Policy Analysis

Cato Institute Policy Analysis No. 19: The Underground Federal Government: Bane of the Balanced Budget?

October 21, 1982

James T. Bennett, Thomas J. DiLorenzo

James T. Bennett is Professor of Political Economy and Public Policy, and Thomas J. DiLorenzo is Assistant Professor of Economics, George Mason University, Fairfax, Virginia.

Introduction

In recent years both academics and the popular press have shown a growing interest in the "underground economy" -- the volume of transactions that involve payment in money or in other goods (barter) but which are not recorded in official statistics. The transactions may not be recorded because they are illegal, such as narcotics and prostitution, or because taxpayers simply refuse to pay in full their ever-increasing tax bills. The growth of the underground private economy is perhaps the ultimate stage of the "tax revolt of the '70s." Numerous constitutional and statutory limitations were imposed on state and local government taxing and spending powers, and 31 state legislatures voted to convene a convention to adopt a balanced budget amendment to the U.S. Constitution.

Tax-imposed constraints on one's ability to accumulate wealth (or to just break even) have induced American taxpayers to conceal literally hundreds of billions of dollars from the purview of the tax collector. Some of the policy implications of the recent excavations of the underground private economy are both powerful and straightforward: We have grossly under-stated actual levels of employment, income, output, savings, and productivity, which renders various "stimulative" spending policies misdirected at best. The economy may be far healthier than generally believed.

Much of the writing and research on the tax revolt of the 1970s has focused on the "first stage" of the revolt -- Proposition 13-type tax limitations -- and the second stage -- growth of the underground economy. There is a third stage, however, that has received much less attention. It involves the question of how politicians, who are, of course, every bit as calculating as the ordinary citizen, have responded to recently imposed constraints on their abilities to accumulate wealth and power through the political process. In general, for nearly a century state and local governments have responded to various taxpayer revolts and the accompanying spending, taxing, and borrowing limitations by giving lip service to fiscal responsibility while simultaneously creating scores of "off-budget enterprises" (OBEs) through which they can conduct "business as usual." Taxpayer demands for fiscal responsibility have also spawned the growth of the off-budget activities of the federal government. In short, just as tax-imposed constraints on individual incomes have created a burgeoning underground private economy, taxpayer-induced constraints on the politician's ability to parlay the public sector to his personal advantage, at taxpayer expense, have generated the growth of an "underground government" at all levels. Thus, the size and influence of the public sector of the economy is much larger than generally believed. This paper examines the activities of the underground federal government in particular, and discusses the implications of "off-the-books" government activity for efforts to secure a balanced-budget amendment.

There are three basic ways in which, through the credit markets, federal spending is kept off the budget. First,

numerous agencies are simply not included in the budget. Second, government control is extended over resource allocation by guaranteeing loans made to specially privileged individuals, businesses, and governments. Third, there are numerous privately owned, but federally sponsored and controlled, enterprises such as the Federal National Mortgage Association, that are also off-the-books borrowers.

In addition to manipulating credit market activities, politicians have increasingly recognized that, in principle, anything that can be accomplished through taxing and spending can also be accomplished with regulation. All of these activities must be taken into account to assess accurately the role of the federal government in the economy.

The Congressional Budget and Impoundment Control Act of 1974 has been praised by U.S. News & World Report as a "revolutionary budget reform intended to give Congress a tighter grip on the nation's purse strings."[1] The Budget Reform Act emerged from a recognition that existing budgetary procedures generated a bias toward overspending and budget deficits. Prior to 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. Each congressman had then, as he does now, a very strong incentive to maximize spending for his own voting constituency, but no congressman was required to take responsibility for the total amount of federal spending that resulted from the appropriations process. The Budget Reform Act created a budget committee for each house responsible for setting overall targets for revenues, expenditures, and the resultant deficit (or surplus). The Congressional Budget Office was created to assist in this process.

The main impact of the Budget Act is to make taxing, spending, and deficit levels explicit and to hold Congress accountable for them; the Act itself does nothing to curb spending. In keeping with the traditions established at the state and local levels of government, the relatively mild budgetary discipline of the Budget Act elicited a great deal of "back-door spending" at the federal level. In the wake of the Budget Act, numerous agencies have been and continue to be placed off-budget and beyond the purview of any appropriations process. Thus, while the Congress was publicly proclaiming a need for fiscal discipline in federal budget matters and enacting legislation to deal with the problem of "uncontrollable" spending, it was simultaneously establishing mechanisms through which spending could be placed off-budget. Off-budget federal outlays, by agency, since 1973 are shown in Table 1. Although the estimated $32.2 billion in off-budget outlays in 1981 was only about 5 percent of the federal budget, this amount has increased by an astounding 32,200 percent since 1973.

Most recently, the Synthetic Fuels Corporation, which began operations in 1981, was also placed off-budget. Congress had previously authorized $20 billion for the development of this "industry." The penchant for back-door federal spending is obviously nonpartisan. Both the Democratic-controlled House and the Republican-controlled Senate, at the insistence of the Reagan administration, voted to place the Strategic Petroleum Reserve "off-the-books." There have even been bipartisan proposals for dealing with the social security crisis by placing the Social Security program, with over $220 billion in expenditures in 1982, off-budget!

TABLE 1
Off-Budget Outlays by Agency
($ Billions)

	1973	1974	1975	1976	TQ	1977	1978	1979	1980	1981e
Federal Financing Bank (1974)	--	.1	6.4	5.9	2.6	8.2	10.6	13.2	14.5	12.1
Rural Electrification and Telephone Revolving Fund (1973)	.1	.5	.5	.2	.1	.4	.1	--	--	--
Rural Telephone Bank (1973)	*	.1	.1	.1	*	.1	.1	.1	.2	.2
Pension Benefit Guaranty Corporation (1974)	--	--	*	*	*	*	*	*	--	--

United States Postal Service Fund (1974)	--	.8	1.1	1.1	.7	.2	.5	.9	.4	.2
United States Railway Association (1973)	--	*	*	.1	*	.2	.1	.1	*	-.3
Total Off-Budget Outlays	0.1	1.4	8.1	7.3	8.7	10.3	12.4	14.3	23.2	--

e -- Office of Management and Budget estimate in fiscal 1982 budget document
* -- less than $50 million
Source: Budget of the United States Government, Office of Management and Budget, 1982.

