Statement of
Robert D. Reischauer
Director
Congressional Budget Office

before the
Task Force on Urgent Fiscal Issues
Committee on the Budget
U.S. House of Representatives

April 11, 1990

NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EDT), Wednesday, April 11, 1990.

Mr. Chairman, I am pleased to appear before the Task Force this morning to present the views of the Congressional Budget Office (CBO) on proposals to reform the budget rules for allocating and accounting for federal credit assistance. My statement today will focus on three topics:

- The need for reform;
- How credit reform would work; and
- Some institutional risk involved in this change.

I will suggest that credit reform offers a feasible, significant improvement over the current budgetary accounting and control of federal credit programs and that certain safeguards can be put in place that will minimize the possibility of unintended, adverse consequences.

THE NEED FOR REFORM

The budgetary treatment of federal credit programs has long been regarded as unsatisfactory. CBO's recent report, *Credit Reform: Comparable Budget Costs for Cash and Credit,* reviewed the history of this discontent and some proposals for change, beginning with the 1967 *Report of the President's Commission on Budget Concepts.* The heart of the problem is that the current budgetary accounting and

control system, which works well for most direct spending programs, is poorly suited to credit assistance.

From a budgeting standpoint, the use of federal financial resources should be recognized at the point of control. When the government makes a final decision to commit a dollar to a particular purpose, the use of the dollar should be attributed to that decision and recognized as consuming $1 of budgeted resources during that fiscal period. In direct spending programs, it is relatively easy to follow this rule. The Congress appropriates amounts to be obligated for a specified purpose, the funds are obligated, and eventually paid out. The budget records the amount obligated and paid when they occur. Consequently, the use of resources is directly controlled, and the resources consumed by this action are recognized in a timely manner.

Credit programs have cash flow characteristics, however, that make it difficult to account for and control costs in a comparable way. A single credit transaction will generate cash payments both to and from the government. Payments in both directions take place at different times, with some deferred into the distant future.

Accounting Biases

Under current budgetary accounting practices, the cost of direct loans and loan guarantees is understated in some periods and overstated in

others. For example, if the federal government makes 10 loans for $1 each, repayable in five years, the budget includes the $10 disbursement in outlays and it raises the deficit just as though it were a $10 grant. This process overstates the loans' long-term costs because some repayment of the loans is expected.

Five years later, some but not all the loans will be fully repaid. If eight loans are fully repaid and nothing is collected on the other two, the budget will show only that outlays and the deficit have been reduced by the $8 collection. The first-year budget cost of the original loans overstates the long-term cost of the transaction, while the collection in the fifth year understates the true cost. The budget, therefore, does not accurately measure the cost of the transaction to the government in any year.

The costs of loan guarantees are similarly both understated and overstated in the annual budget under current practice. If the government guarantees a $10 loan issued by a private lender in exchange for a fee of $1, the budget will reflect the $1 collection in the current year as a reduction in outlays and the deficit. This suggests that issuing guarantees is profitable for the government. In fact, the $1 gain to the government understates the long-term cost because no account is taken of the government's liability for making good on the entire $10 if the borrower defaults. In that event, the budget will record the cost to the government of the default as $10 in outlays. This amount over-

states the government's long-term cost because it ignores the $1 fee that was collected when the guarantee was issued.

A better means of accounting for federal credit transactions in the budget would be to recognize the net long-term cost of direct loans and guarantees when the decision is made to incur those costs.

Limited Control

Budgetary control of most federal credit programs is ineffective under current policy. This ineffectiveness arises largely because controls are applied to levels of credit activity rather than to long-term costs.

Revolving funds finance the majority of federal credit programs, whether entitlements or discretionary. Control of discretionary programs financed through revolving funds is exercised by appropriated ceilings on direct loan obligations and guarantee commitments to be issued in a given year. These ceilings on activity are often set well above projected demand, but even when the ceilings are binding, activity is only a rough proxy for costs. Loan characteristics--interest rates, loan maturity, the likelihood of default, and the quality of collateral--relate more closely to cost than the simple volume of loans. Some programs--Export-Import Bank direct loans for instance--have small costs (about $25 million in 1990), while others of about equal

volume--such as Public Law 480 direct loans-have much larger costs (about $600 million in 1990). Moreover, limits on activity--as opposed to limits on cost-force program administrators to focus their management efforts on the volume of new commitments and obligations rather than on program costs. Direct loans and guarantees provided as entitlements to all eligible beneficiaries are limited and controlled only indirectly by substantive law that defines eligibility and by changes in that law.

Less than 10 percent of new federal direct loans and guarantee commitments are financed by accounts that are not revolving funds. For these, appropriations of budget authority limit activity because total obligations for all programs financed by the account cannot exceed the amount appropriated. Even in these cases, however, levels of activity rather than the cost to the government is the focus of control. A better control system would directly limit costs--not levels of activity.

Credit reform would change the budgetary accounting and appropriations control of federal direct loans and federal guarantees of private loans. It would focus budgetary attention and control on the subsidies provided through federal credit and would recognize these subsidies in the budget when the transaction occurs that extends assistance. The guiding principle is that the costs of credit assistance should be

recognized when the final decision is made to incur these costs rather than when cash is actually disbursed or received by the government.

HOW CREDIT REFORM WOULD WORK

The mechanics of credit reform are based on dividing each federal credit transaction into a commercial component and a subsidy component. The commercial element in a federal credit transaction is the unsubsidized part. In the case of a direct loan, the government advances cash in exchange for a promissory note. If the government advances $100 for a promissory note with an expected value of $80 because of a low interest rate, high probability of default, and high collection costs, then $20 is the subsidy component and $80 of the transaction represents an exchange of assets of equal value.

