The Federal Government in the United States has a wide variety of programs to make direct loans and guarantee private loans in areas ranging from housing to higher education to different types of business. They are not a major part of fiscal activity, but they are large and numerous enough that it has always been necessary to pay them special attention. The Federal Credit Reform Act of 1990 transformed the method of budgeting for these programs. Previously they were not controlled or not controlled adequately by the budget process, but now they are integrated on an equivalent basis with all other types of Federal government spending.\(^2\)

Three systems of budgeting will be compared:

- The previous method, which had serious defects.
- The credit budget, which attempted unsuccessfully to remedy these flaws.
- Credit reform, which has been successful but has its own difficulties.

**Previous Method of Budgeting**

The previous method of budgeting had three crucial features.

*First*, the budget recorded direct loans and loan guarantees on a cash basis.

- For direct loans, the budget recorded an outlay for the amount of the disbursement. Collections of interest and principal repayments were recorded when received in future years as offsets to the outlays in those years.

- For loan guarantees, the budget did not record any outlay when the guarantee was made, because the guarantee was not a cash transaction. Outlays were recorded in future years when default payments were made.

As a result, the budget did not measure the cost of making loans or guaranteeing loans.

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1 Revised 2/20/04 and 4/10/04 to clarify and to include additional statements made at the meeting.

2 This paper does not address other types of credit assistance: the sponsorship of several enterprises that provide financial intermediation for housing, higher education, and agriculture but are privately owned and controlled; insurance of the deposits of banks and other depository institutions that make loans; and the exemption from income tax of the interest on state and local government bonds.
• The budget recorded more than the cost of direct loans, because the cash inflows came later.

• The budget recorded less than the cost of loan guarantees, because the cash outflows came later.

*Second*, loan guarantee programs were most commonly controlled by ceilings in the authorizing legislation on the amount of guaranteed loans outstanding. The ceilings were usually designed to cover several years of activity at once.

As a result, activity was controlled outside the budget process at the initiative of the authorizing committees. They did not review the level of activity annually or compare it with alternative programs or with the overall demand for resources.

*Third*, most direct loan programs were conducted with revolving funds.

As a result, the collection of interest and principal repayments:

• automatically provided the program with budget authority – the authority to enter into new obligations – for making more loan disbursements without Congress taking any action; and

• offset the loan disbursements in calculating outlays.

**Effects of Previous Method**

The previous method had fundamental weaknesses:

• The difference between budget outlays and cost conflicted with the basic needs of good decision making. Decision makers should have the information and the incentive to compare the cost of a proposal with their judgment of its benefits and with other uses of resources. This requires that the budget record the full cost upfront when decisions are made.

• Revolving funds allowed new program activity without Congress taking action.

• The control of loan guarantees in a separate process outside the budget -- based on outstanding amounts -- prevented trade-offs and effective control.

Because of these weaknesses:

• The costs of direct loans and loan guarantees were not included in the budget. As a result:

  o Costs could not be compared with program benefits.
o Trade-offs could not be made between direct loans and loan guarantees and between credit programs and other programs.

- Revolving funds allowed some new direct loans to be made without any trade-offs in the appropriations process or any consideration of the budget totals.

- Loan guarantees could be made without any trade-offs in the appropriations process or any consideration of the budget totals.

- There was an incentive to issue loan guarantees, which appeared free; and not to make direct loans, which appeared more costly than they were.

This was not all. The difference between budget outlays and cost for direct loans was so great that it produced pressure to violate the budget rules.

- Some direct loan programs were moved off-budget or created off-budget by law. Although the off-budget entities were included in the budget documents, their outlays were not included in the budget totals that were most prominent and most widely used.

- Revolving funds sold loans to offset loan disbursements and to obtain budget authority immediately rather than over the normal course of time during which the loans would be repaid. Various devices were employed to get better prices. Individual loans were guaranteed; certificates of participation in pools of loans were sold; and certificates were guaranteed. The so-called “loan asset sales” became the same in substance as borrowing.

