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Statement of

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before the

Special Subcommittee on Control of Federal Credit

Committee on the Budget

United States Senate SEN00803

on

Control of Loan Guarantees

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to testify before your Special Subcommittee on Control of Federal Credit of the Senate Committee on the Budget. In today's testimony, we will summarize the work we have done in the area of Federal credit programs and address some of the questions you posed in your request to us. I believe the most efficient way to do this is by discussing our work in the context of the issues we believe are important and at the same time focusing on your concerns as they relate to our work and the issues. We have appended a bibliography of GAO work in this area to this statement for your information.

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The U.S. Government uses a wide variety of policy tools to affect resource allocation, income distribution, economic stabilization and growth. The Federal Government taxes, spends, borrows, lends, provides services, subsidizes, invests, produces and regulates.

Of these policy tools, credit assistance activities are the least appropriately reflected in the budget. Because of its budgetary treatment, credit assistance is probably the least well understood in its workings, is the most difficult to assess from a cost effectiveness perspective, and has perhaps the greatest potential of being misused as a policy tool.

GAO has been concerned with various aspects of Federal credit programs for a long time. For the past 5 years, our analysis has expanded from program specific aspects of credit assistance to the approach itself.

BACKGROUND

At the end of fiscal year 1979, there were $409 billion in direct and guaranteed loans outstanding. This figure is expected to grow by over $100 billion to nearly $520 billion by the end of fiscal year 1981. There is no adequate mechanism in either the executive or congressional budget process for controlling the growth of these programs nor for allocating resources among the myriad of credit assistance programs.

We believe that the growth and changing composition of Federal credit programs should be of concern to the Congress.

Much of the growth in direct loans and loan guarantees in recent years occurred in non-traditional areas. In 1965, housing credit programs, which involve a large number of small loans, accounted for about 95 percent of all Federal credit activity. This percentage has continuously shrunk over the last 15 years.

In recent years, loan guarantees have been proposed or used to finance synthetic fuels development, urban development, and to finance faltering cities, corporations and industry. The Chrysler Corporation loan guarantee is a recent and highly visible use of the loan guarantee in a non-traditional way. One of the major problems with these types of loan guarantees is that it is not possible to judge reliably, in advance, what the ultimate costs of such programs will be. Because they are large, one-time loan guarantees to activities with an uncertain future, there is no actuarial basis for arriving at reliable estimates of probable loss.

Credit assistance programs are subsidy programs. Like other subsidy programs, they should be evaluated in terms of their cost effectiveness and the extent to which they achieve program objectives. In its various functions, the Congress needs to determine when they are appropriate and when they are inappropriate, guide their design so they maximize the potential for achieving objectives while at the same time protecting the Federal Government's interest, and control them so they compete for resources in the congressional budget process on an equal basis with direct expenditure programs.

Specifically, our concerns about Federal credit assistance in the past and for the foreseeable future center on the following issues:

--What are the direct costs and benefits associated with these programs? How much have they cost the Federal Government and what are the direct benefits to program beneficiaries? Without answers to these questions, it is difficult to analyze their cost effectiveness, there is no analytical basis for deciding how to treat them in the budget process and there is insufficient basis for deciding how many resources to allocate to them.

--When are Federal credit programs likely to be most effective in achieving program objectives? Are there cases where they are clearly inappropriate?

--What are the indirect costs of these programs? How do they affect financial markets and the allocation of the nation's real resources? Are these programs stabilizing or destabilizing in their impacts on economic activity?

--How can we achieve better budgetary control over Federal credit assistance programs? This issue is crucial and must be resolved before we can gain a better understanding of the other issues that these programs pose. It is likely that if a mechanism were created for achieving better control over Federal credit programs we would also have, or discover, better answers to the other questions we have posed.

COSTS AND BENEFITS OF CREDIT ASSISTANCE PROGRAMS

What are the direct costs of Federal credit assistance programs? This is an important question for public policy and certain misconceptions are widespread, particularly with respect to loan guarantees. There is a tendency to propose and discuss these programs in such a way that they appear to cost nothing if there is no default. This is not the case. These programs do have costs. Furthermore, the direct benefits from loan guarantee programs are usually far less than the face amount of the loan. It should be apparent that, for both budget scorekeeping and program evaluation purposes, the Congress needs accurate estimates of historical, current and probable future costs of these programs.

GAO has been engaged in estimating historical and future costs of Federal credit assistance programs for some time.

