

# *The Federal Subsidy Picture: A Blurred Image*

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If there is a negative overtone or stigma surrounding the word "subsidy" for many people today, it is interesting to reflect that such a negative attachment has not always been the case. In fact, the concept of the subsidy is almost as old as our nation itself. When the First Congress convened in 1789, its initial action was to devise a system for administering oaths of office. However, the next item of business was the enactment of a tariff law to protect and promote the new nation's agricultural and industrial development. Included in the legislation was a special subsidy feature designed to encourage the growth of an American merchant fleet. All goods imported into the United States in American vessels were to have their customs duties reduced by 10 per cent, and a tonnage tax favorable to American shipping interests was also made part of the law.

From this early beginning, the Government has used the subsidy time and again, not only to influence the pace and direction of economic development, but for diverse other purposes, including the promotion of science and the

arts, and to mitigate the normal workings of market demand and supply forces when deemed desirable. Not only have their purposes varied over time, but subsidies have taken a number of different forms. For example, from 1827 to 1866, private interests were granted well over 6 million acres of public lands to stimulate the building of canals and the improvement of rivers. In addition, these same interests received right-of-way grants and public funds by means of direct Governmental contributions, stock subscriptions, and loans. Between 1850 and 1871, the railroads were granted more than 180 million acres of Federal and state lands to spur their development. Significant sums of public monies have been used to subsidize the building of ships on American ways as well as the crews that manned them. Although complaints about the U.S. Postal Service are legion, it is, nonetheless, worth noting that the first mail subsidy was paid by the Government in 1845—more than 130 years ago—and the tradition still remains in force. Indeed, the Committee on Agriculture of the U.S. House of

Representatives observed more than 20 years ago:

While originally the subsidy mechanism was employed to expand transportation, to encourage foreign trade, and to foster domestic industrial development, more recently subsidy and subsidylike programs have multiplied to such an extent that their impact is felt by virtually all elements in the Nation's economic structure.<sup>1</sup>

The accuracy of the Committee's observation will be of interest in the analysis which follows. What is abundantly clear at the outset, however, is that there appears to be a growing public interest in Federal spending, of which outlays on subsidies are an integral part.

One of the more frequently recurring themes on the contemporary political scene is the size and scope of the Federal Government and its effects upon the private lives of individuals or in their roles as business or professional persons. In general, many allege that the Government is too big and that its spending has contributed mightily to the problem of inflation in this country. The relative merits of such charges continue to be argued at length with considerable vigor. If the discussants have not yet been successful in **convincing** each other of the rectitude of their position, at least the debate has generated one valuable consequence: The subject of Government spending is no longer confined to economists and/or those with an abiding interest in the field of fiscal finance. Rather, the topic is now one which is more generally discussed by the public at large. And, as a corollary, that same public is subjecting the spending process to closer scrutiny than ever before.

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<sup>1</sup> U.S. Congress, House, Committee on Agriculture, "Government Subsidy Historical Review," 86th Congress, 2nd Sess., Committee Print, June 3, 1954, revised May 10, 1960, p. 1.

The basic reason for the growing wave of public interest in Federal spending would appear to be reasonably straightforward. The sheer volume of spending and its apparent inexorability makes it exceedingly difficult to ignore. For example, during World War II, Federal outlays rose dramatically, increasing from less than \$14 billion for the fiscal year 1941 to a peak level for that period of just under \$93 billion in the 1945 fiscal year. The end of World War II brought a reversal of the growth in Federal outlays. For the fiscal years 1947 and 1948, spending fell to a range of approximately \$30-\$35 billion, and sizable budgetary surpluses were achieved. However, these developments were short-lived, and the period since then has been marked by continuous increases in Federal outlays. Not only have these expenditures grown almost uninterruptedly in absolute amounts--outlays for fiscal year 1977 will likely exceed \$400 billion—but, as Table 1 shows, total expenditures for the various Federal sectors have claimed an increasing share of the nation's gross national product (GNP).

