

# On the “underspending” in the Federal budget

In the summer of 1976, the slow pace of the business recovery raised important questions about the underlying strength of the economy. There was a good deal of speculating about what might be going wrong. One apparent clue surfaced when the Federal Government budget for the fiscal year ended in June 1976 indicated that spending was \$8.8 billion lower than expected.

It was widely anticipated that spending would be back on track by October, when the Federal Government was to introduce a new dating for its fiscal year. (The first fiscal year on the new basis, fiscal 1977, began on October 1, 1976 and will end on September 30, 1977.) These expectations did not materialize and the underspending persisted into fiscal 1977, the current fiscal year. However, the large increase in Federal Government purchases of goods and services in the April-June quarter seems to indicate that the shortfall, at least in some categories of spending, might be ending. Questions about the underspending and its economic effects nevertheless remain.

Interest in the shortfall has focused mainly on its possible downward impact on economic activity, particularly over the short run. There are, of course, other issues concerning the underspending. For one, there is the question of whether the size of Federal spending is already too high relative to that of the private sector. To many who take this view, the shortfall is a welcomed development, despite its possible short-run dampening effects on the economy. For another, there is also the question of determining the appropriate amount of fiscal stimulus with the economy operating below capacity while inflation is still rapid. This article

does not explore these two issues but is restricted to the direct impact of the shortfall on the pace of the expansion.

A close look at the underspending problem turns up some surprising information. Shortfalls in Federal spending were very common in the past. Also, part of the current underspending is not in spending *per se* but in the so-called “offsetting receipts”—revenue netted against certain spending categories in the budget—and some of the offsets have been larger than estimated.<sup>1</sup> Furthermore, it appears that the economic effects of current Federal underspending have probably been exaggerated.

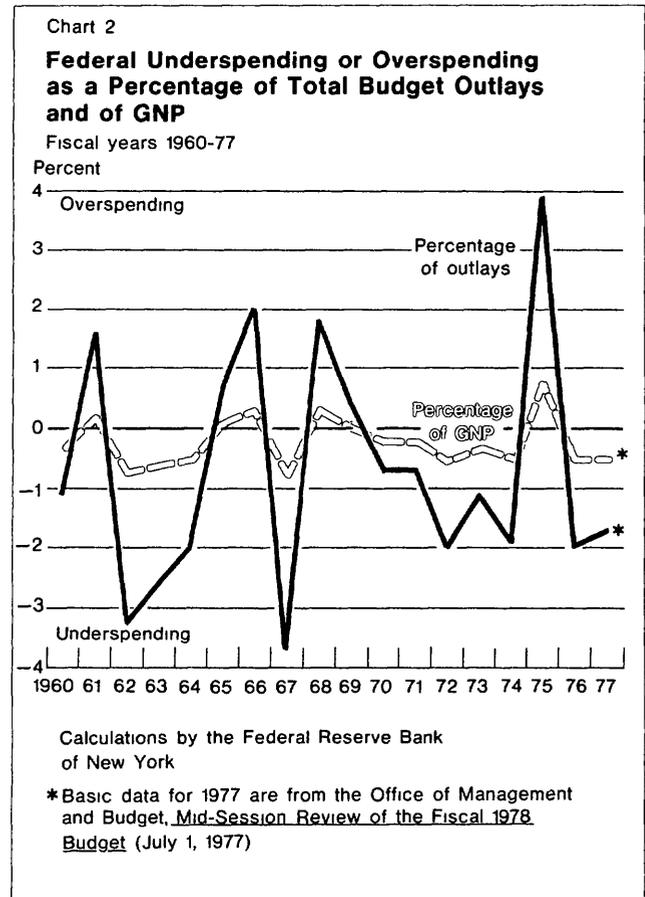
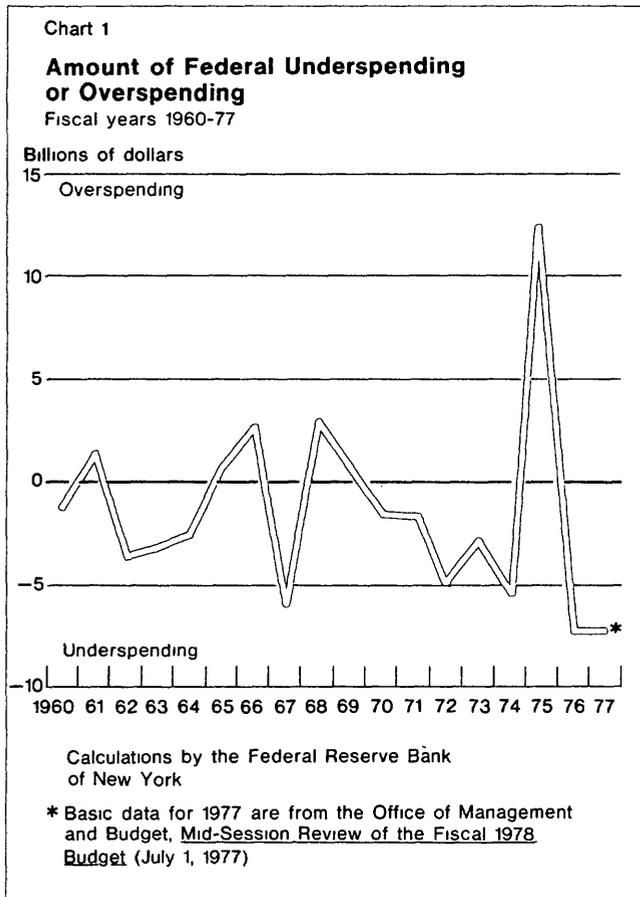
Perhaps the most important consequence of the shortfall controversy will be to accelerate the pace at which the Office of Management and Budget introduces improved spending controls into the Executive Branch. Such a development would have been inevitable in any event, since the Congress has begun to monitor budget matters much more closely under the provisions of the Congressional Budget and Impoundment Act of July 12, 1974.<sup>2</sup>

