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Mr. Chairman, I am pleased to appear before this Task Force to discuss credit budgeting and endorse the Federal Lending Oversight and Control Act, introduced by you and Congressman Bethune. Your bill would make credit budgeting an integral part of the Congressional budget process, enabling the Congress for the first time to control the total level of federal credit activities. After almost two years of experience with an informal credit budget, I believe the Congress is ready to take this important step.

My testimony today covers four areas:

- o The recent growth of federal credit and its probable impact on credit markets and the economy, noting the relationship between this growth and inadequacies in the present budget treatment of credit;
- o The progress of Congressional efforts to improve credit budgeting;
- o The improvements in credit budgeting contained in the Mineta-Bethune Bill; and
- o Additional steps needed to correct remaining problems.

GROWTH IN FEDERAL CREDIT ACTIVITIES; CAUSES AND EFFECTS

In the last decade and particularly during the past six years, federal credit programs--direct loans and loan guarantees--have been growing faster than direct spending programs. Since 1976 federal credit has grown at a rate of 27 percent per year, thus doubling in less than three years. By contrast, during the same years budget outlays rose at a rate of about 12 percent annually. Consequently, credit programs account for an increasing proportion of all federal financial assistance. As of fiscal year 1980, one of every eight dollars extended by federal agencies was in the form of a direct loan or loan guarantee. The volume of loans and loan guarantees outstanding had climbed to $462 billion, a figure two-thirds as large as the federal debt in 19SO.

During these years, the types of activities funded through credit programs have also increased. Programs have been developed in new areas: synthetic fuels commercialization and aid to large individual ventures, such as New York City and the Chrysler Corporation. At the same time, programs in the traditional areas have continued to expand and diversify: housing, agriculture, business assistance, and international development.

Although the reasons for the surge in federal credit during the 1970s are not fully understood, several contributing factors deserve special notice. First, the largest share of guaranteed loans, and an important portion of direct loans, serve the housing market. The lack of available private mortgage funds in recent years has created greater demand for federally assisted funding, and spiraling housing prices have necessitated large loans and guarantees. These factors have resulted in an increase in the single largest credit program—FHA mortgage insurance—from $2.3 billion in net guarantees in fiscal year 1976 to $14.4 billion in 1980.

Second, increasing market interest rates in recent years have opened a large gap between the interest rates offered by many fixed-rate federal loan programs and those available to borrowers through private institutions. This has increased demand for federal low-interest loans, which are now heavily subsidized. Some of this increased demand probably has been accommodated by higher program levels. This is certainly a factor in the explosion of the Guaranteed Student Loan Program, with interest rates at 7 percent until 1980 and open-ended eligibility.

Two other factors in the growth of federal credit relate to changes in its budget treatment. In 1974 the Federal Financing Bank (FFB) began operations, allowing some budget agencies to transform their on-budget direct loans into off-budget loans and others to transform guaranteed loans into off-budget direct loans. This opportunity to lend federal funds without adding to budget costs may certainly have encouraged higher lending levels for those programs able to use the FFB.

Also in 1974, the Congressional Budget Act was passed. This act placed tighter controls on Congressional action on all forms of federal spending with the exception of loan guarantees, which were specifically excluded from its coverage. The change in severity of controls over direct spending relative to loan guarantees may have encouraged an increasing use of the guarantee mechanism. Undoubtedly, the lower budget visibility of credit programs contributed substantially to the spurt in federal credit.

