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Mr. Chairman and members of the Task Force on the Budget Process, I am pleased to be here today to discuss proposals for improving control over federal credit programs. I appear before this task force because I have had a continuing interest in federal credit programs for a number of years and personally consider the lack of comprehensive controls over these activities to be a major shortcoming in the budget process. Other members of the Board of Governors support this position and the analysis in this statement.

The need to improve the budget treatment of federal credit activities has long been recognized. Both the <u>1963 Report of the President's Committee on Federal Credit Programs</u> and the <u>1967 Report of the President's Commission on Budget Concepts</u> called for reforms in budgetary treatment of federal credit programs. To date, however, very little progress has been made in this area. The Congressional Budget Act of 1974 was particularly disappointing in this regard, because it specifically exempted loan guarantees from the budget process and did not develop a comprehensive framework for evaluating these activities. Given this background, it was especially heartening earlier this year when the Administration indicated its intention to establish a system of control for federal credit programs.

The provision of credit assistance through direct loans and loan guarantees in order to achieve particular social and economic objectives is, of course, a legitimate activity of the federal government--provided that the assistance is handled in a responsible manner and held to a reasonable level. Credit programs originally were established to correct imperfections in capital markets which left credit unavailable to many groups or made its cost prohibitive. For example, the FHA-insured loan programs were devised by the federal government during the Great Depression to reduce the risk perceived by lenders in making loans for home purchases. By pooling risks across a large number of loans issued in a standardized fashion, the government program encouraged private lenders to advance credit at a lower cost to borrowers and on less restrictive non-rate terms than would otherwise have been possible. As a result, private individuals were able to finance the purchase of homes on terms involving more reasonable interest charges, more liberal loan-to-value ratios and longer maturities than before. Another popular mortgage assistance program has been operated by the Veterans Administration. Over time, the extension of low down payment - long term mortgages has gained general acceptance by all types of private lenders.

Many other federal credit assistance programs have been introduced over the years to foster desirable social objectives. In contrast to the home mortgage area, however, the default experience in the case of some of these programs--such as student loans and assistance for low income housing--has been comparatively high. Thus the government has had to absorb sizable losses in addition to providing a subsidy to borrowers in the form of loans at below market interest rates. In the past few years, the federal government has also guaranteed sizable loans to single borrowers that carried a large potential for default.

The reference to these recent federal credit activities helps emphasize the point that the benefits of these loan programs are not obtained without cost. These costs include not only the interest subsidies, the administrative expenses, and the default losses but also the real loss in public welfare that occurs when federal credit programs are expanded beyond socially desirable and efficient levels. In this regard, the Administration and the Congress must keep in mind that the supply of credit is not unlimited. Direct government loans or loan guarantees that enable one group of borrowers to acquire funds may make it more difficult for other groups to obtain credit accommodation.

The potential for such displacement depends, of course, on the extent to which the economy's resources are being utilized and on conditions in credit markets. During recessionary periods, when credit supplies are readily available, credit assistance programs may result in an increase in total credit flows, and thus may promote a more intensive use of resources and an expansion in the level of economic activity. On the other hand, in situations where productive resources are being pressed by strong demands for goods and services and credit supplies are tight, there is a much stronger tendency for credit extended under federal auspices to supplant the loanable funds available to other borrowers. Moreover, to the extent that such programs result in an expansion of spending, upward pressures on prices may be exacerbated and the task of government economic stabilization policy may be complicated. Thus, during periods of unusually strong credit market demands, the growth of federal credit programs may need to be restrained in order to ease inflationary pressures.

The recognition that federal credit activities involve substantial costs suggests that all such programs should be subject to a careful and comprehensive examination. As indicated earlier, however, the procedures currently being followed to evaluate, fund and account for the federal government's direct lending and credit assistance activities are seriously deficient. As a result of these deficiencies, the Congress is only able to make an imperfect assessment of the effects of all federal credit activities on economic stabilization and resource allocation. If direct loans, loan guarantees and preferential tax treatment were given the same attention in the budget process as direct federal expenditures, the extent of total federal assistance to particular sectors would look much different from what is currently pictured in the unified budget. The amount of total assistance to agriculture and housing, for example, is substantially greater than the volume of direct loans made to these sectors. Moreover, the American people and their representatives are not being properly informed as to the extent of the government's impact on total credit flows.

