COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-115398

APR 30 1976

The Honorable Richard H. Ichord
House of Representatives

Dear Mr. Ichord:

In your letter of January 26, 1976, you asked GAO to devise a plan whereby Congress could effectively bring under its control Federal loan guarantee programs.

As a general matter, we believe that the public can be assured that public resources are being properly allocated only if there is visibility for the decisions which alter these allocations. In our view, the present budget treatment of Federal credit programs—particularly those involving loan guarantees--does not give adequate visibility to these programs. Loan guarantee programs, for example, do not compete for resources within the same decision framework as applies to direct Federal activities or to grant programs.

We have begun work in this area, but the relatively short time frame for our response limits the amount of information that we can provide at this time and precludes our reaching firm conclusions and recommendations. In the interest of providing a timely response, we have not sought the views of the numerous affected agencies with respect to the material contained in this letter. Thus, our thinking at this stage should be considered preliminary, and is subject to change as our work proceeds.

At the outset, we feel it important to indicate that for any proposed loan guarantee program, supporting material should demonstrate that the loan guarantee is the appropriate vehicle for accomplishing the intended purposes of the legislation. There are numerous means by which the Federal Government can achieve a given program goal. Consideration could be given, for example, to such incentives as price supports, tax credits, grants, direct loans, and protection of competition from imports. These vehicles should be evaluated against criteria such as the extent of Federal liability, competitive impact, surety of meeting established goals and administrative feasibility. Loan guarantees are, thus, only one means of achieving a given objective.

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These remarks relate to the decisions which are made regarding whether a loan guarantee program is the best means of achieving the goals of proposed legislation. The problem of "controllability" is another matter. Controllability is important as it relates to both proposed programs and to the myriad of existing programs.

Current Work

We are currently engaged in a review of Federal credit programs. This analysis is a long-term project, and we anticipate that several reports on this subject will be issued over the course of the next 18 months. At the present time, we envision two major areas of review: (1) An analysis of current and alternative budget treatment of direct and guaranteed loan programs and, (2) an analysis of the subsidies implicit in these programs, with emphasis on their costs and their efficiency in achieving program objectives.

We are planning to conduct a survey of Federal agencies responsible for administration of credit programs in order to gather information on:

1. The nature of each program—specifically isolating the beneficiaries of Federal credit programs.

2. The expansion of Federal credit programs during the past five years.

3. The default, delinquency and refinancing experience of each program for the past five years. For our analysis, it is essential that information on default and delinquency experience be developed in order to accurately estimate subsidies.

4. The credit terms under which loans are made or guaranteed. We anticipate that analysis of data on credit terms will enable us to answer questions such as the following: Would the beneficiary of the program have been able to obtain financing without the program? Does the credit program simply ease the terms under which financing is available, and if so, under what terms would credit have been available without the program.

5. The activities of the Federal Financing Bank as intermediary for Federal credit programs.

Further Observations

Our work is still in the early stages. Nevertheless, it seems clear that limited disclosure of activities, particularly with respect to Federal credit programs is a very troublesome budgetary problem. The growth of loan guarantee programs and the legislated removal of some Government programs from the Federal budget are primary elements of this problem. The remainder of this letter presents some of our thoughts on the matter.

Importance of Budget Information

The Federal budget and related documents should serve two general purposes:

1. It should completely and accurately disclose all Federal activity so as to provide a sound basis for establishing the level of resources that should be devoted to any given purpose in the context of the total resource requirements of the Federal Government.

2. It should disclose the totality of Federal activity in such a way as to provide a basis for estimating the impact of government activity on the economy as a whole. Specifically, the treatment of Federal receipts and expenditures should be such that the budget surplus or deficit has meaning.

In general, these two purposes are not at odds with one another. However, in the case of Federal credit programs, they tend, in some circumstances to be in conflict. There is a definite need to disclose fully all Federal credit activities in the budget, but this should not be accomplished at the expense of diluting the analytical validity of the costs associated with the programs themselves and of the budget surplus or deficit.

For example, the making of a grant and the guaranteeing of a loan will both have an impact on the allocation of resources. Thus, both should, in principle, be subject to the discipline of the budget process. But while both sorts of activity have an impact, the nature of the impacts are significantly different. The cost to the taxpayer is likely to be markedly different; the impact on financial markets will be different; and the extent to which resource allocations are actually altered is likely to be different. Simply to count loan guarantees as if they were the same as grants (for purposes of the budget) would seriously distort the meaning and significance of the budget totals.

