Statement of

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Mr. Chairman, it is a pleasure to appear before this Task Force to talk about controls for federal credit programs. The timeliness of this subject is exemplified by the controversy surrounding such matters as the Chrysler Corporation's request for loan guarantees.

My statement this morning has four parts. First, it describes the current budgetary treatment of federal credit programs, their growth, and the concerns raised by such growth. Second, it reviews the President's proposals for beginning to control federal credit programs. Then, it considers various options the Congress could employ to achieve control over these programs. Finally, it sets out CBO's recommendations with respect to Congressional control of federal credit programs.

UNDERSTANDING FEDERAL CREDIT PROGRAMS

Federal credit assistance, in the form of direct loans and loan guarantees or insurance is growing rapidly--more rapidly, in fact, than direct federal expenditures. If the initial estimates for credit programs during fiscal year 1980 are realized, new direct loans and new loans

guaranteed by both on- and off-budget agencies will have grown by 76 percent between 1976 and 1980, as compared with a growth of only 45 percent in direct expenditures. The greatest growth seems to be occurring in the off-budget direct loan programs and in loan guarantees.

One possible explanation of the recent behavior of federal credit programs may well be their budgetary treatment. The exclusion of loan guarantees from a budget process that controls budget authority and outlays, and the inclusion of direct loans in the budget totals only on a net basis, may largely explain the recent patterns of growth of both types of programs as well as the potential problems they pose for the budget process.

Patterns of Growth in Loan Guarantees

The growth of loan guarantees in recent years may be explained by their statutory exclusion from the definition of budget authority, and thus from a budget process that controls levels of budget authority, outlays, and receipts. The changing nature of loan guarantee programs in recent years provides evidence in support of this proposition.

The first loan guarantee programs were established to provide mortgage insurance for home buyers in the Depression. These programs, primarily in the Federal Housing Administration (FHA) and the Veterans Administration, cover a large number of relatively small loans. Operating as insurance programs, they spread the risk of default on a single loan over the large number of loans in the insurance pool. Estimated losses and premium costs are computed on an actuarial basis. As a class, these programs have always made up a major portion of the total assistance provided through loan guarantees. A 1977 CRS study of major loan guarantee programs showed that mortgage insurance programs constituted 93 percent of outstanding loan guarantees in fiscal year 1960. 1/ As a percentage of the total, however, they have declined in recent years to 65 percent, although they have continued to grow in absolute terms from $49 billion outstanding in 1960 to almost $116 billion in 1976, an increase of 140 percent over the period.

1/ Congressional Research Service, Federal Loan Guarantees and Their Use as a Mechanism to Correct Market Imperfections, Assist Marginal Borrowers, and Finance Discrete Ventures (April 27, 1977).

A second class of loan guarantee programs is targeted to marginal borrowers who are unable to get credit because they pose greater than ordinary risks. These programs incorporate a subsidy: the premiums charged for the guarantee are below an actuarially based price, meaning that the government bears a portion of the risk. Through these programs, the federal government has assisted low-income families in buying houses, students in financing their educations, and small businesses in expanding their operations. As a class, these programs have grown from 6 percent of total guarantees outstanding in 1960 to 32 percent in 1976, from $3.4 billion in 1960 to $58.7 billion in 1976. This is a sixteen-fold increase.

A third class of programs has emerged in the last decade. These programs represent decisions by the federal government to finance discrete ventures or projects by guaranteeing large loans to single borrowers or groups of borrowers. Examples of these programs include loan guarantees to Lockheed, Amtrak, New York City, and the stell industry, as well as the proposals to guarantee loans for synthetic fuel plant construction and for Chrysler. This class, while smaller than the other two in absolute terms, has been growing the most rapidly: from $79,000 in outstanding guarantees in 1960 to over $3.1 billion outstanding in 1976.

The pattern of growth that emerges is one of dramatic growth in those loan guarantee programs that involve a government subsidy or that represent direct allocation of credit resources by the federal government to discrete ventures.

