political, and economic in character. At root, however, is the need to provide public services through a non-price, political system. The process focuses attention on benefits that usually are delivered to specific groups of individuals, but the process cannot adequately account for the total costs that are widely diffused or shifted to future generations. The inherent government bias toward large budgets has been augmented in recent years by macropolicies, designed to hone the economy to full employment, and inflation, which automatically transfers income from the private to the public sector.

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The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

The Federal Sector

Despite repeated attempts to curb federal spending, it has grown as if propelled by its own momentum. Between FY 1970 and FY 1980, for example, federal expenditures, as measured in the budget, grew 11.5 percent per year on average, and the ratio of federal expenditures to gross national product (GNP) rose from 20.3 percent in FY 1970 to 22.6 percent in FY 1980. Federal expenditures will top 23 percent of GNP in the current fiscal year.

Almost two-thirds of the growth in total federal spending between FY 1970 and FY 1980 is attributable to expenditures for human resources. Aid to state and local governments, interest payments on federal debt, and expenditures for natural resources, environment, and energy also have grown rapidly both in absolute terms and relative to total budget spending since FY 1970. Many of the fastest-growing federal programs are also entitlement programs. Entitlement programs automatically provide benefits to any person or state or local government that meets requirements set by U.S. law. Unless Congress is willing to change these laws—a highly visible, politically difficult, and time-consuming process—entitlement outlays in any given fiscal year are determined largely by the number of eligible recipients in that year. Entitlement programs grew at a rapid 14.6 percent average annual rate between FY 1971 and FY 1980, and rose from 47 percent to 56 percent of total outlays over this period.

The budget, however, does not tell the whole story about the growth of the federal sector, because a significant portion of the government's business is not recorded in the budget. Beginning in 1971, for example, Congress rather arbitrarily moved some government agencies "off-budget." So-called "off-budget" spending has grown enormously since then and is expected to top $20 billion in FY 1981. Moreover, the government sponsors many agencies, such as the Federal National Mortgage Association, and mortgage pools, such as the Government National Mortgage Association's mortgage pool, which borrow and relend in the credit market. Government-sponsored agencies and mortgage pools raised $48.7 billion from credit markets during FY 1980, or 11.8 percent of the total funds raised. Although such agencies technically may not be considered part of the government or part of the budget, they are similar to federal government agencies in that they divert resources from uses dictated by private markets to uses dictated through the political process. Federal government loan guarantees have exactly the same effect. Loan guarantees, however, are only recorded as federal budget expenditures when a borrower defaults on a guaranteed loan. In FY 1980, new loan guarantees equaled $32.4 billion, or 7.8 percent, of total credit-market funds.

Many factors, including recessions, high unemployment, persistent inflation, and a growing proportion of retired persons, have been identified as contributing to the rapid, seemingly uncontrollable growth of the federal sector in general and entitlement programs in particular. These factors explain why federal spending has grown over the past ten years; why it sometimes grows in excess of budget projections; and why it is at times very difficult to reduce expenditures. Nevertheless, no spending program is uncontrollable, and no budget has a life of its own. Congress, as stipulated in the Constitution, maintains the power of the purse. If federal spending is controllable, then what explains its relatively rapid growth, and what explains the recent dissatisfaction with this growth?

"Luxury Goods"

One reason why federal spending has been expanding relative to GNP may simply be that our society *wants* more government services. Many government services are similar in some respects to "luxury goods"; as standards of living rise, voters are willing to devote a larger share of their incomes to such public services. Developed countries, for example, devote more resources than less-developed countries to such public goods and services as parks, space exploration, consumer information, environmental improvement, and advanced highway networks. In many respects the rapid growth of U.S. human-resources spending fits the luxury-goods interpretation. It is much easier to redistribute income when the average level of real disposable income is high and rising than when it is low or falling. When incomes are rising, transfers can be made without a reduction in the net worth of middle- and upper-income groups; this is not true when incomes are falling. According to this luxury-goods view of government services, one should not be surprised to see the share of GNP devoted to human-resources spending (or to government in general) rise as GNP grows. Although there naturally may be a limit to the share of GNP that Americans will devote to the government sector, many European nations have significantly larger government sectors than the United States.

Private Sector vs. Public Sector

Even if one accepts the luxury-goods view as a partial explanation for the growth in government spending, there are reasons to believe that the amount of goods and services that the public sector provides would always exceed the amount that the private sector would provide if the private sector produced these same goods and services. In government, there is an inherent bias toward large budgets.

In competing for profit, private-sector firms offer goods and services at a per-unit price that reflects the cost of production. Individuals only purchase goods and services if the price does not exceed their subjective evaluation of the item's worth. Those who do not buy an item generally cannot benefit from its consumption. In addition, the desire for profits, together with the fact that consumers buy less at higher prices, provides a strong incentive for firms to minimize production costs.

In contrast, most services provided by governments are potentially available for consumption by all citizens, and the costs also are borne by all taxpayers, but not in relationship to the amounts that each person consumes or the benefits that each derives.[1] Some services, such as national defense or disease control, benefit all citizens in relatively equal amounts. No individual can be excluded from participating in the benefits. Other government services, such as elementary and secondary education, do not necessarily benefit all individuals, but the government excludes no one from participating in the benefits. Because governments cannot, or do not, charge a unit price for the goods and services they provide, consumption does not gauge whether the costs of programs exceed the benefits derived by society. Moreover, while governments may attempt to minimize the costs of providing public goods and services, the absence of a profit motive eliminates the ultimate incentive to do so.