Recommendations by the Budget Concepts Commission

The problem of finding an appropriate way to treat loan guarantees has been a matter of concern for some years. The most recent formal consideration of the budgetary treatment of Federal credit programs was by the President's Commission on Budget Concepts in 1967. The Commission's concept of a unified budget was adopted in 1969; however, some of its other recommendations have not been adopted.

The most significant of the Commission's recommendations regarding credit programs were:

1. A disaggregation of direct loans from other expenditure-receipt items in the budget for purposes of analyzing the impact of "expenditures" surpluses and deficits on incomes and employment. The presumption was that direct loans have different, though unknown, income multiplier effects than outright expenditures. Nevertheless, the Commission did recommend that the budget explicitly show direct loans in a "loan account" of the budget. The Commission also recognized that "highlighting" direct loans could cause the complication of pushing more and more expenditure and direct loan programs into the loan guarantee area. Although guaranteed loans, under certain circumstances, might have the same effect as direct loans in terms of income generation, the Commission concluded that guaranteed loans should not be included in the budget at their full face value except, perhaps, as a memorandum item.

2. The subsidy elements of all loans (both guaranteed and direct) should be included as expenditures in the budget. Measurement of the subsidy element should, according to the Commission, "reflect both the interest rate subsidy, capitalized at the time the loan is made, and the provision of adequate allowances for losses."

Current Budget Treatment of Credit Programs

Direct loans for "on-budget" agencies are currently reflected in the budget, but they are not presented in the budget as a separate line item (they appear with direct expenditures). For several years, the budget documents made a distinction between loans and other expenditures. This distinction was dropped, however, in the FY 1974 budget.

Administrative expenses and default losses from on-budget agencies for both direct and guaranteed loans are included in the budget. But, in a significant departure from the Commission's recommendations, the budget still does not incorporate an estimate of the subsidy element of Federal credit programs in the budget. Thus, there is still a serious lack of visibility for the true costs of decisions with respect to direct and guaranteed loan programs. The implications are more serious regarding guaranteed loans because, under present budget treatment, a program may be created and substantial contingent liabilities incurred without the cost implications being considered in the context of the budget process. For direct loans, the problem is not as severe because the majority are still counted within the budget totals. Thus, much of the activity associated with the actual authorization and disbursement of direct loans is subject to the budget process.

The Problem of Off-Budget Activities

Another important departure from the Commission's recommendations has been the development of off-budget agencies. Since the Commission's report, legislation has been enacted to remove several Federal agencies from the discipline of the overall budget process; including the Export-Import Bank (the first of the off-budget agencies which moved back onto the budget for FY 1977), the Postal Service, the Rural Telephone Bank, the Rural Electrification and Telephone Fund, the Housing for the Elderly or Handicapped Fund, the Federal Financing Bank, the United States Railway Association, and the Pension Benefit Guarantee Corporation. In addition, an Energy Independence Authority with $100 billion in appropriations and borrowing authority has been proposed by the President with off-budget status in the FY 1977 budget.

The existence of major Federal activities of this sort outside the budget is a matter for serious concern. Programs funded in this way do not have to compete for resources within the same decision framework as is applied to other, perhaps equally worthwhile projects. In addition, the magnitude of such "off-budget" activities is sufficiently large to undermine the credibility and analytical usefulness of the unified budget concept. Thus, we have consistently opposed the creation of "off-budget" agencies except in the very specific and limited circumstances recognized by the Commission. These conditions were, in effect, that the activity in question be owned and controlled by private parties. In the cases noted above, these conditions do not appear to have been met.

The Nature and Justification for Credit Subsidies

The issues with regard to the usefulness and measurement of subsidies contained in Federal credit programs are highly complex. Understanding these issues requires an understanding of the process by which the market finances investment projects and the rationale for Government intervention in the process by means of loan guarantees and direct loans.

In general, direct and loan guarantee programs are justified on the basis that there are socially worthwhile projects which the private market either will not finance, or will not finance on "reasonable" terms. How does the market reach a determination regarding its desired rate of return? In a given market situation, the desired rate of return is determined by (among other things) the probability of default. But the market may not act perfectly in allocating capital. In the first place, it may misjudge the risk and, in the second place, it may fail to consider the social value of the project.

Thus, there are circumstances where the Government should guarantee or make loans on a particular project at a rate that is lower than that required by the market. First, the Government might believe that the market has underestimated the social returns from the project -- i.e., there are external benefits which are unperceived by the private capital market. Second, the Government is better capitalized and, therefore, better able to accept risk than the individual participants in the market.

