

Statement of

RUDOLPH G. PENNER  
Director

Congressional Budget Office

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Mr. Chairman, I am pleased to participate in this hearing on the role of government in capital markets. That role is pervasive, but incredibly complex and difficult to analyze. Almost all spending programs, tax policies, and regulations have some impact on the allocation of capital.

Tax laws are often designed explicitly to favor specific capital investments by providing special deductions, credits, and incentives such as those for housing and energy conservation. But these laws often have unintended effects as well. Since tax burdens depend crucially on such things as whether the investment is in structures, equipment, or inventories, or whether it is a corporate or noncorporate activity, or whether it is financed by debt or equity, effective tax rates on capital income vary greatly from industry to industry and among firms within an industry. These variations, in turn, affect the demand for credit across industries and firms.

Aggregate monetary and fiscal policy also have differential impacts on different sectors of the economy depending on the degree to which interest rates and the foreign exchange value of the U.S. dollar affect those sectors. Different types of investment obviously differ in their degree of sensitivity to such variables, but unfortunately our knowledge of such relationships is in a primitive state and great controversy exists both within and outside of the economics profession regarding which variables and policies are important and which are unimportant. Finally, regulations may have significant consequences for capital markets. For example, environmental rules often

increase the demand for credit while deregulation is increasing the number of suppliers in many financial markets.

This testimony focuses, however, on that portion of the government's efforts whose principal objective is to achieve a different allocation of credit among borrowers from that which would occur in a completely free market. I shall concentrate on the variety of credit programs that provide direct loans, interest subsidies, and loan guarantees.

As you know, the Congressional Budget Office (CBO) under the leadership of my predecessor, Alice Rivlin, has devoted considerable effort to the study of federally assisted credit. Those efforts included the 1980 Conference on the Economics of Federal Credit Activity, organized at the joint request of this Subcommittee and the House Budget Committee Task Force on the Budget Process. CBO will continue to provide analysis and information in support of Congressional action on federal credit.

My testimony today makes three points about government credit policies, all of which I believe are consistent with the exploratory nature of these hearings.

First, credit programs have a substantial impact on U.S. capital markets. Argument can continue about the precise measure of the

government's role, but there is little doubt that credit policy constitutes a major influence on who does and who does not receive financing.

Second, it would be quite wrong to assume that a specific increase in the dollar amount of subsidized credit results in an equal increase in the favored activity. The unintended secondary effects of credit programs may offset a portion of the intended primary effects. For example, the Export-Import Bank attempts to increase U.S. exports by providing below-market financing to foreign buyers. It finances its loans through U.S. Treasury borrowing. These activities tend to raise the foreign exchange value of the dollar by raising U.S. interest rates and, initially, by increasing U.S. exports. A higher-value dollar, however, reduces the foreign competitiveness of unsubsidized U.S. exports and also increases imports. Thus, the extent to which Export-Import Bank activities increase net exports and the allocation of capital to all exporters, subsidized and unsubsidized, remains unclear. Other weaknesses in the link between a credit subsidy and real economic activity will be explored later.

Third, the costs of federal credit programs to the taxpayer are often extremely difficult for policymakers and citizens to discern, even though these costs are large. The costs are concealed by the cash basis of the unified budget; by accounting practices associated with the off-budget Federal Financing Bank; by a tendency to combine a variety of credit programs into a single revolving fund; and, perhaps, by a reluctance to

record the true direct and indirect costs of interest subsidies in the budgets of the agencies administering credit programs.

I would now like to add some detail to my analysis of the role of government credit programs in U.S. capital markets.

### SCALE OF FEDERAL CREDIT PROGRAMS

At the end of 1982, direct loans by the federal government outstanding amounted to more than \$200 billion (see Table 1). Loans made by others and guaranteed by the U.S. government totaled \$330 billion. An additional \$225 billion had been advanced by privately owned, government-sponsored enterprises such as the Federal National Mortgage Association, the Farm Credit Administration, and the Student Loan Marketing Association. Net lending (new loans less repayments) to the public under federal auspices in 1982 amounted to \$87.7 billion. When that figure is compared to an estimated \$409 billion of total funds advanced in U.S. credit markets in 1982, the federal government's role is clearly substantial. Looking ahead to fiscal year 1984, the budget resolution specifies gross limits of \$55.4 billion in new direct loan obligations and \$94.5 billion in new loan guarantee commitments. In addition, the President's Budget projects new obligations by government-sponsored enterprises of \$155 billion in fiscal year 1984.