Patterns of Growth in Direct Loans

The recent growth in direct loan programs reflects another clear pattern: greater growth in off-budget lending programs than in on-budget programs. In fact, the fastest growing element of all federal credit programs has been off-budget direct loans. An examination of this off-budget lending shows, however, that it is in reality off-budget financing of loans by on-budget agencies. Two aspects of the budgetary treatment of direct loan transactions enable agencies to shift direct loans off-budget.

- First, the increasing use of sales of loan assets--largely in the form of certificates of beneficial ownership (CBOs)--to lower on-budget direct loan outlays.

- Second, the increasing practice of financing obligations guaranteed by a federal agency through the off-budget Federal Financing Bank (FFB).

New loans by federal agencies totaled $32.2 billion in fiscal year 1978. After deducting $23.6 billion in repayments, net lending of $8.6 billion was included in the fiscal year 1978 budget totals. Of that $23.6 billion in repayments, $8.4 billion was sales of loan assets and CBOs to the FFB; effectively, $8.4 billion of direct loans were shifted off-budget. An additional $4.8 billion of loans guaranteed by on-budget agencies were bought by the FFB, meaning that $4.8 billion in off-budget direct loans were made at the request of on-budget agencies. As a result, $13.2 billion of direct loans by on-budget agencies were not counted in the budget totals, meaning that the fiscal year 1978 deficit of $48.8 billion was $13.2 billion lower than it would have been in the absence of these off-budget shifts.

This shifting of direct loans off-budget has mushroomed since the creation of the FFB. In its first full year, fiscal year 1975, the FFB purchased over $5 billion in loan assets and $1.1 billion in guaranteed loans, for a total of $6.1 billion. For 1980, it is estimated that the FFB will purchase $9.5 billion of loan assets and $2.5 billion of guaranteed loans of on-budget agencies, for a total of $12 billion, doubling its annual purchases in just five years. FFB will also purchase $4.7 billion in assets and

guaranteed loans of the off-budget programs of the Rural Electrification Administration. Because there are no limitations on the volume of transactions by agencies with the FFB, it can be reasonably expected that this practice will continue to grow.

Consequences of These Patterns of Growth

The extra-budgetary nature of loan guarantees and the ability of direct loan programs to shift their financing off-budget mean that most of the growth in federal credit programs is taking place outside of any Congressional resource allocation process. This poses several problems. First, the year-to-year growth of most programs is largely uncontrolled. The programs are often authorized on an open-ended basis or have only a ceiling on total outstanding indebtedness set so high as to be no restraint at all on annual growth. As a result, The Congress does not set priorities among the competing needs of borrowers seeking loans or loan guarantees from the federal government. Consequently, the rapid expansion in the volume of loan guarantees to marginal borrowers and to discrete ventures in recent years has not been the result of a Congressionally determined plan. Nor was the rapid expansion of off-budget direct loans ever explicitly voted by the Congress for a fiscal year.

A second problem is that the Congress does not limit the total amount of credit it allocates to borrowers through direct loans and loan guarantees. In a period of restraints on the growth of the money supply, such as we are now facing, growth in the total amount of credit provided through federal programs may well mean that borrowers not eligible for these programs who seek credit in the private market may not be able to obtain its, or may have to pay more for it through higher interest rates. Our current knowledge of the interrelationships within our economy's credit system is limited; we cannot with any precision say when such "crowding out" may occur. Nor can we compare the relative economic gain of a federal loan or loan guarantee below the market interest rate to a small business or a steel company in need of plant modernization with a loan by a bank at the market interest rate to an electronics firm that makes semiconductors and microprocessors. The Congress will, however, have to begin addressing these questions if a credit squeeze develops. Thus, the lack of a process for allocating credit resources may hinder the Congress in its attempt to manage the federal credit program more effectively.

The Congress does not totally escape the consequences of unplanned credit growth. The deficit of the off-budget entities is financed by Treasury borrowing, which is, of course, subject to the debt limit.

Therefore, although each additional off-budget loan does not affect the budget deficit, it does increase the amount by which the ceiling on the public debt has to be raised.

