Statement of
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before the
Committee on the Budget
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NOTICE
This statement is not available for public release until it is delivered at 2:00 p.m. (EST), on Wednesday, March 4, 1987.

Mr. Chairman, I am pleased to have the opportunity today to discuss the Administration's credit reform proposals. CBO agrees with the Office of Management and Budget that there are serious shortcomings with the current budgetary treatment of federal credit programs that need to be addressed. Furthermore, we believe the Administration's proposal makes a great deal of sense--namely, to substitute the subsidy cost of credit programs for the cash flows now shown in the budget. A concern that we have with this proposal, however, is that it does not go far enough.

In particular, the Administration's plan deals only with future credit activities. It would not eliminate the distortions in the budget from selling or refinancing loans made in previous years. One way of preventing this abuse of the current cash-based accounting system, which I will discuss this afternoon, is to reclassify federal credit disbursements, repayments, recoveries, and loan sales as a means of financing in the federal budget.

SHORTCOMINGS OF CURRENT TREATMENT

As discussed in the 1987 Annual Report of the Congressional Budget Office (CBO) and in the CBO Analysis of the President's Budgetary Proposals for Fiscal Year 1988, the current budgetary -treatment of federal credit activities gives a misleading picture of program costs and can distort the federal deficit. These dificulties arise because cash-based accounting, designed to capture the cost of spending programs, is ill-suited to credit activity, which necessarily involves the exchange of cash now for promises to pay cash in the future.

Under current, cash-based accounting, when a loan by the federal government is disbursed to a borrower, the full amount is scored as outlays just as if the loan were a grant. This treatment overstates true cost because it ignores the repayments that the federal government expects to receive in the future. On the other hand, repayments are scored as offsetting collections when received. As a consequence of the netting of disbursements and repayments, if repayments from old loans equal new disbursements, credit agencies may show net lending of zero in a year in which a large volume of deeply subsidized loans were originated.

Similarly, loan guarantees have no outlays until a default occurs. The substantial delay between commitment and outlays for guarantees results in an understatement of the costs of new guarantees in the year in which the government commits itself to this liability. Cash-basis treatment also requires that the current year budget accounts show current year guarantee fees as offsetting collections in the year received and current disbursements to honor old guarantees. This information is not useful to the Congress in assessing the cost of current guarantee activity.

A GENERAL SOLUTION

The current treatment of federal credit programs fails to produce useful information because current year cash flow is an inappropriate measure of new direct loan and guarantee cost. Cash flows are often incidental to and separated by time from the delivery of the subsidy. Instead, it would be more informative if the budget included a grant-equivalent measure of the

costs of all current period loan obligations and guarantee commitment entered into in that year. Subsidy cost--or the present value of future defaults, interest losses, capital costs, and administrative expense--is such a measure. Specifically, outlays would more closely approximate long-run costs and the deficit would not be distorted by incidental monetary flows associated with credit if current period outlays:

- Included the subsidy cost of new direct loans and new guarantees but

- Excluded new loan disbursements, repayments from old and new loans, receipts from the sale of old loans, and disbursements to meet guarantee commitments.

This observation is not new. The President's Commission on Budget Concepts recommended in 1967, for example, that only the subsidy elements in federal loans be included in the expenditure portion of the budget.

THE ADMINISTRATION'S PROPOSAL

The Administration's credit reform proposal represents a major step toward improving the budgetary treatment of credit programs by highlighting subsidy costs. Credit subsidy costs of new credit activity would be reported in the agency budget accounts, and the associated cash flows for new loans and guarantees would be included in the account of a new revolving fund in the Treasury. Agencies operating federal credit programs would request

annual appropriations equal to the amount of subsidy to be provided to borrowers during the fiscal year. As loans are originated and guarantee commitment issued, agencies would pay the estimated subsidy value of those credits to the central revolving'fund from these appropriations. The central fund would disburse loans and make guarantee payments, financing these outlays with subsidy payments from the agencies and with borrowing from Treasury.

Subsidy cost is defined as the additional payments a borrower would have had to make for a fully private, rather than a government-assisted, loan. The size of the subsidy can be estimated either by sampling market interest rates and performing the calculations or, more directly, by making and then selling loans, and by reinsuring guarantees with private insurers. For loan sales and reinsurance, the subsidy cost is the government's loss on the transaction: for loans, the amount advanced less the sale price; for guarantees, the insurance fee paid to the insurer less the fee collected by government from the borrower.

The Administration proposes that subsidy cost estimates be obtained both by calculation and by sales and reinsurance. Loans that could be readily sold would be marketed to investors. Where private credit insurance is available, the government would reinsure its risk. For loans regarded as unsuitable for sale, such as those to foreign countries and for uninsurable guarantees, the central fund would calculate the subsidy and charge the agencies that amount.

A CBO CONCERN

CBO's principal concern about the Administration proposal is that it does not go far enough in protecting the budget from artifical cash-flow distortions. In particular, the proceeds from sales and refinancing of existing loans--those originated before credit reform--will still be scored as deficit reductions under current budgetary practice. The reason the proceeds will be offsetting collections is that they represent accelerated repayments that would have been so treated. The budget deficit, which presumably measures changes in the government's financial condition, should not be affected, however, by the receipt of repayments already expected or induced prepayments of existing loans. As Martin Feldstein testified before this committee last week, asset sales are not deficit reduction. Further, as both Feldstein and Alan Greenspan noted, the sale of assets has essentially the same effect on credit markets as the sale of an equal amount of government bonds. The Administration's proposal for loan asset sales from the existing loan portfolio--as distinguished from credit reform--is projected to reduce the deficit more than $5 billion in 1988.