- The Federal Financing Bank was created as an off-budget entity within the Treasury Department. It bought loan assets from revolving funds; and it made direct loans to the public off-budget on behalf of agencies with guarantee programs in lieu of the guarantees those agencies would otherwise have issued.

As a result, the budget was not an effective means to make decisions about allocating resources through direct loans and loan guarantees. Even when transactions were recorded in the budget, credit was effectively off-budget and out of reach of fiscal rules.

**The Credit Budget**

These weaknesses were widely recognized but hard to resolve. A separate credit budget, overlapping with the regular budget, was created in the late 1970s to control direct loans and loan guarantees. The Administration proposed limits on direct loan obligations and loan guarantee commitments in annual appropriation acts. This was intended:

- to control credit at the point where it could be controlled; and
• to integrate control over credit with control over the rest of the budget.

The credit budget was not effective:

• It did not measure the costs of loans and guarantees.

• The volume of commitments or obligations was not commensurate with the outlays of other programs.

• It did not integrate credit with the rest of the budget.
  
  o Trade-offs could not be made between different types of credit or between credit and other programs.

  o The control system had only indirect effects on the deficit and therefore on whether the government met the fiscal rule prevailing in the latter 1980s.

  o Limits were not enacted for all programs and were often generous.

**Credit Reform**

Renewed debate in the middle 1980s placed emphasis on budgetary measures of the cost of credit. Congress passed a law in 1990 that created an accrual method of budgeting for direct loans and loan guarantees. It has several major characteristics:

• The subsidy cost is defined as the present value of all cash flows from the government to the public, minus the present value of all cash flows from the public to the government. The cash flow estimates are made over the entire life of the loan or guarantee. They may be thought of as expected values in the statistical sense.

The cash flows include all dimensions of a loan or guarantee: default losses; low interest rates or other financing features, such as grace periods; interest supplements on guaranteed loans; fees; the administration and sale of collateral property; and so forth. All of these are part of the cost of the loan or guarantee to the government. They need to be combined into one single, comprehensive figure to compare costs with benefits or with the costs of alternative programs.

• Congress must appropriate the subsidy cost before an agency can enter into obligations to disburse direct loans or guarantee loans made by others.

• Outlays in the amount of the subsidy cost are recorded in the budget when the direct loan or guaranteed loan is disbursed.
• Modifications of direct loans or loan guarantees can change the subsidy cost after the loan is disbursed. Congress must provide an appropriation to cover the cost before a modification can be made, and outlays are recorded.

• Agencies must reestimate the subsidy cost throughout the life of the loan. Because they are uncontrollable, reestimates for an increase in cost have permanent budget authority. Outlays are recorded.

• Cash flows are recorded in separate financing accounts that are excluded from the budget totals because they do not measure a cost. Because they do not measure cost, they are outside the budget in concept and therefore are not considered off-budget.

• The Act applies to virtually all direct loans and loan guarantees.

As a result:

• The budgetary costs of direct loans and loan guarantees are equivalent to each other, they are equivalent to the costs of grants that might be provided in place of credit, and they are equivalent to the costs of other types of spending.

• These costs are recognized in the budget upfront when decisions are made about allocating resources – in budget authority, in obligations, and in outlays

Use in Financial Accounting

The board that sets accounting standards for the federal government – the Federal Accounting Standards Advisory Board -- adopted the same accrual method for accounting. They endorsed the method and wanted to support the budget. This has proved helpful:

• It provides some degree of audit assurance about the subsidy cost estimates.

• It gives accountants an incentive to produce the data needed to estimate subsidy cost and to keep track of loans and guarantees on a credit reform basis.

Benefits of Credit Reform

Credit reform has several major benefits.

The way of thinking. – Policy makers, managers, and staff have no choice but to think about the cost of credit programs for the first time. They formerly thought mainly about volume.
Controlling the size of the budget.

- Because the budget authority, obligations, and outlays in credit programs are equivalent to those for other programs, they can be included in fiscal rules that control spending. They were included under the fiscal rule that controlled discretionary spending from 1991 to 2002 – in fact, credit reform was part of the same Act – and they are included in the Administration’s new proposal.