In the face of these developments in overall Federal spending, a closer look at the subsidy picture might appear somewhat misplaced in terms of priorities. For example, during the 3 decades shown in Table 1, outlays for subsidies represented well under 1 per cent of GNP, and accounted for the same share of GNP—0.3 per cent—in fiscal year 1977 as in fiscal year 1947. Indeed, in the last decade, the share of GNP accounted for by outlays on Federal subsidies has fallen by more than one-half. Table 2 shows those areas which receive subsidy payments. In addition, it examines those outlays annually on a fiscal year basis since 1966 and provides the data in dollar amounts rather than as a share of GNP. Yet, even when the deficits of certain business-type operations of the Federal Government such as those shown in Table 2 are added to the outlays on subsidies, the resultant totals still appear quite

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**Table 1**  
**FEDERAL SECTOR EXPENDITURES**  
**AS A PER CENT OF GNP**

Description	Fiscal Year			
	1947 Actual	1957 Actual	1967 Actual	1977 Estimate
Defense purchases	4.3	9.8	8.7	5.1
Nondefense purchases	1.7	1.3	2.5	2.5
Domestic transfer payments	3.7	3.3	4.8	8.9
Foreign transfer payments	.8	4	.3	2
Grants-in-aid to state and local governments	7	9	1.9	3.2
Net interest paid	1.8	1.2	1.2	1.7
Subsidies less current surplus of Government enterprises	<u>3</u>	<u>6</u>	<u>7</u>	<u>3</u>
Total expenditures	133	175	200	220

**SOURCE: Special Analyses, Budget of the United States Government, Fiscal Year 1977** (Washington: U.S. Government Printing Office, 1976), Table A-3, p. 12.

**NOTE:** Individual items may not add to totals due to rounding.

small relative to overall Federal expenditures. Thus, one might question whether those concerned with the size and scope of Federal spending might more profitably apply themselves to looking at some other, quantitatively more significant, aspect of Government spending. Is the earlier characterization of the subsidy picture by the Committee on Agriculture inaccurate, or do the data shown in Tables 1 and 2 tend to obscure the picture? In this regard, the matter of defining a subsidy is of paramount importance.

### ON DEFINING A SUBSIDY

The Office of Management and Budget (OMB), which developed the data in Tables 1 and 2, defines subsidy as "a monetary grant to a unit engaged in commercial activities." Thus, the rather modest scale of subsidy costs shown results from a narrow view of just what constitutes a subsidy. In this particular instance, nonmonetary benefits to recipients not engaged in commercial activities would not appear as subsidies for budget purposes. Such a definition is too confining given the wide

range of Government activities which benefit varying groups in our society and which can and do take forms other than monetary grants.

A single, unequivocal definition of the term "subsidy" would improve objective analysis and promote reasoned debate. Unfortunately, most attempts to establish such an analytical frame of reference founder because, like beauty, subsidy is often in the eye of the beholder. Thus, proponents of some program designed to aid a particular industry, enterprise, or group in society tend to invoke such terms as "incentives," "assistance," or "in the national interest" to describe their aims. The term "subsidy" is notable largely by its absence in most legislative proposals. It should not be surprising, therefore, to note that opponents of a particular program often invoke the word subsidy to brand the program as wasteful or of dubious benefit to the taxpayer. In short, the pursuit of reason all too often is subordinated to appeals to emotion where subsidies are concerned. Therefore, the staff of the Joint Economic Committee of the U.S. Congress (JEC) is to be applauded for their efforts in attempting to develop an analytically clear and operationally useful definition as a first and necessary step in the assessment of Federal subsidy programs. Their work, entitled "The Economics of Federal Subsidy Programs," was published in January 1972, and a number of the observations which follow have been drawn from it.

Viewed from an analytical rather than an emotional perspective, a number of major characteristics of subsidies can be identified. Few would disagree that a subsidy involves a transfer of income either between Government and the private sector or between groups within the private sector. Furthermore, the transfer imposes costs upon the donor. The form of income transfer may involve money or some monetary equivalent. In either case, the increase in income by the recipient enhances his or her ability to satisfy economic demands