The magnitude of federal credit activities has become quite large in recent years and further rapid growth is in prospect. Gross loans and loan guarantees outstanding are estimated to have totalled over $350 billion in the fiscal year just ended. This is more than double the $157 billion level reached just 10 years ago. In addition, loans held by government sponsored agencies are projected to have been $142 billion in fiscal year 1979, up $15 billion from the year before and by over $100 billion from the level 10 years earlier. Moreover, these credit activities are projected to grow rapidly in the years ahead. In January, for example, the Administration forecast that net credit advanced under federal auspices--direct, guaranteed and sponsored--would increase by almost $60 billion in fiscal year 1980. If total credit flows in the coming year turn out to be roughly the same as in the past year, then funds raised under credit assistance will account for about one-sixth of the total net funds raised in financial markets.

As noted earlier, only a small portion of this credit activity is ever considered by Congress in its deliberations on the budget's expenditure targets. Loan guarantees, in particular, do not involve an expenditure of funds and are thus not reflected in the unified budget, except in those instances where appropriations are required to cover the cost of defaulted loans. Moreover, credit extended by privately owned and sponsored credit agencies is not recorded in the budget totals, even though the liabilities issued by these agencies to finance their operations have an implicit (and in some cases explicit) government guarantee.

The picture of federal credit activities also is clouded by the operation of the Federal Financing Bank. The FFB uses funds borrowed directly from the Treasury to support the lending activities of federal agencies and to acquire certain types of guaranteed loans. By operating in this way, the FFB has successfully carried out its mandate, since it has eliminated the congestion which often occurred when the agencies attempted to finance their operations directly in the credit markets. By relieving this congestion, the FFB also helped reduce the interest costs of such programs. In fulfilling its function, however, the FFB has reduced the accountability of federal credit programs, because lending activities are attributed to the FFB rather than to the agency originating the transaction.

These problems of accountability are matched by imperfections in the Congressional review process. All federal credit programs, of course, have been authorized by law and are subject to oversight by the Congress. In the case of some loans made by "on budget" agencies, this oversight is conducted annually. However, most programs are not subject to annual review, as authorizations to engage in activities frequently are set for several years. Moreover, credit limits often are stated in terms of net credit extended (or loans guaranteed) rather than in terms of the gross volume of such lending activity.

In general, these accountability problems--especially as regards resource allocation and stabilization policy--could be improved by establishing a federal credit control budget along the lines suggested by the Administration. Under this approach, annual limits would be placed on gross loan activity for both direct and guaranteed loans. These legally binding limitations would be established annually and would be included in the Presidential and Congressional budget process. When faced with a credit limit, Congress would be forced to consider how each program affects the ceiling, and how it integrates with other credit and noncredit programs to achieve specific budget objectives.

To implement such a control program successfully, Congress should establish a uniform set of accounting procedures for the agencies to follow. At the present time, wide differences exist among agencies in their definitions of assistance provided under credit programs and in the procedures followed in collecting and processing credit data. If Congress is to be supplied with the data required for making informed decisions, such differences must be eliminated.

One tool that might prove useful in evaluating the impact of federal credit activities on overall credit demands is the "Flow-of-Funds Accounts." Flow-of-funds statistics for past periods and credit flow projections for future periods are readily available. The use of this data will serve to emphasize that the nation's credit supply has limits and to indicate that some sectors may be adversely affected by federal credit activities. Furthermore, focusing on the government involvement in overall credit flows should facilitate the coordination of fiscal and monetary policies.

