Statement of

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Subcommittee on Federal Credit Programs
Committee on Banking, Housing, and Urban Affairs

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Mr. Chairman, I am pleased to appear before this Subcommittee and present the report we have prepared at your request--New Approaches to the Budgetary Treatment of Federal Credit Assistance. This paper explores options for improving the quality of budget data and for facilitating comparisons of cost among credit programs and between credit and direct spending. The paper describes the current budget treatment of government credit activity and its weaknesses. It details current practice through an examination of nine, highly diverse revolving funds and government financial corporations. The paper then describes four, not mutually exclusive, accounting and operating changes that would correct, in whole or part, current exclusions and other misstatements of federal credit cost. On grounds of comprehensiveness, timeliness, and comparability of budget costs, each of these approaches is superior to the current budget treatment of federal credit assistance.

I will not attempt to summarize this report fully in my statement. Instead, following your request, I will focus on the shortcomings of the current approach to budgeting for federal credit and on one possible solution to these shortcomings, the so-called "Market Plan." All of the approaches in our study share a common objective: to enable the budget to depict clearly the subsidy costs of federal credit activity. Under current practice, in the absence of this information, some high-subsidy programs occasionally appear to cost very little, while low-subsidy programs may appear to be very

costly. Moreover, these apparent costs may be subject to manipulation. But whether willfully misstated or not, current cost numbers are frequently misleading.

I would also briefly reiterate my support for one reform measure described in the paper--the "FFB Plan." This proposal would require the activity of the Federal Financing Bank (FFB) to be included in the budgets of the originating agencies. My first Senate testimony as Director of the Congressional Budget Office (CBO) was before this Subcommittee on the subject of the FFB. At that time I supported the enactment of such legislation. The current study concludes that this change should be implemented regardless of what action is taken on the other reforms.

SHORTCOMINGS OF CURRENT PRACTICE

If the Budget of the United States is to serve Congressional decision-making efficiently, budget documents must be complete and accurate. At present, the budget treatment of federal credit activity is unsatisfactory because it is neither comprehensive nor successful in representing the subsidy costs of credit assistance. Some activity is excluded by statute; some by accounting convention. Large errors in the assignment of budget

costs to credit also arise because net cash outflow (roughly, disbursements less repayments) is used as the measure of budget cost.

Exclusion. This Subcommittee is aware of the extent to which the off-budget status of some agencies--notably the Federal Financing Bank and the Rural Electrification and Telephone Revolving Fund (RETRF)--results in an understatement of the volume of federal credit activity. The understatement is compounded by treating agency borrowing from the FFB through sales of certificates of beneficial ownership as an offset to outlays. On-budget agencies can also use the off-budget status of the FFB to reduce reported loan activity by guaranteeing loans that are then financed by the FFB.

In 1983, $10.5 billion in federal government net lending was excluded through these means from the unified budget--a document explicitly designed to be a comprehensive statement of outlays and receipts. S. 2213, based on the work of this Subcommittee and introduced by Senator Trible, would do much to correct the budget by moving credit activity from off-budget status to the budget accounts.

Inappropriate Measure of Cost. A budget made more comprehensive by such reform would, however, still suffer from the absence of spending-equivalent subsidy measures of credit cost. Net lending would continue to

be recorded rather than the subsidy inherent in these activities. No subsidy measure would be available for comparing and making tradeoffs between one federal credit program and another or between credit and spending programs.

ILLUSTRATIVE EXAMPLES

One way of demonstrating that net cash outflow or net outlays is a poor measure of credit subsidy costs is to examine specific cases. Consider, for example, three Agriculture Department programs.

- The Agricultural Research Service (ARS) performs research and demonstrations to promote safer and more abundant agricultural production. It provides assistance by spending rather than by lending federal monies.

- The Rural Housing Insurance Fund (RHIF) of the Farmers Home Administration is a revolving fund that makes loans at below-market interest rates for individual home ownership and for rental housing. It provides assistance through loans.

- The Rural Electrification and Telephone Revolving Fund is an off-budget fund that provides investment financing assistance to electric and telephone cooperatives by making direct loans at 5 percent interest and by guaranteeing FFB loans at government interest rates.

Budget documents show the outlay costs of these three programs for 1983 to have been: the Agriculture Research Service, $460 million; the Rural Housing Insurance Fund, $1.8 billion; and the Rural Electrification Fund (minus) -$2 million.

For the Agricultural Research Service, the interpretation of budget cost is straightforward. The Service spent $460 million dollars for personnel, travel, supplies, and equipment in 1983. From a fiscal point of view, the resources allocated to ARS have been consumed and are no longer available. Put another way, all of the spending for ARS reflects the value of services the government provides to farmers.

