Statement of

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Madam Chairman, I am pleased to appear before this Subcommitee today to discuss the status of the Rural Electrification and Telephone Revolving Fund of the Rural Electrification Administration (REA). The Congressional Budget Office (CBO) has analyzed the current financial status of the fund and its prospects over the next 25 years. Our analysis deals only with the adequacy of the fund's resources under various economic, programmatic, and legislative assumptions. We have not assessed the merits of REA's loan program or made any judgments about the appropriate long-term lending levels. My testimony covers three areas:

- o The historical background of the REA revolving fund;
- o The financial status of the fund; and
- o Options for maintaining the fund's solvency.

BACKGROUND

Some historical background is useful in understanding the fund's current condition. Since REA's creation in the 1930s, a major objective has been to ensure that rural cooperatives would have access to the financing needed to provide utility service in rural areas. Initially, interest rates paid by borrowers varied with the government's interest costs. In 1944, the Congress set interest rates on REA loans at 2 percent, which was slightly

above the government's cost of borrowing at that time. In 1973, the revolving fund was established, and the standard loan rate was set at 5 percent--this time slightly below the government's borrowing costs. The Congress provided seed money for the fund, by allowing principal and interest on $7.9 billion in then outstanding loans to be repaid to the fund, instead of to the Treasury. Because the fund is not required to pay any interest on the $7.9 billion, the interest receipts on those loans have provided continuing income for the fund. In addition, the principal repayments have been available to make new loans. The $7.9 billion is to be repaid to the Treasury over a 25-year period, beginning in 1993.

The fund's lending levels are set each year in an appropriation bill, with both minimum and maximum levels specified. If necessary, the fund can borrow from the Federal Financing Bank (FFB) to finance new loans, with interest set at one-eighth of 1 percent above the Treasury borrowing rate and the principal to be repaid in thirty years.

FINANCIAL STATUS

Now, 11 years after its establishment, the fund is on a path towards insolvency. It makes about $1.1 billion in loans each year and finances about 40 percent of them by borrowing from the FFB. Virtually all of these loans are made at a 5 percent interest rate, while the fund has borrowed from the

FFB at an average rate of 11.4 percent. As a result, the fund's interest expenses are increasing faster than its interest income. Consequently, no earnings will be generated for the repayment of the $7.9 billion owed to the Treasury.

At some point in the future, something will have to change. Either lending activity will have to be drastically reduced, or additional resources will have to be provided to the fund. Otherwise, the fund will default on some of its outstanding obligations to the Treasury or the FFB.

Based on CBO's current economic assumptions, we have assumed that the fund would borrow from the FFB at an interest rate varying between 10.6 percent and 11.4 percent between now and the year 2010. At that borrowing rate and if loan levels are maintained at the current $1.1 billion per year with adjustments for inflation, the fund would be unable to meet its outstanding obligations by the year 2002. If no additional resources are provided to the fund, REA would have to make virtually no new loans beginning in 1990 in order to avoid a shutdown in 2002 and meet the fund's obligations at least through the year 2010.

The timing of these events is very sensitive to interest rates. The fund's difficulties will occur sooner if rates are higher, and later if rates are lower than those we have assumed. It would take a borrowing rate close to 5 percent to ensure the long-run viability of the fund.

The fund's problems obviously stem from the current structure of the REA loan program. Because market interest rates far exceed those charged by REA, the fund is now a source of substantial interest subsidies to rural electric and telephone cooperatives. The gap between the 5 percent loan rate and recent borrowing rates from the FFB has eroded the fund's capital, and this process is almost certain to continue for the forseeable future. For example, at the beginning of fiscal year 1984, a total of $3.5 billion in REA loans was financed by borrowing from the FFB. The difference between interest received and interest paid on those loans is about $240 million a year. This loss will rise each year as borrowings increase.

OPTIONS

Under these circumstances, if the Congress wishes to maintain REA's loan program, it has two basic options to secure the fund's solvency. It can provide additional federal resources to the fund to pay for its continuing losses, or it can increase payments to the fund from borrowers by raising interest rates.

Provide Federal Subsidy

If interest rates are not high enough to make the fund self-supporting, the government will have to provide some form of subsidy. Federal funds

can be used to cover REA losses in a number of ways, including annual appropriations or less frequent, but larger infusions of funds. However, as long as lending rates remain at 5 percent, the fund will remain a distributor of subsidies, and the Congress must choose the mechanism to pay for those subsidies. The fund cannot be "self-sufficient" under these circumstances.

