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Meeting public needs: an appraisal

Remarks of Robert P. Mayo
President, Federal Reserve Bank of Chicago
before the National Tax Association
and the Fund for Public Policy Research
Boston, Massachusetts, April 12, 1972

It is a pleasure to meet with you to discuss a few aspects of the national resource allocation process, and the role of the "Budget of the U. S. Government" in that process. I want to talk to you not only from the viewpoint of one who has labored — seemingly endlessly — in the preparation of the budget (and as a former Treasury official who felt the heavy hand of budget constraints on program administration), but also as a citizen who has thought considerably about the budgeting process since laying down the directorship burden. But despite the title of my remarks, let me emphasize that I'm speaking strictly on my own. No one in the executive office has seen my text.

Some initial questions

Fundamental to any appraisal of our capabilities of meeting national needs is the requirement that we distinguish between desires and needs, that we have an accurate appraisal of the extent of our resources, and that we learn to allocate those resources wisely. The key words are "planning" and "priorities." We live in a world where resources and capabilities are not limitless. We should be used to this by now, but oftentimes we refuse to believe it. We cannot have everything we want—not even we Americans.

We must make choices. We must use priorities to allocate our resources in a practical way, both in terms of the assignment of resources to specific federal programs and in the implications of resource distribution between the federal government sector and the rest of the nation's economy.

This process of resource allocation requires that some critical questions—easy to ask but difficult to answer—be answered for every program we examine:

1. Is it a program that the nation really wants, needs, and can afford?
2. Is the federal sector the proper arena for the program's activity?
3. What share of the total resources available should be assigned to the program in the light of other needs?
4. What commitments of future resources are being made when the decision is made to start the program?

Answering these questions may be easy in a dictatorship. In a democracy, particularly one such as ours which has such an elaborate system of checks and balances on power, the necessity for broadly-based support means that the process is extraordi-

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narily complicated. We get the job done, but the process is cumbersome. "To muddle through" is a well-known British phrase; yet it quite effectively describes the way many American problems of resource allocation are "solved."

The three phases of resource allocation

The process of resource allocation at the federal government level occurs essentially in three phases. The first is the year-long (plus) executive task of program examination, resource evaluation, and related tasks which culminate in the formal budget documents presented by the President to the Congress at the end of the January preceding the new fiscal year beginning July 1. The second phase is the legislative task of examining, altering, and authorizing specific programs, providing the obligational authority to incur expenditures, and levying the taxes to pay for them. The third phase is the administrative implementation of the spending authority. The Congress only authorizes; the Executive obligates and spends. The President's powers over the timing of some expenditures and the staffing of executive agencies can, of course, further alter previously assigned priorities—but mostly in a relatively minor way. This third phase is important too—witness the recent outcry from Capitol Hill that the executive branch is withholding spending in direct disobedience of congressional intent. But today I am primarily concerned with the first two phases of the process.

What is the budget?

The conceptual development of the budget has been evolving gradually over many years. Yet only half a dozen years ago it was hard to tell what someone meant when he talked about the budget—or indeed what agencies he included when he talked about the federal government. There was the old traditional administrative budget—the Congress' favorite approach. There was the consolidated cash budget with its more comprehensive approach. The national incomes account budget had special appeal to the economist. And we add to these the confusion of new obligational authority forms, capital versus operating budget concepts, and other ways of viewing the financial expectations of the federal government for the year ahead.

The growing need to improve the usefulness of the budget to the Congress, which has to act upon it, and to the public, that bears the ultimate responsibility, led, in 1967, to the establishment by President Johnson of the "President's Commission on Budget Concepts" to evaluate the various budget approaches. The end result of the efforts of this group was the concept of a unified budget, a framework that has been used for all budget presentations from January 1968 on. Within this framework, the budget has become a much more coherent plan for the financial operation of the government in the year ahead. But the budget is even more than this in its time span. The continuing nature of the governmental process requires planning beyond the budgeted fiscal year. President Nixon was the first President to appreciate the importance of publicly-released forward planning information. As a result, both the budget document and the President's Economic Report for the last three years have included explicit summaries of five-year forward planning for both the federal government and the nation, with the implications for the future of the detailed fiscal planning for the budgeted year.

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The budget process

The preparation of a new budget is a long process which begins well before the ink is dry on the current documents. Although policy determinations by the President, evaluations of agency proposals, and other exchanges of information go on almost continuously from the beginning to the final editing of the budget documents, there are distinct steps in the process. In early spring, each analytical group in the Office of Management and Budget begins to evaluate the programs of each agency and to make cost projections with particular emphasis on modifications to existing programs, innovations, and alternative long-range plans. Even before then, program evaluation studies will have provided in-depth appraisals of individual programs, quite independent of the timing of the budget itself.

By summer, these initial projections will have been reviewed within the White House, revised, shaped into a preliminary summary, and submitted to the President for his consideration. During this same period, revenue estimates have been prepared by the Treasury after consultation with the Council of Economic Advisers and the budget experts. With both sides of the budget in hand, the President establishes his framework of program and fiscal policy within which the final budget is to be constructed. Each agency is given policy guidelines within which it is told to plan its activities. Needless to say, each agency is given a target which it finds unduly restrictive—if not downright unfair. But it is the role of the budget director to be "equally unfair to everyone!" During the fall and early winter, detailed individual agency plans are prepared and reviewed, and finally presented to the President for his final consideration, with the agency head having the right of appeal to the President if he feels he must. The economic and revenue considerations are simultaneously updated, reviewed, and presented to the President for final policy determination. From these deliberations the formal budget is assembled for submission to Congress, and the whole process begins again. At the same time, the congressional committees start their detailed review.