The $1.8 billion in net outlays made by the Rural Housing Insurance Fund is not directly comparable to ARS outlays. As shown in Appendix Table 1, the Fund's net outlays reflect the cash outflow of a revolving fund that makes loans, pays interest, refinances debts, receives payments, and makes other miscellaneous disbursements. Net cash outlays indicate only

the current financing needs of the Fund. The subsidy costs comparable to ARS outlays consist of the Fund's losses from default, interest subsidies, administrative expenses, and other costs attributable to the $3.0 billion in loan obligations the Fund extended in 1983. These are the costs that reflect the value of services provided, but they are not available in the budget documents or from the agency. Instead, the budget records repayments and financing expenses for old loans. These cash flows do, indeed, play a large role in determining net outlays for the Fund, but they are simply asset transfers that do not constitute services provided by current year loan obligations. In sum, the budget accounts for the Rural Housing Insurance Fund contain a great deal of information, but it is of little use in determining the subsidy provided by the assistance programs contained in this account.

The third illustrative account is the Rural Electrification and Telephone Revolving Fund. This Fund reported a $2 million net cash inflow or surplus in 1983. If this figure is accepted as comparable to either the spending cost of the Agricultural Research Service or to the net outlay cost of the Rural Housing Insurance Fund, then the Rural Electrification Fund's operations were profitable and a source of financing for the federal government. Given that the Fund was making loans at 5 percent interest during 1983 when the Treasury's borrowing rates were about 10 percent, and issuing guarantees to cooperatives without charging a premium for doing so,

there is no way the Fund could have been profitable in an economic sense. "Earnings" emerge from the Fund because:

- Financing for $850 million in new direct loan obligations was provided in part by repayments of principal and interest and "sales" of certificates of beneficial ownership to the FFB (See Appendix Table 2);

- A cost of zero is assigned to contingent guarantee liabilities and no funds are set aside to meet potential claims in the event of default; and

- The Fund has a $7.9 billion loan from the Treasury on which it pays no interest.

Under present budget accounting, the spending-equivalent or subsidy cost of current direct loan or loan guarantee activity cannot be determined from the budget documents. This puts the Congress in a difficult position for budget purposes. Either the net financing requirements of a revolving fund are used inappropriately as the measure of spending-equivalent cost or one is left without any cost measure.

REFORM APPROACHES

In the study being released today, CBO identifies several budget reforms that would improve the quality of budget cost data for credit programs. These include the Market Plan, which you asked me to focus on in these remarks; the FFB Plan, which I have already referred to; and the so-called Add-on and Appropriations Plans.

The Add-on Plan would simply require agency estimates of credit subsidy costs to be attached to Budget Appendix statements, reports to the Appropriations Committees, and CBO cost estimates. The Appropriations Plan would further require agencies to pay estimated credit subsidies into a National Loan Fund, which would take over the financing of loans and guarantees on an actuarially sound basis. Annual appropriations would be required to enable the agencies to make these payments into the Loan Fund. The Market Plan uses a different technique for valuing credit subsidies. It requires the National Loan Fund to sell agency-originated loans and to reinsure agency guarantees and insurance with commercial suppliers. The subsidy cost of a loan under the Market Plan is the difference between the amount advanced and the amount recouped by the sale of the loan. Similarly, the guarantee subsidy is the difference between the commercial guarantee premium and the borrower's guarantee fee, if any.

The logic of all these reforms is that the spending-equivalent cost of credit assistance is the subsidy conveyed by direct loans and guarantees. The subsidy is the full cost of the loan or guarantee less the amount paid by the borrower. An assumption of the Market Plan is that the full cost of a credit transaction may be observed in competitive financial market prices. If, for example, the market rate of interest on a loan is 18 percent and the government charges 5 percent, the subsidy is 13 percent of the balance per year as long as the loan remains outstanding. Because the government commits itself to continue the subsidy for the life of the loan, it is necessary to determine the present value of the subsidy and to recognize this cost at the time of obligation, which is when the commitment is subject to control.

The Market Plan obtains a direct measure of the present value of loans and guarantees at the time of commitment by requiring the prompt sale of loans and the reinsurance of risks. In contrast, the Add-on and Appropriations Plans would require government analysts to estimate the market value of the loan or guarantee. In all cases, the difference between the amount advanced and the market or estimated price of a loan is the present value of the loan subsidy. Similarly, the difference between the fee paid or estimated for reinsurance and the fee collected from the borrower is the present value of the guarantee subsidy. These subsidy costs would appear in

the accounts of every credit program and necessitate annual appropriations under the Market Plan.

For example, had the Market Plan been in effect in 1983, the Rural Housing Insurance Fund, would have been required to sell the $3 billion in new loans originated that year. Based on the Office of Management and Budget's (OMB's) subsidy estimate for rural housing, the market value of these loans would be about $1.3 billion. The Fund would have had to cover the loss on this sale with appropriated funds. Thus for 1983, the spending-equivalent cost of the Fund would be $1.7 billion or somewhat less than the $1.8 billion shown as net cash outlays.