As is evident from Table 1 the Federal Financing Bank (FFB) is by far the most active off-budget agency.[2] The FFB, part of the Treasury Department, does business with both on- and off-budget agencies. The predominant activity of the FFB is the purchase of agency debt from funds obtained by borrowing directly from the Treasury. FFB borrowing is not, however, included as part of the Treasury's budget outlays; interest payments from the FFB to the Treasury are, nevertheless, counted as deductions from Treasury outlays. Consequently, FFB borrowing actually results in a reduction in outlays reported by the Treasury Department. In essence, the FFB serves as an intermediary which permits the spending of federal agencies to be place off-budget.

A second type of FFB activity is the purchase of agency loans or loan assets. When a federal agency sells a loan to a private entity, the loan is considered repaid for budgetary purposes. Loans made by federal agencies are afforded the same treatment when the FFB is the purchaser. Proceeds from the sale are counted as loan repayments rather than as a means of financing and thus are an offset to the agency's gross expenditures. An agency's on-budget loan can therefore be converted to an off-budget loan by selling it to the FFB. In 1981, about 90 percent of all federal agency loans and loan asset sales were sold to the FFB.

Rather than selling individual loans an agency can sometimes pool its loans and issue securities backed by the pooled loans. These securities, known as "Certificates of Beneficial Ownership," are then turned over to the FFB for cash, placing them off-budget. The agency has cash to loan again, and can repeat the process as many times as it chooses. This procedure allows federal agencies to make loans to privileged customers with virtually no budgetary limit.

Another type of FFB activity is the granting of off-budget loans to guaranteed borrowers. Typically, a loan guarantee occurs when a federal agency sanctions a loan between a private lender and a private borrower. The result is an interest subsidy to the borrower at no explicit cost to the Treasury unless a borrower defaults. Frequently, however, an agency will ask the FFB to act as the private lender and purchase the borrower's note. In this case the loan guarantee becomes, in effect, a direct loan from the government which is not reflected in the budget. In 1981 FFB purchases of loan guarantees amounted to over $10 billion.

The outstanding holdings of the FFB in 1981, by type of activity, are shown in Table 2. As seen there, total outstanding holdings as of 1981 exceeded $107 billion. The primary beneficiaries have been the Farmers Home Administration (FmHA) and, to a lesser extent, many other agencies which can transfer enormous sums off-budget. The FmHA increased its loans by over 500 percent in the first five years after the establishment of the FFB.[3]

In sum, the activities of the FFB give federal politicians and bureaucrats a virtual blank check, with no direct budgetary consequences, with which to dispense rapidly growing amounts of loans and subsidies to their constituent interest groups.[4] The political cost of federal largesse are effectively reduced by the FFB. As an indication of the political bonanza being enjoyed by various politicians and their supporting federal agencies, Table 3 lists outstanding FFB loans to guaranteed borrowers during the 1980-82 period. At a time when the Reagan administration and many congressmen are calling for fiscal restraint, FFB loans outstanding to guaranteed borrowers are expected to double in just two years, with one category, loans for low-rent housing, increasing by 340 percent.

In essence, the loan guarantees administered by the FFB constitute the "back-door financing" of additional governmental control and regulation of the economy's resources. Government agencies can grant special privileges to select groups of individuals, business firms, foreign governments, or even other

TABLE 2 FFB Outstanding Holdings, 1981 ($ Billions)	
Activity	
Agency Debt	
Export-Import Bank	$12.4
Tennessee Valley Authority	10.9
Other	1.6
Loan Assets*	
Farmers Home Administration	48.8
Rural Electrification Administration	2.6
Other	.4
Direct Loans to Guaranteed Borrowers	
REA loans to rural electric cooperatives	12.3
DOD loans for foreign military sales	9.1
Other	9.2
Total FFB Outstanding Holdings	$107.3

*Primarily Certificates of Beneficial Ownership Source: Joint Economic Committee, U.S. Congress, "The Underground Federal Economy," Staff Report (Washington, D.C.: U.S. Government Printing Office, April 20, 1982), p. 12.

TABLE 3 Outstanding FFB Loans to Guaranteed Borrowers, Fiscal Years 1980-82			
Agency and Borrower	1980	1981	1982*
REA guaranteed loans to rural electric cooperatives	$8.4	$12.3	$16.5
DOD guaranteed loans for foreign military sales	7.2	9.1	11.1
HUD guaranteed loans to low-rent public housing	.1	.9	3.5
TVA guaranteed loans to Seven States Energy Corporation	.7	.9	1.2
Other	2.8	3.1	3.9
Total Loans Outstanding	21.5	30.6	41.5

*estimates Source: Joint Economic Committee, U.S. Congress, "Underground Federal Economy," p. 13. government-sponsored enterprises (e.g., the Tennessee Valley Authority) without being subjected to congressional scrutiny and, theoretically, without budgetary limit. The FFB, therefore, provides federal agencies with a powerful potential for wide-scale intrusion into credit market decision-making.