The Administration's plan also would permit deficit reductions to be achieved through the conversion of direct loans into guarantees and through refinancings of existing loans with federally guaranteed private loans. If, for example, a direct loan program were to be replaced by an equally subsidized loan guarantee, no subsidy cost saving would be achieved but the cash-based deficit would be reduced by the switch in the form of credit assistance. Similarly, refinancings of existing loans which resulted in

prepayment of the loans would be scored as deficit reduction under current policy and under credit reform.

THE MEANS OF FINANCING APPROACH

One way to immunize budget outlays and the deficit from the distorting effects of repayments, existing guarantee disbursements, asset sales, and switches from direct loans to guarantees would be to include subsidy cost in the agency accounts, as the Administration has proposed, and to reclassify all credit cash flows as a means of financing the deficit. Under current conventions, the deficit is considered to be financed by changes in Treasury balances, changes in checks outstanding, seigniorage on coins, and borrowing from the public. The means of financing portion of the budget could be defined to include all credit cash flows on the grounds that repayments and loan asset sales (net of disbursements) are sources of cash financing for the budget.

The consequences of such an expansion of the means of financing section for the budget deficit are illustrated in the attached table, which uses data from the President's proposed budget for 1988. For example, the first line of the table shows the cash-based deficit, $212.3 billion in 1985. Then, it adds subsidy cost, which is the objective of credit reform. Next, net loan disbursements, which inappropriately increase budget outlays and the deficit, are subtracted. Similarly, loan sale receipts are added to the deficit because they have been used to reduce inappropriately the cash-based deficit. In our view, the adjusted deficit is a more meaningful measure of the changes in the financial condition of the government.

TABLE 1. EFFECT OF RECLASSIFYING CREDIT CASH FLOWS AS A MEANS OF FINANCING, 1985-1986 ACTUALS AND THE PRESIDENT'S PROJECTED AND PROPOSED BUDGETS, 1987-1988 (By fiscal year, in billions of dollars)

	1985	1986	1987	1988
Cash-based Deficit	212.3	220.7	173.2	107.8
Credit subsidy cost	16.3	16.9	15.0	12.7
Loan disbursements (including outlays for guarantees, net of repayments, recoveries, and fees)	-32.5	-15.2	-15.0	-10.6
Loan sale receipts (less reinsurance premiums paid)	1.5	1.6	6.0	6.6
Adjusted Deficit	197.6	224.0	179.2	116.5
Means of Financing				
Credit subsidy cost	16.3	16.9	15.0	12.7
Loan repayments (net of disbursements, guarantee outlays, recoveries, and fees)	-32.5	-15.2	-15.0	-10.6
Loan sale receipts (less reinsurance premiums paid)	1.5	1.6	6.0	6.6
Means of financing- other than borrowing a/	15.0	-15.6	10.9	1.0
Borrowing from the Public	197.3	236.3	162.3	106.8
Total	197.6	224.0	179.2	116.5

SOURCE: Congressional Budget Office.

NOTE: Excludes Commodity Credit Corporation price support loans from credit; and also excludes subsidy cost for GNMA secondary guarantees. Details may not add to totals because of rounding.

a. Includes changes in Treasury cash balances, checks outstanding, accrual of interest payable on Treasury debt, profit on sale of gold, and seigniorage on coins.

Below the dotted line, the table shows how the adjusted deficit is financed. The cash deficit, which includes the disbursements for credit, may be considered to be financed exactly as it is now--by changes in fund balances, checks outstanding, seigniorage, and borrowing from the public. Subsidy costs that have been recognized but not yet paid and the receipts from loan asset sales provide the residual means of financing for credit activity, not financed by other means.

Notice that borrowing from the public is not affected by this reclassification. That is a sensible result inasmuch as no real change in activity results from a mere accounting change.

The budgetary consequences of this reclassification are significant, however. The deficits for 1987 and 1988 using the President's budget figures increase by $6.0 billion and $8.7 billion, respectively. Adding in other CBO reestimates of the President's budget, the deficit for 1988 would be in the neighborhood of $142 billion using this means of financing classification. If this accounting convention were adopted, therefore, some revision of the deficit targets in the Balanced Budget Act might be necessary.

Reclassifying the cash flows from federal credit assistance as a means of financing effectively protects the budget from distortion by disbursements, repayments, and loan asset sales. In addition, this change will assure that if loan asset sales are carried out, it will be for programmatic reasons rather than artificial "deficit reduction."

Notice that precedents exist under cash basis accounting for the recognition of costs not yet paid and for the inclusion of these costs in the means of financing section of the budget. Both OMB and CBO include the accrual of interest payable on Treasury debt in federal outlays and the deficit and as a means of financing. A further expansion of the financing portion of the budget would not represent a fundamental departure from existing concepts.

In summary, by emphasizing subsidy cost rather than cash flows, the Administration's proposal for credit reform should substantially improve the usefulness of the budget in depicting the cost of federal credit assistance. Further, by reclassifying federal credit cash flows as a means of financing the budget rather than "above the line" outlays and receipts, the potential budgetary distortions from the pre-reform portfolio of loans and guarantees can be avoided. These advantages appear to be sufficient to warrant further consideration of such a reclassification.