Statement of

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Before the

Committee on Banking, Housing, and Urban Affairs
Subcommittee on Economic Stabilization
United States House of Representatives

May 24, 1984

Mr. Chairman, I am pleased to be with you this morning to discuss federal credit activities. As debtor, regulator, guarantor, intermediary, creditor, and creator of tax incentives, the federal government is a major force in the U.S. credit and capital markets. The many facets of the government's role complicate the task of understanding their effects. Despite the difficulties, it is vital to improve our understanding of the processes through which these policies work. Such understanding is a prerequisite to the measurement of these programs' effects and to improving their design. This need--clearly recognized by this Committee--is the force motivating these hearings.

My remarks today will focus on those policies involving direct loans and guarantees issued by the federal government. My testimony is divided into three parts:

- First, I will briefly review the size and recent growth of federal credit activities;

- Second, I will touch on the analytic difficulties that hamper attempts to evaluate the effectiveness of these programs; and

- Finally, I will offer some suggestions for improving the budgetary control of credit programs.

SIZE AND GROWTH OF FEDERAL CREDIT

Federal credit activity has grown significantly in the past decade. Between 1970 and 1983, annual direct loan obligations increased from $10 billion to $41 billion (see Table 1). The government's primary guarantee commitments rose from an annual rate of $27 billion in the early 1970s to $97 billion a year in 1983. Over that 13-year period, the level of outstanding loans and guarantees (which also reflect repayments and the expiration of guarantees) grew at annual rates of 12 percent and 9 percent, respectively.

At the end of 1983, more than $220 billion in direct federal loans originated by the government was outstanding. Loans made by other lenders and guaranteed by the federal government totaled $360 billion. An additional $240 billion had been advanced by privately owned government-sponsored enterprises such as the Federal National Mortgage Association, the Farm Credit Banks, and the Student Loan Marketing Association. Net lending to the public under federal auspices (that is, new loans less repayments) totaled $86.5 billion in 1983, or about 17 percent of all funds advanced in U.S. credit markets in that year. This compares with a peak federal lending participation ratio of 22.4 percent in 1980.

TABLE 1. ANNUAL AND OUTSTANDING DIRECT FEDERAL LOAN OBLIGATIONS AND LOAN GUARANTEE COMMITMENTS, BY PROGRAM TYPE, 1970-1983 (By fiscal year, in billions of dollars)

Fiscal Year	Direct Loan Obligations	Primary Loan Guarantee Commitments	Secondary Loan Guarantees	Outstanding Direct Loans	Outstanding Loan Guarantees
1970	10	27	---	51	125
1971	10	39	3	53	140
1972	19	45	4	50	159
1973	18	36	4	57	174
1974	19	29	4	61	180
1975	29	30	6	74	189
1976	30	26	9	86	201
TQ a/	6	9	3	90	200
1977	36	59	17	101	214
1978	50	55	18	120	226
1979	39	87	42	141	265
1980	45	82	64	164	299
1981	50	77	44	185	309
1982	43	54	36	208	331
1983	41	97	64	223	364

SOURCE: Congressional Budget Office, An Analysis of the President's Credit Budget for Fiscal Year 1985 (March 1985).

a. Transition quarter.

Although the General Accounting Office has reported that there are 281 active credit programs, most direct loans and guarantees are issued by just a handful of these. 1/ For example, the direct loan programs that

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1. General Accounting Office, Catalog of Federal Credit Programs and Their Interest Rate Provisions, PAD-83-12 (December 28, 1982) p. 1.

obligated more than $1 billion in 1983 (including Federal Financing Bank--FFB--direct loans based on agency guarantees) accounted for about 85 percent of total federal lending (see Table 2). In descending order of size, the seven are: Commodity Credit Corporation (CCC) price supports, foreign military sales, Farmers Home Administration (FmHA) rural housing, Rural Electrification and Telephone Revolving Fund, FmHA agricultural fund, Federal Housing Administration (FHA), and the Veterans Administration (VA). Moreover, the seven programs issuing more than $1 billion in guarantees accounted for 99 percent of the total not financed by the FFB. These are the FHA, VA loan guarantee revolving fund, low-rent public housing, Export-Import Bank, the Guaranteed Student Loan and other education programs, the CCC, and the Small Business Administration.