Economic Implications of FFB Guarantees

Many advocates of free enterprise have objected to congressional action that granted New York City and the Chrysler Corporation several billion dollars in highly publicized loan guarantees. The New York City loan guarantee does little to address the city's fiscal problem -- deficit spending -- and encourages other cities to follow the same route to bankruptcy, with hopes of being "rescued" by the taxpaying public. The Chrysler loan guarantee, its critics observe, simply bails out an inefficient business enterprise by siphoning over a billion dollars in credit that would be put to

more highly valued uses by more credit-worthy borrowers. The consequences of subsidizing failing businesses are well-known and are diagnosed worldwide as the "British Disease." Great Britain's anemic industrial performance of the past several decades is due largely to the fact that the British government forces taxpayers to subsidize on a wide scale failing or grossly inefficient business enterprises. The Chrysler loan guarantee is a step in this direction, and has been denounced by both conservatives who favor free enterprise and oppose subsidies to business, and by liberals who proclaim a fear of the powers of "big business." Nevertheless, the Chrysler and New York City loans pale in comparison with the off-budget guaranteed loans administered by the FFB. These two loan guarantees were subjected to congressional oversight and subsequently received much media exposure, but FFB loan guarantee decisions are made by a few nonelected bureaucrats in a small office at the Department of Treasury.[5] This system provides opportunities for "social engineering" by nonelected bureaucrats that the Chrysler loan does not. Consider the $2 billion in off-budget loans recently extended by the FFB to the Tennessee Valley Authority, a federally sponsored off-budget enterprise.[6]

In 1979 the TVA decided that its nuclear fuel inventory had become excessive due to nuclear power plant construction delays. To remove the burden of excessive inventories from its books, the TVA created a wholly owned subsidiary -- the Seven States Energy Corporation -- with which TVA could enter into a leaseback arrangement. Seven States would purchase TVA's nuclear fuel inventory and then lease it back as needed. To finance the arrangement, TVA originally approached a private investment banking firm, which suggested a $1 billion line of credit. Before the agreement was completed, however, the Treasury Department suggested that the FFB could provide the credit, and would increase the amount of the loan to $2 billion. Thus the TVA, in effect, extended a $2 billion line of credit to itself -- more than either the Chrysler or New York City loan guarantees -- and Congress had not been involved at all. This has far-reaching implications for the future role of the federal government in allocating credit -- a role which has, in the past, had unfortunate consequences in terms of both equity and efficiency. According to the FFB Act any entity wholly owned by the federal government has this access to off-budget federal financing. Several such entities do exist and have the legal authority to order the FFB to lend money to anyone, provided that they guarantee the loan.[7]

In addition to substituting inefficient and inequitable political resource allocation for the more efficient market allocation of capital, the existence of the FFB also increases the borrowing costs to the federal government, despite the argument that by pooling agency borrowing, financing costs are reduced. The reason for this is that the increased interest rate on federal debt resulting from FFB borrowing from the Treasury is far more expensive than the minimal savings to federal agencies. Agency debt appeals to a different market than does Treasury debt, as the difference in interest rates attests. When the Treasury issues more debt (to finance the FFB), it crowds the market segment to which its issues appeal, and that forces rates up on Treasury debt. One would think that this invalidates the entire economic (but not the political) rationale for the FFB.[8]

Loan Guarantees and the Allocation of Credit

In addition to the loan guarantee and other functions of the FFB there are over 150 federal loan guarantee programs administered by federal agencies that comprise yet another category of off-budget operations. Loan guarantees to individuals, businesses, state and local governments, or foreign governments are only reflected in the budget if the borrower, dealing through a private bank, defaults. In that case, the federal government is liable for part or all of the principle and interest on the loan. Although not reflected in the budget document, loan guarantees serve the same purpose as direct, tax-financed appropriations: They provide transfer payments to select groups at the expense of the general public. The major difference, of course, between tax-financed subsidies and loan guarantees is that the latter are far less visible and do not arouse as much taxpayer resistance. For example, a tax-financed subsidy to a college student whose parents earn $100,000 per year will surely meet more resistance, especially from the less wealthy, than will a guaranteed loan which most people think does not involve a subsidy. The partial or full guarantee of such loans does, however, permit the favored borrowers to borrow at reduced interest rates. Because of the hidden nature of these "interest subsidies," loan guarantees have become the largest component of federal credit activity. This is shown in Table 4, which lists the growth of federal loan guarantees, as well as on- and off-budget loans, from 1974 to 1982. The data indicate that loan guarantees comprise over 65 percent of all credit activity and about four times the volume of direct, on-budget loans. They are also the fastest-growing type of federal credit activity, having increased by 320 percent since 1974

The major costs of federal loan guarantee programs, like the benefits, are indirect. A major difference, however, is that the benefits of loan guarantees accrue to well-organized interest groups, but the costs are widely dispersed among the general public. The predominant indirect cost of federal loan guarantees is borne by less-favored borrowers who are crowded out of the credit market or who must pay higher interest rates on the loans that are obtained. Loan guarantees tend to increase the overall demand for credit while at the same time reducing the supply of credit available to nonguaranteed borrowers. The effect is to increase the rates charged to nonguaranteed borrowers to levels higher than they would otherwise be, which crowds out much private borrowing by businesses, individuals, and state and local governments. This process seriously distorts the market process whereby unregulated markets allocate credit to its most highly valued uses -- enhancing economic growth.

TABLE 4
Annual Federal Credit Outlays,
Fiscal Years 1974-1982
($ Billions)

	Loan Category Direct Loans, Direct Loans, Guaranteed		
Year	Direct Loans, On-Budget	Direct Loans,Off-Budget	Guaranteed Loans
1974	$12.3	$ 3.5	$31.8
1975	12.9	10.8	31.1
1976	18.8	10.2	31.8
1977	14.7	13.6	43.3
1978	23.5	16.4	45.5
1979	21.0	17.3	60.5
1980	25.7	23.6	68.7
1981*	24.6	32.2	90.5
1982*	28.1	26.2	101.5

*estimates Source: Budget of the U.S. Government, Special Analyses various years.