**Table 2**  
**SUBSIDIES LESS CURRENT SURPLUS OF GOVERNMENT ENTERPRISES**  
**(In Billions of Dollars)**

	Fiscal Year											
	Actual										Estimates	
	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977
<b>Subsidies</b>												
Commodity Credit Corporation	2.0	3.1	2.6	3.0	3.1	3.6	3.0	4.0	2.4	6	3	.4
Maritime . . . . .	.3	3	3	3	3	4	.4	4	4	.5	6	7
Housing (HUD)	2	3	3	4	5	8	13	17	1.9	2.1	2.4	3.0
Railroad.	—	—	—	—	—	—	.1	1	1	.5	.7	5
Small Business Administration .	—	—	—	—	—	—	—	7	•	—	—	—
Other (mainly Agriculture)	5	6	6	5	4	4	4	4	.3	5	3	.2
Subtotal . . . . .	31	42	37	42	44	52	52	73	52	42	43	48
<b>Enterprise surpluses (-) or deficits</b>												
Commodity Credit Corporation	1.6	7	3	5	6	6	6	13	5	3	4	3
Postal Service . . . . .	8	10	9	9	13	20	14	13	2.0	2.1	2.4	1.7
Tennessee Valley Authority	-1	-1	-1	-1	-2	-2	-2	-2	-3	-4	-3	-4
Federal Housing Administration	-2	-2	-2	-2	-2	-3	-3	-3	-1	-1	•	-1
Federal Deposit Insurance Corporation	-1	-1	-1	-1	-1	-1	-2	-1	-1	-2	-2	-2
Federal Savings and Loan Insurance Corporation	-1	-1	-1	-1	-1	-1	-1	-1	-2	-2	-2	-2
All Other† . . . . .	-2	-3	-3	-3	-2	-3	-4	-4	-2	-1	-2	-2
Subtotal.	17	10	4	4	11	17	12	18	27	15	1.9	9
Total subsidies less current surplus . . . . .	4.8	52	41	46	54	68	64	91	79	5.7	6.2	5.6

†Less than \$50 million.

‡Includes impact of retroactive pay raises.

**NOTE:** Excludes the transition quarter.

**SOURCE:** Special Analyses, Budget of the United States Government, Fiscal Year 1977 (Washington: U.S. Government Printing Office, 1976), Table A-7, p. 21.

**NOTE:** Individual items may not add to totals due to rounding.

or desires. A second characteristic of subsidy is that, insofar as a transfer of income occurs, it is a one-way transfer. This aspect of a subsidy undoubtedly has caused many people to view subsidy programs simply as giveaways, a view undoubtedly reinforced by another characteristic of subsidies. Subsidies are restricted in nature and accrue to a special group—a subgroup of the private sector—rather than to the public at large. This feature, in part, distinguishes them from the provision of free public services or public goods. For by its nature, a public good such as national defense cannot be provided solely to some special

group in society; when it is provided to any one member of society, it is provided to all.

It was noted earlier that the subsidy device has been used to mitigate the normal workings of market demand and supply forces when it was deemed desirable. In other words, a subsidy is intended to directly influence the pattern of production and consumption in the private economy in a manner the Government may wish. More specifically, a subsidy involves a Government action that serves to modify, but not eliminate or take the place of, private market activities or prices. Thus, a fourth characteristic of a subsidy is that it seeks to

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change some particular private market behavior without doing away with the market. By use of the subsidy, price-cost relationships in the market are changed, and as a consequence, market participants have incentives to behave differently. It is important to remember, however, that despite the fact that the subsidy may take the form of a one-way grant from the Government, it is the private marketplace utilizing the pricing mechanism which carries out the economic activity associated with the subsidy. This role of the private market serves further to contrast subsidy programs with free public services or public goods. For as noted by the JEC:

. . . Usually, then, a free government service is an economic activity that takes the place of the private market, represents government ends rather than means, and operates through the rule-making of a bureaucracy rather than the price system—all characteristics that tend not to be associated with subsidies . . . .<sup>2</sup>

This market-modifying aspect of subsidies is associated with a fifth and related subsidy characteristic. The notion that subsidies generate incentives to alter particular market behavior suggests that wherever a subsidy is tied to a particular market, the recipients of the subsidy must give some *quid pro quo*. The subsidy requires an alteration in market performance—either increased or decreased output or sales, or, increased or decreased use of a particular good or service or productive factor. Without such alteration, the subsidy does not apply even though the person may be a part of the market to which the subsidy is tied. For example, farmers who chose to limit their acreage would be the beneficiaries of crop

support payments, while those who did not do so would not share in the program benefits. It is this expectation of performance in return for the subsidy that serves to distinguish subsidies from welfare payments. A welfare payment, such as to an indigent, is not conditional upon some increase or decrease in a particular market activity. Instead, payment is given solely to raise the level of income of people with certain characteristics such as **being** out of work, infirm, or below some specified income level.

