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BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

APRIL 29, 1981

I am particularly pleased to have this opportunity to discuss federal credit programs and policies with the Subcommittee on Economic Stabilization. Under its previous chairman, Congressman Moorhead of Pennsylvania, this Subcommittee was among the first to call attention to the rapid increases in federal loans and loan guarantees. CBO's own work on federal credit has been built on the hearings that the Subcommittee held in 1976 and 1977.

My statement this morning will review recent growth trends of federal credit programs, and will then discuss the costs of these programs, the concerns raised by federal credit activity, and the alternatives available to the Congress for addressing those concerns.

Trends in the Growth of Federal Credit

The decade of the 1970s witnessed four major developments in the growth of federal credit activities:

- o Rapid growth of both loans and loan guarantees, especially in the second half of the decade;
- o The emergence of the Federal Financing Bank (FFB) as an off-budget conduit for credit programs;
- o A shift in the emphasis of guarantee programs from actuarially sound insurance programs to programs providing a subsidy; and
- o The first use of guarantees for loans to very large borrowers, such as Lockheed, New York City, and Chrysler.

Between 1970 and 1980, direct federal spending rose from \$197 billion to \$580 billion, almost tripling. Direct lending, however, more than quadrupled, rising from \$12 billion to \$49 billion in the same period. In the second half of the decade, the increase in loan guarantees was especially rapid. In the 1976-1980 period alone, new loan guarantee commitments more than tripled, rising from \$26 billion to \$82 billion.

One factor contributing to this rapid growth was the emergence of the Federal Financing Bank as a source of off-budget financing for both direct and guaranteed loans. By selling loans that they hold to the FFB, agencies can transfer on-budget loans off-budget. And those agencies that can fully guarantee a loan can secure off-budget financing for such loans through the FFB. In 1980, on-budget agencies were able to transfer \$11.4 billion in new loans off-budget by selling them to FFB. FFB also made \$10.1 billion in new loans guaranteed by other agencies.

The 1970s saw a continuation of the postwar shift in loan guarantee programs from insurance-type programs to the provision of subsidized credit for particular borrowers or projects. The first large-scale loan guarantee programs provided insurance for home mortgages on an actuarially sound basis. The insuring agency, the Federal Housing Administration (FHA), pooled the risks of a large number of

small mortgages and calculated a premium sufficient to cover losses and operating costs. In 1950, FHA and Veterans Administration (VA) mortgage insurance accounted for over 97 percent of all new loan guarantee commitments. By 1970, however, that proportion had declined to 74 percent of all new commitments; by 1980, it had dropped to 54 percent.

The actuarially sound insurance programs have given way to programs that allocate subsidized credit to particular borrowers or projects in order to achieve various public purposes. The subsidies may take several forms. First, the guaranteeing agency often does not charge fees high enough to cover default losses and operating costs; consequently, the agency must cover any shortfall with its own funds. This subsidy appears in the unified budget. Second, interest rates on these loans are often set below prevailing market rates, giving the borrower a subsidy equal to the difference between the rate he pays and the market rate. Because no explicit outlay is required, this subsidy does not appear in the unified budget. Finally, in some cases the federal government pays lenders to encourage them to participate in guarantee programs. For example, in the guaranteed student loan program, the government pays participating lenders a premium equal to the difference between the 9 percent statutory interest rate on the loans and the lenders' cost of money. This subsidy is included in the unified budget.

Subsidized guarantee programs have assisted a wide variety of borrowers: small businesses, college students, troubled industries, and exporters arranging financing for buyers of their products. The proportion of new loan guarantee commitments going to these purposes has increased steadily. For example, new loan guarantee commitments by the Export-Import Bank and the Small Business Administration, as a proportion of total commitments, increased from 9.9 percent in 1970 to 17.8 percent in 1980.

The 1970s also saw the first use of loan guarantees to allocate credit to a single large borrower: Lockheed, Chrysler, and New York City. These allocations of credit to discrete ventures are much riskier than insurance-type programs, or even programs offering small subsidized loans to a large number of borrowers, because risks cannot be spread across a pool of borrowers. The growth potential of this kind of program is great, particularly if guarantees are extended to synthetic fuel plants.

Assessing the Cost of Federal Credit Programs

The rapid growth of direct loans and loan guarantees in the 1970s, and the increased emphasis on programs offering subsidized credit, have dramatically increased the potential economic and budgetary costs of the federal government's credit programs. In assessing these costs, it is essential to distinguish between the actuarially sound insurance

programs and subsidized loan and guarantee programs. In an insurance program, such as the FHA's mutual mortgage insurance program, the budgetary costs of the program are paid--in the form of premiums--by the program's beneficiaries, and so there are no costs to the taxpayer. Moreover, if the insurance program is not sheltered from, or given any competitive advantage against, private sector competition, it may have no significant adverse effect on the economy.