From a budgetary point of view, it is desirable that the subsidy cost of an activity be explicitly recognized in the budget, at a time when the cost is still controllable--that is, before the funds are committed to the recipient. This suggests that a preferred means of providing subsidy funds would be through an annual appropriation to cover interest subsidies implicit in the loans to be obligated in the current year. A recent CBO report, _New Approaches to the Budgetary Treatment of Federal Credit Assistance_, includes several procedures that would achieve this result.

A number of other mechanisms are also available for providing additional resources to the fund. Some of them, however, are neither explicit nor timely, and thus limit the Congress's ability to make informed decisions about the subsidy amounts. These include, for example, the conversion of Treasury debt to equity; interest-free loans to the fund; or the shifting of interest losses to the FFB by permitting the fund to refinance its debt if interest rates drop. Such hidden subsidies hinder Congressional oversight and budgetary control over lending programs by obscuring the true

cost to the government. These mechanisms may also be of limited use to the fund. For example, converting the $7.9 billion liability to equity would not, by itself, enable the fund to meet its obligations. As another example, allowing the fund to refinance when market rates fall would provide the greatest benefits to the fund when its needs would be least--that is, when interest rates were low--and the smallest benefits when its needs would be greatest.

All these options would result in costs to the federal government. While they would differ in their effects on the unified budget, they would all increase the federal deficit and the public debt at some point in the future by making it possible for REA to maintain its lending activity. This would increase federal outlays over the level that would otherwise occur.

Raise Interest Rates

The major alternative to ongoing subsidization of the revolving fund is to change the interest rates charged to borrowers--currently 5 percent for most loans and 2 percent for hardship and certain other special cases. A return to the original policy of charging the government's cost of borrowing would eliminate losses on future loans, though losses on outstanding loans would continue. Because the fund has the use of $7.9 billion in capital at no interest cost, such an increase in interest rates would generate sufficient

earnings to compensate for past losses and to pay the $7.9 billion owed to the Treasury. This could be accomplished even if, in special cases, a portion of the loans were made at less than the government's cost.

Interest rates could be set at other levels--for example, to balance interest income and expenses on future loans. But this approach would require an infusion of funds to cover losses on the existing portfolio. Of course, any increase in the interest rates charged would raise the costs of rural cooperatives and affect the rates charged to consumers.

S. 1300

S. 1300, now before this Subcommittee, represents one combination of these different approaches. Under the bill, the interest rate on loans to cooperatives for a given year would be set to cover the average interest cost of the REA funds used to finance those loans--calculated by combining FFB borrowings (at the full interest cost) with the fund's other capital (at no interest cost). The federal government would provide capital by forgiving the fund's obligation to repay the $7.9 billion owed to the Treasury, and by allowing REA to refinance its outstanding borrowings from the FFB if current interest rates fall 1 percent below the rate on those notes.

Repealing the fund's liability to the Treasury would increase the amount of funds available for loans to cooperatives. It would also have the effect of moderating the increase in interest rates paid by borrowers under this bill, because it would increase the interest-free capital in the REA fund. Under the interest rate formula in the bill, this would reduce the average interest cost associated with any year's loans.

The provision allowing the fund to refinance its FFB borrowings would have relatively little impact under the CBO assumptions, because our assumed interest rates would not trigger much refinancing. Greater savings to the fund would occur if interest rates are lower. For example, if future Treasury rates were assumed to be about 6 percent, the fund's interest payments to the FFB would be reduced by an additional $4 billion. Such savings to the fund would shift losses to the FFB.

The resources provided by S. 1300 would enable the fund to maintain current lending levels in real terms over the 1985-2010 period. The bill would raise interest charged to the fund's borrowers, but the rates would remain below projected FFB borrowing costs. This would increase the fund's receipts, but, under our economic assumptions, the fund's interest expenses would overtake its interest income before the year 2010. Thus, the fund would need another infusion of resources at some point in the future, because these interest losses would erode the fund's assets.

In total, under CBO's economic assumptions, the bill would increase the combined on- and off-budget deficits by a total of $10.4 billion over the 1985-2010 period--by providing the resources for REA to maintain its current lending levels, adjusted for inflation, throughout the period.

Madam Chairman, this concludes my statement this morning. More details on this analysis appear in CBO's cost estimate of S. 1300. I will be happy to answer any questions you or the Members of the Subcommittee may have.