

STATEMENT OF
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before the

TASK FORCE ON CREDIT
COMMITTEE ON THE BUDGET
UNITED STATES SENATE

December 10, 1981

Mr. Chairman, I am pleased to appear before this Task Force to discuss the importance of improving the budgetary treatment of federal credit activities. After two years of experience with an informal credit budget, I believe the Congress is ready to make credit budgeting an integral part of the Congressional budget process. My testimony covers three areas:

- o The recent growth of federal credit and its probable impact on credit markets and the economy;
- o The progress of Congressional efforts to improve credit budgeting; and
- o Needed next steps in credit budgeting.

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, more than doubling every 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. By **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 1980.

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.

Causes

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 larger loans and guarantees than previously required. 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 pegged at 7 percent until **1980** and open-ended eligibility.

Two other factors in the growth of federal credit relate to changes in its budgetary treatment. In **1974** the Federal Financing Bank (FFB) began operations, allowing some federal 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 by those agencies 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 prompted an increasing use of the guarantee mechanism. Undoubtedly, the lower budget visibility of credit programs contributed substantially to the spurt in federal credit.

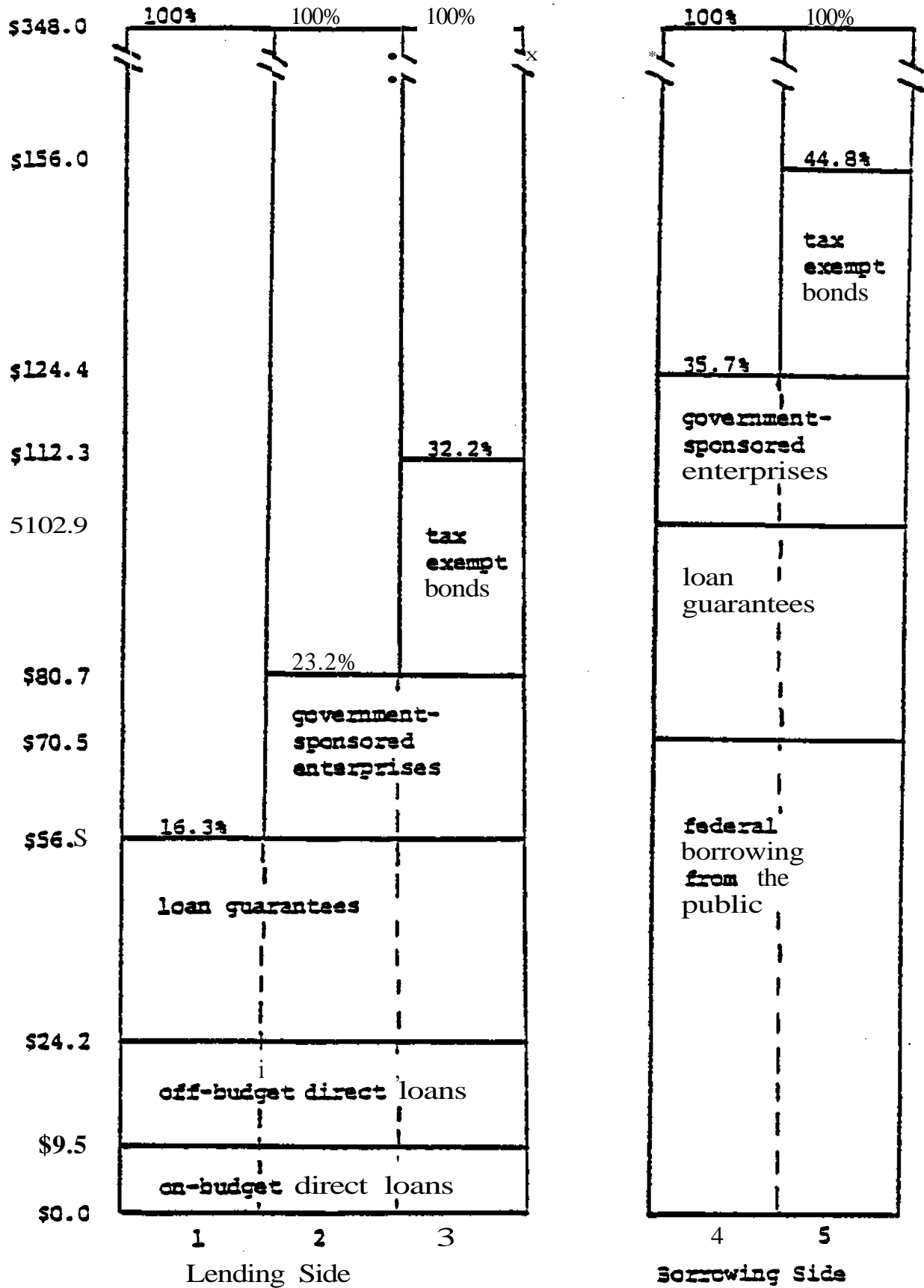
Economic Effects of Federal Credit in Capital Markets

The federal government now makes 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 exemptions; and, of course, financing the budget deficit. Figure 1 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** data, these activities absorbed **45** percent of total credit in the **nation's** capital markets (see column five of Figure 1). **Such** large federal demands on capital markets raise the possibility that a large amount of private credit may 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 of recent years.