It would be nice to believe that this whole budget process was highly analytical, smoothly determining priorities and costs. Unfortunately, the real world is not that accommodating. It is true that a number of analytical tools have been developed which facilitate both revenue estimating and certain aspects of program evaluation. Use of program analysis has become widespread throughout the government, and it has certainly proved useful in evaluating the relative merits of two similar programs—such as two different weapon systems or alternative space programs. When it comes to determining the relative merit of a socially-oriented program, such as the Job Corps versus a new nuclear carrier, we have a long way to go. We face a major challenge in the development of useful yardsticks, particularly for socially-directed programs. The development of good social statistics, measures of social well-being—analogous to the national income accounts for measuring economic well-being—is just one new approach which is still in its infancy.

The heavy hand of the past

At present, the budgeting process is largely pragmatic. The pragmatic element will never be eliminated, no matter how complete the stock of analytical tools becomes. There are too many constraints which limit budgeting freedom, quite apart

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from the effectiveness of program evaluation. The past lays a heavy hand on the whole budget process. Programs initiated years ago make major demands on today's resources. Although the budgetmakers may spend substantial time and energy in devising better ways to meet current problems through alteration and replacement of current programs, they can never start the preparation of a new budget with a clean slate.

The past presents its demands in several ways. First, there are always outstanding appropriation balances to cover contracts and other firm commitments where the Congress has previously provided funding covering more than one year. Obligational authority of this type accounted for 40 percent or more of spending proposed in recent budgets. These long-term authorizations affect much more than just the current year. Funds carried forward to years beyond the budget year from these past actions have averaged 70 percent of annual outlays during the past five years. During this same period, the total authority to be carried forward, including the new authority requested in the budget for expenditure in future years, has been, on average, more than 20 percent larger than the proposed current year's expenditure. These carryovers of funds, and the commitments they represent, are a major restraint on budget planning; but they are not the only ones.

Many of the outlays which the federal government must make are classified as "relatively uncontrollable" either by virtue of continuing authority or the nature of the expenditure. These include such programs as veterans' pensions, social security benefits, and similar costs almost totally determined by legislation that the Congress will almost never restrict and almost always expand. Other "relatively uncontrollable" items are farm price supports, largely determined by farm productivity, political considerations, and world market conditions; and interest on the public debt, determined by past fiscal policy and, to some extent, dictated by the money and capital markets. Taken as a whole, in any particular year, about 70 percent of total proposed spending is relatively uncontrollable—and the percentage is growing.

The fact that 70 percent of the outlays are classed as "relatively uncontrollable" does not mean that the remaining 30 percent is available for discretionary allocation. Much of this is needed to meet the rising costs of existing programs because of the normal growth of the population or the number of eligible recipients of benefit programs, because existing programs are enlarged in accordance with pre-existing plans, or because they grow out of firm contracts to purchase goods and services.

I mentioned earlier that the budgeting process must include planning. What is likely to happen in future years is another constraint. Very rarely are programs initiated, funded, and completed in a single year. Programs, both new and in being, must not only fit within current resources, but within the resources which will be available in the future. Furthermore, some future resources should be left available to fill future needs.

The Social Security Program

It is instructive to look at the growth of a specific program in the years following its inception to see how today's initiatives can command tomorrow's resources. The Social Security Act of 1935 first provided for retirement benefits in 1940. By 1950, the number of beneficiaries had grown from

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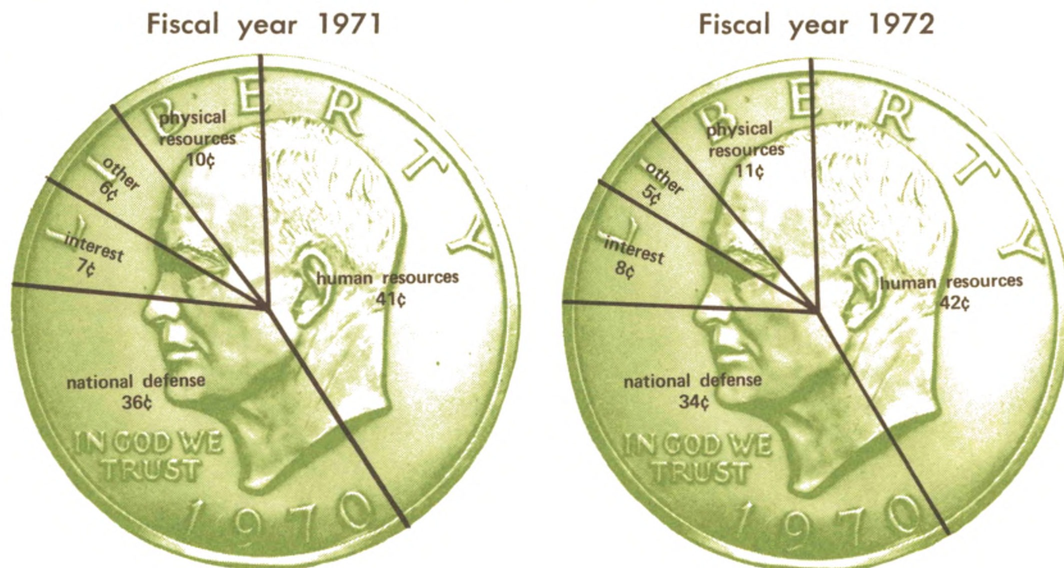
The Social Security Program— How yesterday's initiative commands tomorrow's resources

Year	Total payments		Retirement payments		
	(billion dollars)	*(percent of budget)*	*(billion dollars)*	*(percent of budget)*	*(average monthly payment)*
1940	0.04	0.4	0.02	0.2	22.60
1950	0.96	2.4	0.56	1.4	43.86
1960	11.25	12.2	7.05	7.7	74.04
1970	31.86	16.1	18.44	9.3	109.20
Fiscal 1973*	42.50	17.3	25.50	10.4	130.00

*Estimated.

nothing to 1.75 million, and the average monthly benefit had reached almost $44. Total annual expenditures were about $1 billion—about 2.5 percent of the budget. Twenty years later, in 1970, 17 million persons received retirement benefits, the average monthly benefit had grown to $100, or more than $18 bil-

The shifting emphasis in federal budget expenditures



Note: **Human resources** include: education & manpower, health, income security, and veterans benefits and services. **Physical resources** include: agriculture and rural development, natural resources and environment, commerce and transportation, and community development and housing. **Other** includes: general government, international affairs and finance, space research and technology, and the federal government share of federal employees' retirement and allowances. **Interest** is net of interest paid to the trust funds.