- There is no special incentive to remove direct loans from the budget.

- Making guarantees will increase budget outlays now, not in the future.

Program decisions and trade-offs.

- The Executive branch and the Congress can compare the cost of a program with its benefits.

- The Executive branch and the Congress can trade-off credit programs against each other; against programs that are aimed at the same group but use grants instead of credit; and against other programs in general. This is because these programs are all measured on an equivalent basis; they affect the budget totals in an equivalent way; they are subject to the same limits; and they are subject to the same congressional procedures.

Providing credit efficiently.

- The appropriation of subsidy cost is limited by competition from other programs. This provides agencies with an incentive to design programs to get as much benefit as possible from a given subsidy cost.

- For example: (a) Some guarantees have been made for less than 100 percent of the principal to lower the subsidy cost. This not only reduces cost directly; it also gives lenders an incentive to examine borrowers for creditworthiness. (b) Fees have been used to reduce cost, even bringing it down to zero. (c) Agencies have compared costs of direct loans and loan guarantees in designing programs.

- A new direct loan program can be created without facing insurmountable barriers from the way it is measured in the budget. The previous Administration created a direct loan program for students to compete with loan guarantees, but this would not have been feasible without credit reform unless it had been off-budget.

Accountability.

- Credit reform has forced agencies to substantially improve their accounting.
• By requiring reestimates, agencies are held accountable for their estimates and decisions.

**Difficulties**

Nevertheless, there are significant difficulties in budgeting for credit this way.

**Subsidy costs are understated in the design of credit reform.**

• Administrative costs are excluded. Instead, they are recorded separately on a cash basis every year and subject to annual appropriations. This was done to avoid the problem of budgeting in advance for an element of cost that can be controlled in the future.

• The credit subsidy is based only on the expected value of cash flows discounted by Treasury borrowing rates. It does not include a charge that compensates the government for its exposure to unexpectedly high losses due to economy-wide fluctuations. Options pricing is being considered at the staff level, but this is only the start of a process that may take years even if it is successful.

• Some programs have costs that are hard to estimate, such as supplementary payments to lenders of student loans that are due only if interest rates exceed a certain level.

• The understatement of subsidy cost leads to negative subsidy estimates in some programs. In these cases, the size of the program is controlled by obligation limits rather than cost.

**Credit reform is complex by nature**

• It is demanding in terms of conceptual understanding when one goes beyond the most basic ideas to such subjects as which Treasury interest rate to use for discounting or how to make reestimates; and it has been applied to more sophisticated cases than contemplated when it was designed. Agencies may not be able to afford financial specialists with fully adequate skills.

• Subsidy cost estimates need statistical models for each type of loan to estimate the cash flows throughout the life of the loan and to reestimate the cash flows when more information is learned.

• Statistical models need to be developed from accurate and comprehensive databases, yet some agencies have outdated systems or, in the case of guarantees, have difficulty obtaining timely and adequate information from the lenders.

• The demands on the accounting system are very great to maintain a database of pact activities and keep track of loans and guarantees by cohort.
• Reestimates can be very large, larger in a single year than the subsidy cost of new loans or guarantees.

• The Office of Management and Budget has simplified its original guidance. For example, reestimates are not required every year. However, agencies still find credit reform difficult to implement.

Subsidy costs are estimates about an uncertain future and could be manipulated.

• There is pressure on occasion to manipulate the estimates.

• The Congressional Budget Office and General Accounting Office have not found evidence of systematic bias. Having the Office of Management and Budget in final control of the estimates made by the agencies is important in limiting mis-estimates.

Conclusion

Despite these difficulties, credit reform has greatly improved the budgeting for credit.

Addendum

The United States has a obligations-based budget in which most transactions are recorded in cash. The case of credit is not an argument for an accrual-based budget. It is instead an argument for using accruals as a tool in the budget when the government makes a binding commitment now that will result in large cash inflows or outflows in later years. These cases are not common, but they are important when they occur.