## Understanding the shortfall

Underspending implies that Federal outlays are running below some target. That target is the cumulative amount of spending needed at any point during the

<sup>1</sup> Offsetting receipts cover a wide variety of items, including repayments of loans, interest payments on loans, rents, sales of products, and insurance payments by veterans.

<sup>2</sup> For an explanation of the new Congressional budget procedures, see Joseph Scherer, “New Directions for the Federal Budget?” in this Bank’s *Quarterly Review* (Spring 1977), pages 1-10.



fiscal year if the total in the official budget is to be met by that fiscal year's end. There are two aspects of estimating any shortfall: to calculate how much of a shortfall has already occurred and to determine whether the underspending will continue and what its ultimate size will be. Analyzing both aspects necessarily involves a number of uncertainties.

The Administration can measure any current shortfall by comparing actual spending totals for any month with the estimates it previously made for that month. When a shortfall turns up, the Government can then identify the particular spending categories in which it has arisen. It is much more difficult for outsiders to spot possible shortfalls during a fiscal year, since the official budget presents no monthly distribution of Federal spending. Analysts can attempt to fill this information gap in several ways. One is to apply seasonal adjustments to reported monthly expenditures. The purpose is to see whether or not expenditures are tending to run at a monthly rate that seems plausible in light of the annual estimates given in the budget. Another is to calculate the percentage of the total

year's spending represented by the period for which actual data are in hand and to compare this percentage with the percentages for similar periods in previous years. Neither of these methods provides sure answers.

Answers are uncertain since both techniques assume a normal pattern of Federal spending to which incoming data for a current year can be compared. However, the pattern of spending within a fiscal year is not consistent. Experience shows, for example, that the proportion of yearly spending can shift several percentage points from the first half of a fiscal year to the second half, and vice versa. Since a single percentage point of the current budget, that for fiscal 1977, is worth about \$4.1 billion, the range of error by any method of estimating a shortfall—or of estimating an overage—can be very large. Consequently, the underspending in fiscal 1977 cannot be verified with much certainty by outside analysts.