In the absence of a market mechanism, governments rely on a political mechanism to determine the amount of public services and to allocate their costs. In the United States this function is performed at the national level through elected representatives in the legislative and executive branches.

1. The government may establish certain eligibility requirements, such as being unemployed; however, all individuals share some probability of meeting those requirements. The government does not limit participation via a price mechansim.

Lobbying for Public Services

Most of the services provided by the government benefit specific groups of citizens appreciably more than the public at large. Social-Security payments benefit retirees, food stamps benefit the poor, and trade restrictions benefit specific industries. The costs of such government services, however, are not borne by the benefiting groups alone, but are more widely diffused through the tax system.

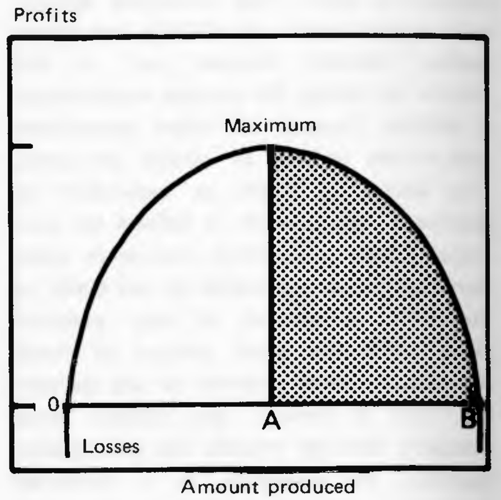
Often individuals who stand to benefit most directly from government actions form political interest groups to promote their causes. They lobby Congress, extolling the importance of their programs and promising political support in return for congressional backing. Political interest groups are useful because they provide Congress with a measure of the intensity of the public's preference for specific issues. This measure of public preference will be incomplete, however, if an adequate forum for opposing views does not exist. Because the costs of government programs are widely diffused, many programs are unopposed. The costs to individuals of mounting an effective opposition often greatly exceed the cost of not opposing an issue.

Moreover, even if all groups generally agree on the need to cut government spending, each group naturally seeks to protect its own programs. Besides reaping individual benefits far in excess of individual costs, interest groups may view their specific programs as an inconsequential part of total spending. Food stamps, for example, amount to only 1.6 percent of the total federal budget; in some years, budget errors have been larger.

Political interest groups and Congressmen have a strong incentive to trade their support for various and unrelated programs to secure passage of measures that benefit their specific constituencies. Such compromises are a necessary part of a democratic political process. Again, however, because the costs of government programs are spread widely across the voting public, members of one interest group, for example, incur only a small additional cost for supporting another interest group's programs. At the same time, they benefit much more if, through trading votes, they secure passage of their own programs. Congressmen or interest groups can increase the size of a political coalition until the additional costs of trading support exceed the benefits of doing so. These characteristics of the political process seem to bias federal spending upward. This bias does not exist in a competitive private market where costs and benefits are equated through prices and are internalized to those consuming the goods and where restraint of trade does not exist.

The incentive structure of government also adds to the bias.[2] In contrast to the private sector, there is less incentive for bureaucrats to seek routinely the most efficient level or means of production. None of the many government agencies responsible for producing public services attempts to generate profits; the salaries earned by agency heads or management are not related to profits. Instead, salaries, prestige, and political power of agencies' heads are more closely tied to the size and scope of programs. If public goods and services could be produced in the private market, a profit-maximizing firm would produce at point A on chart 1. In contrast, a budget-maximizing government agency would produce up to point B. In the shaded area of chart 1, the additional costs to society of expanding a program exceed the additional benefits. A private firm would go out of business if it produced beyond point B. Similarly, government agencies probably would not provide services beyond point B, because the waste at this level would be evident to voters. Consequently, while government agencies do not conspicuously waste budget funds, the incentive structure in the public sector nevertheless biases agencies toward inefficiently large programs.

Chart 1 Profits and Losses



2. See, for example, William A. Niskanen, "Nonmarket Decision Making: The Peculiar Economics of Bureaucracy," *American Economic Review*, vol. 58 (May 1968), pp. 293-305.

Expenditures, Revenues, and Deficits

Also contributing to the growth in federal spending in recent years is the congressional treatment of expenditure and tax legislation. Various appropriation committees consider spending proposals, while the House Ways and Means Committee and the Senate Finance Committee consider tax proposals separately. Until the Congressional Budget Reform and Impoundment Control Act of 1974, appropriation committees did not need to consider various spending initiatives in light of total spending and available receipts. The Congressional Budget Reform and Impoundment Control Act established procedures to place a ceiling on total outlays and a floor on total receipts. It also established two budget committees to oversee and coordinate the budget process. Unfortunately, when spending threatened to breach the limits set by the new process, the limit rather than spending was adjusted. The deficit was still the residual in the budget process.

Understanding the Treasury's unique ability to borrow and the changing attitudes about deficit finance is important for appreciating the congressional budget procedure and the bias in government for