

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

Federal Credit and Insurance Programs: Beyond the Deficit Diversion

by David Altig

Over the past decade and a half, public discussion of U.S. fiscal policy has been dominated by a growing obsession with the level and trend of government borrowing, manifested in federal budget deficits and the outstanding stock of public debt. The intensity of concern with these issues has, not surprisingly, increased in tandem with the magnitude of both. The view that something must be done to reduce the level and growth of government debt is nearly unanimous, and the sentiment that we require a dramatic remedy, such as a balanced-budget amendment to the Constitution, is not uncommon. Indeed, the durability of the Ross Perot presidential candidacy was in large part attributable to the sense that he alone among the candidates had insistently focused on the federal deficit.

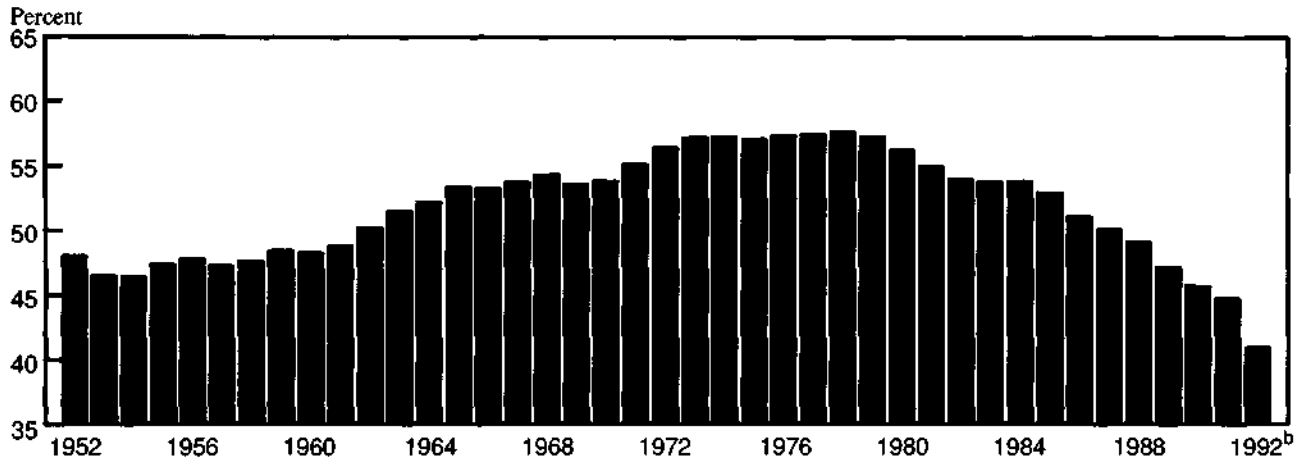
The concern is easy to understand. By the end of fiscal year 1991, the value of gross federal debt outstanding was more than \$3.5 trillion, or about 73 percent of that year's gross domestic product (GDP). By the end of fiscal year 1993, this number is expected to exceed \$4.4 trillion.¹ Reflected in this increase, and most troubling to many, is the fact that the reported deficit is expected to rise through the end of fiscal year 1993, as it has every year since 1989. In fact, recent projections by the Congressional Budget Office (CBO) put the federal deficit at more than \$500 billion by fiscal year 2002.²

But as large as these numbers are, the deficit is an arbitrary and inadequate focal point for fiscal decisionmaking. This point was made forcefully in a recent *Economic Commentary* authored by Alan Auerbach, Jagadeesh Gokhale, and Laurence Kotlikoff, who argue for an alternative fiscal measure that provides a systematic accounting of *future* tax liabilities and transfers that will accrue to different age groups under existing law.³ This alternative, coined generational accounting, shifts emphasis away from the narrow perspective of short-run outlays and receipts (and the sometimes questionable methods of defining these items) toward an examination of the long-term issues and burdens that our fiscal policy choices imply.

Generational accounting recognizes the long-run consequences of tax and expenditure policies on the allocation of resources across generations — consequences that are not readily apparent from a straightforward examination of measured federal deficits, which focus almost exclusively on cash flows at a point in time. More broadly, informed and intelligent debate about budget policy requires that explicit attention be paid to its allocative effects in general, across different activities as well as different age groups. The deficit is almost entirely uninformative about these effects.

By examining the budgetary and economic effects of federal credit and insurance programs, this paper highlights the problems inherent in making federal budget deficits the centerpiece of fiscal decisionmaking. First, these programs entail taxpayer obligations that are not captured by standard cash-flow accounting. Although recent changes in budget procedures have improved the deficit measure, more remains to be done. Second, these programs distort the allocation of resources, introducing economic costs that are not well considered when deficits become the focal point of policy debate.