In a guaranteed loan, the government often collects a fee for assuming the liability associated with the guarantee. If the government issues a guarantee that has an expected cost of $5 but imposes a $1 fee, then $1 of the transaction is a commercial, unsubsidized exchange. The subsidy element is the $4 committed by the government in excess of the fee received.

The subsidy component of a federal credit transaction uses federal budgetary resources; the commercial part of the transaction does not.

Credit reform would separate credit transactions into their subsidy and commercial components and treat these components differently in the budget. Specifically, the subsidy component would be used as the budgetary cost of a credit program. The subsidy amount would be shown as the cost of each transaction, and no credit assistance could be provided to a borrower unless the Congress had previously appropriated the subsidy amount.

One way that the subsidy and commercial components could be distinguished in the budget is to assign each to a different account and report it separately in the budget. Subsidy costs would be provided to the subsidy account for each program in appropriations acts. As these subsidies are obligated by government agencies, they would be paid to the commercial or financing accounts. For direct loans, financing accounts would fund federal loans with these subsidy payments and monies borrowed from Treasury. Similarly, the financing accounts would make loan guarantee payments with funds obtained from subsidies, guarantee fees, and interest earned on fund balances.

Take the example of a $100 direct loan with a $20 subsidy. When the federal government disburses the loan, the subsidy account would show a $20 outlay and the financing account would show a net outlay of $80 ($100 for the disbursement less $20 payment from the subsidy account). All repayments would be credited to the financing account.

Since the expected value of repayments is $80, repayments plus the $20 subsidy will balance the financing account.

Under all versions of credit reform, the subsidy account would be treated as the program account in the budget. The financing accounts may be reported either in a nonprogram financing function (function 950, for example) or "below the deficit line," where they would be shown as a means of financing the deficit.

If the financing accounts are reported "above the deficit line" in a nonprogram function, credit reform would not affect total outlays and the deficit. That is, the program account would show $20 in outlays for a hypothetical $100 direct loan, and the financing account would show the remaining $80. As shown in the table below, if the financing accounts are reported below the line, only the subsidy amount would be included in budget outlays and the deficit.

TABLE 1. EFFECT ON THE DEFICIT OF "ABOVE THE LINE" VERSUS "BELOW THE LINE" TREATMENT OF FINANCING ACCOUNTS

Budgetary Treatment	Loan Amount	Subsidy Account	Financing Account	Outlays and Deficit
Above the Line	100	20	80	100
Below the Line	100	20	80	20

SOURCE: Congressional Budget Office.

The essential feature of credit reform is that the budget would distinguish subsidies from the cash flows associated with costless, equal-value exchanges. The subsidy component would be elevated to the budget cost of credit assistance, and the commercial component relegated to a less visible position in the budget. Whether the financing component should be shown in an above the line, nonprogram function or below the line, depends on the confidence one has in the estimates of subsidy costs and on how far one is willing to go in diminishing the prominence afforded the financing flows.

RISK OF CREDIT REFORM

In the report, *Credit Reform: Comparable Budget Costs for Cash and Credit,* which was mandated by law, CBO recommended that the Congress adopt credit reform. We further recommended the use of subsidy costs as the budgetary measure for credit programs and that subsidy costs be subject to annual appropriation.

Nonetheless, we are mindful that all institutional changes can have unintended consequences. In particular, one risk seems sufficiently great as to warrant special care and attention. I refer to the risk that subsidy costs will be systematically underestimated or otherwise subject to distortion for political purposes. The more the nonsubsidized, financing accounts are removed from the focus of budget atten-

tion, the greater the incentive to underestimate subsidies and shift costs to the financing accounts. Although it is unlikely that these incentives can be completely thwarted, some preventive measures can be adopted. It may be helpful, for example, to separate the responsibility for the methodology to be used in calculating subsidy costs from the responsibility for producing the estimates. Most proposals assign the first task to the Secretary of Treasury (and require extensive consultation with other budget agencies) and the second to the Director of the Office of Management and Budget.

Another safeguard would be to require full public disclosure and justification of subsidy costs as calculated for individual programs so that the results can be examined and replicated. It would be preferable to leave some latitude to the subsidy cost authorities in calculating subsidy cost so that they can learn from their efforts and continually improve their estimates. Similarly, restrictions on calculating subsidy costs that would create bias, such as requiring the use of either the lowest or highest discount rate observed in financial markets, should not be mandated in law.

It is also important to assure full and timely reporting, not just on the calculation of subsidy cost rates, but on the financial performance of the financing accounts. At least once a year, those who exercise responsibility for estimating subsidies and for managing the federal

credit portfolios should be required to report the condition of the financing accounts for each credit program.

Finally, it seems prudent to reserve the decision to move the financing accounts below the deficit line until experience has been gained in estimating subsidy costs. This step will dampen the incentive to underestimate subsidy costs and initially leave the deficit unaffected by credit reform.

CONCLUSION

In conclusion, I believe credit reform would improve budgetary accounting and control of federal credit programs. The risks that credit reform will lead to a systematic bias in subsidy cost estimates, though significant, seem manageable through the safeguards of required disclosure and a gradual approach to moving the financing accounts below the line. It seems premature to attempt to foreclose errors in subsidy costs by legislating in detail how these calculations are to be performed. There are significant deficiencies in the historical data and consequently the state of our knowledge is incomplete about the long-term cost of these programs.

I would emphasize in closing that budgetary decisions about credit need to focus on the size of the subsidies that are being extended. This

reform would provide that focus in a manner that renders budget costs comparable for both cash and credit transactions.