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STATEMENT OF

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BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

ON

FEDERAL CREDIT PROGRAMS

Mr. Chairman and Members of the Subcommittee:

We are pleased to appear today to discuss federal credit programs, their development, growth, control, and evaluation. This is a subject in which we have had a strong interest for a number of years.

Development

In our society, the allocation of credit for private purposes is generally a function of private credit markets and private financial institutions.

These institutions are subject to varying degrees of federal and state regulation, but that supervision is primarily aimed at assuring safety, soundness and disclosure of risk to potential

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depositors and investors. Government intervention to influence the allocation of credit is the exception, rather than the rule. The exceptions can be put in two categories. The first involves broad efforts to constrain the volume of credit through quantitative controls. Wartime controls were one example; another was the effort to constrain the growth of credit card use a few years ago.

The second category of intervention is aimed at encouraging credit to flow to one borrower or class of borrowers. Here, too, the intervention can be either general or specific. For example, tax regulations applying to thrift institutions are designed to enhance the availability of housing credit on relatively favorable terms.

When we speak of "federal credit programs," however, we are usually not referring to any of these forms of intervention. Rather, we are referring to decisions to intervene on behalf of specific borrowers, seeking to help them obtain credit on terms which would not otherwise be available to them.

I mention the other forms of intervention only to establish the context for a discussion. Federal credit programs of the more specific type represent one point on a very broad continuum of intervention. It is quite appropriate to focus attention on the particular issues related to federal credit programs, but we should not lose sight of the fact that other forms of credit market intervention have occurred in the past and may be seen again.

Growth and Development of Credit Programs

Federal credit programs of the specific type have usually arisen from the premise that credit markets are not allocating enough credit to an activity that has been judged by Congress to be beneficial to society as a whole. Sometimes this premise reflects apparent institutional gaps, such as in the size and number of institutional lenders in rural areas. In other cases the concern has been over the presumed unwillingness of credit institutions to take socially beneficial risks or to do so on "reasonable" terms and conditions.

While the justification for the programs has varied, credit programs have been a feature of federal policy for many years. Without seeking to trace the origins of this policy mechanism, it is worth noting that credit programs have been prominent since at least the 1930's.

The major growth in credit programs, however, has been in the forty years since World War II. This can best be illustrated with respect to housing, which represents the largest single component of that growth. In 1945 there was a total of $4 billion of mortgages outstanding which had been guaranteed by FHA or VA. By 1960, that had increased to $62 billion. By 1970, it was $109 billion and by 1982 it was about $250 billion. This represented about three-quarters of the $331 billion in outstanding primary guaranteed loans.

The full picture of the cumulative results of federal credit programs, however, must also include the direct loan programs. Here the concentration is somewhat different. By 1983, the federal government had accumulated a portfolio of about $223 billion in direct loans. Of this total, about $116 billion was in support of agriculture and rural development activities.

In looking at the direct loan portfolio, however, it is important to note something else. More than half of that portfolio (and over three-fourths of the agriculture and rural development portion) is off-budget.

This brings me to the second point I would like to discuss--how we deal with credit programs in the budget.

Budgeting for Credit Progams

It has been recognized for some time that credit programs are difficult to handle in a budget process that is basically cash-oriented. The problems of budgeting for credit programs were the subject of extensive debate, for example, at least as far back as the President's Commission on Budget Concepts in 1967.

It is obvious that direct loans and loan guarantees are different from grants or payments for salaries. Direct loans involve cash outlays, but they also carry the prospect of repayment. Loan guarantees involve cash outlays only in the event of default. Both types of credit assistance carry costs, but in neither case is the true cost accurately represented by the immediate cash outlay.

While these facts have been well-recognized, they are not reflected in the way we currently budget. Most of the time we treat the cash outlays of direct loans (and the absence of cash outlays for loan guarantees) as if that were the true cost of the program. The most prominent exception to this rule is we treat some direct loans as if they didn't exist at all by defining them as being "off-budget."

If we are to come to grips with the problems of budgeting for credit programs, we must find solutions for two separate but closely related problems:

1. We must find a meaningful way of measuring the true cost of credit programs.
2. We must find a way of bringing those costs into the budget process so that credit programs can be controlled in a way that is equivalent to that for other programs.

We have made progress on both problems, but acceptable solutions are not yet in hand.

Progress on the "control" problem is evident in the fact that mechanisms are now in place to limit the volume of guaranteed loans. The mechanism of the credit budget, including limitations in appropriation acts, is far from perfect, but it is (in my view, at least) an important step forward. We hope that Congress and the executive branch will continue to strengthen that mechanism as they gain experience in using it.

The other immediate "control" problem is the off-budget status of certain entities, the most prominent of which is the Federal Financing Bank. For several years we have recommended that the FFB be placed on budget.[1] We continue to support the

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[1] "Government Agency Transactions With the Federal Financing Bank Should Be Included On the Budget" GAO/PAD 77-70, August 3, 1977, and several subsequent statements before various committees.

enactment of legislation to accomplish that objective, which we view as another important step in the incremental process of developing effective budget controls for credit programs.

While we are encouraged by the progress that has been made, we doubt that full success can be achieved until we solve the related problem of measuring the cost of credit programs. Our objective should be to find a way to measure these costs in such a way that the result is comparable to the cost of, say, a grant program.

