

Federal Government Spending on Interest, Transfers, and Grants

By Dan M. Bechter

The changing composition of Federal Government spending tells a story of trends and swings in national priorities during our country's two-century history. From the earliest years through the 1920's, the expenditure side of the Federal budget primarily reflected the nation's involvement in wars. Expenditures would increase to pay the cost of a conflict. Then, after the war, total spending would decline, and the budgetary emphasis would shift from paying for arms to paying interest on a war-inflated public debt.

Those who worry about today's national debt may derive some comfort from knowing that in most years before 1803, interest on the public debt claimed more than half of the outlays of the Federal Government. With the exception of veterans' compensation and pensions, Federal spending for social welfare was virtually unknown during the Republic's first 150 years. During fiscal year 1976, expenditures for income security, health, education, and veterans' benefits will account for 53 per cent of Federal **budgetary** outlays. In contrast, net interest on the public debt now claims about 8 per cent of the budget.

Federal spending for social welfare has roots in the Great Depression. By 1939, such expenditures had risen to 44 per cent of Federal outlays, or to over 50 per cent, if veterans' services and benefits are included. But World War II reversed this trend by ending the Depression and by requiring enormous defense expenditures. Veterans' benefits increased sharply after the war, but Federal spending on other welfare programs fell to nearly one-fourth the prewar dollar amount. Not until the late 1950's did the Federal Government again spend as much on social welfare as it did in 1939.

Clearly, major shifts in the composition of Federal Government expenditures are nothing new. But the trend of the past 20 years is not a repeat performance of historical cycles in Federal spending. It is a compositional shift that underlines a national commitment to use Federal spending as an instrument for redistributing income in relatively good times as well as in depressed economic periods. Thus the percentage of Federal outlays going for purchases of goods and services (two-thirds of which is currently for national defense) has declined from 64 per cent in 1956 to 55 per cent

in 1966 and, with accelerating momentum, to 35 per cent in 1976. A previous article has dealt with the implications of changes in Federal spending for goods and services.¹ This article is about the other principal subdivisions of Federal outlays—interest on the public debt, domestic transfer payments, and grants-in-aid to state and local governments.

INTEREST ON THE NATIONAL DEBT

All but 1.3 per cent of the gross debt of the U.S. Government is in the form of marketable bonds, notes, and bills and certain nonmarketable series issued by the U.S. Treasury. Issues of several Federal Government agencies, such as the Export-Import Bank, the Tennessee Valley Authority, and the Federal Housing Administration, account for the remainder. A large proportion of gross Federal debt—43 per cent at the end of 1975—is held by Federal Government agencies, primarily in trust funds, and the Federal Reserve Banks. Thus, much of the interest paid on the gross Federal debt amounts to internal bookkeeping transactions that do not affect the public.

Net Federal indebtedness is that amount that the Federal Government owes to domestic and foreign investors. To the extent that the net Federal debt is held by U.S. investors, interest payments do not constitute a net burden on this nation's economy. No external burden is involved on domestically held debt because tax receipts from Americans are used to pay interest to Americans. However, even though "we pay interest to ourselves" on a national debt that "we owe to ourselves," a burden to current and future generations from past wars has been said to exist. This burden, the argument goes, is in the form of what might have been, had wars not interrupted the development of resources and the advancement of technology. According to this point of view, private investment has been crowded out by

Government borrowing over the years, and the amount of interest on the Federal debt can be considered a rough estimate of the additional national income that would have been generated by that foregone investment. This argument has merit, but it is by no means clear that Government borrowing always crowds out private investment, or that Government spending slows technological change. In particular, when resources are underutilized, deficit spending by the Federal Government can stimulate economic activity, including private investment.

Americans do not hold as much of the net Federal debt as they did formerly; a growing share is owed to investors outside the United States. Foreign holdings of U.S. debt have increased dramatically in relative importance since 1969. Increases in the early 1970's were due to an overvalued dollar, but more recently oil exporting nations have accumulated dollar claims in several forms, including U.S. Government securities. At the end of 1975, investments of foreign and international accounts included an estimated 20 per cent of the net Federal debt.

The real burden of externally held Federal debt is borne by Americans when foreigners convert this debt to dollars, or use the interest on it to buy U.S. goods and services. To the extent that U.S. debt is held by foreigners, Americans are borrowing from future domestic output to satisfy current demands. On the one hand, it is fortunate that other countries have been willing to accumulate dollar balances because if economic activity is constrained by an inflation-fighting policy, an increase in exports would require an offsetting decrease in domestic purchases of goods and services. On the other hand, were inflation not such a problem, this period of underutilized resources would be an ideal time for the stimulus that a major increase in exports would provide.

Various categories of domestic investors hold net Federal debt. Individuals hold the largest

¹ Dan M. Bechter. "Federal Government Purchases of Goods and Services." Federal Reserve Bank of Kansas City *Monthly Review*, November 1975.