A third problem presented by the lack of a resource allocation process for federal credit programs is the potential for making inappropriate decisions. Loan guarantees, in particular, are subject to being used inappropriately as a means of financing. Their great appeal stems from the perception among many people that they are a no-cost financing device. Inappropriate uses of loan guarantees pose a danger of program failure and of substantial losses by the government.

Modern financial theory has drawn relatively clear distinctions between equity financing and debt financing, and between entrepreneurial risk and other types of risks, mainly external. Loan guarantees, according to the theory supporting their use, assist borrowers in overcoming the artificial obstacles in their access to credit in the marketplace posed by a lack of protection for lenders from external risks. There exists the possibility today, however, that loan guarantees may be used to finance equity-type projects, or to protect lenders and borrowers against

entrepreneurial risks as distinquished from external risks. Examples exist of inappropriate decisions that have led to program failures, and of recent proposals for loan guarantees that have failed to distinguish carefully between the different kinds of risks.

Failures in Credit Financing

The failures that have occurred have all been the results of attempts to finance by guaranteed loans capital expenses that should have been equity-financed. For instance, when it established the New Communities Program in 1968, the Congress authorized both appropriations and loan guarantees. Subsequently, appropriations for the New Communities Program were terminated; the program was, however, continued by using loan guarantees to finance land assembly, site preparation, and other capital items. The cash returns of new communities were slow in starting and irregular at first, a pattern unsuited to paying off credit-financed construction. As a result, the guarantee premiums drained cash from the developers during this period of irregular cash flow. The results were unfortunate: of 13 guarantees granted to new community projects, all required reorganization and interim federal assistance. It is estimated that total losses in the program will exceed $90 million by the end of fiscal year 1980.

Let me briefly mention two other programs involving guarantees of a single discrete venture that have also experienced difficulties. This Congress has had to enact programs of direct assistance to bail out both ventures, which are again examples of efforts to finance capital construction with loan guarantees. Amtrak, the National Railroad Passenger Corporation, received Transportation Department guarantees on $900 million of loans made by the FFB. By 1975, the annual interest payments alone exceeded $30 million. In the Amtrak Improvement Act of 1975 (Public Law 94-25), the Congress recognized that Amtrak was severely undercapitalized and that guaranteed loans were not an effective way of making further capital expenditures. Subsequently, direct grants were authorized and appropriated for Amtrak's capital needs. In addition, $25 million was appropriated for fiscal years 1978 and 1979 for direct payments by the Transportation Department to FFB to reduce Amtrak's outstanding debt. In the Amtrak Reorganization Act of 1979 (Public Law 96-73), the 96th Congress authorized continuation of the $25 million debt reduction payments for fiscal years 1980, 1981, and 1982. In addition, section 129 requires the General Accounting Office to prepare a report to the Congress recommending appropriate means to eliminate Amtrak's guaranteed debt, freeing it of the burdensome annual interest payments as well as the principal amount of the loans.

METRO, the Washington area's subway/bus transit system, experienced a similar fate. The National Capital Transportation Act of 1972 (Public Law 92-349), authorized the Secretary of the Treasury to guarantee $1.2 billion of bonds and other borrowing by the Washington Metropolitan Area Transit Authority (WMATA) and to pay one-fourth of the interest costs on such bonds. Like Amtrak, WMATA's troubles stemmed from the debt financing burdens imposed by the guaranteed loan financing. Finally, it had to appeal to the federal government for relief from its burdens. A package negotiated by the Secretary of Transportation with WMATA, and embodied in a modified form in H.R. 3951, passed the House in July. H.R. 3951, the National Capital Transportation Amendments of 1979, provides that the federal government would, assuming enactment of the bill, pay two-thirds of the principal and interest due to holders of the guaranteed bonds. The participating governments are to pay the remaining one-third of principal and interest. The annual cost to the federal government of its share of the interest costs will be $51.6 million. In the year 2012, when the bonds begin to mature, the federal government will also be obligated to pay two-thirds of the principal amounts.

In retrospect, we must conclude that the use of loan guarantees to finance capital expenditures is inappropriate because it places a heavy debt-servicing burden on the borrowers during the development stages--before any income can be expected from the projects.