Credit markets serve the role of evaluating the riskiness of alternative projects, and those with higher probabilities of failure (to meet consumer demands) are charged higher borrowing costs. In this way, the credit markets provide consumers and producers with invaluable information about the most productive uses of resources. Loan guarantees, by socializing risk, make it impossible for consumers and producers to make accurate benefit-cost calculations, and resources are put to lower-valued, not higher-valued, uses once politics rather than the market is used to allocate credit. At times when high interest rates force private firms to invest in only the most productive projects promising very high yields, federally assisted borrowers may continue to invest in projects which yield only a fraction of the nonguaranteed investments. Thus, the federal government is actively subsidizing inefficient investments. This reduces the productivity of the nation's capital stock and consequently lowers the rate of economic growth. The slower rate of economic growth is, of course, accompanied by higher inflation and higher unemployment.

As an example of how private sector investments are crowded out in favor of government-sponsored investments, consider the following: In 1980 when a 20 percent prime rate and 16 percent consumer loan rate contributed to the bankruptcy of thousands of small businesses such as auto dealerships and grocery stores, the Rural Electrification Administration began a new program to provide 35-year loans at 5 percent interest to finance rural cable television systems; rural home mortgages were available at 3.3 percent; and insured student loans went for 7 percent, to name just a few. Also during that year, while many private utilities were paying 16 percent on their long-term bonds, the TVA was borrowing at a rate several percentage points lower. As a result of this and other subsidies, the cost of electricity supplied by the TVA is lower than in many areas served by less favored private companies. In 1979, for example, TVA rates were about 50 percent lower than in such "frost belt" states as New York and Massachusetts and were about 38 percent below the national average.[9]

It is very difficult, if not impossible, to gauge the extent of crowding out caused by federal loan guarantees, but some preliminary estimates have been made. Economist Herbert M. Kaufman of the University of Arizona conducted an empirical study of federal loan guarantees in which he estimated that for every $1 billion in loan guarantees, between $736 million and $1.2 billion in private investment is crowded out.[10] These are rough estimates, but they nevertheless indicate that loan guarantees, which are being extended at a rate of over $100 billion per year, are sure to have a profound negative impact on economic growth, employment, and inflation. The effect on inflation is not likely to be very significant, however, since changes in aggregate output occur relatively slowly as a result of reductions in private investment spending. However, the potential exists that the upward pressure on interest rates caused by federal intrusion into the credit markets via loan guarantees may bring pressure to bear on the Federal Reserve to "accommodate" the Treasury by expanding the money supply, thereby "reinflating" the economy.

A somewhat more subtle way in which the federal government uses loan guarantees to control the allocation of resources is with its influence over the recipients. For example, the Federal Housing Administration, which administers the largest loan guarantee program, attempts to implement various social policies by vetoing a loan application if a builder does not comply with FHA's regulations regarding marketing to minority groups, environmental impact statements, architectural review, underwriting minimum wages, and so on. Because of the division of responsibility for all these objectives, considerable confusion and delay arises, which increases the cost of housing construction. Further, once a firm or an industry is dependent upon financial assistance from the government, the dependence is often used as a lever to impose additional regulatory controls which may be totally unrelated to the government's contingent liability. Current administration and congressional efforts to deregulate the private sector in order to foster more rapid economic growth are sure to be confounded by the regulatory requirements that accompany the rapidly growing volume of loan guarantees.

A closer look at the pervasive influence of the federal government through its loan guarantee programs is provided by the data in Table 5, which show the guaranteed loan transactions of the federal government in 1980 by agency or program. Housing and agriculture, two of the strongest political constituencies in the nation, dominate the field, accounting for over 80 percent of all loan guarantees. The use of guaranteed loans for housing was nine times greater than the direct loan program in 1980 and contained 43 separate programs. The Export-Import Bank (which subsidizes selected American exporters), student loan programs, and the Small Business Administration also administers a large volume of guaranteed lending, which amounted to approximately $16 billion in 1980.

Equity Aspects of Federal Loan Guarantees

In addition to fostering a less efficient allocation of resources and hindering economic growth, many of the loan guarantee programs listed in Table 5 would be considered by many to be inequitable. An extreme case in point is the student loan program which, with few eligibility requirements,

TABLE 5
Guaranteed Loan Transactions of the Federal Government: 1980
($ Millions)

Agency or Program	Guaranteed Loans
PRESIDENTIAL APPROPRIATIONS	
International security assistance	$2,505
International development assistance	105
AGRICULTURE	
Farmers Home Administration	15,329
Commodity Credit Corporation export credit	1,516
Rural Electrification Administration	4,793
COMMERCE	
Economic development assistance	178

National Oceanic and Atmospheric Administration	31
Energy research and technology	1,278
DEFENSE: military	1
HEALTH AND HUMAN SERVICES	
Health programs	69
HOUSING AND URBAN DEVELOPMENT	
Subsidized low-rent public housing	16,853
Federal Housing Administration	17,742
Community development	45
GNMA: mortgage-backed securities	16,853
INTERIOR	
Indian programs	1
TRANSPORTATION	
Rail programs	104
Washington M.T.A. bonds	--
Federal ship financing fund	928
Aircraft loans	429
TREASURY	
Guarantees of New York City notes	300
Chrysler Corporation loan guarantee program	400
Biomass energy development	--
NASA: Long-term satellite leases	111
VETERANS ADMINISTRATION (housing)	10,354
EXPORT-IMPORT BANK	4,899
FOUNDATION FOR EDUCATION ASSISTANCE	
Guarantees of SLMA debt issues	1,955
Student loan insurance form	7,762
Government Services Administration	14
NATIONAL CREDIT UNION ADMINISTRATION	85
SMALL BUSINESS ADMINISTRATION	
Business loan guarantees	85
Business loan guarantees	2,986
Disaster loan fund	1
Pollution control bond guarantees	100
Tennessee Valley Authority	3,624
OTHER AGENCIES & PROGRAMS	14