SOURCE: Office of Management and Budget "The U. S. Budget in Brief," (U. S. Government Printing Office).

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lion in total expenditures — almost 10 percent of all federal expenditures. And we have been talking about retirement payments only. Total social security expenditures in 1970 totaled $31 billion. They had reached over 16 percent of total expenditures. The 1973 budget estimates social security expenditures will reach $42.5 billion, 17.5 percent of the total budget. This assumes that the President's proposal of a 5 percent increase in benefit level is adopted—and there are, of course, indications that Congress is seriously considering a larger increase. And it matters not to say that these expenditures are made out of a self-sufficient trust fund and therefore we have no problem. From a strictly economic viewpoint, there is no difference. A dollar of federal spending for a given purpose is the same regardless of the accounting fund structure that records it.

I have gone into detail on this one example because it shows clearly the growth pattern of a major program—a program laudable in its social objectives—to show the limits it places on budget flexibility. Of this massive total of $42.5 billion, only the proposed 5 percent increase can be considered in the "relatively controllable" category. Given the public desire for increased human resource spending and the impact of inflation on benefit levels over the past several years, the priority assigned to this increased commitment must be rated very high. Furthermore, if I had to guess, I would expect that the level of expenditure for social security will be higher in 1976 than any current estimates of that level used for analysis now indicate.

As we look ahead

Forward planning is needed not only on the expenditure side of the budget but also on the revenue side. Resources for new federal programs can be obtained in only three ways:

1. The normal growth of revenues associated with the growth of the economy, insofar as that growth rate is larger than the aggregate growth of current programs.
2. Curtailment or elimination of existing spending programs.
3. Increasing the federal government's share of total economic activity, financing it either by increased taxes or borrowing.

All of these sources of funds must be viewed from a standpoint of priorities and

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the political and economic realities of the time. The revenue may not grow enough faster than current programs to provide resources for new initiatives. Existing programs will, by the very nature of our political process, have priority over new programs merely because they were on the scene first. As long as they are serving a popular purpose, they will also have the first stubbornly-held claim on new funds, although, as we demonstrated in 1969 and 1970 with both the military and space programs, when conditions are right, growth can be restrained.

Curtailment or elimination of existing programs typically is politically even more difficult than restraint on program growth. This alternative will never provide a large source of funds for new initiatives as long as it is easier for both the agencies which make proposals and the Congress, which provides the funds, to continue existing (although relatively inefficient) programs, rather than to do the work necessary to establish more useful alternatives. Furthermore, there are limits—and there should be in my judgment—on the share of the total economy which belongs in the federal sector in a free society. Many people forget that except for the impact of the Vietnam military commitments, this share has been remarkably constant for many years. Thus, the margin of the available resources for new initiatives after meeting existing commitments each year is exceedingly small.

Despite what I have said about the stability of existing programs, it is possible to achieve changes over time, and this is precisely why forward planning is urgent. The 1971 budget allocated 41 percent of expenditure to human resource needs, 36 percent to national defense, and 23 percent to all other costs. That budget represented the beginning of a trend to reduce the share of total expenditure allocated to national defense and transfer that allocation into human resource needs areas. Both the 1972 budget and the recently submitted budget for 1973 have continued this trend. The most recent allocations assign 45 percent for human resource needs, 32 percent for national defense, and 23 percent for all other needs.

Providing for future needs

Considering the rigidity of the framework in which budgeting must be done, what, then, are our capabilities for meeting these growing and changing needs? When the 1971 budget was prepared, it was estimated that the nation's output would rise from $960 billion in 1970 to $1,360 billion in 1975. Government revenues were expected to rise from $199 billion to $266 billion, somewhat less than proportionately because of the effect of tax reductions. With these assumptions and the projected estimates of growth of already existing or publicly-budgeted programs, it was estimated that $22 billion would be available in 1975 to cover new programs initiated during the period. (Parenthetically, if the 1969 tax reduction had followed the lines of the Administration proposal instead of the final congressional enactment, the margin would have been $12 billion higher). It was believed at the time that this $22 billion margin was exceedingly small as compared to the demands likely to be placed on our resources—less than 1.5 percent of gross national product—and events have proved that belief to be correct.

During fiscal 1971, there were several developments which were not foreseen when the budget was prepared. Inflation was at a higher rate than had been anticipated. Economic activity was softer than expected.

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Congressional action did not implement the budget exactly as proposed. The net result when the 1972 budget was prepared a year later was that the margin of $22 billion for new programs which had been predicted for 1975 had shrunk to $12 billion. And there was only partial consolation in the fact that the new projections led to an estimate of a $30 billion margin for 1976 in the new five-year look.