Conceptually, the net federal cost of a direct loan is the initial cash outlay, plus interest on the funds and administrative costs, less repayments of principal and interest. The cost of loan guarantees is the sum of administrative costs, plus the expenses associated with defaults, less any guarantee or insurance fees. In either case, in the event of default, the value of any collateral may offset some of the costs which would otherwise accrue. Because these elements of cost occur at different times, the best way to meaningfully measure and compare the costs of various programs is through calculation of their present value using a discounting procedure. Costs measured in this way would be greatly superior to the pure cash outlay approach currently used to allocate resources in the budget process.

While defining costs in this way is relatively straight forward, their measurement is very difficult in practice. One of the greatest difficulties lies in estimating the probability of default.

In some programs, such as FHA mortgage insurance for single family houses, estimates can be based on decades of experience with millions of cases. Those estimates are generally quite good, and are probably reliable enough to be used in the budget process today. In other cases (Lockheed, Conrail, and Chrysler come to mind as extreme examples) there is no such history and, thus, little basis for making any estimate.

We have not yet found a satisfactory solution to this problem, but in March of this year, the Congressional Budget Office made an important contribution on this subject with the issuance of their study, "New Approaches to the Budgetary Treatment of Federal Credit Assistance." While we are not yet in a position to endorse any of the specific options posed in that study, except on-budget status for the FFB, we believe it provides an excellent foundation for further exploration and analysis.

I think it is very clear that we and CBO agree on the need to find a way of budgeting for credit programs that reflects their true cost, rather than their immediate outlay effect. The CBO study only adds to my conviction that the problems can be solved.

A more accurate portrayal of costs is vitally important if we are to put budgeting for credit programs on a sound basis. But good cost data, while essential, is only part of the information needed for decisionmaking. Congress must consider the effects of programs, as well as their costs, and the remainder of my statement will be addressed to this topic.

Evaluation

You asked that we discuss ways in which to evaluate the appropriateness and effectiveness of federal credit programs. I might be most helpful in this regard by describing an evaluative process that should to be undertaken when considering new program proposals. The process has equal relevance in many respects to evaluation of on-going programs. Several years ago, we issued a report entitled, "Federal Credit Assistance: An Approach to Program Design and Analysis" (GAO/PAD 78-31). You may find that report useful, as it addresses many of these points in greater depth.

In evaluating federal credit programs, or any other type of program for that matter, it is important to distinguish social goals from the means used to achieve those goals. Judgments on the merits of social goals are political decisions and, in many cases, are analytically non-quantifiable. Thus, analysis of appropriateness and effectiveness should seek to determine the best means of achieving given social goals and how much it will cost.

Credit assistance, in the form of direct and guaranteed loans is one means of achieving program objectives. This policy instrument is an alternative to other mechanisms such as direct subsidies, tax expenditures, price supports and, tariff protection. All of these mechanisms are intended to reallocate resources and induce individuals, businesses and industries to behave in ways that further the government's objectives. They do this by conveying subsidies in various forms.

In general, when deciding to subsidize a sector, whether through a credit program or other device, we need to first decide in light of policy objectives why they are not being met by the market, whether a subsidy can correct the problem, and what unassisted segments of the economy might be adversely affected by a subsidy and the associated costs.

If these considerations indicate that a subsidy is warranted, it is then necessary to evaluate the relative efficiency of each type of subsidy in promoting program goals. A subsidy's efficiency can be measured by comparing the value to the potential recipient with its cost to the government. Value conveyed is important because it provides a proxy for the extent to which behavior is likely to change and further the achievement of program objectives. Put simply, the more valuable something is to individuals, the more likely they are to change behavior to conform with program standards or objectives.

Federal credit programs typically involve concessionary interest rates and other terms that reduce the financial burden of an undertaking relative to those obtainable on an unassisted basis. There is a direct translation of the cash flow benefits from the concessionary terms into value conveyed. In general, federal credit programs will convey the most value and thereby are most likely to achieve program objectives when the borrower's project is perceived by the market to be risky. For example, we would not expect a direct loan to a large, national corporation with a strong financial position, to be as valuable to the borrower or elicit as much of a behavioral response as we would expect in the case of a struggling small or medium sized business firm. Another factor would be the relationship of the size of the subsidy to the overall cost of the project. The greater the extent to which a project is financed with debt and the larger the share of total costs comprised of financing costs, the more effective will be the redirection of resources into desired activities.

In light of this, we should not expect federal credit programs to be particularly effective when project risk is low because obtaining commercial credit on reasonable terms should not pose serious problems. Furthermore, if the debt service burden is only a small fraction of costs, we should not expect the less stringent terms of federal credit programs to be sufficiently important to induce a change in behavior.

These points suggest that program effects are relatively straight forward when described in conceptual terms. As with costs, however, applying them in practice--measuring those effects--is extremely difficult and complex. In evaluating any program, the essential objective is to compare what happened with the program to what would have happened in its absence.

It is usually possible to ascertain what actually happened, though doing so can be expensive. The difficulty lies in estimating what would have happened without the program and, thus, what difference the program made. It is rarely possible to implement the sort of experiment which would allow those effects to be measured with confidence.

Often, therefore, conclusions about program effects embody a large element of assumption and judgment. In this regard, credit programs are like any other program. The key is to assure that those judgements and assumptions--when they are made--are explicit, reasonable, internally consistent and derived from a coherent body of theory about how people and institutions behave. These characteristics are essential if the decisionmaker is to have any basis for deciding how much confidence to place in the results of any evaluation.

As with the measurement and control of costs, much remains to be done in assessing credit program effects. In an important way, the two are related. As we find better ways to measure costs appropriately and bring them into the budget process, the need to measure effects will assume greater importance. That, more than anything else, is likely to encourage better evaluation.

That concludes my prepared statement. My colleagues and I would be pleased to respond to any questions.

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