We hasten to add that the methodologies we have developed represent only a starting point from which Federal agencies, using their own data, may make improvements. As you are aware, OMB estimates the future potential costs of credit assistance programs by discounting to present value the cash flow from lower interest rates charged to assisted borrowers. These estimates are presented in the Special Analysis of the Budget of the United States Government, but because of the uncertainty associated with the estimation procedure, the figures are not included in the budget totals. If it were possible to estimate, with accuracy, the likely future costs associated with the various programs, there would be a budgetary measure of Federal credit assistance activity comparable to direct expenditure programs.

GAO has developed a methodology for estimating the historical costs and interest subsidy benefits associated with Federal credit programs. We believe it is important to focus on costs and their incidence across the various functional totals so that decisionmakers know what they have been and, in some instances, extrapolate them into the future. Our exposure draft on "A Methodology for Estimating Costs and Subsidies From Federal Credit Assistance Programs" has been widely circulated for comment inside and outside of government and in general has been favorably received.

We have also done some work in estimating the likely future costs of specific credit assistance programs. In response to a request by the Chairman, Subcommittee on Agriculture and Related Agencies, Senate Committee on Appropriations, we developed a method for estimating future costs of expanded Farmers Home Administration and Rural Electrification Administration Loan Programs.

In addition to this, we have also been concerned with cost comparisons between credit assistance and alternative policy instruments. Our report on Federal disaster assistance policy, to be issued shortly to the Senate Budget Committee, compares the costs of the loan approach with those of the insurance approach to disaster assistance.

It is clear from our work that credit assistance programs are quite costly to taxpayers. We estimate that in fiscal year 1975, direct and guaranteed loan programs had direct costs in the neighborhood of $3.0 billion. Given trends since that time, these costs are no doubt higher today. In addition, a significant portion of the growth in costs since 1965 has occurred because of the growth in loan guarantees and direct loans outside the housing area.

IMPACTS ON FINANCIAL MARKETS AND THE ECONOMY

In addition to the direct costs of these programs which arise largely because interest rates charged do not adequately cover the costs incurred in running credit assistance programs, there are indirect costs which need to be considered when evaluating existing and proposed programs. Evaluating a credit program by considering only the direct impact on the taxpayer (assuming it can be estimated) misses what may be a significant component of the overall effects of these programs.

When credit is allocated to a favored group of borrowers, it necessarily affects non-assisted borrowers mainly through changes in non-assisted interest rates or loan availability. In addition, to the extent credit assistance programs increase or redirect the supply of loanable funds, they can be either stabilizing or destabilizing in their impacts on financial markets and aggregate economic activity. The myriad of loan guarantee and direct loan programs currently in existence were, and continue to be, conceived on an ad hoc basis with little consideration given to the economic impact of the totality of programs. With Federal credit programs currently lending on the order of $150 billion per year, it is quite likely that they are having some impact on financial and other markets.

We have begun research in this area. We are trying to answer three basic questions:

--Have these programs been stabilizing or destabilizing in their impacts on economic activity? Basically, do they follow or oppose movements in economic aggregates indicative of economic boom or bust?

--If they are on balance destabilizing can a mechanism be found to control Federal credit activity in a manner more consistent with movements in the business cycle?

--If such a mechanism can be found, is it workable in the sense that in controlling the totals it does not seriously undermine the goals of the myriad of Federal credit programs?

We are still in the early stages of this research, but our preliminary results indicate that Federal credit programs moved in a countercyclical manner during the 1960's. During the 1970's, they have moved procyclically, thus possibly contributing the volatility of the business cycle. As our research continues, we hope to get a much better fix on this relationship, its strength and its implications.

THE APPROPRIATE USE OF LOAN GUARANTEES

Guaranteed loan programs are, to all intents and purposes, excluded from the budget. The budget treats them as if they had no cost at all. Because of this budget treatment, it is logical to conclude that credit assistance is overused and in some cases, misused--even without a program-by-program review. Existing budget treatment is therefore at least one reason for the increasing use of the credit assistance device. Also, because knowledge of these programs' indirect impacts on financial markets and the economy is limited, they have appeal because of their apparent simplicity.

GAO has been heavily involved in analyses of the appropriate use of loan guarantees. Our guidelines document, "Federal Credit Assistance: An Approach to Program Design and Analysis" outlines the unique characteristics of Federal direct and guaranteed loans and describes when those devices are likely to be most effective. It was also our purpose in this document to provide decisionmakers with suggestions and guidelines for designing credit assistance programs so they become more efficient in conferring benefits and producing results consistent with objectives.

