

CBO TESTIMONY

Statement of
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before the
Subcommittee on Procurement, Tourism,
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Committee on Small Business
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Mr. Chairman, I am pleased to have this opportunity to discuss the new budgetary treatment and procedures for federal credit programs that will become effective for fiscal year 1992. The new treatment and procedures, generally referred to as credit reform, were enacted as part of the budget reform provisions contained in Title XIII of the Omnibus Budget Reconciliation Act of 1990. My statement today will focus on three topics:

- o The purpose of credit reform;
- o How credit reform will work; and
- o The effect of credit reform on credit programs.

Essentially, credit reform is expected to improve **significantly** the budgetary accounting, control, and management of federal credit programs. It changes the focus of budgetary accounting from cash flows to the expected long-term costs to the government of providing credit assistance. It also changes the focus of Congressional control from the volume of credit assistance to the long-term costs. No changes will be made in the types or terms of federal credit assistance. Credit reform is primarily an accounting change that

should make an important contribution to improving federal financial management.

THE PURPOSE OF CREDIT REFORM

The budgetary treatment of federal credit programs has long been regarded as unsatisfactory. The heart of the problem is that the budget, which fundamentally depicts the cash flows of the government, is poorly suited to portray transactions that involve streams of loan **disbursements**, guarantees, interest and principal repayments, and defaults over time. Before credit reform, the budget tended to exaggerate the costs of direct loan programs and to understate the costs of guarantee programs in their early **years--the** years that attract the keenest attention of **policymakers**.

The distortions of **cash-flow** accounting for credit programs are readily apparent. When initially disbursed, a direct loan is recorded as an outlay and looks just as costly as a grant. This perception is misleading since some or all of the loan would be repaid later. In contrast, **cash-flow** accounting makes guarantee programs appear inexpensive. A guarantee typically involves no budget outlays at the outset, even if there is every

reason to expect a future default. Perversely, if the government collects guarantee fees, these are recorded as collections. Thus, even high-risk guaranteed loans could appear to be money-makers during the first budget year.

Under cash-flow accounting, therefore, the initial budget impacts are misleading because the costs of loans and guarantees are not accurately reflected. Moreover, this distortion skews the incentives facing **policymakers**. Loan guarantees were favored over direct loans, for example, because their initial impact on the budget was more favorable, even though the expected long-term cost to the government was the same or higher.

The major purposes of credit reform, as stated in the provisions of the Omnibus Budget Reconciliation Act entitled the Federal Credit Reform Act of 1990, are to:

- o Measure more accurately the costs of federal credit programs;
- o Place the cost of credit programs on a budgetary basis equivalent to other federal spending;

- o Encourage the **delivery** of benefits in the form most appropriate to the needs of beneficiaries; and
- o Improve **the** allocation of resources among credit programs and between credit and other spending programs.

Federal credit programs are costly to the federal government because they are intended to provide more favorable terms to targeted borrowers than are available from private lenders. The federal government often lends to those who have been rejected as poor credit risks and **often** does so at less than the **Treasury's** borrowing rates. Hence, most loan programs experience losses from net interest costs, delinquencies, and defaults.

The costs of a direct loan transaction can be divided into two components. The first is the subsidy component, which is the value **of** the cash disbursement that is not expected to be returned to the federal government from borrower payments. The second is the unsubsidized component, which is the amount of the transaction that the government expects borrowers to repay fully over the life of the loan.

Most federal loan guarantees also have a subsidy cost component. Under a guarantee contract, the federal government **usually** pays a private lender when a borrower defaults. In some cases, grace periods are provided during which the **federal** government pays the interest for the borrower to the private lender. The cost of the default and interest payments usually exceeds the value of any guarantee fees the government collects from the **borrower**.

HOW CREDIT REFORM WILL WORK

The central feature of the new credit accounting reform is to identify the subsidy costs inherent in nearly all federal credit programs and separate these costs from the nonsubsidized cash flows. The Federal Credit Reform Act of 1990 defines subsidy as "the estimated long-term cost to the government of a direct loan or loan guarantee calculated on a net present value basis, excluding administrative **costs**." Simply stated, the subsidy is the current value of the amount that the government expects to lose on a credit transaction.