TABLE 1. DISTRIBUTION OF FEDERAL CREDIT ASSISTANCE, FISCAL YEAR 1982 (In billions of dollars)

	New Obligations or Commitments	Net Change	Outstanding
<b>Direct Loans to:</b>			
Foreign purchasers of military goods	3.9	2.2	11.7
Foreign purchasers of U.S. exports	3.5	0.8	16.6
Rural electric cooperatives	6.3	4.1	26.1
Tennessee Valley Authority	4.6	0.4	1.5
Farm owners and farm operators	4.2	0.9	24.2
Producers of agricultural commodities	11.5	6.3	12.5
Owners of low-income rural housing	3.5	2.4	24.4
Other housing assistance	4.0	0.4	13.2
Other	<u>6.1</u>	<u>5.9</u>	<u>77.6</u>
Total	47.6	23.4	207.8
<b>Guaranteed Loans to:</b>			
Foreign purchasers of U.S. exports	5.8	-0.9	6.1
Home mortgage borrowers (FHA)	18.6	6.8	142.3
Small businesses (SBA)	2.0	-*	9.9
College students and their families	6.2	5.7	22.7
Local public housing authorities	13.3	3.2	20.8
Veterans purchasing homes	6.0	5.2	108.8
Other	<u>1.8</u>	<u>0.9</u>	<u>20.6</u>
Total	53.7	20.9	331.2
<b>Loans by Government-Sponsored Enterprises</b>			
Student Loan Marketing Association	2.1	1.7	6.0
Federal National Mortgage Association	27.9	17.3	76.9
Farm Credit Administration	51.5	5.6	81.4
Federal Home Loan Bank System	72.5	19.4	111.0
Other	<u>-2.3</u>	<u>-0.6</u>	<u>-49.7</u>
Total	151.7	43.4	225.6

\* Less than \$50 million.

SOURCE: Budget of the U.S. Government, Fiscal Year 1984, Special Analysis F.

State and local governments are also active in attempts to reallocate capital, although their role is restricted in most cases to the issuance of tax-exempt bonds to finance preferred forms of public and private investment. In 1982, long-term tax-exempt bond issues totaled \$88 billion. Of this, more than \$42 billion was used to extend credit to private entities for residential construction, the establishment or expansion of private hospitals, student loans, airport and port facilities, industrial parks, and investment in various types of plant and equipment. The volume of private-purpose tax-exempt bonds issued in 1982 plus credit advanced under federal auspices sums to about 6 percent of gross national product (GNP).

Obviously, the fact that a federal credit program is big or that its impact is uncertain does not necessarily mean that it is undesirable. Many direct outlay programs are big and their impacts uncertain. Moreover, most policymaking involves some uncertainty in the pursuit of desirable national goals.

Many factors suggest that modifying the market allocation of capital and credit may be socially desirable. It has long been felt, for example, that policies to increase home ownership strengthen our society. Encouraging small business is likewise thought to stimulate competition and the pace of technological innovation. Expanding private overseas investment can contribute to U.S. development goals abroad. Thus, it may be entirely appropriate to have a policy to enhance the flow of capital to enterprises

that generate "spillover" benefits. The fact that a large volume of credit is advanced under such policies may simply reflect their substantial social benefits. The pertinent issue is not so much the size of government credit market intervention as its effectiveness in achieving the intended goals and its costs. In fairness, one can probably say that these issues are not reexamined as frequently as they should be.