We were heavily involved in the analysis of the New York City financial situation in 1977 when Federal involvement was being considered. We discussed the credit assistance alternative (among others) in our report on New York City's Long-Term Fiscal Outlook.

Our report on disaster assistance policy, which was requested by your Committee on the Budget, and which will be issued shortly, finds that loans and loan guarantees, though a necessary interim means of assistance, are not a long-run solution to efficient delivery of financial assistance to victims of natural disasters. We believe that superior alternatives exist. Our study shows that loans and loan guarantees have deficiencies which may promote poor locational decisions and perpetuate the incidence of disaster losses. These deficiencies result both from characteristics inherent in the credit assistance device and from improper design of the programs.

Most recently, the Comptroller General is serving as a member of the Chrysler Corporation Loan Guarantee Board. As a member of the Board, the Comptroller General has been confronted with problems of the auto industry and the intricacies of a large loan guarantee program. One point has become critical. When the Federal Government enters into a large loan guarantee arrangement, it is paramount that its risk exposure be amply collateralized because it is virtually impossible to accurately predict success or failure of the venture whose activities are being financed. The Comptroller General will continue to be involved in the Chrysler situation and based on this experience as well as studies of other industries, such as steel, we hope to publish a guidelines document on appropriate policy responses to faltering industries or companies.

BUDGET TREATMENT OF FEDERAL CREDIT ASSISTANCE ACTIVITES

In our opinion, stronger budgetary control of Federal credit assistance will help the Congress deal with most of the current concerns over these programs. A systematic means for allocating resources to credit assistance programs within the budget process will surface these issues and allow Congress to resolve them. We are glad to see that the Congress started such an allocation in its First Concurrent Resolution on the Budget for Fiscal Year 1981, and that you are considering legislation such as S. 2151 to give this process a statutory basis.

In 1976, we presented a preliminary general overview of our position on the budget treatment and control of Federal credit programs. The major issues remain with us today. Because of the rapid and continuing growth of credit programs and because of the growing use of this device in non-traditional areas, the issues are simply becoming more critical.

We have consistently maintained that credit assistance which escapes systematic congressional scrutiny because of its off-budget status must be brought fully into the budget totals and in the congressional budget process.

We will comment briefly on aspects of credit budgeting we have covered in our work. We would first like to direct attention to the operation of the Federal Financing Bank (FFB), especially the guaranteed loans that are "purchased" by the FFB. The appropriate budgetary treatment of loan guarantees not going through the FFB is difficult enough, but their conversion into direct loans when they do go through the FFB clouds the issues even further. In our opinion, this practice is in violation of sound budget principles. However, we cannot say with any assurance that the existence of the FFB has resulted in an expansion of Federal credit assistance activity. However, the potential for this to occur exists. If the FFB were not off-budget, would the guaranteed loans that go through it actually have been direct loans? Probably not. But this does not imply an expansion of credit assistance activity, only a change in its composition.

On the other hand, some programs might never have grown to their present size were it not for the ready availability of permanent financing from the FFB.

Second, we also are concerned with the current budget treatment of Certificates of Beneficial Ownership sales by the Farmers Home Administration (FmHA). By statute, these Certificates, which are used to finance FmHA lending activities, are treated in the budget as asset sales and thus as an offset to (i.e., subtraction from) expenditures. Sales of these Certificates should be treated as debt transactions, as was recommended by the Budget Concepts Commission. If they were, FmHA lending operations would be reflected in the budget totals regardless of FFB's budget status. Currently, the Federal Financing Bank holds about $35 billion in FmHA Certificates. By the end of fiscal year 1981, this figure is expected to reach $41 billion. This means that since the FFB's beginning in 1974, there has been a total of <u>at least</u> $35 billion in direct lending by the Farmer's Home Administration that has not been counted in the outlay totals of FmHA and the Federal budget. This has caused the budget deficit to be understated by an equivalent amount.

In our reports on these two subjects, we have recommended that:

--FFB receipts and disbursements be included in the Federal budget totals;

--the receipts and disbursements of off-budget agencies that borrow from FFB be included in the budget; and

--CBOs be treated as agency debt and, therefore, be treated in the Federal budget as borrowing.

These recommendations have not yet been implemented. We strongly believe that they should be.