The Market Plan would have had a sharper effect on the reported cost of the Rural Electrification Fund. Again, accepting OMB's subsidy estimate, which in this case is 50 percent of the amount loaned, and assuming a 6 percent reinsurance fee for guarantees, the Fund's $1.1 billion in loans had a subsidy cost of $550 million. Insurance for the $3.1 billion in new guarantees would have cost an additional $186 million, for a total subsidy cost of $736 million instead of the $2 million cash flow surplus reported. 1/

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1. In fact, RETRF guarantees are currently financed by FFB. This effectively converts these guarantees into direct loans.

The Market Plan also envisages the sale of the existing portfolio of government loans and the reinsurance of existing outstanding guarantees. Such a step would prevent the confusion caused by the simultaneous use of two budget accounting approaches: one for old loans and another for new loans and guarantees.

The principal objective of all four plans would be to improve the value of budgetary data in the decision process. Nonetheless, given the size of the present and projected deficits, the effect of these plans on the budget is certain to be an issue. Adoption of the Market Plan would lower the unified budget deficit and require less borrowing by the Treasury. But the sale of loans by the government would absorb credit, thereby offsetting many of the effects on private credit markets. Consequently, little economic significance should be attributed to this reduction.

Drawbacks to implementing the Market Plan include uncertainty about the ability of markets to absorb loans originated by the government and to reinsure risks assumed by government under current policy. Some programs--for example, foreign military sales credits--are routinely forgiven. These loans would have a market value of zero. Other loans such as Commodity Credit Corporation price support loans are also strangers to U.S. credit markets. In addition, some loans might be priced too low and insurance too high, if loan contract terms are not well specified, if financial

markets are highly specialized and dominated by a few firms, or if government has some advantage in diversifying risks. Over time, one would expect competition for excess profits to improve offer prices, but the speed with which improvement would take place is difficult to foresee.

More generally, the Market Plan would be easier to implement for some federal credit progams than for others. In some cases, evaluations might be obtained better by nonmarket appraisals. This would be especially appropriate for programs that are:

- Very small and for which secondary markets are not expected to develop;

- Used to finance high-risk enterprises whose collateral is highly specialized; and

- Providing credits that are not expected to be repaid.

These reservations about the Market Plan should not be interpreted as opposition but rather as cause for addressing the difficulties of transition from the current, unsatisfactory approach to one that is not perfect, but has many appealing features. Improved budgeting for federal credit is necessary for the Congress to address rationally the allocation of the government's and

the nation's scarce resources. Without knowledge of cost--or amount of resources consumed--by a particular course of action, informed choice is impossible. Without a measure of the subsidy cost of credit, the Congress has little hope of selecting a budget that will maximize public benefits.

APPENDIX TABLE 1. RURAL HOUSING INSURANCE FUND

A. Program and Financing Statement, Fiscal Years 1982 and 1983
(In millions of dollars)

Obligations	1982	1983	Financing	1982	1983
Loans	3,580	2,951	Repayments	905	2,473
CBO purchases	2,525	2,718	Interest received	1,167	
Interest on CBOs	2,516	2,878	Sale of CBOs	5,170	4,440
Other expenses	645	470	Other receipts	50	9
	9,266	9,017		7,292	6,922

	1982	1983
Net obligations deficit:	1,974	2,095
Net cash outlay:	1,246	1,828

B. Balance Sheet, End of Fiscal Year
(In millions of dollars)

Assets	1982	1983	Liabilities and Government Equity	1982	1983
Balance with Treasury	267	27	Debt to Treasury	2,241	2,621
Accounts receivable	240	255	Accounts payable	1,267	1,360
Loans	432	325	Other liabilities	282	357
Real property	300	379	Government equity	-2,550	-3,351
	1,239	987		1,240	987

	1982	1983
Contingent liability for guarantees outstanding:	24,986	26,671
Portion of guarantees outstanding to FFB:	23,921	25,676

SOURCE: Budget of the United States Government, Appendix, Fiscal Years 1984 and 1985.

APPENDIX TABLE 2. RURAL ELECTRIFICATION AND TELEPHONE REVOLVING FUND

A. Program and Financing Statement, Fiscal Years 1982 and 1983
(In millions of dollars)

Obligations	1982	1983	Financing	1982	1983
Interest expense on CBOs	213	254	Loan repayments	389	750
Electrification loans	850	850	Interest income	327	
Telephone loans	249	251	Sale of CBOs	528	344
Other	8			1,244	1,094
	1,321	1,355			

	1982	1983
Net obligations deficit:	76	261
Net cash outlay (surplus):	(0.2)	(2)

B. Balance Sheet, End of Fiscal Year
(In millions of dollars)

Assets	1982	1983	Liabilities and Government Equity	1982	1983
Loans	9,745	9,848	Debt to Treasury	7,865	7,865
Other assets	412	425	Other liabilities	1	
	10,157	10,273	Government equity	2,292	2,408
				10,157	10,273

	1982	1983
Contingent liability for guarantees outstanding:	20,125	23,268
Portion of guarantees to FFB:	19,404	22,406

SOURCE: Budget of the United States Government, Appendix, Fiscal Years 1984 and 1985.