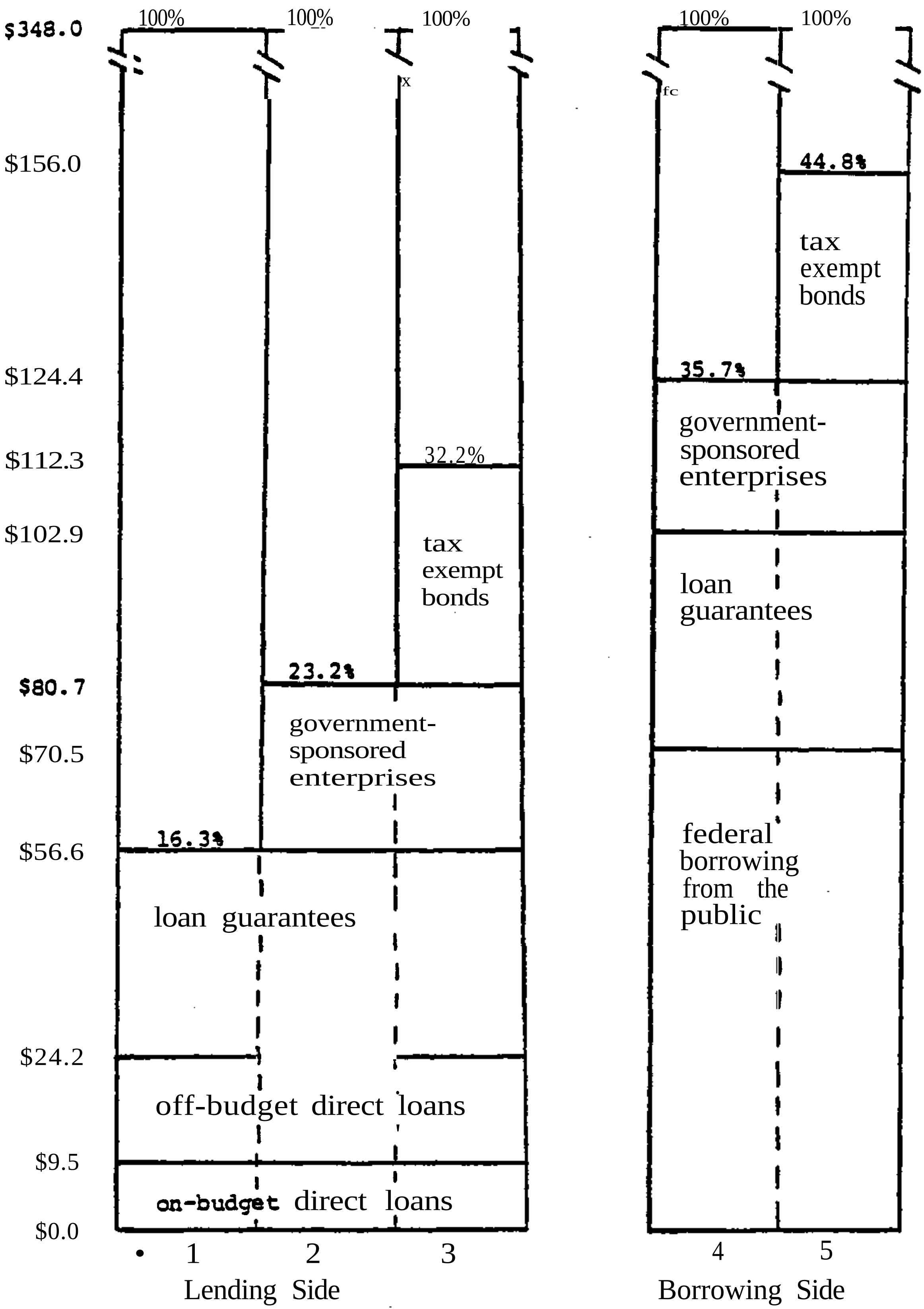
Federal Credit in Capital Markets

The federal government is now making heavy demands on credit markets in several ways--direct loan and loan guarantee programs, borrowing by government-sponsored enterprises, bonds for local industrial and housing development subsidized through federal tax exemption, and, of course, financing the budget deficit. The attached figure shows the size of these forms of borrowing relative to total funds raised in domestic credit markets. In fiscal year 1980, the year of the most recent available figures, these activities absorbed 45 percent of total credit in the nation's capital markets (see column five of Figure 1). With such high federal demands on capital markets, the possibility exists that a large amount of private credit can be "crowded out." Risk-free, federally assisted credit is given first preference in the queue for the relatively inelastic supply of funds in credit markets. The high volume of new federally assisted borrowing may also contribute to the sustained high interest rates we are now experiencing.

Among the varieties of federally assisted credit, direct loans and loan guarantees, which account for 16 percent of all funds advanced in the economy (see column one of Figure 1), merit our attention for two reasons.

First, many of the loans are heavily subsidized. Subsidized credit displaces private credit that would have been spent on activities considered more profitable by market standards. If this were not so, the market would have allocated credit to the federally favored uses without federal intervention. By diverting resources from more to less productive uses, subsidized credit programs can reduce the efficiency of the nation's capital stock. And because increases in overall productivity depend on the effective use of capital, subsidized credit may retard national productivity growth. In particular cases, the benefits of subsidized credit programs may

FIGURE 1. FEDERAL PARTICIPATION IN DOMESTIC CREDIT MARKETS, FISCAL YEAR 1980 (Expressed as percent of total funds in credit markets, dollars in billions)



Source: Budget of the U.S. Government for Fiscal Year 1982, Special Analysis on Federal Credit Programs.

well outweigh the costs. Nevertheless, the potentially large economic costs of federal credit activities call for continuous review and assessment by the Congress.

