

**Statement of  
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**before the  
Committee on Governmental Affairs  
United States Senate**

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**NOTICE**

**This statement is not available  
for public release until it is  
delivered on Tuesday, May 13,  
1986.**

Mr. Chairman, I am pleased to have this opportunity to present the views of the Congressional Budget Office (CBO) on the budgetary treatment of federal credit programs. I will make three points in my statement:

- o First, the current budgetary treatment of federal credit assistance fails to depict accurately the costs to government of current activity. More precisely, current budget treatment focuses on the first-year financing costs rather than long-run subsidy cost. Budget accounting for credit is also susceptible to manipulation, by which I mean that one can favorably affect budget cost by changing the names and form rather than the substance of particular credit programs.
- o Second, most observers agree that in order to capture the relevant costs and to prevent manipulation of the budget numbers for credit assistance, subsidy costs should be substituted for program financing costs in the budget documents.
- o Third, several means exist to accomplish this change, and I wish to note some of the advantages of each.

## DEFICIENCIES IN THE CURRENT BUDGETARY TREATMENT

Time is an essential feature of a credit transaction. Usually, credit involves an exchange of money now for a promise (sometimes conditional) of money later. By definition, an annual cash-based budget like ours is going to have difficulty accounting for multi-year credit transactions. Consider three hypothetical examples:

- o The government lends \$100 for 10 years. It has exchanged cash now for a promise to pay principal and interest in the future. The cash-based budget shows this as an outlay of \$100 in year one, or the same as the reported cost of a grant of \$100. This method of accounting overstates the cost of the loan to the government.
  
- o The government receives a payment of \$100 from a loan made 10 years earlier. In the cash-based budget, this payment is shown as a negative outlay of \$100. If the receiving agency relends the \$100, reported net outlay costs will be zero. The new loan thus appears to be costless.
  
- o The government agrees to guarantee \$100 of private debt. The cash-based budget records no cost for this commitment until the commitment has to be honored

with an outlay. This understates the cost of the assistance at the point when the commitment becomes binding on government.

In each of these cases, the budget accurately records the effect of the transaction on government's current financing requirements: +\$100 in the case of the loan disbursement; -\$100 in the case of the loan repayment; zero in the case of the guarantee. But the real cost to government over the long run will depend on a number of factors not reflected in the financing requirement. These factors include the interest rate and guarantee fees charged, government's cost of money, expectations of default, and the value of collateral.

The inadequacies of using current financing requirements as a proxy for credit costs have been recognized for years. But the pressures to misstate true long-run governmental costs are greater now than before because of constraint on the unified budget deficit by the Balanced Budget and Deficit Control Act of 1985. For credit programs, this constraint has created an incentive to substitute programs with low first-year or off-budget financing requirements for high first-year on-budget financing, without reducing the real cost to the government and without changing the substance of the program.

Proposals have been offered recently, for example, to convert direct loans into equivalent guaranteed loans; to sell loans to private

investors with recourse and other types of guarantees; to switch borrowers with 100 percent federal guarantees from the Federal Financing Bank (FFB) to private lenders; and to convert agency debt into agency "equity". These types of budget manipulation are possible because the budget focuses on the financing costs of credit assistance rather than the subsidy cost.

#### SUBSTITUTING SUBSIDY COST FOR FINANCING REQUIREMENTS

If individual credit programs were charged in the budget for the subsidy conveyed rather than for current financing requirements, the budget would permit comparisons between the real cost of credit and the cost of other forms of assistance, including grants. Moreover, such a change would transform the incentive to reduce first-year financing requirements into an incentive to reduce true, long-term subsidy costs.

The subsidy cost of a credit transaction is the net, long-term loss to the government on the transaction. Suppose, for example, that the government advances \$100 in exchange for a promise to pay that amount. Suppose also that, because of the low interest rate charged, the substantial administrative costs of debt service and collection, and the high probability of default, the loan has a private market value of only \$65. In that case, the loss or subsidy cost to government is \$35,

and the substitution of true subsidy cost for first-year financing requirements would reduce the reported cost of the loan in the budget from \$100 to \$35.

For guarantees, the actuarial value of insurance provided by the government could be \$100 for which government might charge no fee. If so, the subsidy cost of the guarantee is \$100. Substituting subsidy cost for financing requirements in the case of guarantees will raise the reported first-year cost of guarantees, and in this particular case, the reported cost would rise from \$0 to \$100.