On the other hand, subsidized direct loan and loan guarantee programs have both budgetary costs and costs to the economy. Budgetary costs arise from differences between the government's costs of money and the rates of interest it charges on loans; from subsidies paid to lenders to encourage participation in a guarantee program; or from differences between an agency's income from guarantee fees and its administrative costs and losses. These budgetary costs are borne by the taxpayer, not by the beneficiary of the program.

Of greater importance, perhaps, are the costs imposed on the economy. By lowering the price of credit for favored borrowers, subsidized credit programs increase the demand for credit without increasing its overall supply.^{1/} As a

^{1/}It is sometimes suggested that federal guarantees might increase the supply of credit by providing savers with a risk-free form of saving. This suggestion would be more plausible if risk-free financial assets were not already widely available in the form of U.S. government securities.

result, interest rates faced unsubsidized borrowers increase. The higher interest rates squeeze or "crowd out" some unsubsidized borrowers from the market. The investment projects crowded out by subsidized federal credit would, however, have been more profitable, by market standards, than the favored activity or projects. If this were not so, the market would have allocated credit to the favored uses without federal intervention. Thus, by diverting resources from more productive to less productive uses, subsidized credit programs reduce the efficiency of the nation's capital stock. And because increases in productivity are dependent on the growth and effective use of capital, subsidized credit may reduce the growth of national productivity.

In particular cases, the benefits of subsidized credit programs may well outweigh the costs. Nevertheless, the existence of these potentially large costs of federal credit activities calls for continuous review and assessment by the Congress.

Addressing the Federal Credit Issue

The rapid growth of federal credit and the increasing proportion devoted to subsidized credit programs and discrete ventures means that the risk and costs associated

with the government's credit activities are increasing rapidly. Traditional budgetary techniques, with their focus on direct spending and taxing, are unable to control credit program levels, particularly for off-budget direct loans and loan guarantees. Consequently, the increases in the aggregate level of resources being allocated by the federal government through loans and guarantees--and of the potential costs of these activities--have occurred without any explicit decision by the Congress that they should occur.

How can the Congress respond to this situation? First, individual committees can reexamine the costs and benefits of programs within their jurisdiction. These assessments are very difficult to make and will require much work and careful study.

Second, the Congress can take steps to improve the ability of the budget process to account for and control federal credit programs. One such step might be the inclusion of the FFB and its off-budget loans in the unified budget. This would make federal lending activities more obvious, but would not by itself provide a means for the Congress to debate and decide on their overall size.

A third alternative would be the development of a credit budget that would give the Congress a means of accounting for and controlling the aggregate level of federal

credit activity and its distribution among individual credit programs.

The Carter Administration included a credit budget in its 1981 budget request. It consisted of aggregate totals for 1981 direct loan obligations and loan guarantee commitments and of requested limitations on the activity of specific programs. The limitations would be included in the appropriations language for particular agencies. The Congress responded by including aggregate targets for loans and loan guarantees in the first and second concurrent budget resolutions for fiscal year 1981.

The Carter Administration's 1982 budget also contained a credit budget. The Reagan Administration incorporated the credit budget into its economic program and recommended substantial decreases in individual credit programs, reducing the 1982 credit budget total 13 percent below the Carter Administration's January estimate.

This year the Congress will have another opportunity to vote on a credit budget, since the Budget Committees in both houses have recommended aggregate and functional targets for loans and loan guarantees in the first concurrent budget resolution for fiscal year 1982. In addition, the Congress can consider credit budget legislation, such as H.R. 2372, a bill introduced by Congressmen Bethune and Mineta that

would amend the Congressional Budget Act to require explicitly a credit budget in the Congressional budget process. Similar legislation has been introduced in the Senate.

CBO has recommended before, and I recommend again today, that the Congress proceed to implement a credit budget immediately. The credit budget will not solve all of the problems associated with federal credit. In particular, it will not immediately help the Congress in understanding or attempting to control the economic costs of credit programs. All it can do is help the Congress be informed about the aggregate level of federal credit for a fiscal year and provide a framework permitting the Congress to begin making decisions about that level and about the allocation of credit among competing needs.

Making these decisions will not be easy, especially given the lack of concrete information about the economic costs of credit programs. But neither was it easy making decisions about 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: witness the intense debate over the effects of the Administration's tax package.

In closing, I should point out that, while a credit budget will enable the Congress to control the volume of federal credit activity each year, many important issues about the costs, benefits, and effectiveness of existing programs remain to be studied by the committees responsible for oversight and reauthorization. In addition, many issues of program design and accountability that cut across all programs remain to be studied. This Subcommittee, with its responsibilities for oversight of federal intervention in the credit markets generally, may wish to address questions such as:

- o What factors should govern the setting of interest rates and fees for direct and guaranteed loans?
- o Is it feasible to convert some subsidized credit programs to an actuarially sound basis?
- o How much of a reserve for default should be established for loan guarantee programs?
- o Under what conditions should a loan be declared delinquent? In default?
- o What steps should an agency be able to take to assist a borrower in avoiding default?

These and many other questions could benefit from the attention of this Subcommittee.