Second, the failure to account fully for credit programs in the budget gives them an inappropriate advantage over direct spending programs. Improved budgetary oversight of loan and loan guarantee programs could enable the Congress to monitor their use and growth in a way that would consider federal priorities as well as the needs of national credit markets. Fortunately, better control of these programs is now within our reach.

THE CREDIT BUDGET

Three principles form the foundation of good credit budgeting:

- Congressional Control. The budget process should enable the Congress to make informed choices specifying both individual program levels and the volume of total credit activities.

- Comprehensive Coverage. The budget and budget process should include all forms of federal financial activity. Nothing should be hidden.

- Accuracy of Information. The budget should present the Congress and the public with information about all federal programs which is clear, accurate, and includes measures of both volume of activity and long-run costs.

Until 1980, the following deficiencies in the budget treatment of credit violated all of these fundamental goals of good budgeting:

- o Many credit programs were not given annual directives on the level at which they could operate.

- o Direct loans were counted in the budget only net of repayments, a practice that obscured the actual volume of activities for many programs.

- o Off-budget direct loans were--and are—excluded from budget totals. These loans create an unrecognized federal deficit, which is expected to add $18 billion to federal borrowing in 1982.

- o The budget totals and the Congressional budget process explicitly excluded loan guarantees.

Not only did the budget understate the costs to the government; it virtually ignored the perhaps even greater costs to the economy at large. The inadequate treatment of federal credit contributed to a perception of credit as close to a free good, and enabled many programs to grow without explicit Congressional approval.

Beginning with the fiscal year 1981 budget, the Congress and the Administration have adopted an informal credit budget that functions in tandem with the unified budget to enhance control of total direct loan and loan guarantee levels in all credit programs. This credit budget has two major components: inclusion of credit targets in the concurrent resolutions on the budget and annual limitations on gross activity levels for credit programs in appropriations bills.

In terms of the three budgeting objectives discussed above, the most significant achievement of the new approach has been the annual limitations applied to many credit programs for the first time. This represents a step forward in Congressional control. The budget resolution credit targets have improved Congressional and public understanding of the overall volume of federal credit and its claim on the financial resources of the economy. In its present form, however, the credit budget cannot improve control or budget process coverage of credit totals. In 1981, the first year of the credit budget, federal credit was 20 percent higher than in 1980, according to preliminary estimates.

The two years of experience with the informal credit budget can serve, however, as a prelude to the improved oversight and coverage offered by the Mineta-Bethune Bill. General awareness and supporting services now have been developed sufficiently so that an official credit budget would be easy to implement. For example, in this year's first concurrent resolution, credit targets were voted by function and included targets for the Federal Financing Bank.

The two Budget Committees and the Congressional Budget Office have the capability to monitor action on credit programs at each stage of the authorization and appropriation process. CBO has developed an automated credit scorekeeping system that can compare Congressional action on credit program bills against the functional targets established in the concurrent resolutions. This system has been used this year by the House Budget Committee in its early warning memoranda on bills likely to exceed resolution targets. CBO will shortly begin to issue credit budget statements as a part of ail cost estimates for bills affecting loan or guarantee programs. We are also developing the ability to make independent five-year projections and reestimates for the credit budget as we now do for the unified budget.

THE FEDERAL LENDING OVERSIGHT AND CONTROL ACT

The Mineta-Bethune bill is the logical next step in increasing Congressional control over federal credit programs. The bill would subject credit bills to points of order if their totals violated credit budget aggregates. It would also allow reconciliation instructions to be written for the credit budget. The bill would accomplish the following objectives:

- It would make credit totals enforceable. The Congress could decide how much federal credit should be allocated through loans and guarantees, and know it would stay within the set limits.

- It would further enhance control over levels of individual programs.

- It would bring loan guarantees into the budget process officially for the first time.

- It would provide a means for controlling off-budget lending, if the Congress wished to use it. Binding levels could be set in the second resolution for off-budget loans or for Federal Financing Bank activity.

Each of these new provisions would contribute importantly towards making the budget process a more effective vehicle. They would eliminate the current budgetary advantage of credit programs over direct spending and give the Congress explicit control over aggregate credit levels. If this bill is acted on expeditiously, the Congress could have this system in place when it considers the fiscal year 1983 budget.