During fiscal 1972, the government again chose to reduce the available margin by direct actions and still more of it has eroded because of economic circumstances. The 1976 margin was reduced by $7 billion through more individual, corporation, and excise tax reductions, transferring those resources back to the private sector. Further reductions resulted from the higher pay scale needed to spur an all-volunteer armed service. These and other factors produced estimates in the 1973 budget that the remaining 1976 margin is now only $5 billion, and the 1977 margin will be $23 billion. So if we are reluctant to return to a higher tax structure once again, and if we refuse, appropriately, to refuel inflation, we have essentially already made our spending choices through 1976.

Only a few years ago, the phrase "Peace Dividend" received widespread currency. The coiners of this phrase were saying that the resources normally available for social welfare programs which result from the growth of revenues would be substantially supplemented by the drop-off of military expenses in Vietnam. The funds which had been used to keep the military pipelines full could be diverted to many new initiatives. Estimates that as much as $30 billion a year could be transferred to these new programs were given wide publicity, since this was the Johnson Administration's estimate of peak Vietnam spending. Now we have reduced substantially our commitments in Vietnam and are reaching the time when these billions are supposed to make their appearance —but it seems they have mysteriously vanished. But those who forecast the dividend weren't wrong; the funds haven't really vanished. What has happened is that the dividend has already been declared. First, part of the funds have been absorbed by the rapid growth of some nondefense programs and by ongoing defense programs—some of which were severely curtailed as long as Vietnam expenditures were growing. Second, funds have been returned to the private sector by means of very substantial tax reductions, where their allocation has become a matter of private judgment rather than public policy.

The actual resource allocations made in each year thus completely change the basis for planning in the next budget cycle. Nevertheless, the planning process is our tool for insuring the availability of some resources for future, unspecified needs.

There is one last constraint on the budgeting process which must be emphasized. The budget as it is delivered to the Congress is the President's financial plan for the nation. It fully reflects his policies as leader of the nation, his assessment of the nation's needs and resources, and his assessment of political realities. It must also be a plan which he believes can be approved successfully by the Congress, during the second major step in the resource allocation process. It must also be a plan which, in his judgment, will command popular support. As I see it, the budget document is, each year, the most definitive overall state paper emanating from the Presidency. It is the detailed statement of executive policy, set forth not in high-sounding phrases but in

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quantitative terms for the nation to see and evaluate.

The Congress plays its role

Now, we turn our attention to the second phase of the federal resource allocation process—the authorization of programs and the appropriation of funds by the Congress. Unfortunately, the Congress really has no formal way of looking at the total budget picture as such. After brief meetings between Administration spokesmen and the House and Senate Appropriations Committees to discuss the overall outlook, the Congress examines the budget requests piecemeal, by agency (initially through 13 House subcommittees), and takes up the revenue side separately. Furthermore, with some exceptions, each agency program request is also examined by the substantive committee having jurisdiction over that agency to provide authorization—e.g., the Joint Atomic Energy Committee, the Armed Services Committee, etc.—after which funds are provided in separate bills coming from the Appropriations Committee. Still further complicating matters is the fact that the whole process is usually duplicated in both houses, often with separate bills leading to the development of a final bill in a joint conference committee of the two houses. The whole process is complicated, it is cumbersome, it is lengthy. It is so lengthy that Congress rarely passes any of the major appropriation bills before the new fiscal year starts, adding to confusion and inefficiency.

By its very nature, the Congress operates in a different framework than the executive branch of government. The President is most concerned with the nation as a whole and is responsive to a nationwide constituency. Each of our legislators has a local constituency to whom he must pay close heed and whose views and needs he must represent. In many ways, the sum is not necessarily the same as the whole. The Congress must resolve its internal differences by discussion and compromise, while the President can, and sometimes does, resolve differences among his subordinates simply by making the decision himself.

Anyone watching from the sidelines certainly gets the impression that the Congress is not as well organized as the executive branch when it comes to dealing with the whole process of resource allocation. Perhaps the most serious deficiency is that the Congress has never faced up to the need for its own budget staff, one that is both large enough and skilled enough to analyze the President's budget independently; to provide the Congress with the tools for expressing priority judgments of its own, and for introducing its own viewpoint into planning for the longer range. Furthermore, such a staff could function only if it is directly responsible to a centrally powerful Joint Committee on the Budget—something which does not exist today. Unless the Congress adopts such a total viewpoint and provides itself with the necessary expert support and centralized responsibility, it can do little beyond accepting the President's plan, tempered by supplemental information gleaned from departmental hearings—much of it over-detailed and extraneous—and modified by its general feeling for public desires.

The President's budget should be examined primarily program by program rather than agency by agency. As programs become more complex and goal-oriented, they also increasingly cross the jurisdictional boundaries that Congress has defined for its major committees. These boundaries must somehow be given a flexibility that allows the committee structure to take the same

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kind of goal-oriented approach. These steps, taken together, would go far toward returning to Congress a more effective voice in deciding how national needs are to be met.

Choices between alternative programs are difficult at best. When the capability for detailed analysis has important shortcomings, making choices becomes an extremely difficult task. It is, therefore, not surprising that the Congress, often in desperation, seeks the easy path. It is usually simpler to expand a well-known ongoing program by "throwing more money at it" even when it may be obvious that the program's operation is inefficient. This tends to resolve the responsibility to consider and choose between new alternatives for achieving the same goals even though they may promise to reach those goals at lower cost.

Congress has, it is true, tried very hard to give some recognition to the total scope and size of federal action. It has made this attempt principally by setting a maximum limit on the public debt, and by imposing total spending limitations. By now, however, it is clear that these both have been largely ineffectual, with extremely minor impact on either spending level or total debt. Limits on spending have always had to include enough loopholes to take care of uncontrollable and emergency expenditures so that they were truly inoperative, and while the legal debt limit has provided the opportunity for much political "one-up-manship" whenever an increase has been needed, it is not a significant factor in spending restraint.