Recent proposals for loan guarantees for the financing of synthetic fuel plants provide additional examples of the potential for inappropriate decisions when a clear distinction is not made among types of risk. In testimony before various committees of the Congress this year, I have stated that there are three sources of risks that cause the private sector to be reluctant to invest the $2 billion necessary to build a synthetic fuel (synfuel) plant of sufficient size to take advantage of the economies of scale. First, there is technological risk: specific synthetic fuel processes have not been demonstrated on a scale sufficiently large to offer businessmen the level of certainty that they desire regarding cost and technology. Second, there are risks posed by regulatory uncertainties that present cost and technological problems. And third, there are risks that world oil prices will not increase as rapidly as they have in the past, thus raising the relative cost of synfuels. To assist in financing a synfuels plant, the federal government should choose a mechanism that would allow the

government to absorb the external risk that future OPEC prices will not increase as fast as expected. Technological and cost risks should be absorbed by the private sector, which has traditionally accepted such risks in making investment decisions. Such a separation of risks would maintain the incentives for the private sector to construct and operate synthetic fuel plants efficiently.

A better alternative than loan guarantees as a means of stimulating synfuel development would be purchase agreements, under which the federal government would contract to buy a given amount of synthetic fuel production. The private sector would absorb the technological and cost risks, while the federal government would absorb the external risk posed by uncertain OPEC price behavior. Purchase agreements, however, require budget authority and thus are subject to the controls of the budget resolution. The seemingly costless loan guarantees thus appear as a tempting alternative.

One can ask whether the existence of an allocation mechanism for credit resources could prevent inappropriate program design decisions, of the type I have discussed. The answer, I think, is yes. By setting limits on the growth of loan guarantees and on direct loan programs, the Congress

would cause all credit programs to receive greater scrutiny as they compete for an allocation from the limited credit resources available to the federal government. Without controls, individual authorizations of new loan guarantees do not challenge the availability of federal credit for other purposes.

THE PRESIDENT'S INITIATIVE TO CONTROL CREDIT PROGRAMS

In the Budget of the United States Government--Fiscal Year 1980, President Carter announced a plan to establish a system of controls over federal credit programs. The controls would be exercised program-by-program through annual ceilings on both direct lending and loan guarantees, established separately for each program in the appropriations bills. The President's recommended total for credit extended by the federal government would be the sum of the recommended limitations on individual programs.

These controls are now being implemented as part of the process of preparing the fiscal year 1981 budget, under the supervision of the Office of Management and Budget (OMB). OMB examiners are considering proposed limitations on credit programs that were included in the agencies' submissions of estimates for fiscal year 1981.

The 1981 budget will contain not only the President's recommendations for program ceilings but also expanded information on credit programs. Furthermore, OMB will begin updating its credit program estimates several times each year, creating a rudimentary credit program tracking system.

In announcing his plan in the 1980 budget, the President suggested that the Congress could set aggregate ceilings on gross direct lending and loan guarantees in the budget resolutions and set limitations for individual programs in the regular appropriations acts. He has not, however, sent legislation to Capitol Hill to establish a formal federal credit program control system. Instead, the procedures for recommending limitations on credit programs are being established by OMB without formal legislation.

The notion of limitations on credit programs is not new. OMB has included in previous budgets recommended limitations on some credit programs. The Appropriations Committee have included some of these limitations in their bills and on their own initiative have proposed limitations in various appropriations bills on other programs. What is now proposed is merely an extension of these procedures across-the-board to all programs.

OPTIONS FOR CONGRESSIONAL ACTION

A Congressional response to the President's initiative for credit program controls could take several alternative forms. First, the Congress could choose to continue its case-by-case approach to federal credit program controls. While for many programs the Congress has set no limitations at all, or only a very high limitation on total activity, for some programs the Congress has enacted limitations on annual activity, either in authorizing legislation or through limitations enacted in the appropriations bills. Continuing this piecemeal approach to credit program control, the Congress could pick and choose among the limitations recommended in the President's budget, enacting those that for one reason or another seem needed. Under this status quo approach, the initiative would remain with the various authorizing committees and appropriations subcommittees to recommend in their bills and push for enactment limitations on individual programs.