Under credit reform, only the estimated subsidy costs will be included in the budget. The nonsubsidized

cash flows will be recorded in nonbudget financing accounts. The new accounting procedures will apply to new loans and guarantees made in fiscal year 1992. Loans and guarantees made in earlier years will continue to be treated in the budget on a cash flow basis, unless new subsidies are conveyed through debt forgiveness or other **means.**

This new accounting treatment is intended to put loans and guarantees on a comparable cost basis and to permit a more accurate comparison of credit programs with alternative means of aiding **recipients--such** as outright grants. It will end the distortion of budgetary treatment caused by cash **flow** accounting and the skewing of incentives for policymakers to favor one kind of assistance over another.

Appropriations will be required for the estimated subsidy costs for new discretionary direct loans and loan guarantees. For mandatory credit programs, which are entitlements or otherwise uncontrollable through the appropriation process, indefinite budget authority will be provided to cover the subsidy costs for the projected volume of loans and guarantees. Administrative expenses are excluded from the definition of subsidy costs, and

separate discretionary appropriations of budget authority will be required to cover these costs.

Two examples of special interest to this committee may prove helpful. The Small Business Administration runs both the Business Loan and Investment Fund (**BLIF**), which primarily guarantees loans, and the Disaster Loan Fund, a direct loan program. The Congressional Budget Office (**CBO**) estimates that **BLIF** involves a subsidy rate of about 6 percent; that is, with annual guarantee activity of nearly \$5 billion, and even with the collection of guarantee fees, the government expects long-run losses of slightly over \$250 million. The Congress must appropriate these losses (**subsidies**), driving home the point that the guarantees are not costless to the government.

The Disaster Loan Fund, in contrast, would (under baseline policies) make about \$365 million in direct loans in 1992, entailing subsidies of about \$110 million, a subsidy rate of nearly one-third. To maintain this volume of loans, the Congress would have to appropriate these subsidies **explicitly--highlighting** the fact that some, though not all, of the loan is virtually indistinguishable from an outright grant.

The appropriations for subsidy costs and administrative expenses will be recorded in budget accounts that are called credit "program **accounts.**" As new direct loans and loan guarantees are made, the estimated subsidy costs involved in the transactions will be paid to non-budget "financing **accounts.**" These financing accounts will record all of the cash flows associated with new credit activity, including loan disbursements and repayments, collections of interest and loan guarantee **fees**, and default payments. Separate financing accounts will be maintained for direct loans and for loan **guarantees.**

If the subsidy calculations are accurate, the financing accounts will have just enough resources to meet their liabilities. If the subsidies are inaccurate, however, then the financing accounts will record shortfalls or surpluses. Shortfalls will require a budgetary payment. For example, if defaults are greater than expected and shortfalls occur, permanent indefinite budget authority will be available to the program accounts to make additional payments to the financing accounts. In turn, if experience indicates that the subsidies were overstated and the **financing** accounts have

assets greater than claims, the financing accounts will make payments to the budget to refund the overage. These payments would be shown in the budget as offsetting **receipts**.

As noted earlier, the financing accounts are non-budget accounts and their **cash-flow** transactions will no longer be included in the budget totals. There is an important reason for excluding the nonsubsidized cash flows associated with new direct loans and guarantees from the budget. Only the subsidies represent a cost to the government. These subsidy costs should be the focus for analysis and decisionmaking. Nonsubsidized cash flows are not relevant for measuring the costs of providing loan assistance. The aim of credit reform, which is to focus on costs rather than on cash flows, would not be served if the financing accounts were included in the budget.

Since credit reform is **prospective--it** affects only new credit assistance starting in **1992--something** had to be done about the loans and guarantees made before October 1, 1991. These transactions will continue to be treated in the budget on a cash-flow basis in "liquidating **accounts**." Any activity in the liquidating accounts will be treated as mandatory because their spending is no

longer subject to Congressional **control**. In other words, they will not be included in the accounts subject to the discretionary spending limits imposed by the Budget Enforcement Act. **However**, if any legislative changes are proposed that would affect these pre-1992 loans, such as debt forgiveness or refinancing previous loans with new terms, these changes would be subject to credit reform accounting. That is, the cost of the subsidy inherent in the proposal would be calculated and charged to the appropriate scorecard--pay-as-you-go if done by the authorizing committees or to discretionary spending if done by the appropriations committees.