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 special attention for two reasons. First, many of the loans are heavily subsidized. Subsidized credit displaces 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 uses favored by the government 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, of course, the benefits of subsidized credit programs may well outweigh the costs. Nevertheless, the potentially large economic costs of federal credit activities call for continuous review and assessment by the Congress.

FISCAL YEAR 1980 (Expressed as percent of total tunas in credit markets, dollars in billions)



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

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:

- o 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.
- o Comprehensive Coverage. The budget and budget process should include all forms of federal financial activity. Nothing should be hidden.
- o Accuracy of Information. The budget should present the Congress and the public with information about all federal programs that is clear, accurate, and includes measures of both volume of activities and long-run costs.

Until 1980, the following deficiencies in the budgetary 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 \$20 billion to federal borrowing in 1982.
- o The budget totals and the Congressional budget process explicitly excluded loan guarantees.

Before the improvements of 1980, not only did the budget understate the governmental costs of federal credit activities, but it virtually **ignored** the perhaps even greater costs to the economy at large. The inadequate treatment of federal credit activities contributed to a perception of credit as close to a **free** good, and enabled many programs to grow without explicit Congressional approval.

Since 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.

The two Budget Committees and the Congressional Budget Office now have the capability to monitor action on credit programs at each stage of the authorization and appropriation processes. 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. CBO **will** shortly begin to issue credit budget statements as a part of all 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 two years of experience with the informal credit budget have served to increase general awareness of the importance of federal credit activities and to develop supporting services to monitor these activities. An official credit budget would now be **relatively** easy to implement.

NEXT STEPS IN CREDIT BUDGETING

The next logical step in increasing Congressional control over federal credit programs is to incorporate credit activities fully into the **Congressional** budget process. The significant changes from the informal procedures used for the past two years could be the following:

- o Make credit totals binding;
- o Subject credit **bills** to points of order if their totals violated credit budget aggregates;
- o Write reconciliation instructions for the credit budget;
- o Require appropriations action for all credit programs; and
- o Incorporate credit programs in the Impoundment Control Act of **1974.**

The procedures used in establishing a credit budget thus **far** have been agreed to informally. Credit has been included in the budget resolutions using the authority of Sec. **301(a)(6)** of the Budget Act. That section provides for the inclusion of "such other matters relating to the budget as

may be appropriate . . ." The shift to a formal credit budget might be taken more seriously if the Budget Act is formally amended. Senator Percy has introduced a bill to make such changes.

Each of these new procedures 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. A framework would be provided 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 effects 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

Although the improvements just discussed would be an important advance in strengthening the Congressional credit budget, they would not **completely** solve the inadequacies in the budgetary treatment of credit I described **earlier**. There is a need to bring off-budget credit activities on budget, to restructure the whole budget to distinguish among the economic **effects** of various federal activities, and to improve **Congressional** control.

Revising the Budgetary Treatment of the FFB. The off-budget status of the Federal Financing Bank will understate the budget deficit by approximately \$20 billion in fiscal year 1982. 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 makes direct loans to borrowers, at interest rates only **marginally** above the cost of Treasury borrowing, whenever the agencies guarantee the full repayment of interest and principal in the event of default by the borrowers.

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.

One possible solution to the understatement of the deficit presented by off-budget lending would be simply to abolish the FFB. This action would, however, eliminate the benefits provided by the **FFB--coordinating federal** borrowing and reducing **total** federal borrowing costs.

Another approach would be to put the FFB on budget. This, however, would have the drawback of forcing the FFB to establish priorities by selecting which agencies to assist within its budget totals.

The best approach would be to require the agencies initiating FFB transactions to keep the resulting outlays on their own books. Such a 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. At the request of this Task Force and the House Budget Committee, CBO will soon publish a paper examining the FFB question in greater depth.

Budget Restructuring. **Finally,** let me describe a more drastic solution to credit budgeting 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 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 begin the task. Such a commission could also examine other issues in the budget process. Tax expenditures immediately come to mind.

CONCLUSION

The Congress has made substantial progress in improving its review of federal credit activities. I encourage this Committee to take the next steps. First, the credit budget **should be fully implemented**, within the context of the current Congressional budget process. Next, the misleading impact on the deficit of **off-budget** lending should be corrected. Finally, the Congress should initiate a review of the entire budget structure in an attempt to allow comparable treatment for spending, lending, and tax expenditures.