Second, the Congress could extend across-the-board the practice of setting limitations on annual activity for federal credit programs. Under the case-by-case approach, some limitations were proposed by committees with authorizing jurisdiction over the programs; others were proposed by an

appropriations subcommittee having jurisdiction over funding for an agency operating a credit program. Extending limitations across-the-board can be done through either the authorizations process or the appropriations process.

In proposing that the Congress set credit program limitations through the appropriations process, the President is recommending that the Congress follow his practice of reviewing simultaneously an agency's budgetary plans and its credit programs. By so doing, the Congress would gain an opportunity to balance the assistance it provides various activities directly with the assistance it provides through the extension of credit. This approach would create for credit programs the same sequence of authorization followed by appropriations that is the rule for most spending programs. It would reinforce the philosophy that decisions on allocating resources to a particular program should not be made by the same committee that authorizes the program.

Some credit programs already operate under appropriations limitations such as those being proposed by the President. Therefore, such limitations are not new or untried. Nor would they constitute a major increase in the annual workload of the appropriations committees, since the number of programs for which limitations would be appropriate is relatively small.

Setting limitations through authorizations is also workable but, for several reasons, might produce a less effective system of controls for credit programs. First, this approach would require action by each committee with jurisdiction over a credit program every year or every two years, instead of action just by the Appropriations Committees. Second, while this would not constitute a major workload for any individual committee, it might result in a significant increase in overall Congressional workload, measured in terms of the number of bills required. Limitations could be set for more than a year at a time as a way of reducing the annual workload, but unexpected circumstances could require increases in a limitation, necessitating a supplemental bill. Finally, such an approach might make it less likely that crosscutting reviews of both expenditure programs and credit programs for the same agency or functions would take place.

In either case, enacting limitations on particular programs takes care of only one problem: it provides the Congress an opportunity to make allocations among competing programs. It does not, however, help the Congress decide on and enforce a ceiling on the total amount of credit extended. Only by adding a process to set targets and ceilings on the total amount of credit can the Congress address both problems. This creates the

third form of Congressional response. The Congress could add a separate section to its budget resolutions to set targets for total direct lending loans and for total loan guarantees for a fiscal year, or it could go one step further and break down those totals by functional category. Going yet one step further, the Congress could even adopt the process of setting targets in the first resolution and ceilings in the second as a way of ensuring strict control over the enactment of additional limitations authority after the beginning of the fiscal year.

H.R. 5683, the Federal Credit Program Control Act of 1979, introduced by yourself, Mr. Chairman, and by Chairman Giaimo of the Budget Committee and Representatives Conable, Gephardt, Holt, and Nelson, is a proposal to implement this third form of response by amending the Congressional Budget Act of 1974. The bill would extend the target- and ceiling-setting processes of Title III to gross direct lending and to loan guarantees. The bill would also amend Title IV to require appropriations action for new loan guarantee programs. This bill offers the Congress a complete credit program control system: individual program limitations recommended in the appropriations bills, based on targets in the budget resolutions.

RECOMMENDATIONS BY CBO

Based on our review of federal credit programs in Loan Guarantees: Current Concerns and Alternatives for Control, I recommended to the Congress last August that it adopt a separate credit section in the concurrent budget resolutions to set targets and ceilings on annual federal credit activity. The bill you introduced, Mr. Chairman, embodies these recommendations and those of the President. I strongly recommend that the Congress take immediate steps to implement credit program controls of the type contemplated in H.R. 5683 for fiscal year 1981.

To talk of full implementation of the control procedures of H.R. 5683 for the next budget cycle is optimistic. Yet, I believe at the same time it is possible. The Congress could consider phasing in credit program controls, as it did for the procedures of the Congressional Budget Act for fiscal year 1976. I believe that the experience gained by the Congress in five years of operating under the new budget process, plus the ease with which the Congress has moved to multiyear targeting, argues that full implementation of credit program controls for the next budget is practical. The Congressional Budget Office would be pleased to assist the Committees on the Budget and the other committees of the Congress in achieving that goal.