To an economist, neither limit makes sense. Forces already set in motion by the Executive in compliance with congressional authorization have determined spending and borrowing. But the limits aren't just window dressing. As a pragmatist, I have to justify their continued use until Congress itself comes up with something better to focus on. The executive branch can do nothing in any immediate crisis when spending is about to break through such an arbitrary ceiling (except to hold back today's spending, which would set up a howl and be unfair) so Congress can point accusingly to executive irresponsibility (even though Congress may have set the stage for the situation in the first place).

Conclusion

I have spent most of my allotted time discussing the two principal phases of the federal government resource allocation process and dwelt on some of their major shortcomings because I think that the process itself plays a major role in determining our capabilities for meeting national needs. The more efficiently we use our resources, the more accurately we define priorities, and the more effectively we choose the best way of achieving our goals, the greater is our capability for meeting newly-arising needs.

What, then, is our capability for meeting our public needs? If we view this question strictly in the framework of adding newly-defined desires to the presently met needs within the resources now allocated to the federal sector, the answer is simple. We can't meet these new needs. However, this is the simple answer to the wrong question. The real question is not do we have the resources to meet the needs, but rather have we accurately identified those particular needs which are important enough to command the use of our resources?

Measured by this standard we do have major unmet needs, and our citizenry is demanding that these needs be met in the federal sector. A small part of these needs can be met by redirecting currently mis-

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spent dollars if we will face up to the facts. But we must not be naive. Demands on the federal sector are so strong that it seems inevitable that our federal tax rates will be higher five years from now than they are today. No hopeful candidate for federal office in 1972, be he Democrat or Republican, can say this, but I don't see any practical way to avoid it.

The key words remain priorities and planning. The executive branch specialists assigned the budget task must continuously strive to improve the budget process to insure that resource allocations are made in accordance with priorities which reflect accurate appraisals of need and cost. Congress must find better ways to handle the authorization and appropriation process to make its voice more effective in determining our national priorities. But planners, budgeters, and legislators cannot work in a vacuum. All of us, as citizens, must bear a major responsibility. We must utilize the political process to inform our government of our priorities. The proper allocation of resources will occur only when the priorities assigned in the total budgeting process coincide with the priorities which arise from the consensus of our society. For it is our society which provides the resources.

Rural bank needs for external funds

The need to acquire funds from sources outside the local community has gained increased importance among rural banks in recent years. Rapidly-expanding credit demands in many areas have outstripped locally-generated deposits, rendering many rural banks short of loanable funds. In addition, overline requests—loan requests which exceed a bank's legal lending limit to individuals—have become much more frequent, reflecting the rapid gains in debt per borrower. To overcome these factors, rural banks increasingly have had to turn to funds available from outside sources.

There is little evidence to indicate the trend toward expanding rural credit needs has run its course. Indeed, it is expected that future credit needs will push rural banks to an even greater reliance upon external funds in the years ahead. Farm debt, a major lending activity of most rural banks, is expected to nearly double during the Seventies. Other rural credit needs also are expected to increase substantially. Alternative methods of financing rural services and business opportunities are currently topics of debate in federal and state legislatures, and all indications are that rural development will receive major emphasis in this decade.

Despite increased use of external funds over the past several years, various impediments have limited their availability to rural banks. Costs of obtaining such funds are high, and the uses which can be made of the funds are limited. Moreover, the present sources of external funds appear unduly restrictive, especially during periods of monetary restraint. These impediments, in light of future needs, have generated renewed concern to develop new alternatives for improv-

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ing the flow of funds between urban and rural areas. Studies being conducted by the Federal Reserve System and the American Bankers Association, recently-passed legislation, and bills pending in Congress are evidence of this concern.

Traditional sources

Sources of external funds vary between the large city bank and the typical rural bank. Large city banks often supplement the lending capacity of their local deposits by selling negotiable certificates of deposit, commercial paper, bankers' acceptances, and debentures, and by borrowing federal funds and Eurodollars. These alternatives provide large banks direct access to national money and capital markets.

Rural banks are effectively precluded from direct access to these markets. Their relatively small size and unknown status limit their attractiveness to investors in such markets, and the high fixed cost of direct market participation is not justified by the comparatively small transactions with which rural banks would enter national money and capital markets. Rural bank access to outside funds, therefore, hinges on arrangements with other institutions that are large enough to have direct market participation. These other institutions traditionally have been correspondent banks, Federal Intermediate Credit Banks (FICBs), and insurance companies.

Correspondent banks

Other commercial banks are the most important source of external funds for rural banks. In some cases, these funds may be provided by informal arrangements with neighboring banks. More typically, however, rural banks obtain outside funds through the credit services provided by correspondent banks.[1] Such services include loan participations, direct correspondent-to-customer loans, sale of assets, and interbank loans.

Loan participations are arrangements which allow correspondent banks to share in loans made by rural banks. These loans, which must have the approval and consent of the correspondent bank, are made under conditions specified in a participation agreement. The participation agreement assigns to the correspondent bank, without recourse, either a portion or all of the loan—including a commensurate portion of the collateral and the principal and interest repayments. Loan participations are used mostly for overline requests, but may be used as a means of offsetting a shortage of loanable funds at the rural bank. For overline requests, the funds provided by the correspondent are usually restricted to that portion of the loan which exceeds the rural bank's legal lending limit.

Direct correspondent-to-customer loans are similar to loan participations except that the correspondent bank holds the customer's note, rather than a participation agreement, as evidence of the debt. Like loan participations, this credit service normally is used for overline requests but may be used by a rural bank to meet credit demands when loanable funds are in short supply.