The credit budget bill also would help provide a framework within which the Congress could consider the appropriate level and allocation of credit among the many programs competing for limited federal resources. Making these decisions would not be easy, especially without concrete information about the economic costs of credit programs. But neither was it easy to decide the total level of federal spending and revenues in the concurrent budget resolutions when they were first introduced in 1975 and 1976. Nor is it easy today. Our understanding of the economic effects of spending and tax proposals is not as complete as we would like it to be, and the Congress would face even greater uncertainties in debate over credit levels. But only binding Congressional action on aggregate credit levels can create the attention needed to inspire the research that will improve understanding.

REMAINING PROBLEMS

As important an advance as the Mineta-Bethune bill is, it does not completely solve the inadequacies in the budget treatment of credit I described earlier. There are further improvements not yet ripe for implementation. I will not go into the need for better program standards and administration, such as default reserve requirements. That is a topic for another day. The three issues I want to raise now concern the budget and budget process on a more general level.

Off-Budget **Lending.** Most importantly, the problem of off-budget lending remains, with its distorting effect on the budget deficit. Because the Federal Financing Bank comprises over 90 percent of off-budget outlays, the distinction between on- and off-budget credit activities is not one of substance. The bank, in fact, acts as an off-budget lender for on-budget agencies. By purchasing loans and certificates of beneficial ownership (pools of loans called CBOs) from on-budget agencies, the FFB transfers on-budget loans to off-budget status. The FFB also acts as a primary lender at the request of various on-budget federal agencies. The FFB will make a direct loan to the borrower, at interest rates only marginally above the cost of Treasury borrowing, whenever an agency guarantees the full repayment of interest and principal in the event of default by a borrower.

The distinction between on- and off-budget credit programs is thus virtually meaningless—except with respect to the unified budget deficit. Although the Congress currently exercises no control over the timing or amounts of off-budget financing of direct loans by the FFB, it cannot escape its consequences. The ceilings on the public debt must be increased for each dollar of net lending by the FFB. Even with a balanced budget, the public debt ceiling would still have to be increased because of the FFB's off-budget lending.

Under the Mineta-Bethune bill, agencies could continue to use the FFB to hide billions of dollars in federal funds they administer in the nether world of off-budget rather than declare them openly in their own on-budget accounts. The most satisfactory solution to this problem would require agencies initiating FFB transactions to keep the resulting outlays on their own books. Adopting any such change would increase the unified budget totals and deficit by the amount of FFB lending. This would not alter the actual state of federal finances, but rather would reflect that state more accurately. CBO will soon publish a paper examining the FFB question in greater depth.

Impoundment Control. Another remaining budget problem is the lack of impoundment control for loan guarantees. As now drafted, the Mineta-Bethune bill would not prohibit the Executive Branch from withholding guarantees without prior Congressional approval. The current Administration is proposing to decrease loan guarantee programs solely through executive action, which it can do despite Congressional action setting upper limits for many of the programs. To correct this weakness in Congressional control, the definition of budget authority in the Budget Act could be revised to include loan guarantees. If this presented problems, a new kind of authority--loan guarantee authority--could be created instead and subjected to the Budget Act's impoundment control provisions.

Budget Restructuring. Finally, let me describe a long-run, idealized solution to credit budget problems. If we were to start afresh and devise a budget that would accurately report the nature of federal financial transactions, the following picture might emerge. The three types of aid extended by federal agencies would be recorded separately and completely: direct spending, direct loans, and loan guarantees. On the revenue side, each of these would be matched against its source of offsets: taxes, loan repayments, and expiring guarantees. Attention would be directed not towards one budget deficit of ambiguous interpretation, but towards two or more clear-cut measures—deficit spending and net credit extensions being the most important. If the budget were restructured along these lines, our three budgeting objectives would essentially be fulfilled:

- o Congressional Control. Under the present system action on credit programs occurs both in the unified and credit budgets, though in different forms. Restructuring the budget would focus all attention on credit in one place.

- o Comprehensive Coverage. Restructuring the budget would solve the off-budget problem, and would do so without creating one large off-budget deficit.

- o Accuracy of Information. All measures relevant to credit program evaluation would be displayed clearly: gross activity, net additions to outstanding credit, and expected direct costs.

Restructuring the budget would not require a change in law, but rather agreement between the Congress and the Administration on budget concepts. A study commission similar to the 1967 Budget Concepts Commission would probably be the best way to accomplish the task. Such a commission could also examine other issues in the budget process. Tax expenditures immediately come to mind.

The reforms covered in the Mineta-Bethune bill are important steps, ones that the Congress is sufficiently prepared to take now. In fact, the process the Congress has been following to improve credit budgeting could serve as a model for pursuit of other budget reforms.