This criterion of performance which distinguishes subsidy from welfare is of crucial importance in evaluating the extent to which a particular program is succeeding. Indeed, it is this expectation of a modification or alteration in some specific private sector performance which both the Government and the taxpaying public expect in return for the transfer of income through the subsidy. If there is no *quid pro quo* forthcoming from the recipient, such an income transfer should be more properly labeled welfare. This is not to imply that one category of public outlays is better than another, but rather that confusion between the two is often the fault of applying inappropriate standards for evaluation. The public has a right to expect performance in return for a subsidy; that is its justification, the benefit in return for the cost. In the absence of such performance, the subsidy program should be reevaluated to determine if the objects of the subsidy should instead be more appropriately objects of a welfare program.

From the preceding discussion, it should be clear that there is a wide variety of ways by which the Government can effect income transfers. It should be equally clear that not all such transfers should be regarded as subsidies, and that any meaningful definition of the term should encompass those characteristics which have some reasonable degree of economic merit. By these standards, the definition used by the **OMB** and cited earlier is far too

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<sup>2</sup> U. S. Congress, *The Economics of Federal Subsidy Programs*. 92nd Congress, 1st Sess.. Joint Committee Print. January 11, 1972, p. 14.

restrictive. Given the preceding analysis dealing with the matter of definition, the proposal of the JEC appears to represent a far better alternative:

. . . a subsidy is defined as the provision of Federal economic assistance, at the expense of others in the economy, to the private sector producers or consumers of a particular good, service or factor of production. The Government receives no equivalent compensation in return, but conditions the assistance on a particular performance by the recipient—a quid pro quo—that has the effect of altering the price or costs of the particular good, service, or factor to the subsidy recipient, so as to encourage or discourage the output, supply, or use of these items and the related economic behavior.<sup>3</sup>

And, in contrast with the explicit cash payment nature of a subsidy as set forth by the OMB, the JEC definition also specifies that:

The assistance may take the form of:

- (a) Explicit cash payments;
- (b) Implicit payments through a reduction of a specific tax liability;
- (c) Implicit payments by means of loans at interest rates below the Government borrowing rate or from loan guarantees;
- (d) Implicit payments through provision of goods and services at prices or fees below market value;
- (e) Implicit payments through Government purchase of goods and services above market price; and
- (f) Implicit payments through certain Government regulatory actions that alter particular market prices.<sup>4</sup>

<sup>3</sup> See Joint Committee Print, January 11, 1972, p. 18.

<sup>4</sup> *Ibid.*

## ANOTHER LOOK AT SUBSIDY COSTS

The efforts of the JEC bore fruit in the form of estimates of Federal subsidy costs more in keeping with its expanded definition of the subsidy concept. These data are shown in Table 3 for the fiscal years 1970 and 1975. However, several observations are in order' before assessing the totals. According to the Committee, its accounting for direct cash subsidies, tax subsidies, and credit subsidies is reasonably complete. Accounting estimates of benefit-in-kind subsidies are described as "considerable, but not complete." Because of the difficulty in generating reliable quantitative estimates, there is no accounting of Government subsidies arising from Government purchases of goods and services at above market prices—so-called purchase subsidies.<sup>5</sup> Similarly, regulatory subsidies are also excluded from the estimates in Table 3.<sup>6</sup> Finally, the estimates shown exclude certain types of Federal assistance either held to be nonsubsidy or beyond the Committee's scope, such as some Government outlays for research and development, subsidies implicit in international tariffs and quotas, Federal grants to state or local governments used to provide general benefits rather than benefits to a specific class or group of recipients in the private sector, most public work expenditures,

<sup>5</sup> For additional discussion of purchase subsidies, see Joint Committee Print, January 11, 1972, p. 40.

<sup>6</sup> The term "regulatory subsidies" is not typically associated with the issue of Government subsidies, since neither money nor payments-in-kind are extended by the Government. However, it is the Government's power to set prices, to restrict entry, and to require service that makes the subsidy possible. Despite the difficulty in quantifying these costs, the fact that they exist and their pervasiveness in the economy should be noted. Indeed, the 1975 *Economic Report of the President* devoted a full chapter to the subject. For a further excellent analytical treatment of this subject, see Richard A. Posner, "Subsidization by Pricing in the Regulated Industries," in *The Economics of Federal Subsidy Programs*. 92nd Congress, 2nd Sess., Joint Committee Print. May 8, 1972. pp. 41-54.