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share, about one-fourth of the total. Commercial banks hold almost as much. The remaining 30 per cent that is not part of foreign accounts investment is divided up among state and local governments, thrift institutions, insurance companies, other corporations, nonprofit institutions, corporate pension trust funds, dealers and brokers, and other miscellaneous investors.

Interest payments from the Federal Government to the private sector have risen sharply in recent years, for four reasons. First, the rate of growth of the net Federal debt has accelerated. From **1964 to 1969**, it grew **1.2** per cent; from **1969 to 1974**, **17.7** per cent. Then, in fiscal **1975** alone, privately held Federal debt grew **17.5** per cent, a postwar record. Second, interest rates have trended upward. Between **1964 and 1974**, the average annual yield on 3-month Treasury bills increased **122** per cent; on 3 to **5** year issues, it increased **92** per cent. Bond interest—the yield on securities with many years to maturity—increased **60** per cent or more, with the greater increases associated with the shorter maturities. Third, the maturity distribution of the Federal debt has shifted toward shorter issues, where rates have been rising the **fastest**.² In **1964**, the average time to maturity of marketable public debt was **5** years; in **1974**, it averaged **3** years. In **1964**, **39** per cent of the marketable public debt came due within the year; in **1974**, that percentage had risen to **52**. Over most of this period, the upward push on interest payments that came from the shift to the shorter maturities with rapidly rising rates was offset by the fact that the shorter debt instruments carried lower yields. But this normal relationship between yield and maturity underwent a twist in **mid-1973**, so that for more than a year there

² A major reason for this shift is the law that limits the rate of interest that the Federal Government can pay on long-term issues. Since the ceiling rate is below the market rate, bonds of longer maturities cannot be sold. Thus the U.S. Treasury has been forced to concentrate on short issues in its debt expansion and refunding operations. By doing so, of course, it has pushed up short rates faster than if a wider range of maturities could have been offered.

was a fourth reason why interest payments on the Federal debt were rising—Treasury bill rates were higher than those on notes at a time when (and largely because) a growing proportion of the Federal debt was being shifted into bills.

Although the size of the net Federal debt jumped almost **30** per cent during calendar **1975**, interest payments grew less than half as fast, thanks primarily to falling interest rates on Treasury bills. A further decrease, to **2** years **9** months, in the marketable debt's length of time to maturity helped the Treasury draw even greater benefit, for the short term, from declining interest rates.

The Federal Government's interest payments to the public have increased dramatically in the past **10** years, but so have most other economic variables measured in dollars, because of inflation. Relative magnitudes, therefore, are more meaningful. As a share of the nation's potential output, Federal interest payments to the public have stayed about the same for many years.

DOMESTIC TRANSFER PAYMENTS

While all nonpurchase expenditures by the Federal Government must be transfer payments of some sort, the category known as domestic transfer payments includes only certain types. In particular, it excludes interest payments on Federal debt and subsidy payments to business and government enterprises. Domestic transfer payments are payments directly to (or in behalf of) individuals because of their personal (nonbusiness) special circumstances. Included in this category are social insurance and veterans' benefits; food stamp expenditures; retirement benefits for railroad workers, civil servants, and military personnel; benefits to individuals who are learning, training, or employed under manpower programs; and supplemental security income benefits for the aged, blind, and disabled. This is not an exhaustive list of Federal spending for social

welfare. Other "human resources" programs are financed by the Federal Government through grants-in-aid to state and local governments. But these expenditures, considered in the following section, are not Federal transfers directly to persons.

During the fiscal year ending June 30, 1976, domestic transfer payments are expected to total \$155 billion, almost 5 times more than 10 years earlier, and more than double the amount in fiscal year 1972. Inflation explains some, but not all, of this growth--consumer prices have not doubled in the past decade. Most of the rapid increase in transfer payments is attributable to escalating benefits under old welfare programs and the adoption of new programs since the early 1960's. These new programs did not come about by chance. For better or worse, the economic and political climates of the 1960's favored the increased use of Federal expenditures as a mechanism to reduce the hardships of those living on low incomes, as well as a means to compensate those unduly harmed by recession and inflation.

In the absence of compensatory measures, inflation and economic growth redistribute income and wealth in favor of the productive members of society and against those who are not employed. One of the ways that Congress has offset prosperity's redistributive effects and simultaneously acted to support persons with low incomes is by legislating substantial increases in old age, survivors, and disability benefits. Between 1965 and 1973, partly because of such legislation and partly as a result of the increases in average benefits and in number of beneficiaries, total payments under these Social Security programs rose at an average annual rate of 14 per cent. Even faster rates of growth were recorded by Federal civil service retirement benefits, military retirement pay, and manpower training programs. Excluding unemployment benefits, which will be discussed separately, the slowest growing

domestic transfer programs between 1965 and 1973 were railroad retirement and veterans' benefits which grew at about 10 per cent annual rates. The medicare, food stamp, and coal miner programs were begun and grew rapidly in those years. All told, the average annual rate of growth of domestic transfer payments, excluding unemployment benefits, came to 15 per cent from 1965 to 1973.