A rural bank may also obtain funds from a correspondent bank either by *selling assets* to the correspondent, or by obtaining an *interbank loan* from the correspondent. Assets

[1]All banks maintain one or more relationships with other—and usually larger—banks for purposes of obtaining special services. These other banks are called "correspondent banks." Rural banks look to correspondent banks for such services as check clearing, safekeeping, portfolio advice, coin and currency services, etc. To pay for these services, rural banks maintain demand balances on deposit at the correspondent bank. The revenues obtained from investing these balances compensate the correspondent bank for the services it renders.

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sold to correspondents are usually limited to mortgages, municipals, or consumer instalment loans, while borrowings from correspondents are limited to short maturities. These two credit services are useful for alleviating shortages of loanable funds at the rural bank but do not solve problems of overline requests unless the overline loan is sold to the correspondent bank.

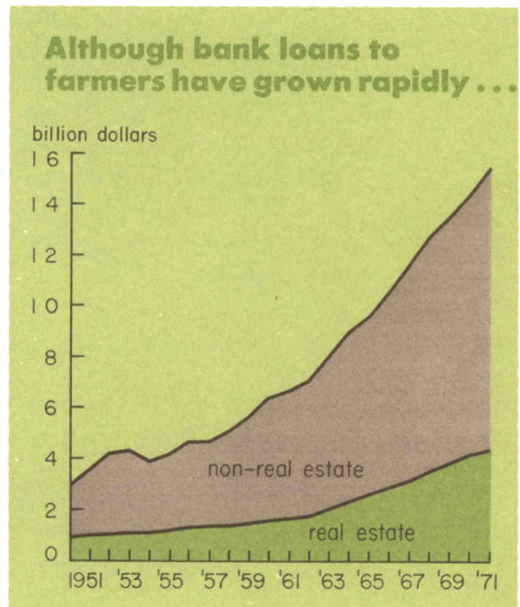
Evidence on correspondent funds

Evidence on bank utilization of credit services provided by correspondent banks is rather fragmented and not entirely focused on rural banks. Although it appears that correspondent banks are the most important source of external funds, the amount of funds so obtained is small relative to total loans of rural banks.

A 1963 survey conducted by the U. S. House of Representatives Committee on Banking and Currency found that a little over two-fifths of all commercial banks with less than $100 million in deposits had outstanding loan participation arrangements with correspondent banks.[2] The correspondent's share in these loans totaled $1.4 billion, or only about 2 percent of the total loans of all U. S. banks of this size. Only a small fraction of banks with less than $100 million in deposits had borrowing arrangements with correspondent banks, and even fewer had sold assets to them.

A 1966 study on agricultural loans outstanding at banks estimated that about one-fourth of all banks had originated farm loan participations with correspondent banks. This study estimated that correspondents provided about $304 million—or about 2.6 percent of total farm lending by all banks.

A 1969 survey of banks in the Tenth Federal Reserve District—which includes all or part of Colorado, Kansas, Missouri, Nebraska, New Mexico, Oklahoma, and Wyoming—found that approximately three-fifths of the banks with less than $100 million in deposits had loans outstanding in which correspondent banks were participating. The survey found that the additional funds provided by correspondents ranged from about 10 percent of total loans outstanding among banks with less than $5 million in deposits to about 4.5 percent among banks with $50 to $100 million in deposits. The study found that about one-tenth of the banks had borrowed funds from correspondents in the previous year, and that a little over 3 percent of the banks with less than $100 million in



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[2]Banks of less than $100 million in deposits include many banks in major metropolitan areas, as well as most rural banks. Among banks with less than $10 million in deposits—which would include a higher portion of rural banks—the study found 37 percent had loan participation arrangements with correspondent banks.

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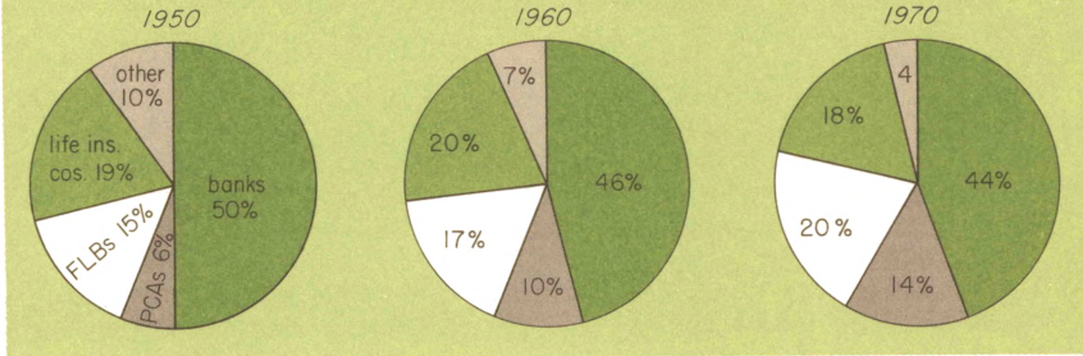
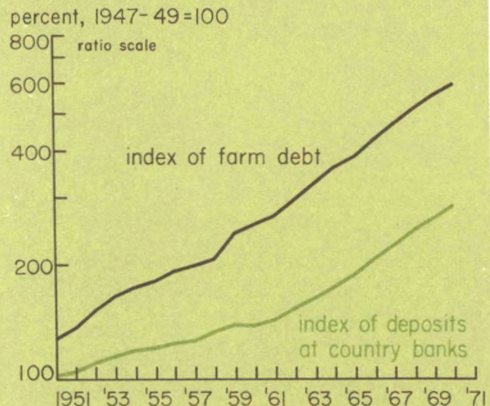


deposits had sold assets to correspondents.