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**Table 3**  
**SUMMARY OF FEDERAL SUBSIDY COSTS**  
**(In Billions of Dollars)**

	Fiscal Year									
	Direct Cash Subsidies		Tax Subsidies		Credit Subsidies		Benefit-in-kind Subsidies		Total Order of Magnitude	
	1970	1975	1970	1975	1970	1975	1970	1975	1970	1975
Agriculture . . . . .	4.4	.6	.9	1.1	.4	.7	—	—	5.7	2.5
Food . . . . .	—	—	—	—	—	—	1.5	5.9	1.5	5.9
Health . . . . .	.8	.6	3.2	5.8	—	—	4.6	10.2	8.6	16.6
Manpower . . . . .	2.0	3.3	.6	.7	—	—	1	.1	2.6	4.1
Education . . . . .	1.9	5.0	.8	1.0	1	1	.4	.4	3.2	6.5
International . . . . .	1	—	.3	1.5	.6	.9	—	—	1.0	2.4
Housing . . . . .	.1	1.7	8.7	12.9	3.0	1.1	—	—	11.7	15.7
Natural resources. . . . .	1	.1	2.0	4.1	—	—	1	.1	2.1	4.4
Transportation . . . . .	.3	.6	—	.1	—	—	.2	1.7	.5	2.3
Commerce . . . . .	2.0	.3	14.1	19.3	.1	—	1.8	1.9	18.0	21.5
Other. . . . .	—	—	9.4	13.1	1	1	—	—	9.5	13.2
 Total order of magnitude . . . . .	 11.6	 12.3	 39.9	 59.7	 4.1	 2.9	 8.8	 20.2	 64.4	 95.1

**NOTE:** Individual items may not add to totals due to rounding.

**SOURCE:** Federal Subsidy Programs, Joint Economic Committee (Washington: U.S. Government Printing Office, 1974), p. 5.

and subsidies provided in connection with defense procurement. Thus, even though the data in Table 3 may indicate a much larger element of subsidy costs than shown in earlier estimates, they still might be regarded as somewhat conservative in light of the exclusions noted above.

Table 3 reveals the wide difference in estimates of subsidy costs by the JEC as compared to those cited earlier. In fiscal year 1970, the order of magnitude of subsidy costs shown in the budget was \$4.4 billion, or \$5.4 billion including Government enterprise deficits. As estimated by the JEC, those costs exceeded \$64 billion. For the 1975 fiscal year, they were essentially unchanged in the budget. As seen in Table 3, however, they had increased nearly 50 per cent, to \$95 billion, according to JEC estimates. While these aggregate change figures are notable in themselves, the varying trends among the

different types of subsidy expenditures are of particular interest.

Direct cash subsidies represent cash payments from the Government to a firm or individual in the private sector engaged in a market activity as specified in the subsidy legislation. Among these activities are housing construction, school attendance, and production of certain crops, to name just a few. Overall, this type of subsidy showed very little change, rising from \$11.6 billion in 1970 to \$12.3 billion in 1975. Within this category, however, subsidies to agriculture fell dramatically, as did cash subsidies to the commerce category involving such programs as community action, model cities, and urban renewal and neighborhood development. The education category rose from less than \$2 billion to \$5 billion largely as a consequence of increased outlays for veterans' education and basic education opportunity grants. Other large

gains occurred in manpower—through increased manpower revenue sharing **outlays**—and in housing, primarily as a result of increased cash subsidies for public housing assistance.

Credit subsidies arise whenever the Government enters into a loan transaction with the effect of lowering the rate of interest below that which the borrower would otherwise have to pay. They may take the form of a straight cash payment to offset part of the interest cost of the loan; they may involve a direct loan from the Government at lower interest rates than the borrower could obtain in the private market; or they can utilize a Government guarantee or insurance of a loan to effectively lower the risk of default and thereby the rate of interest obtainable by the borrower. Overall, these credit subsidies fell from about \$4 billion in 1970 to less than \$3 billion in 1975. This drop was largely the result of declines in the housing category traceable to reduced assistance for mortgage insurance and low-rent public housing programs.