National income grew at an 8 per cent rate during that period, substantially less than the 15 per cent increase in transfer payments. Clearly, income was distributed from those who worked to those who did not. About half of the 8 per cent rate of gain in money income of the employed represented an increase in purchasing power, and this was much more than enough to finance the increase in domestic transfer payments. Even though transfers grew faster, their absolute increase of \$60 billion from 1965 to 1973 was dwarfed by the \$500 billion increase in national income, four-fifths of which was employee compensation. Only relative after-tax shares of national income shifted toward the nonproductive and those of low productivity.

The story was quite different between 1973 and 1975. The two fiscal years from mid-1973 to mid-1975, or fiscal years 1974 and 1975, included five quarters of recession. Because of continued inflation, national income did grow in money terms over that period, by about a 6 per cent annual rate. But domestic transfer payments jumped at a 23 per cent annual rate. A shift in relative shares occurred, and this time some of the gain by transfer recipients did come at the absolute expense of the employed. This is because real output declined, so that the redistributed purchasing power had to be spent on fewer goods and services.

Payments in most categories of domestic transfers continued to rise from mid-1973 to mid-1975. Coal miner benefits were the exception: they were flat. Consumer prices rose at a 10 per cent average annual rate in those 2

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years, which partly explains the accelerated rates of growth of civil service retirement benefits (25 per cent), military retired pay (20 per cent), veterans' benefits (15 per cent), medicare (25 per cent), and other Social Security benefits (15 per cent). To some extent, growth of benefits in these categories reflects the recession. Relatively poor economic conditions tend to encourage retirement, for example.

The most pronounced impact of recession on domestic transfer payments is shown in unemployment benefits, which increased more than 2% times between 1973 and 1975, and by food stamp payments, which increased 67 per cent. These increased transfers are similar to the others in that they do represent a redistribution of income from the working to the idle population. They differ, however, in that the unemployed are cyclically idle, drawing benefits that will eventually decline as the economy recovers.

During the current fiscal year which ends June 30, 1976, domestic transfers are estimated to total 18 **per cent** more than in fiscal 1975. At least half of this increase is attributable to the still depressed economy—the high unemployment benefits and other payments that are larger under such conditions. On the brighter side, however, the economy is recovering from the recession of 1974-75, and the increase in real national income will again be far more than enough to "pay" for the increase in real transfer payments.

GRANTS-IN-AID TO MUNICIPAL GOVERNMENTS

Federal grants-in-aid to state and local governments have grown almost as fast as domestic transfer payments in the past decade. The growth rates of the two would have been even closer, had the Federal Supplementary Security Income program, a domestic transfer category new in 1974, not replaced some state income assistance programs that had been

funded by Federal grants. For fiscal year 1976, grants-in-aid are estimated to total \$60 billion, compared to \$155 billion in domestic transfer payments.

More than half of Federal grants-in-aid to state and local governments finance social welfare activities. The programs receiving the most money include aid to families with dependent children, school lunch and other child nutrition, medicaid, and several programs in education, training, and social services. The shorter end of Federal grants-in-aid (about 45 per cent of the total) goes for various purposes. Highways and general purpose fiscal assistance (primarily revenue sharing) split half of nonwelfare grants. Other programs supported include environmental improvement, urban mass transit, airport construction, scientific research, community and regional development, natural resource and energy, and law enforcement and justice.

The amounts of aid granted to states by the Federal Government differ. On a per capita basis, states with relatively more poverty tend to receive the most Federal social welfare assistance. The big, thinly populated western states also rank high in per capita grants because, on a per person basis, they receive more Federal money for highway construction, and because they share, with the Federal Government, revenues from extensive Federal lands within their boundaries. Ranking lowest in per capita aid are the midwestern states, where Federal land is scarce, where relatively few people live on low incomes, and where highway construction is closer to average on a per person basis.

CONCLUDING NOTE ON INCOME REDISTRIBUTION

In the past several years, Federal spending has grown rapidly because of the very large increases in domestic transfer payments and grants-in-aid to state and local governments.

Both of these expenditure categories are weighted heavily toward human resources, or social welfare, programs. Their intent, as indicated earlier in this article, has been to better spread the costs of the battles against inflation and recession, and to reduce income inequality. Because of the failures and abuses of some programs, and the high cost of the total package, many people, both liberal and conservative, are disillusioned with Federal welfare activity. But there can be little doubt that despite the waste, fraud, and economic inefficiency of Federal redistributive spending,

the overall effect of these programs has been to alleviate those severe hardship cases that are directly due to inadequate income. Money measures of income still show more than 10 per cent of U.S. residents living below the arbitrarily defined poverty level. But, as Edgar Browning establishes, money income data miss the fact that many welfare programs provide income in kind. In other words, he argues, few Americans today live below a poverty level of consumption.³

³ *Redistribution and the Welfare System*, American Enterprise Institute for Public Policy Research, Washington, D.C., 1975.