A 1970 survey of agricultural banks in Illinois—banks with $15 million or less in deposits and agricultural loans accounting for at least 30 percent of total loans—found that a little over two-fifths of the banks had originated loan participation arrangements. On average, the funds provided by correspondents through such arrangements represented a little over 3 percent of total deposits at originating banks. Non-real estate farm loans — mostly for financing cattle — accounted for slightly over one-half of the total funds provided by correspondents, while business loans absorbed a majority of the remainder. The 1970 study also found that about 14 percent of the banks used direct correspondent-to-customer loans, while less than 5 percent had obtained a loan from, or sold assets to, correspondent banks.

FICBs

In 1923, Congress established 12 Federal Intermediate Credit Banks (FICBs) to serve as a central discount mechanism for agricultural loans made by commercial banks. The FICBs were authorized to sell bonds in national money and capital markets and use the proceeds to discount agricultural loans made by commercial banks. Since banks made little use of this facility in the initial



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years, Congress created the Production Credit Associations (PCAs) in 1933 and gave them discounting privileges similar to those afforded banks. Although the priority of FICB discounting has changed from commercial banks to PCAs over the years, the privilege of bank discounting remains intact.

Banks can apply for FICB discounting privileges either directly or through an affiliated agricultural credit corporation. Establishing such privileges, however, has at times been restricted, and new proposals for establishing discount arrangements pose further restrictions. Under the proposed criteria, a bank applying for discount privileges must: 1) have an agricultural loan volume equal to at least 25 percent of its total loans; 2) have a loan-to-deposit ratio of at least 60 percent at the seasonal peak; 3) prove a continuing need for discountings in order to maintain its volume of agricultural loans at a three-year average; and 4) establish that the participation alternative with PCAs—a new feature implemented this year—is either not available or of no assistance in meeting local farm credit needs.

All FICB discounting is on a recourse basis. This precludes a bank from discounting loans that exceed its legal lending limit. However, FICB discounting can be beneficial to rural banks faced with a shortage of loanable funds.

Funds acquired by banks from FICBs have grown rapidly in recent years, but the volume of discountings is still comparatively small and concentrated among a few banks in limited geographical areas. The volume of bank, or bank-affiliated, discountings outstanding at FICBs increased sixfold during the Sixties and reached $59 million at the end of 1970. However, this volume represented less than four-tenths of 1 percent of total farm loans outstanding at banks. Moreover, only 68 banks, or bank-affiliated credit corporations, shared in this volume, and most of these institutions were located in only three of the 12 FICB districts.

Insurance companies

Funds provided to rural banks by insurance companies, largely involving real estate mortgages, allow rural banks to finance these credit needs without committing their funds to the long-term maturities normally associated with such loans. In the past, a bank financing a local real estate transfer through an insurance company would make the loan, with the approval of the insurance company, from its own funds, and then hold the mortgage for a period of time—usually up to two years. At the end of this period, the bank could assign the mortgage to the insurance company on a non-recourse basis and recoup the funds originally disbursed.

The mechanics of obtaining funds from insurance companies has changed somewhat in recent years, and banks now function primarily as "finders," with the insurance company, rather than the bank, disbursing the mortgage funds. This change has been important since it allows rural banks to finance local real estate overline requests.

Evidence of funds provided by insurance companies suggests that this source, like FICBs, is used by relatively few banks. The 1966 survey of agricultural loans found that only 7 percent of banks had worked with insurance companies during the mid-Sixties in obtaining additional financing for farm customers. A similar portion of banks reported using insurance companies in a mid-1971 survey of agricultural banks in the Seventh Federal Reserve District. Overall, the total amount of funds obtained from insurance companies has been small compared to total rural bank lending.

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Problems with traditional sources

Costs are perhaps the most obvious problem for rural banks attempting to acquire funds from external sources. Practically all studies on credit services provided by correspondent banks acknowledge that the acquisition of such services requires rural banks to increase correspondent balances by at least 15 to 20 percent of the funds obtained.[3] These supplemental balances—over and above those balances needed to cover the acquisition of other correspondent services—not only significantly reduce the supply of loanable funds at the rural bank, but cost the bank the revenue it would otherwise earn if the funds were invested in earning assets. Moreover, the 15 to 20 percent requirement probably represents a minimum—especially during periods of monetary restraint. Both the 1969 and the 1970 studies found instances in which rural banks were required to purchase assets from the correspondent in an amount equivalent to the funds advanced by the correspondent bank. The cost factor also applies to funds acquired from FICBs. Commercial banks or affiliated agricultural credit corporations, which discount agricultural loans through FICBs, must pledge acceptable securities to, or purchase participation certificate from, the FICB equal to 10 to 20 percent of the discounted volume of loans. (This requirement is comparable to the stock purchase requirement associated with all lending practices of the cooperative agencies within the Farm Credit System.)

Restrictions on uses of funds is another common problem discouraging acquisition of funds from external sources. For example, funds from insurance companies are restricted to large real estate mortgages, such as farm transfers or land development projects. Such funds, however, are not typically available for single-family housing mortgages or the host of other rural credit needs. Similarly, discountings by FICBs are available only for short- and intermediate-term agricultural loans but not for the wide range of other rural credit needs. Also, funds obtained from FICBs are not suitable for handling overline requests since the rural bank retains an interest in the entire loan due to the recourse discounting arrangement.

There are also restrictions on funds provided by correspondent banks. In this case, however, the restrictions are related to the type of borrower rather than the use which can be made of the funds. Although correspondent banks provide short-and intermediate-term funds to agriculture and other rural businesses, such funds are largely restricted to overline requests. Thus, while this source of funds benefits the few large borrowers at rural banks, it provides little assistance in meeting the overall volume of credit needs in rural communities when supplies of loanable funds are tight.