THE EFFECT OF CREDIT REFORM ON PROGRAMS_____

All credit programs are currently subject to some form of Congressional **control**. The Congress has used three methods to limit direct loans and loan guarantees: setting limits on loan volume in appropriation bills; appropriating a limited amount of budget authority for new credit activity; and, for mandatory programs, setting eligibility criteria and benefit levels in legislation. None of these methods, **however**, is closely related to measuring and controlling the cost of credit assistance to the government.

Under credit reform, the focus of control will be on subsidy costs. For discretionary programs, no new federal credit can be extended without an appropriation of budget authority to cover the estimated subsidy **costs**. These appropriations will be subject to the discretionary spending limits set by the Budget Enforcement Act. That is, discretionary credit programs will compete for new funding authority with all the other discretionary spending programs. But since credit reform focuses on subsidy costs, the competition for new funds will be more fair. Costly loan guarantees will no longer have the advantage of cash-basis accounting, and direct loans will not be disadvantaged in comparison to direct grants.

Although credit reform may improve the **Congress's** ability to control spending associated with discretionary programs, little will change for credit entitlement or mandatory programs, such as the loan guarantees **for veterans'** housing loans or **for** student loans. Eligibility criteria will continue to control volume. Any legislative changes in the terms of these mandatory programs, or changes in eligibility criteria that would affect loan volume, however, would be subject to the new pay-as-you-go provisions of the Budget Enforcement Act.

As I noted earlier, credit reform will not change the **types** or terms of credit assistance currently being provided. Most borrowers will probably be unaware of this accounting change. Borrowers will continue to receive direct loans and loan guarantees from the same federal agencies that currently provide assistance, and agencies will administer loans and guarantees as they do **now**.

In addition to improving the budgetary treatment of credit programs, and enhancing the **Congress's** control of credit costs, credit reform will result in improved financial management. But the transition involves formidable challenges. Credit reform will require changes at the Office of Management and Budget (which presents budget information and apportions **funds**), in the Department of the Treasury (which will set agency reporting standards and report actual budget outcomes) and, most critically, at the agencies that administer credit programs. The agencies must establish new accounting systems in order to provide data for calculating and tracking subsidy costs. For example, they must collect information on cash flows for each cohort and type of loan, so that default rates and recovery rates can be calculated. They must also issue clear guidance to field offices and to participating

private lenders, instructing them, for example, on how to report loan **disbursements**.

Credit reform has been advocated for several years. The Office of Management and Budget, the General Accounting Office, and the Congressional Budget Office recommended its adoption. Nonetheless, we should be mindful that all institutional changes can have unintended consequences. In **particular**, one risk of credit reform seems sufficiently great as to warrant special care and attention. This risk is that subsidy costs will be systematically underestimated or otherwise subject to distortion for political purposes. Since the financing accounts are not included in the budget totals, there is an incentive to underestimate subsidies and shift costs to the financing accounts. Subsidy cost estimates will need careful monitoring by disinterested parties, such as the GAO, CBO, and the Inspectors **General**.

Fortunately, the Budget Enforcement Act acknowledges that subsidy cost estimates remain somewhat uncertain, and contains special provisions that protect Congressional committees against changes in estimates, while enabling more and better information to be incorporated. The discretionary spending caps for 1992 have already

been adjusted for the switch to a new mode of accounting. The caps will be revised again in 1993 and 1994 if estimates of the subsidy rate changes--that is, if OMB decides that a given level of lending involves higher (or lower) subsidies than it **previously** thought.

CONCLUSION

Undoubtedly, there will be problems in carrying out the accounting requirements of credit reform. Federal agencies and Congressional committees will need to adjust to the new procedures. Nevertheless, the expected benefits of credit reform in terms of improved budgetary **treatment**, Congressional control, and agency financial management should far outweigh any of the costs of this institutional change.