The Office of Management and Budget (OMB) estimates that the subsidy cost for federal direct loans obligated and guarantee commitments extended in 1985 was about \$16 billion compared with a financing requirement cost of \$28 billion. The financing requirement, therefore, exceeded 1985 credit subsidy cost by \$12 billion. For 1984, OMB estimates that subsidy costs were about \$15.7 billion compared with the financing requirement cost of \$6.3 billion. Thus, credit costs were understated by \$9.4 billion in 1984.

### PROPOSED SOLUTIONS

Having gone to some lengths to point out the current failings of the cash-based unified budget in treating credit transactions, I wish to

emphasize that I regard the retention of such a budget as indispensable. The Congress, the Treasury, and the public need to know the overall magnitude of the government's fiscal operations as well as how this activity is financed. Fortunately, the major proposals for substituting subsidy cost for financing requirements are fully consistent with a cash-based, unified budget.

### The Market Plan

S.2142 would preserve the comprehensiveness and cash basis of the unified budget and substitute subsidy cost for financing requirements by the competitive sale to the public, without recourse or other guarantees, of newly originated loan assets. Such sales would produce a market valuation of the asset acquired by government in exchange for a cash disbursement. In addition, these sales would generate offsetting receipts, which when netted from amounts disbursed would yield an exact measure of both subsidy costs and government financing requirements. Thus, the Market Plan substitutes subsidy costs for financing requirements by forcing the subsidy and only the subsidy to be financed. All subsidies would be charged to credit agencies, which would require appropriations to finance them.

To address the understatement of guarantee cost and avoid creating an incentive for the conversion of all direct loan programs into guarantees, S.2142 could also require the reinsurance of all

guarantees with private entities. By this means, the Market Plan would force the subsidy cost of guarantees to be financed. This option would work efficiently only if a competitive private reinsurance market evolved quickly. To the extent that development is expected to lag, some phase-in may be necessary. Moreover, a few areas may exist in which a market might not develop at all because private insurers may encounter considerable difficulty in identifying risks and in diversifying these risks.

The Market Plan is the most direct means of accounting for subsidized credit transactions in a cash-based budget. It achieves the desired objective of recognizing the amount of government assistance provided by means of a competitive sale of the assets acquired and reinsurance of risks. The Market Plan also minimizes the government's cost of assigning values to assets and liabilities. Further, the Market Plan provides (through a desire to maximize loan sale prices and to minimize reinsurance costs) keen incentives for standardizing credit contracts and improving record keeping for loans and guarantees.

Standardized loan agreements and improved record keeping are essential to the development of secondary markets for government-originated loans. Such markets reduce interest costs by reducing liquidity risks. Where secondary markets are slow to develop, some



transition may be useful in assuring that government receives the best possible price for these loans.

### The Appropriations Plan

This approach was taken in the recently introduced S. 2428 and separates subsidy costs from first-year financing requirements. It would do so by consolidating all separate revolving funds into one central, actuarially-sound revolving fund for credit activities within the Department of Treasury. All direct loan disbursements and guarantee payments would be charged to this fund. Similarly, all loan repayments and fees would be credited to this fund. Existing credit agencies would continue to operate the credit programs, but they would be required to pay (with appropriated funds) the subsidy costs of these activities to the central loan fund. As with the Market Plan, these subsidy cost payments would be shown in the budget as outlays of the credit agencies. The residual unsubsidized financing requirements would be charged to the revolving fund rather than to the credit agency.

A crucial element in the success of the Appropriations Plan will be the ability of the central loan fund to assess the value of various credit instruments accurately and at reasonable costs. The fund staff would be greatly aided in this effort by the sale of some loans and the commercial reinsurance of some credit risks. Over time, as market

acceptance increased, the loan fund might increase the proportions of loan assets sold and guarantees reinsured. In this manner, the Appropriations Plan could provide a transition vehicle to the Market Plan.

## CONCLUSION

The current budgetary treatment of federal credit assistance is inadequate in that it fails to provide the Congress and others with a timely measure of the real cost of current activity. As the nature of this failure has become more apparent and budgetary pressures more intense, it has become increasingly difficult to avoid exploiting this failure. Both the Market and Appropriation Plans provide a solution through the substitution of subsidy costs for current financing costs. The choice between these proposals probably hinges on one's relative confidence in market and nonmarket pricing mechanisms and the speed with which one believes the market can adjust to these new financial instruments.