Source: Budget of the United States Government, Special Analyses, Federal Credit Programs," Appendix F, 1982.
creates generous subsidies for higher-income households With such loans available to students and their parents at 7 percent interest regardless of financial need, the high market interest rates of the late 1970s and early 1980s have provided many lucrative investment opportunities for wealthy families. As the spread between interest rates on student

loans and market rates widened, new student loans rose from $2.7 billion in 1979 to $7.2 billion in 1981, reflecting a widespread recognition of the opportunities to borrow thousands of dollars at 7 percent and invest the proceeds in long-term bonds or money market funds paying 14-16 percent.[11] Furthermore, hundreds of millions of dollars in student loans are now in default, rendering these loans outright gifts to the students and their parents.

The vast majority of federal loan guarantee programs provide subsidies to individuals who are not generally considered to be financially disadvantaged, regardless of the rhetoric associated with such programs. There is a very strong incentive for the administrators of loan guarantee programs to subsidize politically powerful groups, regardless of income, who will, in return, provided support for the agency at appropriations time. Consider the fact that even though HUD's chief goals are supposedly "the elimination of substandard and inadequate housing through the clearance of slums and blighted areas..." it has established hundreds of programs which have nothing to do with slum clearance. For example, HUD's housing rehabilitation loan program has extended 3 percent guaranteed loans to individuals earning over $50,000 per year to finance skylights and greenhouses.[12]

In sum, if there is a pattern of behavior guiding the granting of federal loan guarantees, it is based on the ability of the subsidized group to provide political support for the agency and not on efficiency or equity considerations.[13] Eliminating many, if not all, loan guarantees would inflict short-term losses on specially privileged groups, but would increase the productivity of the nation's capital stock and limit the negative-sum transfers of wealth to higher-income groups, which come at the expense of the general public.

Debt Collection, Default, and Debudgeting the Budget

The huge indirect costs of federal loan guarantees and off-budget lending are accompanied by billions of dollars of direct costs in the form of loan defaults. When a borrower defaults, the loan or loan guarantee then becomes a gift to the borrower and a way in which the federal largesse can be distributed without undergoing the scrutiny of the appropriations process. History shows that many federal credit programs appear to be designed to do exactly that. It is very difficult, if not impossible, to obtain an accurate account of the volume of loan defaults, for federal agencies are reluctant to make such data available. GAO conducted a limited survey of debts owed the federal government in 1979 and found that by the end of 1978 over $140 billion in overdue loans were outstanding, a $22 billion increase over the previous year.[14] One GAO auditor stated, "I'd say we're losing about a half billion dollars a year in bad debts that go uncollected."

GAO surveyed 12 federal agencies and found that most do not even attempt to collect many of their debts: Nine major agencies simply wrote off $428 million in uncollected debts in 1978, and many agencies don't even report their "uncollectibles" at all. When federal agencies do attempt to collect their debts, they are notoriously inefficient and slow in doing so. For example, GAO found that one federal agency, which kept data on debt collection costs, spent $8.72 per account in 1976 compared to a large commercial agency in the U.S., which averaged $3.50 per account for the same function. Private firms surveyed by GAO stated that it is profitable to attempt to collect debts as small as $25 to the point in the collection process where a decision is made on whether to seek a court judgment. By contrast, in 1977 most federal agencies simply wrote off debts up to $600. In one instance, an individual could afford a $17,000 mortgage, but the VA wrote off his $638 debt as "uncollectible." Whenever the federal government does follow through with seeking a court judgment, it takes a minimum of one year to reach the court stage, compared to about five months for private firms surveyed by GAO. Among the agencies failing to collect debts are the Small Business Administration, the Veterans Administration, and the Farmers Home Administration, which wrote off $274 million in bad debts in 1978, a 66 percent increase from 1976 figures. SBA has a particularly high default rate, and for good reason -- a loan applicant must prove that he is not credit-worthy in order to qualify! That is, a borrower is eligible for a direct SBA loan only if he can prove he was turned down by at least two banks and that his loan is too risky for even SBA's loan guarantee program. The SBA direct loan program wrote off $166 billion in loans in 1980, which was topped by the SBA's $368 million in guaranteed loan defaults during that year.[15]

The Office of Education (now the Department of Education) was another agency surveyed by GAO which had severe debt-collection problems. Defaulted guaranteed student loans soared from $52 million in 1974 to $1.7 billion in 1982, a 3,300 percent increase in just eight years. The Education Department also has a collection problem with direct loans. As of July 1982, an estimated 1.2 million students had defaulted on direct loans amounting to about $600 million. The

federal government has actively encouraged students to believe in the student loan Santa Claus with a new law making it illegal for personal credit checks to make any mention of student loan defaults. Surely if the Congress had any intention of collecting these debts, it would not have passed this law. It also would not permit the SBA to virtually guarantee itself a high default rate.

In sum, billions of dollars of loans and loan guarantees which distribute indirect off-budget subsidies are being turned into direct gifts by simply not enforcing the terms of the loan. Furthermore, it is difficult to believe that members of Congress did not intend for the system to work that way, for it is in their self-interest that it do so

Federally Sponsored Off-Budget Enterprises

A third category of federal off-budget operations is "government-sponsored enterprises," most of which engage in credit activity. Included 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). These agencies were at one time on-budget, but their large and rapidly expanding borrowings became an embarrassment to some member of Congress and were therefore omitted from the budget in 1968.[16] They were originally char- tered by the federal government but are now privately owned. They are, however, subject to government supervision and by law must consult with the Treasury Department in planning the marketing of their debt. In addition, many of their board members are presidential appointees, and various decisions must be cleared by other government agencies as well as the Treasury. For example, many of FNMA's decisions must be approved by the Secretary of HUD.