Low credit priorities, especially during periods of monetary restraint, are an additional problem limiting rural bank attempts to acquire funds from traditional outside sources. Banks have been efectively cut off from new funds from the FICBs since 1970 because of an FICB-declared moratorium on granting new discounting privileges to banks. This moratorium—which was in response to a surge in the number of banks seeking discounting privileges during the 1969-70 period of tight money—clearly established the FICBs pri-

[3]The earnings which the correspondent bank receives from investing the supplemental balances are in addition to the interest the correspondent receives on its share of the participated loan. Interest rates on such loans are normally set at some fraction above the prime rate.

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ority in first accommodating the needs of Production Credit Associations.

Similar priorities have been noted in funds provided by correspondent banks. In addition to the substantial rise in effective balance requirements during the recent period of tight money, many correspondents reduced the volume of funds provided to rural banks by giving first priority to their own customers. Indeed, the 1970 survey found a significant decline in the volume of funds provided by correspondent banks in Chicago to rural agricultural banks in Illinois between 1968 and 1969.

Restrictive monetary policies are intended to reduce the extension of credit. However, the principle of rationing credit among its most profitable employment opportunities remains effective regardless of tightness of monetary policies. Despite this, it appears that the indirect access which rural banks have to national money and capital markets is inequitably restrictive in periods of monetary restraint.

New directions

Most expectations for future relief from the impediments that limit rural bank acquisition of external funds are tied to pending legislation and to studies being conducted by the Federal Reserve System and the American Bankers Association. However, some measures have been taken to alleviate the situation.

One, embodied in the Farm Credit Act of 1971, will allow PCAs to participate in loans made by commercial banks. This provision of the act—expected to be implemented by midyear—has both positive and negative aspects for rural bankers. On the positive side, participations with PCAs would be available for rural banks facing problems of both overline requests and shortages of loanable funds. PCA participations could prove to be cheaper than similar arrangements with correspondent banks or discounting through FICBs since neither supplemental balances nor purchases of participation certificates would be required.

On the negative side, tentative guidelines indicate that the Farm Credit System will carefully monitor PCA participations to ensure that bank use is not excessive during periods of monetary restraint. The new provision provides additional funds primarily for agricultural loans but not for other rural credit needs. Finally, many banks view PCAs as their principal competitors and, therefore, may be reluctant to enter into participation arrangements with them for fear of losing a customer's entire line of credit.

Another recent development for improving the flow of external funds into rural areas is the "Kansas plan," which has improved the marketability of loans made by commercial banks and guaranteed by the Small Business Administration (SBA). The SBA-guaranteed portions of bank loans are purchased by the Kansas Development Credit Corporation and, in turn, sold to the Public Employees Retirement System. After six months of operations, this program had handled approximately $2 million in such loans, with most of the funds going back into towns of 5,000 or less in population.

Several attractive features of the Kansas plan have stirred an interest among bankers in other states. It provides rural banks a more direct access to funds that otherwise would flow into national money and capital markets. Pension and retirement funds have become an important component of these markets in the past few years, and the Kansas plan is one of the first steps in directing these funds into rural areas. Another feature of this program is that it tends to pro-

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vide more funds for small businesses—a crucial facet of rural development. It also allows rural banks to make overline loans since a ready market exists for the guaranteed portion of the overline loans.

Pending legislation for expanding the lending authority of the Farmers Home Administration (FHA) could permit development of arrangements similar to the Kansas plan. Both houses of Congress have passed bills which allow the FHA to broaden its lending programs in the rural nonfarm area. These bills would permit the FHA to guarantee 90 percent of loans extended by banks to qualified borrowers. Although no well-defined market currently exists for these loans, the desire to expand the marketability of rural bank assets could generate such arrangements in the future.

The American Bankers Association (ABA) and the Federal Reserve System are studying ways to improve rural bank access to external funds. In a preliminary report issued in November, the ABA recommended creation of a national or regional institutions(s) for the purpose of creating a market for agricultural paper. The proposal suggests that the institution be capitalized either by cooperating banks or through government backing, and that operating funds be obtained from the sale of debt instruments in national money and capital markets. Such funds would be used to discount, purchase, or participate in agricultural loans made by banks in the plan.

A study by the Federal Reserve System is investigating the possibility of improving the marketability of several bank assets and liabilities as a means of obtaining funds in national money and capital markets. Developing a market for liability instruments of rural banks—such as negotiable certificates of deposit—is especially appealing since it does not restrict the flow of funds to any one particular credit need, as do proposals calling for a market in a single type of asset, i.e., agricultural loans. Rather, once the rural bank received the funds, it would be free to allocate them according to local priorities. Moreover, research at the Federal Reserve Bank of Chicago indicates there is an inverse relationship between bank size and interest rates paid in selling negotiable certificates of deposit. If this relationship is due primarily to bank size, rather than a differential risk factor or size of obligation, it would appear that some means of organizing and insuring sales of small bank deposit liabilities could enhance the ability of rural banks to attract external funds.

Another Federal Reserve study proposes, among other things, a seasonal borrowing privilege, in the Fed's discount window operations, for banks that experience large seasonal swings in deposits and credit demands. The proposal defines banks eligible for the seasonal borrowing privilege as those whose monthly net available funds—defined as total deposits less total customer loans—vary by more than 5 to 10 percent of their average annual deposits. If adopted as proposed, eligible banks could borrow for up to nine months the full amount of the variation in excess of the 5 to 10 percent limit.

Although rural banks have increasingly turned to external funds in recent years, the funds so obtained have been insufficient to allow them to keep pace with rapidly-expanding rural credit demands. This has caused a renewed concern for improving the flow of funds between urban and rural areas, and new developments indicate some of the existing impediments soon may be overcome. When this happens, rural banks should be better equipped to meet the credit needs of their communities.

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