In contrast with stable to declining outlays for the direct cash and credit subsidies, benefit-in-kind subsidies increased during this same period nearly 130 per cent—from less than \$9 billion in 1970 to over \$20 billion in 1975—while tax subsidies rose \$20 billion to nearly \$60 billion. When the Government sells to the private sector a good or service at a price below the prevailing market price or below its actual cost in the case where a private market may not exist, a benefit-in-kind subsidy arises. One of the most notable examples is the food stamp program. Indeed, rising food stamp outlays, and to a lesser extent, increased expenditures for the school lunch program, were responsible for the nearly \$4.5 billion increase from 1970 to 1975 in the food category. In the area of health, benefit-in-kind subsidies rose by about \$5.5 billion in the same period as a consequence of sharp jumps in the medical assistance program (Medicaid) and in

health insurance for the aged (Medicare). Quantitatively, one other item of significance was a more than \$1 billion increase in urban mass transit capital improvement grants which accounted for most of the rise in the transportation category. Although commerce showed essentially no change over the period, benefit-in-kind subsidies to the postal service continued to account for the major share of expenditures in this category.

The type of subsidy showing the largest absolute increase in Table 3 is tax subsidies. A tax subsidy is generated when a special provision in the law allows an individual or a firm engaged in a specific market activity to make a smaller tax payment to the Government than would have otherwise been the case. The estimates in Table 3 measure the reduction in revenues to the Government resulting from these special provisions. Those categories showing sizable increases between 1970 and 1975 include health, housing, natural resources, commerce, and "other." During the period, substantial and, in most cases, rising sources of revenue loss were attributable to such areas as the deductibility of medical expense and allowances for medical insurance premiums and medical care, in the health category. In housing, major areas of revenue loss resulted from the deductibility of both interest and property taxes on owner-occupied homes, as well as the failure to tax imputed net rent on owner-occupied housing. The depletion allowance accounted for the largest revenue loss in the natural resource category; while in commerce, the investment credit, individual capital gains, the accelerated depreciation range, and the exclusion of interest on life insurance savings were largely responsible for the roughly \$5 billion rise in revenue shortfalls through tax subsidies during the period. The final category in Table 3, "other," showed a large increase over the period as well. Both the exclusion of interest on state and local debt and the net exclusion of pension contributions for

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employees accounted for most of the change. The deductibility of charitable contributions was an allowance which showed little change over the period, but was, nonetheless, responsible for an estimated revenue loss of about \$3.5 billion on average per year.

### **A CONCLUDING OBSERVATION**

The foregoing analysis demonstrates that subsidies do exert a pervasive influence on our economy. Their scope of application, their diverse forms, and the significant sums of money involved are all persuasive reasons for ongoing public concern. More than 15 years ago, the Joint Economic Committee asserted:

Federal programs aimed at supporting or improving the economic position of particular groups or industries should be constantly reevaluated in the light of changing circumstances. Whatever their initial justification, subsidy programs should be so contrived as to eliminate the necessity for their continuation. The broad changes which must be expected in our economy require frequent revision in the scope and character of these programs if they are to achieve their purposes. Failure to adapt the substance of subsidies to changing demands and

opportunities may be expected to prevent most efficient use of resources in the subsidized activities as well as in other types of economic endeavor. Where this is the case, the subsidy not only fails of its immediate objective but also imposes real costs on the entire economy over the long run.'

Their words are just as relevant today as they were in 1960. In the intervening years, the growth of subsidies has continued unabated. Whether such growth is warranted remains an appropriate subject for research. For by their nature, subsidies represent the conferring of benefits on special groups in our society, rather than on the general public. In a society which stresses the dominant role of free competitive markets, and, at a time when there is so much concern over the appropriate role and size of Government, both fiscal prudence and simple equity demand that objective and appropriate standards be applied where the public purse is involved. To that end, there should be no flagging in the effort to sharpen and to clarify what for many still remains a blurred image of the subsidy picture.

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7U.S. Congress, "Subsidy and Subsidylike Programs of the U.S. Government," 86th Congress. 2nd Sess., Joint Committee Print, 1960, p. 1.