These agencies are also granted special preferences and certain tax exemptions which permit them to borrow funds for governmentally authorized purposes at rates only slightly above the Treasury's own rates and lend the money to certain specified groups. Thus, federally sponsored enterprises are private in name only, and are yet another way in which the federal government directs the allocation of billions of dollars of credit without being subject to the federal budget review process.

The special assistance granted federally sponsored enterprises also hinders the development of private firms which would compete in performing these same tasks more efficiently. A case in point is FNMA, which in 1980 owned $56 billion of mortgages with an average life of over 14 years and an average yield of about 9.5 percent.[17] While betting on long-term rates to drop, "Fannie Mae" relied heavily on short-term financing, accumulating $17 billion in short-term debt that must be rolled over within a year. About half of that $17 billion was costing Fannie Mae 17 percent, with the rest at around 9.7 percent, but that would have to be refinanced at about 17 percent. Consequently, Fannie Mae lost $146 million in the first half of 1981. Despite these huge losses, it has had no trouble in rolling over its debt, which has been trading at less than a percentage point above short-term Treasury bills. The reason for this, of course, is the implicit (and explicit) guarantee of the federal government. Unlike a private firm, which bears the brunt of hundreds of millions of dollars in losses, Fannie Mae and the other federally sponsored OBEs are protected by law from such losses and therefore have weak incentives to do anything about them.

TABLE 6
Borrowing by Federally-Sponsored Enterprises
($ Millions)

	Borrowings or repayment (-) Debt			
	1980	1981	1982	1983
Housing and Urban Development:				
Federal Nat'l. Mortgage Assoc.	6,347	4,342	11,646	11,657
Farm Credit Administration:*				
Banks for cooperatives	1,542	737	1,093	1,126
Federal intermediate credit banks	3,536	1,921	2,882	3,502
Federal Land Banks	7,076	6,819	6,842	7,494

Federal Home Loan Bank Board:				
Federal home loan banks	6,454	21,029	3,662	4,075
Federal Home Loan Mortgage Corporation	3,141	1,847	20,948	23,460
Foundation for Education Assistance:				
Student Loan Marketing Association	1,070	2,223	1,603	1,543
Total	29,165	38,917	48,676	52,867

*The debt represented by consolidated bonds is attributed to the respective Farm Credit Banks. Source: Budget of the U.S. Government, Special Analyses, Appendix E, "Borrowing and Debt," 1982.

The total estimated volume of borrowing by federally sponsored enterprises during 1980-1983 is shown in Table 6. Estimated borrowing is expected to nearly double by 1983, to a total of over $52 billion, with $315 billion in debt outstanding at that time. This would continue the recent trend of a very rapid expansion in borrowing by federally sponsored enterprises which, up until 1974, had never borrowed more than $14.9 billion annually. This amount increased sharply to $24.1 billion by 1978, to $27.5 billion in 1980, and exceeded $38 billion in 1981. Thus, during periods of high and rising interest rates which crowded out many private-sector borrowers, federally sponsored and controlled borrowing expanded at a rapid pace. Nearly three-fourths of all federally sponsored borrowing during the 1981-83 period will be used to support the mortgage market. As one senator recently said, it seems as though the federal government is trying to make everyone a "preferred borrower" of some sort these days.

There are also numerous other federally sponsored enterprises throughout the country which provide various services to federally specified constituent groups but bypass the federal appropriations process. Two of the best-known examples are the TVA and the Bonneville Power Administration, both federally chartered OBEs, which obtain most of their funds by issuing revenue bonds but are also the recipients of federal grants and some appropriations.

Fiscal Discipline and Government Regulation

Off-budget activities are by no means the only way in which balanced budget or tax/expenditure limitation requirements have been evaded by politicians. Politicians can subsidize a particular group without resorting to the appropriations process by enacting various forms of "sweetheart legislation." For example, import quotas on automobiles (or any other product) would restrict the supply of automobiles, increasing the prices paid by consumers and the profits of the owners of the auto industry. The effect is the same as a tax-financed subsidy -- a special-interest group benefits at the expense of the general public. Government regulation provides myriad ways to conduct "business as usual" regardless of budgetary restrictions.

Another example is the direct regulation of industry by various agencies such as the Interstate Commerce Commission (ICC), the Federal Trade Commission (FTC), and the Federal Communications Commission (FCC). Politically influential groups such as the trucking industry, the airline industry, and labor unions have used these agencies to restrict competition and increase profits and wages. For example, with the sanction of the ICC, trucking firms have been able to act as a cartel in setting their rates. Representatives of the regulated firms meet periodically to set freight rates. These "rate bureaus" have been specifically exempted from the antitrust laws regarding price fixing. The Teamsters union has also benefited from the ICC's policies of entry restriction because such restrictions prevent nonunion firms from entering the industry and competing for traffic carried by union- ized firms. Consequently, the Teamsters have been able to raise the wages of their drivers to a level about 50 percent higher than those in the unregulated sector.[18] Regulation of this sort, which is quite pervasive, imposes great burdens on taxpayers and consumers even though there are no budgetary entries to reflect such costs. In addition, special interest groups spend millions of dollars each year lobbying for preferential treatment; such expenses are an additional cost to society since the resources could have been used to produce additional goods and services, rather than merely redistributing income.[19]

Another way in which government conducts its business without explicitly taxing or spending is by regulating the day-to-day activities of businesses, including working conditions, finances, consumer safety, the environment, and hiring

practices. Although these regulatory activities may or may not result in diminished competition in various industries, they surely impose enormous costs on taxpayers in return for sometimes questionable benefits. Economist Murray Weidenbaum conservatively estimated that the direct, measurable cost of federal regulation of business was $102.7 billion in 1979, of which only $4.8 billion, or approximately 5 percent, was budgeted as administrative costs; the remaining $97.9 was the cost of compliance, which was largely paid by consumers.[20]