Spending shortfalls have occurred in eleven of the seventeen years from fiscal 1960 to 1976, or about two thirds of the time (Chart 1). Moreover, when the

eleven shortfalls over this period are calculated as a percentage of the budget for the entire year or as a percentage of GNP, they are relatively as large or larger in earlier years than they have been in the seventies (Chart 2). On such calculations, the shortfall registered in fiscal 1976, as well as the estimated shortfall for the current fiscal year, seems no larger than other recent—and unnoticed—ones, e.g., those registered in fiscal 1972 and 1974.

### The economics of the shortfall

Most discussions of the shortfall have simply drawn the following conclusion. Because Federal spending is running below target, ergo, the budget is or will be less stimulative than planned.

In reality, the effects of a shortfall on the economy are much more complicated. One of the first qualifications to be made about the significance of a shortfall is that it may make a considerable difference in which categories of spending the shortfall occurs, for all categories may not have the same economic impact. For example, one standard version of macroeconomic theory says that changes in spending on goods and services have a larger impact than equivalent changes in spending on transfer payments. The explanation offered is that direct expenditures have an immediate and full influence on economic activity whereas, while transfer payments increase personal income, some spending out of these transfers may be saved.

Shortfalls that arise from offsetting receipts generally can be expected to affect the economy more slowly and less strongly than reductions in actual spending. This is especially true for financial offsets, such as loan repayments. They do not affect the nation's income stream, although in time they could affect the economy indirectly to the extent that they influence financial market conditions.

The impact of underspending for grants-in-aid to state and local governments may depend importantly on the particular grant involved, the reason for the shortfall, and the resultant change in spending by the lower levels of government. If there is a delay or reduction in those grants that require matching funds by the lower levels of government, the shortfall probably reduces state and local government spending as well. In contrast, some lower governmental units might assume the entire funding on their own. If the Federal shortfall is only a temporary delay in paying funds, the impact will be short-lived. In general, the economic effects of a shortfall arising from grants-in-aid cannot be determined simply on a *priori* grounds.

Another critical question in determining the effects of underspending concerns the extent to

which the shortfall involves spending in real terms. Indeed, some impact on real Government spending seems implicitly assumed in all of the discussions about the present shortfall. But there is the possibility that the underspending reflects a misestimation of the impact of inflation on Government spending. That is, the actual rate of inflation may turn out to be lower than the expected rate of inflation, and thus the budget's estimates of how much particular programs cost would be too high. In that case, *real* spending is no different from that implicit in the Government's programs, and the underspending is simply a forecasting error of what goods and services were likely to cost in the marketplace. Such a shortfall would seem to have no direct impact on the physical volume of business activity.

The importance of underspending can also be approached in another way. That way is to use the data in the Federal sector of the national income accounts (NIA) as opposed to the official budget. The Federal sector of the NIA adjusts the amount and the timing of some official budget data and eliminates purely financial transactions. The President's Council of Economic Advisers made a calculation on both bases in its 1977 annual report. The comparison showed that the combined spending shortfall in the official budget for fiscal 1976 and for the July-September transition period between the "old" and the "new" dating of fiscal years was \$11.4 billion. The shortfall as measured in the Federal sector of the NIA was only \$6.2 billion.

Regardless of the composition of underspending, the resulting lower Federal deficit reduces the Treas-

Table 1

### Relationship between the Administration's February and July Estimates of Federal Budget Outlays for Fiscal 1977\*

In billions of dollars

Budget items	Amount
February budget estimate . . . . .	416.6†
Withdrawal of proposals to stimulate the economy . . . . .	— 3.2
Underspending . . . . .	— 7.0
July budget estimate . . . . .	406.4

\* Fiscal 1977, on the Government's new dating, began on October 1, 1976 and will end on September 30, 1977.

† The estimated budget outlays as presented in February were, for technical reasons, \$0.8 billion higher. This change is unrelated to the amount of underspending.