These programs, which account for the bulk of federal credit activity, provide assistance to farmers and other rural residents, foreign governments, rural and suburban power consumers, home buyers, investors in government-originated multifamily mortgages, public housing authorities, foreign purchasers of U.S. goods, students, and small businesses. Though it is difficult to generalize about the common features of such a diverse set of beneficiaries, one can say that, at some point in the past, each was deemed needy or worthy of credit assistance.

TABLE 2. COMPOSITION OF FEDERAL CREDIT ASSISTANCE BY MAJOR PROGRAM IN FISCAL YEAR 1983

Program	Billions of Dollars	Percent of Total
Direct Loan Obligations a/		
CCC price support loans	13.9	33.6
Foreign military sales credits	5.1	12.3
Farmers Home rural housing loans	4.7	11.4
Rural Electrification and Telephone Revolving Fund	4.5	10.9
Farmers Home agricultural loans	3.7	8.9
Federal Housing Administration	1.5	3.6
Veterans Administration	1.1	2.7
Other	6.9	16.7
Total	41.4	100.1 b/
Primary Guarantee Commitments		
Federal Housing Administration	44.6	45.9
Veterans Administration loan guarantee revolving fund	14.7	15.1
Low-rent public housing	14.3	14.7
Export-Import Bank	8.5	8.7
Education programs	7.2	7.4
Commodity Credit Corporation export credits	4.7	4.8
Small Business Administration	2.6	2.7
Other	0.6	1.0
Total	97.2	100.3 b/

SOURCE: Budget of the U.S. Government, Special Analysis on Federal Credit, 1985.

a. Direct loan obligations include those advanced by the FFB on the basis of agency guarantees.

b. Exceeds 100 percent because of rounding.

ANALYTIC DIFFICULTIES IN ASSESSING FEDERAL CREDIT ASSISTANCE

Economists have succeeded over the years in developing a conceptual framework for analyzing the effects and effectiveness of federal credit programs. That framework, however, remains essentially conceptual, rather than operational. What this means is that one cannot make strong positive statements about the consequences of particular credit programs. It would be useful if one could say, for example, that:

- A $1 billion credit subsidy to the Export-Import Bank will increase exports by $X billion; or

- $1 billion in guaranteed mortgages will increase the number of new houses by Y units; or

- $1 billion in loans to small business will increase national productivity growth by Z percent.

But we cannot.

The reason we have been unable to produce such "if/then" statements is that the processes through which credit subsidies affect investment, employment, portfolio holdings, and other economic variables are extremely

complex. Important factors that influence the extent to which a credit subsidy increases the flow of credit to a target activity include:

- The responsiveness of credit supplied and demanded in subsidized markets to changes in interest rates;

- Whether the funds to pay the subsidy are obtained through taxes or borrowing;

- The form in which the subsidy is provided--that is, by explicit payments or by modifications in the character of debt instruments with, for example, guarantees; and

- The tax structure applying to participants in subsidized markets, and those participants' responses to such tax incentives.

All these factors are difficult to measure, and they are different for each credit program.

Evaluating the effects of particular credit programs requires knowledge of these factors that we rarely have. Even if we can confidently predict the credit flow to a target sector from a credit subsidy, many factors can weaken the program's impact. For example, suppose that a credit subsidy is provided to an industry to promote investment and

employment in that sector. Attainment of these goals will depend in large measure on the extent to which the credit subsidy:

- o Increases debt-to-equity ratios--that is, induces borrowers who could have gotten financing anyway to substitute debt for equity without increasing the volume of the targeted activity;

- o Increases wage rates rather than employment or productivity;

- o Increases interest rates for unsubsidized borrowers and reduces investment in nontargeted areas; and

- o Increases the value of the U.S. dollar, which in turn reduces exports and increases imports.

In sum, the chain between the implementation of a credit program and the impact on some targeted activity has many weak links. These prevent credit subsidies from serving as a very effective tool for altering the allocation of economic resources in a predictable way.