Regulation and Labor

Government regulation has major allocative and distributive effects not only on product markets, but also on labor markets.[21] Occupational licensing requirements, for example, are a means of subsidizing special interest groups without resorting to explicit taxation. One well-known example of the effects of licensing is the regulation of the taxicab business. In New York City a license costing $65,000 must be purchased to own and operate a cab. Consequently, the supply of taxi services is severely restricted, increasing cab fares to the benefit of existing drivers at the expense of potential drivers and customers. Similar inequities occur in other industries as a result of more than 3,000 statutory provisions requiring occupational licenses for such diverse professions as fortune tellers, funeral directors, and doctors.[22]

A second way in which government regulation of labor markets redistributes wealth is through enforcement of the minimum wage law. It is a well-established empirical fact that, regardless of good intentions, the effect of the minimum wage law is to hurt precisely the group that the law is supposed to help -- those with the least skills, seniority, and income.[23] If an unskilled worker, for example, can contribute $2.50 per hour to a firm's profits, and the law mandates a $3.50 per hour minimum wage, it will be more profitable for the firm not to hire the unskilled worker. Thus, increases in the minimum wage are accompanied by increased unemployment of unskilled workers, predominantly teenagers. The major beneficiaries of the minimum wage law are politicians who can convince people they are doing something positive about unemployment and poverty, relatively skilled workers who retain their jobs at the higher (minimum) wage, and members of labor unions who, being relatively skilled, compete with unskilled, nonunion labor. It is difficult to believe that labor unions in California, for example, advocate the enforcement of minimum wage laws to nonunion migrant workers because of altruism rather than a desire to price migrant workers out of the market.

"Equal employment opportunity" regulation also affects the allocation of labor resources. The "equal-pay-for-equalwork" rule, for example, most likely increases employment discrimination. If an employer discriminates by paying male workers $10 an hour and equally qualified female workers $5 an hour, in a competitive labor market the firm's female workers will be bid away at wages greater than $5 an hour. Eventually, all of the firm's female labor will be bid away, leav-ing the firm at a competitive disadvantage, reducing its profits. Thus, in an unregulated labor market, discrimination is costly to employers. Equal-pay-for-equal-work rules lower the cost of discrimination in employment since an employer's profits are no longer lowered by passing over equally qualified women to hire men. Therefore, enforcement of such laws will more likely lead to more, not less discrimination. American labor unions comprised mostly of white males are among the most vocal advocates of equal-pay-for-equal-work laws, and it is hard to believe that this concern is based on altruism. Labor unions in South Africa have similarly lobbied intensely for such laws, and openly admitted that the reason for doing so is because government programs "no longer protected the white worker. [24]

Finally, government also influences labor market outcomes by enhancing the market power of labor unions through actions of the National Labor Relations Board (NLRB). A recent study has shown that the NLRB's regulation of collective bargaining has greatly enhanced the power of labor unions at the expense of those who are barred from employment by unions as well as consumers who pay the price of reduced economic efficiency and higher inflation.[25] The social cost of NLRB regulation was estimated to be at least $22 billion in 1979. Overall, the total social cost of labor market regulation was estimated to have been $170.3 billion in 1979

In summary, it is important to recognize that in addition to off-budget activities, existing regulatory mechanisms permit politicians to affect the allocation of hundreds of billions of dollars of resources without taxing or spending. The predominant activity of government, the redistribution of wealth from the general public to special interest groups, is conducted through extensive regulation of product and labor markets. The administrative costs are trivial when

compared to the social cost of regulation, and is carried on at all levels of government.

Some Concluding Observations

Following the precedents established at the state and local levels of government, the federal government has evaded constraints on its spending and taxing activities largely through the credit market activity of off-budget agencies such as the Federal Financing Bank, the issuance of hundreds of billions of dollars in loan guarantees, and the activities of privately owned, but governmentally controlled, enterprises such as Fannie Mae.

The advent of the Budget Reform Act of 1974 and the taxpayer revolt of the 1970s has led to a tremendous expansion in the off-budget activities of the federal government so that of total federal credit outlays of $155.8 billion in 1982, fully 82 percent ($127.7 billion) was in the form of either off-budget loans or guaranteed loans, neither of which are fully reflected in the budget document or undergo budgetary review by the Congress. In addition, borrowing by "government-sponsored enterprises" is estimated to approach $50 billion in 1982 so that the federal government will be responsible for over 40 percent of all credit advanced in U.S. credit markets in that year, compared to an 11 percent participation rate in 1969.[26]

Even though many have treated off-budget federal credit activity as though it constituted the proverbial free lunch, the crowding out of the private sector and the subsidization of economically inefficient, but politically popular, investment projects will surely lead to slower economic growth, higher unemployment, and, possibly, higher inflation. In addition to the off-budget credit activities, federal regulation provides another way of accomplishing the ends of politicians without explicitly appropriating funds. In principle, anything that can be accomplished through the taxing and spending aspects of the budget can be accomplished instead through government regulation.

As pressures for a balanced budget and restrictions on federal spending mount, one may expect an accelerated use of the federal government's off-budget mechanisms. The proposed balanced budget amendment to the Constitution (S.J. Res. 58) does take into consideration the activities of the FFB and proposes to include them within the budget. The proposed amendment does not, however, address the larger problems created by loan guarantees, federally sponsored enterprises, and regulation and should therefore be seen as only a first step in the direction of fiscal responsibility, but not necessarily a major one.