#### NET EFFECTS OF INTERVENTION

It is far from clear that government efforts to reallocate capital achieve the results expected. The impact of government credit programs seems to be too weak to measure in a statistically satisfactory way. 1/ This may simply reflect the technical difficulty of separating their impact from that of a myriad of other factors affecting capital markets, but there may also be other explanations. The number of programs may have grown to the

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1. Empirical studies of the effects of federal programs include: Ronald Utt, "An Empirical Analysis of the GNMA Tandem Plan," Capital Markets and the Housing Sector, Robert Buckley, John Tuccillo and Kevin Villani (eds.) Ballinger, Cambridge, Mass., 1977, pp. 347-362; U.S. General Accounting Office, What Was the Effect of the Emergency Housing Program on Single-Family Housing Construction? CED-78-155, Washington, D.C.; and Timothy Bates, "Effectiveness of the Small Business Administration in Financing Minority Business," Review of Black Political Economy (Spring 1981), 11(3) pp. 321-336. Explanations for the apparent ineffectiveness of these programs may be found in CBO Proceedings of the Conference on the Economics of Federal Credit (December 1980) pp. 19-30, 33-34 and Rudolph G. Penner, "How Much Is Owed by the Federal Government?" Carnegie-Rochester Conference Series on Public Policy, 16 (1982) especially pp. 242-243.



point where they are starting to offset each other. To take an extreme example, if all borrowers were subsidized equally, none would have any more advantage than they would have in a free credit market. In addition, unanticipated adjustments by subsidized borrowers and the induced price effects of federal credit may weaken the impact of credit assistance.

Credit Priority and the Number of Preferred Borrowers. One way to think about government credit market intervention is as an attempt to change the order in which borrowers stand in line for credit. It begins when policymakers observe that an especially desirable activity is receiving credit only after other, less beneficial activities have been financed. The next step is to increase the priority afforded preferred borrowers by moving them up the line to near-equal status with the U.S. Treasury. A few borrowers can be successfully moved up in this manner. But it is impossible to move all borrowers to a preferred position in the credit markets. Today, however, the government has given preferred status to a vast number of potential borrowers: home buyers, home builders, limited-partner owners of multi-family residences, farmers, businesses of all sizes, students, those touched by economic and natural disaster, electric and telephone cooperatives, state and local governments, exporters, overseas investors, banks, savings institutions, and credit unions.

Adjustments by Subsidized Borrowers. A second obstacle to the goal of reallocating credit by government is that subsidized borrowers may

behave in unanticipated ways. For example, subsidies designed to increase the flow of capital to increase the number of home owners are likely to be undercut by a tendency of some to use the subsidies to acquire larger homes than they would otherwise have bought. To take another example, businesses and individuals will, to some extent, substitute government-assisted financing for equity capital and other private borrowing. Moreover, it is impossible to prevent some assistance from going to borrowers who would have been quite willing to engage in the favored activity even if it were not subsidized. For example, a program lowering mortgage interest rates from 13 to 10 percent may subsidize some borrowers who would have been quite willing to pay 13 percent. We often attempt to minimize this problem by limiting eligibility to those income groups most in need of the subsidy, but this is never easy to do. In short, one dollar of government-provided capital generally does not add a full dollar to the flow of capital resources toward the target activity. It should also be said, of course, that many direct outlay programs also have unintended effects. For example, federal health payments intended to reduce the financial burden imposed by health costs sometimes serve instead to increase the demand for health care.

Price Effects of Credit Programs. To the extent that credit programs do increase the net flow of capital to an activity, they also tend to trigger offsetting price changes. For example, increasing the flow of capital to the purchase of farmland by young farmers tends to drive up the price of farmland and reduce the ability of unsubsidized farmers to buy their own

farms. Another example may be found in the well-meaning attempt to raise and diversify the income of family grain farms by providing low-interest loans to finance poultry production. As the poultry supply increases, the price of chickens and eggs falls and the overall effect on farm net income is uncertain. I have already noted that federal credit programs aimed at increasing exports may lead to off-setting movements of exchange rates.