Source: The July 1, 1977 Budget Review issued by the Office of Management and Budget.

Table 2

### The \$7 Billion Underspending in the Federal Budget during Fiscal 1977

In billions of dollars

- = spending less than budgeted

+ = spending more than budgeted

Type of outlays	Amount
<b>Defense:</b>	
Military personnel . . . . .	-0.5
Operation and maintenance . . . . .	-0.8
Procurement . . . . .	-0.2
Research and development . . . . .	-0.5
Military assistance . . . . .	-1.1
<i>Subtotal</i> . . . . .	-3.1
<b>Nondefense:</b>	
Farm price supports . . . . .	+1.6
Energy Research and Development Administration . . . . .	-0.4
Petroleum storage program . . . . .	-0.1
Water resources . . . . .	-0.3
<i>Subtotal</i> . . . . .	+0.8
<b>Transfers:</b>	
Medicare . . . . .	-0.4
Veterans programs . . . . .	-0.4
Social security . . . . .	+0.7
Federal employee retirement and disability . . . . .	-0.3
Unemployment insurance . . . . .	-0.2
Other . . . . .	-0.4
<i>Subtotal</i> . . . . .	-1.0
<b>Grants:</b>	
Sewage plant construction . . . . .	-0.5
Highway improvement and construction . . . . .	-0.2
Community development block grants . . . . .	-0.2
Local public works . . . . .	-0.2
Educational programs . . . . .	-0.5
Training and employment . . . . .	-0.8
Antirecession fiscal assistance . . . . .	-0.4
Medicaid . . . . .	-0.4
<i>Subtotal</i> . . . . .	-3.2
<b>Interest:</b>	
Interest on public debt . . . . .	-0.3
<i>Subtotal</i> . . . . .	-0.3
<b>Other:</b>	
Export-Import Bank . . . . .	-0.4
Mortgage credit and insurance programs . . . . .	-0.7
Miscellaneous . . . . .	+0.9
<i>Subtotal</i> . . . . .	-0.2
<b>Total underspending</b> . . . . .	<b>-7.0</b>

Source The net estimates of budget underspending are based on the differences between the February 1977 and the July 1977 versions of the fiscal 1977 Federal budget. These differences are given in the July 1, 1977 Budget Review issued by the Office of Management and Budget. The classifications shown here, however, are based on those of the Federal sector that is presented in the national income accounts (NIA). The reallocations of the outlays to the NIA basis were made by the authors of this article.

sure's borrowing needs and, consequently, helps to keep interest rates below the levels they might otherwise be. Such a tendency should stimulate spending by the private sector. In addition, a lower Federal deficit could serve to dampen inflationary expectations which, in turn, might also spur private demand. In time, effects of this kind could offset much of the short-term impact of the shortfall on economic activity.

It can thus be seen that the economic impact of a shortfall in Federal spending may be many-sided and depends on a host of factors. The direct effects on economic activity can vary considerably according to where the shortfall occurs. Understanding on goods and services might have a significant impact on the economy; a shortfall that arises from offsetting receipts that are higher than expected and from financial transactions may have relatively little effect. To the extent that the shortfall is merely a redistribution of total spending within the fiscal year, its significance would be short-lived. The shortfall's real influence would also be reduced substantially if it arose from a lower than expected rate of inflation. Finally, the direct short-term economic impact of a shortfall in Federal spending could, after a while, be partly offset by increased private expenditures induced by a reduction in interest rates and inflationary expectations that would tend to flow from the resulting reduction in the Federal deficit.

#### Measuring the underspending

The Administration estimated last February that total expenditures in fiscal 1977 in the unified budget would be \$417.4 billion. In April, the estimate was revised downward by \$9.3 billion, largely because of the perceived underspending. In the mid-session review in July, the Administration reduced its estimate of fiscal 1977 outlays an additional \$0.9 billion for the same reason. Part of the combined \$10.2 billion downward revision—\$3.2 billion—was due to the elimination of a portion of President Carter's stimulus package. Hence the spending shortfall that can be inferred from the latest estimate of the budget amounts to \$7 billion (Table 1). For the purposes of analyzing the shortfall in more detail and identifying its economic impact with more precision, it is useful to reclassify the shortfall data into the categories shown in Table 2.