The Administration's study also has suggested that sales of certificates of beneficial ownership (CBO) be treated as a form of borrowing rather than as a negative outlay. This proposal should be adopted, given past attempts by agencies to hold down net loan activities and hence outlays through the use of offsetting CBO sales. Another proposal that seems sensible involves requiring FFB purchases of guaranteed loans to be attributed to the agency originating the guarantee. Additional legislation, however, may be needed in order to prevent agencies from circumventing this allocation process. Agencies, for example, should be prohibited from guaranteeing obligations sold to the public when the issues resemble assets currently being sold to the FFB. The inclusion of all direct lending and loan guarantees in the credit control system and the imposition of limitations on these programs, of course, will reduce incentives to channel loan guarantees away from the FFB. Safeguards will also have to be established to constrain agencies from turning to other arrangements-- such as increased regulatory activity, long-term leasing agreements and price support activities--which can be used to achieve the same allocation purposes as loan guarantees.

In general, the scorekeeping proposals set forth by the Administration in last January's budget appear sound. However, logic would argue against the recommendation to keep direct lending of federal agencies in the unified budget. In the Board's view, direct loans should be taken out of the unified budget and recorded instead in a carefully controlled credit assistance budget. After all, they are not the same as other government outlays, since financial assets are acquired in conjunction with the disbursal of funds. In addition, direct loans appear to have essentially the same implications for economic stabilization, resource allocation, and income distribution as do loan guarantees. The removal of direct loans from the unified budget assumes, of course, that coincidentally a comprehensive federal credit budget will be adopted, so as to prevent any loss in the scrutiny and control of these programs. Certainly such a change should <u>not</u> be made until the credit budget is in place and working.

While a broad range of questions pertaining to the budgetary treatment of federal credit activities have been covered by the Administration, a number of other important issues did not receive adequate attention. First, procedures need to be developed that will permit policymakers to determine the trade-offs between accomplishing social objectives through direct outlays, on the one hand, and through federal credit programs on the other. Similar criteria need to be developed to provide guidance for choosing between giving credit assistance through direct loans or loan guarantees.

Second, the budgetary treatment of nonrecourse loans--such as those made by the Commodity Credit Corporation to farmers--should be studied in greater detail. Since nonrecourse loans need not be repaid, an ongoing question exists as to whether these transactions should be treated as outlays or as loans at the time when the funds are disbursed. Similar accounting questions also can be raised in connection with other direct nonrecourse loan programs, especially foreign loans. For example, the accounting and budgetary treatment of funds disbursed as loans under the International Development and International Security Assistance programs is far from clear, since the ultimate collectibility of such loans may depend on unforeseen international developments.

Given the importance of these unanswered questions, the Board believes that a new budget commission should be appointed to study these issues. The creation of a new commission need not delay the implementation of the Administration's credit control proposals. Rather, it would be advisable in our view to push ahead and set up the new control system, and then make adjustments to this system, if the commission's studies deemed such changes to be desirable.

The establishment of a credit control budget to appraise, control and keep track of federal credit programs should lead to the proper evaluation of new programs and, at the same time, insure that such activities are subject to wide publicity and intense review. Past experience, however, suggests that the mind of man can be highly inventive. Whatever restrictions are placed on fiscal activities or credit programs, ways may be found to circumvent them. Thus, Congress should carefully consider the advisability of establishing formal rules to require the reconvening, at regular intervals, of a budgetary commission to review the conceptual and measurement problems associated with the unified and credit control budgets.

Finally, consideration should be given to establishing a Credit Control Office within the CBO in order to provide Congress with detailed technical data on the costs and benefits of federal credit programs, and with up-to-date scorekeeping reports on federal credit activities. These reports also would include a credit information system that encompasses total federal lending activity by budget function and by economic sector. Ideally, such a system also would provide information that highlights the federal government's total involvement in, and assistance to, sectors in the form of direct outlays, direct loans, loan guarantees and tax expenditures.

To sum up, the Board of Governors fully supports the Administration's decision to establish a credit budget. Such action is urgently needed to improve our ability to evaluate and control federal credit activities. In addition, we believe that a standing commission should be formed to carefully study a number of unanswered questions regarding the accounting treatment of federal credit programs and that a Credit Control Office should be established in order to provide Congress with the technical data and analysis needed for control purposes.

This concludes the prepared statement, Mr. Chairman. I will be happy to answer any questions that the Task Force may have.