Research Department
Federal Reserve
Bank of
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Business & Financial Letter

How Government Spends

American governments at all levels have become very conscious of their outlays. The word "crisis" has been widely used, especially in the wake of the New York debacle, as citizens have felt compelled to reduce expenditures even for the worthiest of purposes. This growing concern suggests the need to determine how Federal, state and local governments have been exercising their spending powers—either to demand resources or to transfer funds from one group in the economy to another.

Final and enterprise demand
Most of the overall government demand for resources represents final demand for goods and services, for such purposes as defense, education and public safety. But a significant proportion represents demands by government enterprises—that is, institutions which sell their output and whose products are thus a final demand for someone outside government. The difference, sometimes a narrow one, depends on whether or not the price reflects a reasonable value of the product. Thus the postal service and municipal power, water and transit systems are government enterprises, whereas public universities are not because tuition typically bears little relation to the cost of operation. (Highlighting the difference, national-income statisticians exclude government enterprises from the government-expenditures category of the GNP accounts.)

Government enterprises constitute a fairly large portion of the economy in most countries. In Great Britain, for example, the Government controls all the "commanding heights" of the economy, such as coal, steel, transportation and utilities. In this country, the opposite is true; in 1975, government enterprises accounted for only 1.5 percent of GNP with a value added of $22 billion. And judging from the experience of such government enterprises as the postal service, expansion in other fields seems unlikely.

Resource demand trendless. . .
In contrast, government's final demand for goods and services in 1975 amounted to 22.4 percent of GNP, or $339 billion. Just over half of this was the government's wage bill, but the rest represented a range of purchases, from paper clips to schoolrooms to guided-missile cruisers. On the average, final government purchases amounted to 25.0 percent of real GNP in the 1951-55 period, fluctuated narrowly during the next 20 years, and then fell to 21.5 percent of real GNP in the 1971-75 period. This downtrend does not show up when current-dollar figures are used instead of real-GNP figures—but by either standard, government has not increased its relative share of the

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demand for resources in the past quarter-century.

Nonetheless, a radical shift has occurred in the mix of spending by level of government. Between 1951-55 and 1971-75, the mix shifted from 63 percent Federal to 61 percent state and local, largely because of a secular decline in (Federal) defense spending coupled with a similar increase in (state-local) education spending. These are the two dominant spending categories, defense accounting for 68 percent of Federal demand for goods and services, and education for 41 percent of state-local demand. The shift in the mix of spending may be slowed by the recent increase in defense expenditures and the slowdown in education spending, but a reversal of the trend seems unlikely.

. . .but transfer share up

As noted at the outset, government may exercise its powers either to demand resources or to transfer funds from one group to another. Over time, spending has increased somewhat faster in the latter category than in the former. Thus, between the first half of the '50s and the first half of the '70s, total government spending rose from 26.0 to 32.5 percent of GNP—almost entirely because of the rise in the transfer share from 5.6 to 10.9 percent of GNP.

The term "transfer" might suggest a conscious government reallocation of income to the poor, but this is only a partial truth. Aside from some $20 billion (1975) in subsidies to business and net interest on government debt, the $172 billion in transfers to persons is split in a number of ways—48 percent for social security (OASDI) and related programs, 13 percent for government employees' retirement, 12 percent for direct welfare relief, 11 percent for unemployment compensation and workmen's compensation, 9 percent for veterans' programs, and so on. The large bulk of these transfers thus represents a major part of the nation's pension system, with payments going to individuals at all income levels.

The rapid growth of transfer payments has been almost entirely a Federal phenomenon. This reflects the broadened coverage of the social-security program after 1966, reinforced in recent years by growing Federal administration of direct relief programs. The principal milestones include the advent of food stamps in the 1960's and the start in 1974 of the supplementary security-income program (SSI), which replaced the locally-administered programs of aid to the elderly, blind, and totally disabled. State-local transfers now consist largely of employee pensions and aid to dependent children (a Federally-funded but locally-administered program).

Result: more government

Altogether, the major trends over the past quarter-century have included a sharp increase in the share of GNP going to state-local spending for goods and services, offsetting a declining share of Federal spending for such purposes, along with a sharp rise in the relative importance of Federally-centered transfer programs, especially social security. The result (as noted) is a quarter-century of expansion in total government spending from 26.0 to 32.5 percent of GNP. But because of the offsetting movements in goods-and-services and transfer spending, the Federal-spending share of GNP has fluctuated around a fairly flat trend during this quarter-century. The rise in the overall spending burden has been concentrated at the state-local level, which helps explain the hard-pressed situation of many state and municipal governments today.

The solution has largely been found in increased Federal transfers, although of course at the cost of rising Federal deficits. The partial Federalization of direct welfare relief in 1974 was partly a response to the cities' funding problems—though the actual savings to the cities was small because the old programs themselves were largely Federally-funded. More important has been the recent increase in Federal grants-in-aid to state and local governments, from $24.4 billion in 1970 to $54.4 billion in 1975.

Grant programs have shifted in purpose while growing rapidly in size. Until 1971, grants-in-aid were used for a number of purposes, such as direct welfare programs. In 1972 and 1973, most of the growth was in the form of general revenue-sharing programs, funds that state-local governments could use as they pleased. Since 1973, however, all of the growth has been in tied programs, where funds can only be used for a specific purpose.

This shift in emphasis represents a response to the overly diffuse results which some Federal officials have discerned in the general revenue-sharing program. But it can be argued that state-local funding problems *are* diffuse, because of the sharp expansion of state-local spending in a number of different areas over the past quarter-century. Thus, state-local government officials tend to believe that Federal aid programs should help provide a maximum of funding relief for whatever those officials themselves believe to be the most urgent problems.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/05/77	Change from 12/29/76	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	95,092	– 64	+ 5,236	+ 5.83
Loans (gross, adjusted)—total	70,716	– 330	+ 4,639	+ 7.02
Security loans	1,904	+ 6	+ 404	+ 26.93
Commercial and industrial	22,847	– 82	– 647	– 2.75
Real estate	21,523	– 12	+ 1,876	+ 9.55
Consumer instalment	12,320	+ 34	+ 1,646	+ 15.42
U.S. Treasury securities	11,341	+ 139	+ 360	+ 3.28
Other securities	13,035	+ 127	+ 237	+ 1.85
Deposits (less cash items)—total*	96,094	+ 723	+ 4,587	+ 5.01
Demand deposits (adjusted)	27,762	+ 634	+ 2,458	+ 9.71
U.S. Government deposits	531	+ 196	– 126	– 19.18
Time deposits—total*	66,194	– 73	+ 2,461	+ 3.86
States and political subdivisions	5,890	– 32	– 1,863	– 24.03
Savings deposits	31,154	+ 243	+ 8,446	+ 37.19
Other time deposits‡	26,648	– 229	– 2,978	– 10.05
Large negotiable CD's	10,957	– 244	– 4,602	– 29.58

Weekly Averages of Daily Figures	Week ended 1/05/77	Week ended 12/29/76	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	+ 67	+ 57	+ 98
Borrowings	1	1	0
Net free(+)/Net borrowed (–)	+ 66	+ 56	+ 98
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (–)	– 175	– 46	+ 708
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (–)	+ 282	– 124	+ 703

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .
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