The shortfall in the defense sector of the budget, \$3.1 billion, comprises about one half of the total. Defense spending, to the extent that it involves purchases of goods and services, can have a relatively large economic impact. This is particularly true for defense purchases of privately produced goods and services. Thus, the \$1.5 billion underspending in such categories as procurement, operation and maintenance, and research and development is potentially the most im-

portant component of the total shortfall. However, preliminary NIA data on the speedup in Federal defense purchases during the April-June quarter suggest that most of the underspending in this sector took place before then. Therefore, the bulk of the economic impact from underspending in defense is no longer being felt.

The underspending in military payrolls is relatively small and of minor economic significance. The half a billion shortfall in this category reflects the experience during much of last year, when there was a low rate of recruiting for the armed forces. The Administration reports a shortfall of \$1.1 billion on outlays in another category of military spending, military assistance. This underspending reflects a procedural change in the management of the military assistance trust fund. The change has led to a slowdown in the number of transactions processed this year, so that underspending here merely involves the recording of purchases and sales, which has no economic impact.

Purchases of nondefense goods and services are now calculated to be \$0.8 billion higher than in the February estimate. Underspending for some nondefense items—mainly construction projects—should be more than offset by the unexpected increase for farm price supports, which amounts to \$1.6 billion. The supports have complex effects on the income stream because, if such loans were not made available, farmers might still keep crops in storage rather than sell them in the open market. Yet, since the farm products in question have already been produced, the direct effect on the GNP lies in the past.

Underspending on transfers is anticipated to be only about \$1.0 billion in fiscal 1977. Its economic impact should be minimal: the amount of money involved is small and a shortfall in transfers has only indirect effects on spending.

#### **Delays in grants**

Among the remaining spending categories, a sizable shortfall exists in Federal grants, which can have a significant impact on state and local government spending. But much of the \$3.2 billion underspending there appears to reflect legislative delays and, therefore, is very likely to be made up. This is particularly true of grants for public works and for manpower training and employment programs. Other grants, such

as those for sewage plant construction, are lower than expected partly because of delays resulting from adverse weather conditions last winter. There also appear to be shortfalls in educational programs as a result of slow drawdowns of Federal grants by local school authorities. Taken as a whole, there would seem to be some deflationary impact from the delayed flow of grants, which appears to have continued through the past quarter.

Interest payments on the public debt are currently expected to be \$0.3 billion lower than in the February budget projection. The estimated deficit for fiscal 1977 was too great, and the projected level of interest rates was too high.

Finally, the activities of the Export-Import Bank, which provides loans for United States exports, as well as Government activity under mortgage credit programs, are considered purely financial transactions. The shortfall in these categories amounts to \$1.1 billion. The bulk of \$0.9 billion overspending included in the "miscellaneous" category shown at the bottom of Table 2 comes under the heading of offsetting receipts, which also are at most of secondary importance in their direct impact on economic activity.

In summary, about 30 percent of the Administration's estimated shortfall occurs in defense (excluding military assistance), and underspending in this category, especially for hardware, tends to dampen GNP directly. Since it seems that most of the shortfall on defense is over, its major economic impact has probably already occurred. Nearly 50 percent of the shortfall occurs in grants, which can have a noticeable though probably indirect effect in holding GNP down. But the effect of the current shortfall in grants cannot be determined with precision: the legislation for public service jobs and countercyclical aid has already been passed, and disbursement of the funds could proceed more quickly or more slowly than the Administration's estimate assumes. The remaining portion of underspending is scattered in rather small separate amounts and with varying effects.

All in all, it thus seems that the total shortfall of \$7 billion in the budget is not a major influence on economic growth this year. The immediate dampening effect on economic activity, moreover, could over the longer run be offset by the shortfall's indirect effects that tend to work in the opposite direction.

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