FAILURES IN THE BUDGETARY TREATMENT OF FEDERAL CREDIT

A number of reasons have been offered to explain the common use of credit programs when more direct subsidy techniques are available. Some proponents have suggested, for example, that this form of assistance is especially appropriate as an instrument for correcting credit market failures. That is true, but it is also important to note that federal credit assistance can be made to appear a very low-cost course of action. The opportunity to do so arises because the U.S. budget operates on a current cash basis. Program costs are defined as the amount of cash required to finance current-year activities. But cash outflow can be a poor measure of credit program costs. Consider for a moment four instances in which current budgetary practice can be used to understate the subsidy cost of federal credit assistance.

First, loan guarantee commitments, which can be of great value to a borrower but that do not require a federal cash outflow until a default occurs, have an immediate budget cost of zero. As I mentioned above, the U.S. government issued commitments to guarantee $97 billion in debts of other parties during fiscal year 1983. Because these commitments produced some premium income--notably for FHA 203(b) basic home mortgage insurance--these contingent liabilities, which may eventually cost taxpayers billions of dollars, appeared not only as costless but as "profitable" in the budget.

Second, loan asset sales to the off-budget FFB can be used to generate offsetting receipts for a program and to reduce the fund's reported cash outflow cost. In 1983, for example, the Farmers Home rural housing insurance fund sold $4.4 billion in loan assets to the FFB. If these loans were actually sold to private investors, it would be appropriate to classify the proceeds as offsetting receipts. "Sales" to the FFB, however, are indistinguishable from interagency borrowing--which is not an offsetting receipt--in that the "selling" fund retains all risk of default on the underlying loans.

Third, new loan programs can be financed from existing revolving funds using repayment receipts of older, established programs to offset new program disbursements. For example, the FHA Fund consists of 40 different programs divided into four groups. This mingling of funds effectively obscures the performance of individual programs and conceals the costs of current lending.

Fourth, current practice permits federal guarantees to be converted into off-budget direct loans. This is accomplished when an on-budget agency grants a 100 percent guarantee to a borrower. On the strength of this guarantee, the borrower may obtain a direct loan from the FFB. Not even the cash financing requirements of this transactions will appear in the unified budget.

Even though the general tendency is for current budget accounting techniques to understate the cost of credit assistance, it can on occasion result in overstatement. For example, the entire amount of a direct loan from an on-budget agency is counted as an outlay in the year it is disbursed, even though the present value of the subsidy is only a fraction of the loan amount which is expected to be repaid.

Clearly, it is important to improve the budgetary treatment of federal credit programs so that costs will be neither understated nor overstated. In a recent CBO study, we outlined some options that could achieve this result. 2/ These reforms would substitute the spending-equivalent or subsidy costs of federal credit for the current measure of net cash flow. For direct loans this can be achieved by estimating the difference between their market value and par value or, alternatively, by selling the loans in the open market and recording the government's net loss as an outlay. For guarantees, the estimated actuarial value or the cost of reinsuring the risk in private insurance markets would properly be included in the budget as their cost.

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2. See Congressional Budget Office, New Approaches to the Budgetary Treatment of Federal Credit Assistance (March 1984).

Recently introduced legislation (H.R. 5247, H.R. 4629, and S. 2213), would, for example, assign FFB loans to the appropriate on-budget agencies and/or create binding credit ceilings in the budget resolution. Putting the FFB on-budget would certainly be a step in the right direction. A fully developed credit budget would also prompt more oversight of credit programs and help control credit aggregates. But as I noted earlier, credit volume totals do not provide an accurate measure of the costs of credit programs. A more useful credit budget would consist of subsidy-cost data that would facilitate comparisons among credit programs and between credit and spending alternatives.

CONCLUDING COMMENT

In summary, Mr. Chairman, the growth of federal credit assistance poses two distinct challenges. The first is to increase the ability to understand and measure the effectiveness of these programs. We analysts have far to go in this endeavor. The second is to identify and implement budgetary methods that will enable the subsidy costs of these programs to be included in the unified budget in a timely manner. The means for meeting the budgetary challenge are at hand and awaiting action.