Some attempts have been made to reduce the extent of off-budget credit activity, but these have had little success. In the 1981 credit budget, President Reagan proposed that direct loans increase by only 1.7 percent and loan guarantees by 8.3 percent. By the time the President's 1982 budget was published, however, it showed that loans had increased by 21 percent, while loan guarantees rose by an estimated 31 percent. Formally including all federal credit activities in the congressional budget process is likely to improve our ability to put a cap on seemingly runaway federal spending and borrowing, although even more imaginative financing schemes would surely follow.

Even when federal loan guarantees are effectively curtailed, there is the possibility that the cost of these programs will merely be shifted to lower levels of government rather than reduced. Recently, the Reagan administration proposed cutting the federal government's $6 billion student aid program by limiting loan guarantees to lower- and middle-income families earning less than $30,000 per year. In response, Dartmouth College, Harvard, Northwestern University, and over 100 other universities have either created off-budget "educational finance authorities" or made use of existing OBEs, which have issued revenue bonds to finance student loans.[27] At least five states -- New Hampshire, Massachusetts, Maine, Illinois, and Iowa -- have established newly created OBEs, and four other states -- New York, Maryland, Pennsylvania, and Florida -- have legislation pending that would establish more of such authorities. Tactics such as this are sure to confound attempts to constrain governmental credit activity and should be considered by citizens and policymakers seeking to do so.

FOOTNOTES

[1] As quoted in James M. Buchanan and Richard E. Wagner, Democracy in Deficit: The Political Legacy of Lord Keynes New York: Academic Press, 1977), p. 156.

[2] For background information on the FFB see Congressional Budget Office, Loan Guarantees: Current Concerns and

Alternatives for Control (Washington, D.C.: U.S. Government Printing Office, 1979).

[3] Joint Economic Committee, U.S. Congress, The Underground Federal Economy, Staff Report (Washington, D.C.: U.S. Government Printing Office, April 20, 1982), p. 12.

[4] There is no free lunch, of course. The economic effects of the FFB are discussed shortly.

[5] The authors attempted to contact FFB officials, but found that their agency is neither in the District of Columbia phone book nor in the current listings of federal agencies.

[6] TVA is a regional OBE, obtaining most of its revenue from the sale of revenue bonds. It does, however, receive federal aid in the form of appropriations, grants, and guaranteed loans. The following example is found in C. Hardin and A. Denzau, The Unrestrained Growth of Federal Credit Programs (St. Louis: Washington University Center for the Study of American Business, December 1981).

[7] There are at least 20 such agencies, including the Commodity Credit Corporation, the Export-Import Bank, Corporation for Public Broadcasting, Government National Mortgage Association, Community Development Corporation, U.S. Railway Association, Revision Benefit Guarantee Corporation, Legal Services Corporation, and others.

[8] This point was brought to our attention by Professor Yale Brozen of the University of Chicago in personal correspondence.

[9] As cited in R. Utt, "Federal Lending Programs," testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, October 7, 1981.

[10] Herbert M. Kaufman, "Loan Guarantees and Crowding Out," Economics of Federal Credit Activity (Washington, D.C.: Congressional Budget Office, April 1980), pp. 35-39.

[11] Budget of the U.S. Government, Special Analyses, various years.

[12] As reported in D. Lambro, Fat City: How Washington Wastes Your Taxes (South Bend, Indiana: Regnery Co., 1980), p. 128.

[13] When both inefficiency and inequity are widely acknowledged, loan guarantees are often justified on "national security" grounds. In hearings before the Senate Banking Committee on October 7, 1981, on the subject of loan guarantees to Exxon and Tosco Corporations for a shale oil project, a Department of Defense official testified that shale oil development and, consequently, the loan guarantee for Exxon and Tosco, was urgently needed to enhance the strategic oil reserve. Senator Harrison Schmitt of New Mexico discredited that viewpoint, however, by mentioning that shale oil was far more expensive than "conventional" oil, and was therefore a bad deal from a national defense standpoint.

[14] U.S. General Accounting Office, The Government Can Be More Productive in Collecting its Debts by Following Commercial Practices (Washington, D.C.: U.S. Government Printing Office, February 23, 1979). GAO recently reported that the number of foreign governments in default for loan guarantees to purchase military supplies increased from two in 1978 to 13 as of February 1982. This type of guarantee permits Congress to extend military aid to selected countries without going through the appropriations process and being subjected to wide publicity. See D. Morgan, "13 Arms Buyers in Default on Interest to U.S.," Washington Post, July 17, 1982, p.1.

[15] C. Hardin and A. Denzau, p. 25.

[16] Budget of the U.S. Government, Special Analyses, Appendix E, "Borrowing and Debt," 1982.

[17] A. Sloan, "Saving Fannie," Forbes, October 26, 1981, pp. 54-55.

[18] Rayburn M. Williams, Inflation: Money, Jobs? and Politicians (Arlington Heights, Ill.: AHM Publishers, 1980), p. 105.

[19] These lobbying activities have been termed "rent-seeking" and are discussed in detail in James Buchanan, Robert Tollison, and Gordon Tullock, eds., Toward A Theory of the Rent-Seeking Society (College Station: Texas A&M Press, 1980).

[20] Murray Weidenbaum, The Future of Business Regulation (New York: American Management Association. 1979).

[21] For a discussion of labor market regulation see James T. Bennett, Dan C. Heldman, and Manuel H. Johnson, Deregulation Labor Relations (Dallas: The Fisher Institute, 1981).

[22] Walter E. Williams, "Government Sanctioned Restraints That Reduce Economic Opportunities for Minorities," Policy Review, Fall 1977, pp. 1-29.

[23] Bennett, et.al., pp. 86-98.

[24] Walter E. Williams, p. 11.

[25] Bennett, et.al., pp. 112-119.

[26] "Federal Credit Programs," Budget of the U.S. Government, Special Analyses, Appendix F, 1982, p. 6.

[27] R. Bucklin, "Colleges Aid Students With Bonds," Washington Post, July 2, 1982, p. C-9.