### OBSCURE COSTS

Government efforts to reallocate credit escape the oversight they deserve. One reason is that the costs of these programs are obscured by their current budget treatment. Under present budget accounting practices, the costs of federal credit activity are not shown in a clear or timely fashion. First, direct loans enter the budget net of repayments and asset sales. This understates program activity levels. Second, since loan guarantee commitments require no immediate cash outlay, they have zero cost in the budget, even though they may subsequently lead to substantial outlays. As an illustration of the first point consider the Agricultural Credit Insurance Fund (ACIF) of the Farmers Home Administration. The major credit programs financed through this fund are direct loans for farm and nonfarm enterprise ownership, farm operations, and disaster relief. The unified budget significantly understates the level of lending in the ACIF by the practice of netting loan repayments and loan "sales" against loan

extensions and by the willingness of the off-budget Federal Financing Bank (FFB) to "purchase" loans from agencies. <sup>2/</sup> In 1982, the ACIF obligated \$4.1 billion in loan funds; after netting its obligations against payments received and loan asset sales, however, the ACIF reported net obligations incurred of only \$717 million. As shown by the FFB holdings of loan assets displayed in Table 2, activity levels in loan programs other than the ACIF are also understated by the sale of loan assets to the FFB.

The unsatisfactory nature of the current budget treatment of loan guarantees and government insurance programs is illustrated by the Federal Housing Administration Fund, which consists of about 40 different mortgage insurance programs including the basic home mortgage insurance plan established by Section 203(b) of the National Housing Act. In fiscal year 1982, programs covered by this fund issued commitments to guarantee loans by private lenders of \$18.6 billion. But budget documents for 1982 show outlay costs of minus \$237 million for the fund. The outlay figure indicates that these programs yielded a positive cash flow to the government, even though in 1982 it was necessary to appropriate \$222 million to cover past costs and new default claims totaled \$890 million.

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2. Under these loan asset sales, the originating agency retains all risk of default and late payment. So, it is arguable whether a "sale" and "purchase" has taken place.

TABLE 2. FEDERAL FINANCING BANK HOLDINGS OF LOAN ASSETS BY ORIGINATING ENTITY, FISCAL YEAR 1982 (In millions of dollars)

Agency	1982 Asset Sales
Overseas Private Investment Corporation	23
Farmers Home Administration	
Agricultural Credit Insurance Fund	23,412
Rural Housing Insurance Fund	23,921
Rural Development Insurance Fund	6,403
Rural Electrification Administration	3,124
Health and Human Services	
Medical Facilities Guarantees	154
Health Maintenance Organizations	133
Small Business Administration	
Business Development Loans	66
Total Loan Assets	57,236

SOURCE: Budget of the U.S. Government, Fiscal Year 1984, Special Analysis F, Table F-8.

These two examples illustrate some of the many difficulties confronting policymakers and analysts when they attempt to monitor the performance and assess the cost of the many federal credit programs now in place. Existing budget practice does not produce information that would be useful to the budgeting and oversight functions of the Congress. The unified budget accounting principles that keep the budget simple and allow us to derive a meaningful bottom line--the deficit--should be preserved. For

analytical purposes, however, it is important to recognize the budget's shortcomings and to work to develop better measures of program level and cost. 3/

### CONCLUSION

The effect of federal credit programs on capital markets could be brought somewhat closer to that which is intended by improving oversight and budget control. The key to bringing this about, I believe, is to raise the quality of analytic information about these programs. Changes are also required in the accounting rules and budget procedures pertaining to federal credit. In particular, the budget treatment of those agency activities financed through the FFB ought to be ascribed to the administering agencies. Also, the credit budget, implemented on an experimental basis by the Budget Committees, should be fully incorporated into the Congressional budget process and made binding.

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3. Many of these issues are discussed in Alice M. Rivlin and Robert W. Hartman, "Control of Federal Credit Under the Congressional Budget Process," Toward a Reconstruction of Federal Budgeting (The Conference Board, December 1983).

The recent report by the Committee for Economic Development, Strengthening the Federal Budget Process: A Requirement for Effective Fiscal Control, made suggestions for improving budget data on the cost of credit and recommended further study of these proposals. The CBO is now conducting an analysis of new approaches to the budgetary treatment of federal credit, and we will be sharing these results with the Subcommittee as soon as they are complete.