Default risks are unchanged irrespective of whether the Government or the market underwrites investment projects. And, the potential cost to the Government that arises from direct or guaranteed loans is roughly the capitalized value of the difference between the rate at which the Government guarantees or makes loans and the rate at which the private sector would have underwritten the projects.

But the potential cost to society as a whole of loan programs may be greater than the cost to Government. Both guaranteed and direct loans reallocate resources in the private sector by encouraging projects that would not otherwise be undertaken. Given the fact that credit programs use up resources (whether the budget discloses that fact or not) there is also a reallocation of resources in the public sector or between the public and private sectors. The cost of guaranteed loans can, for example, be expressed not only in terms of the dollar value, but theoretically in the number of schools or highways or factories which must be given up.

Thus, it is very important to recognize that the costs of a loan guarantee program are not measured strictly by the subsidy, but also include the private opportunity costs associated with alternative programs. When projects are evaluated in the budget process, they should not be evaluated strictly on the basis of subsidy costs associated with a loan guarantee or direct loan program. Nevertheless, the subsidy element in a credit program should be an important input into the decision-making process.

Measurement of Credit Program Subsidies

As mentioned, at the present time, the subsidy element in Federally guaranteed and direct loan programs is not included as an expenditure in the budget. Rather, losses and administrative expenses are included as expenditures as they occur. For purposes of planning and control, it would be more desirable (as the Commission recognized) to have the costs of these programs recognized in the budget at the time the authority is provided, rather than at some later time when the Congress no longer has any choice about funding them.

Measurement of the subsidy element in Federal credit programs presents some conceptual problems. There are, for example, difficulties in estimating, as one budget figure, the value of the subsidy to the borrower and the cost of the subsidy to the Government. Theoretically, the value of the subsidy to the borrower would be useful for macroeconomic analysis. But the cost of the subsidy seems more appropriate from a resource allocation point of view.

There are additional difficulties. Estimation of the cost of the subsidy to the government involves estimation of the capitalized value of expected losses from defaulted loans. Successful accomplishment of this procedure will depend upon our ability to overcome some severe problems. For example, FHA expected losses would be fairly easy to measure based upon the historical default experience of the program and/or data on the market clearing mortgage rate in conventional loan markets. Similar treatment of programs such as the Lockheed emergency loan or the proposed Energy Independence Authority program is considerably more difficult. For these programs, there is little information on default experience and, in some cases, there is no reasonable interest rate at which activities of this sort could obtain financing.

The only existing estimate of the interest rate subsidies implicit in Federal credit programs is contained in Special Analysis E of the Federal Budget. Based on our preliminary work, we have some reservations about the assumptions regarding interest rates and the discounting factor employed in that analysis.

We hope that our survey of Federal credit programs will result in a more accurate estimate of the subsidy element of credit programs and help pave the way for a better treatment of credit programs in the budget.

Mechanisms for Congressional Control

You also asked that we suggest an appropriate mechanism by which the Congress could gain effective control over Federal credit programs, especially those involving loan guarantees. At this stage of our analysis, we do not yet have a sufficient basis for recommendations in this regard. However, it seems to us that there are several devices which could be used for this purpose.

One approach would be to count the authority to guarantee loans as budget authority and treat it as being the same as authority to make a grant or authority to purchase goods and services. Apart from the fact that this would require amending the Congressional Budget Act, it involves serious conceptual problems. As we noted earlier, the costs associated with guarantee programs are not the same as those of, say, a grant program. Treating them in identical fashion would seriously distort the budget totals.

A second approach would be to continue the present budget treatment, but require that loan guarantee authority be provided only in specific amounts enacted by the Congress. A possible variant of this would be to require that the use of loan guarantee authority be made subject to approval in annual appropriation acts. As a tentative conclusion, we believe that this approach should be explored.

A third approach would be to treat the subsidy element (not the full amount of the guarantee) as being budget authority. Whether or not this approach is practicable is not yet clear. We believe that our review of this area will help resolve that question. If this approach is feasible, we believe that it is the preferable approach for congressional control of loan guarantee programs.

I hope you find this information helpful. We will keep your staff apprised of the progress and results of our analysis as it proceeds.

Sincerely yours,

(SIGNED) ELMER B. STAATS

Comptroller General
of the United States

cc: Mr. Staats (OCG)
Mr. Keller (OCG)
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