

STATEMENT OF DR. RICHARD D. MORGENSTERN  
ECONOMIST, CONGRESSIONAL BUDGET OFFICE  
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COMMITTEE ON BANKING, CURRENCY AND HOUSING  
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Mr. Chairman, I appreciate the opportunity to testify before the Committees today on the subject of loan guarantees.

I apologize for not having prepared remarks available before the hearing; as you know, we appear on very short notice.

My purpose today is to set a general framework for the discussion of loan guarantees, and to address some specific concerns regarding both the budget process and the application of loan guarantees to resource development.

Since the Congressional Budget Office is required to provide non-partisan analysis of policy options, I will make no recommendations and take no positions. I would, however, like to pose certain questions which the Committees may wish to consider.

Background

There are now in excess of \$ 170 billion in outstanding federally guaranteed and insured loans. Many of the larger programs are familiar: the Federal Housing Administration, the Veterans Administration, and the Small Business Administration, for example.

Traditionally, such programs have involved large numbers of relatively small loans, for example for home mortgages. On the basis of fairly extensive experience with such programs, it is often possible to predict what default rates are likely to be. Such default rates will vary with economic conditions and the nature of the loans guaranteed or insured, but in general the patterns are predictable: there will probably be some defaults, but they are unlikely to amount to the total face value of the loans guaranteed.

In recent years, however, new applications of loan guarantees have been made. Very large special situations have arisen: New York City and Lockheed Aircraft are examples. In such cases, past experience with low-income housing or with student loans is of little help.

Recently, proposals have come before the Congress for guarantees of loans to projects quite different in character. In the energy area, for example, the 94th Congress has considered proposals for loan guarantees for the commercialization of processes to convert basic energy forms like coal to other, cleaner or more useful forms such as oil and gas. The Congress has also considered proposals for the commercialization of uranium enrichment activities, using tailored guarantees many of whose characteristics are similar to those of loan guarantees.

The considerations which arise in these cases are relevant to a large collection of issues -- those dealing with the development of natural resources in general, and those dealing with

major industries. In particular, special problems result from the very large scale of individual projects.

When Should the Government Intervene?

What circumstances might recommend a public underwriting of some of the costs or risks of particular private-sector projects? Two major arguments have been advanced for government participation in the energy sector. Both presuppose a situation in which Congress perceives that a larger national goal--such as reduced dependence on imported oil from insecure foreign sources--is unlikely to be met solely through the normal functioning of the marketplace:

- Energy prices may be too low to make the desired amount of investment profitable. Especially if, in our example from the energy area, domestic prices are regulated below world levels, domestic production may not increase sufficiently to meet demands, and domestic dependence on imports may grow.
- Risks and scale of some potentially profitable private energy projects may make them unattractive to investors.

It is important to determine the precise reason for the failure of the marketplace, because the instruments for Federal intervention should reflect the cause of the problem. In general, price supports are most suitable in cases where energy prices are too low to make the desired amount of investment profitable, and loan guarantees are most suitable when the risks associated with the large scale make potentially profitable investments unattractive to investors.

When Should Loan Guarantees be Made?

Given a determination that Federal intervention is necessary, it is appropriate to ask under what circumstances loan guarantees should be the instrument of choice.

Certainly, loan guarantees provide an option which allows for government participation, but keeps that participation at arm's length.

When risks associated with the large scale of a project are the principal factors inhibiting otherwise profitable private investment, then loan guarantees would probably not result in outlays, and thus may represent a costless way to stimulate the private market toward socially desirable decisions. The reason for the expectation of zero government outlays, of course, is that we are assuming that the project in question is a potentially profitable one -- it is only the project's large size which is deterring investment. Whereas joint ventures or syndications may, in principle, obviate the need for loan guarantees, either legal or institutional difficulties may make them difficult to assemble.

Alternatively, when low energy prices (perhaps brought on by government regulation), are what inhibits energy production, loan guarantees may not be efficient instruments for dealing with the problem. In such cases, loan guarantees might lead to excessive defaults or simply fail to attract the desired investment and other government actions--such as deregulation or price supports--might be preferable.

Thus, where risk associated with the large scale of potentially profitable investments make them unattractive to investors, loan guarantees may be appropriate.

Problems in Implementing Loan Guarantees

Once a decision is made that Federal involvement is called for, and that loan guarantees are the appropriate mechanisms, additional questions of implementation remain. As we have noted, most traditional loan guarantees have been for large populations of projects for which it is possible to make actuarial estimates of expected government outlays. Those expected outlays are then entered in the appropriate agency's budget, and the programs handled in routine fashion.

In the case of large, unique projects--such as uranium enrichment and synthetic fuels--such treatment is not possible. The number of projects is not large enough to permit statistical treatment, nor is there a long history of experience on which to draw. Thus, for example, the President's fiscal year 1977 budget contained a request for synthetic fuels for \$ 1.5 billion in borrowing authority (along with additional funds for price guarantees and construction grants)--but no provision for expected outlays.

The extreme situations are clear. In one case, one assumes that outlays are unlikely, and so makes no provision for them in the budget. Yet, if there were no serious risk of default, presumably there would have been no reason to seek guarantees in the first place. Thus, failure to make any provision for outlays is unrealistic.

The other extreme is also unrealistic: it is quite unlikely that all projects guaranteed would fail; to enter the total loan guarantee authority as a budget outlay estimate would overstate the case.

In either situation, the usefulness of the budget as a tool for setting Federal financial priorities would be impaired: in one case because actual outlays (program costs) would be understated; in the other, because they would be overstated and hence would not leave adequate provision for other desirable programs.

Another problem in the use of loan guarantees is that they may have significant impact on private capital markets, by substituting low-risk government-backed securities for higher-risk private paper. To the extent that the public does not want to purchase such large quantities of low-risk securities, borrowing costs for all federal debt may rise. Also, of course, the higher-risk private ventures not federally guaranteed would be less able to attract financing. Depending on the nature of the investment displaced, this could be good or bad; it is the purpose of loan guarantees to reallocate private investment.

The role of the Federal Financing Bank is important. The FFB is authorized to purchase Federally-guaranteed loans, and to do so borrows from the Federal treasury. Thus, purchase of a guaranteed loan by the FFB -- which does not appear in the Federal budget -- converts the loan guarantee to a direct loan in all but name.

Conclusion

CBO is not unique in raising these issues. I am sure that many of the participants in today's hearings share some of these concerns and questions. Other Federal agencies, as well as individuals and groups in the private sector and in universities, are actively researching some of these same issues.

Earlier in this session of the Congress, CBO was asked to examine a number of specific programmatic issues in which decisions on the appropriateness of loan guarantees were an important factor. We have prepared reports on synthetic fuels commercialization, on uranium enrichment, and on financing of energy developments in general, and I append copies of these reports to this testimony. We also worked closely with the Senate Budget Committee Task Force on Energy in the preparation of their recent report on Federal Energy Financing.

We are continuing to monitor these issues, and are working with the House Budget Committee staff in its current investigation of the question of guarantees. As we develop additional understanding of alternative policies and procedures for achieving adequate levels of financing in the energy sector and in other sectors as well, we hope to be able to continue to report to the Congress on our findings.

Thank you.