We note that this Committee in its report (No. 96-654) on the First Concurrent Resolution on the Budget for Fiscal Year 1981, recommended that the President and the Congress, through the appropriations process, limit aggregate off-budget lending activities to a specified level ($25.8 billion). This proposal, incorporated into the First Concurrent Resolution is a welcome step forward in subjecting FFB and other off-budget lending activities to the discipline of the appropriations process. It is important to bear in mind, however, that this action is only a partial remedy to the off-budget problem; it will not correct the understatement of budget outlays associated with the off-budget status of certain Federal organizations including the FFB.

Third, we have addressed certain budget control problems related to Federal revolving fund loan programs. In our report, "Revolving Funds: Full Disclosure Needed for Better Congressional Control" (PAD-77-25, August 30, 1977), we analyzed how outlay totals for public enterprise revolving fund loan programs are understated in budget reporting because of the practice of offsetting loan repayments from new loan outlays. The result is that the reported outlays are net outlays rather than total outlays. We believe that this offsetting practice distorts budget outlay amounts and makes it difficult for the Congress to accurately guage and control budget outlays. And in our current report, "Spending Authority Recordings in Certain Revolving Funds Impair Congressional Budgetary Control" (PAD-80-29, to be issued shortly), we address the lessening of congressional budgetary control when budget authority recordings for revolving fund loan programs are expressed, largely as authorized net borrowings (gross borrowings less repayments). As a consequence of this procedure, a program's total loan obligations in a fiscal year can easily exceed its recorded budget authority for entering obligations. For example, FmHA's Rural Housing Insurance Fund made about $4.9 billion in loan obligations in fiscal year 1979, but showed recorded budget authority of only about $790 million. Our report recommends that the Congress set annual limitations on the obligations that may be made in individual revolving fund loan programs, and treat these limits as the relevant budget authority amounts.

I wish to point out that while the executive branch and the Congress are now moving to set statutory limits on loan program obligations, in total and for individual programs, there is no action to record these limits on direct loans as the relevant new budget authority amounts. The limitations therefore do not appear in the budget totals. We believe that the needed and logical next step is to treat the limitations as the controlling new budget authority amounts. This would put the loan programs on a more comparable basis with other programs and facilitate congressional budget control.

S. 2151, which would amend the Congressional Budget Act of 1974 to establish congressional budget process procedures for setting targets and ceilings on loans and guarantees, stops short of requiring that the limitations be treated as the budget authority amounts. We would prefer that it require such a treatment.

Fourth, in one of our recent reports, "Alternatives for Eliminating Amtrak's Debt to the Government" (PAD-80-45, March 28, 1980), we discuss certain obligations of the National Railroad Passenger Corporation (Amtrak) which highlight the need for full disclosure and strengthened control and accountability of Federal guarantee programs within the budget process. The obligations in question consist of $850 million in loan obligations. Amtrak originally borrowed from private lenders and the loans were guaranteed by the Federal Government. Subsequently, they were converted to direct Federal loans from the Federal Financing Bank. Amtrak's guaranteed loans illustrate how loan guarantees adversely affect certain budgetary principles. The loan guarantees were converted to direct Federal loans that were not included in the budget. Budget and deficit totals were understated, creating problems in accountability such as lack of full disclosure of budget information and loss of congressional budgetary control.

With regard to overall control of Federal credit assistance activity, I would like to make the following observations.

Accurately reflecting the aggregate outlays and commitments from Federal credit assistance programs in the budget numbers is important, because they are the basis for some very important policy decisions. If the reported budget aggregates are not what they purport to be, misunderstanding is inevitable and the credibility of the policy formulation process itself is at risk.

It is equally important, however, that we find a means of assuring that Federal credit programs compete on the same basis as other direct expenditure programs so that decisions regarding the allocations of our nation's resources will be made in a more balanced framework.

Whatever control mechanism is decided on, it must control more than the total. Someone has to decide about the pieces as well as the total. If the Congress does not find a way of doing so, the task--and the power that goes with it--will pass to the Executive. The issues of budgetary control of the totals and the pieces and who is doing the controlling of each are important, as the Congress itself concluded when it enacted the Congressional Budget Act. We believe that program outlays should be approved by the Congress after weighing the benefits and costs of each program in the context of an overall judgment on the appropriate level of total credit asistance activity. We do not believe that a mechanism which only controls the total will do the job, nor will increased visibility of the credit assistance totals alone be sufficient. Both represent a good start, but we believe the Congress should go beyond this to the development of a systematic approach for budgeting credit assistance; one which is similar to and linked with the existing congressional budget process.

Mr. Chairman, this concludes my prepared statement. I would be pleased to try to answer any questions.

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