FIGURE 1 PRIVATE DOMESTIC DEBT ASSISTED BY THE FEDERAL GOVERNMENT ^a



a. Percent of total face value of private credit-market debt outstanding.
 b. Data for 1992 are through the second quarter.
 SOURCE: Office of Management and Budget.

I provide in this *Commentary* an overview of one specific class of government activity: federal credit and insurance programs. These programs illustrate the problems inherent in making federal deficits the centerpiece of fiscal policy. First, they impose taxpayer exposure and obligations that are simply not captured by standard deficit accounting. Although recently adopted budget conventions offer a clearer picture than has been available in the past, a contemporaneous accounting of program receipts and outlays remains an incomplete measure of the full dollar cost of many programs.

Second, federal credit and insurance programs have an important influence on the flow of economic activity that is independent of direct budgetary considerations. Sometimes the costs of such distortions eventually become direct, and painfully obvious, as in the case of the recent thrift industry problems, to which federal deposit insurance is commonly thought to have been a contributing factor. Sometimes, the costs are far more subtle, as in the case of federal loan and loan guarantee programs.

But the costs of current programs are not absent simply because of their subtlety or the fact that they linger only in some nonspecific future. Sound fiscal policy requires, minimally, that the

presumed benefits of any particular policy be confronted with its ultimate costs. Federal credit and insurance programs show how a myopic fixation with the federal deficit is an unproductive position from which to force this confrontation.

■ **A Brief Taxonomy and History of Federal Credit and Insurance Programs**

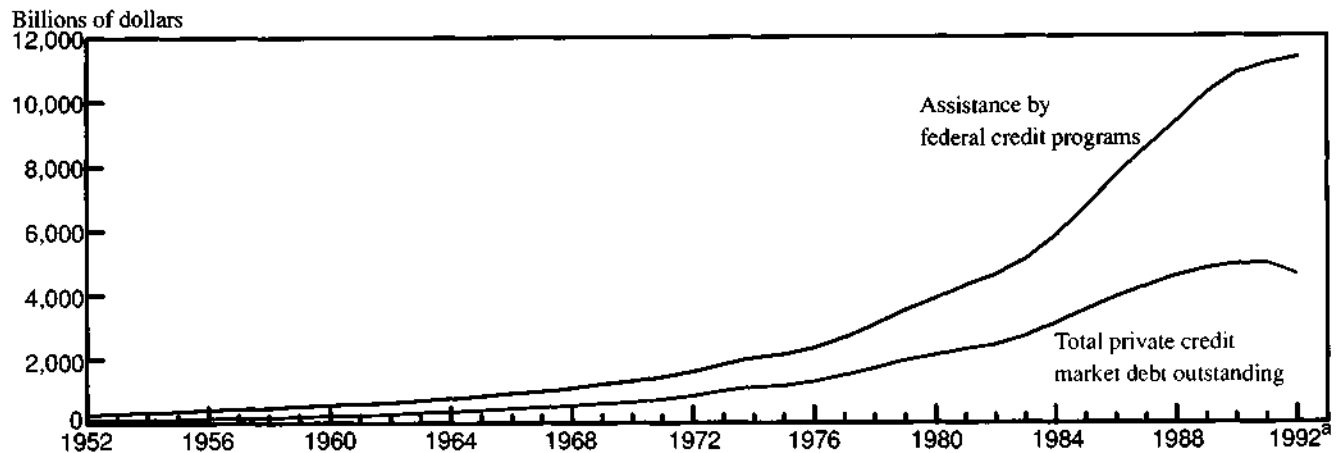
Federal credit and insurance programs represent the role of the central government as a source of credit and underwriter of risk. For budgetary purposes, these programs are broadly grouped into four categories: direct loans, loan guarantees, government-sponsored enterprises, and federal insurance. These categories loosely correspond to the federal government's roles as lender, cosigner, market-maker, and insurer.

Direct loan programs involve the government as the direct source of funds to borrowers. The majority of these loans, in dollar terms, originate in the Department of Agriculture via the Farmers Home Administration, Rural Electrification Administration, and Rural Telephone Bank which, as the agency names imply, provide loans for rural housing and development. However, a significant proportion of the total originates through the Agency for International Development.⁴

Loan guarantees essentially collateralize private loans with the full faith and credit of the U.S. government: In the event of default, the government honors the obligation of the borrower and becomes the creditor of record. By far, the bulk of federally guaranteed loans are associated with housing and education, the former through the Federal Housing Administration and Veterans Administration mortgage programs and the latter through the Department of Education's Guaranteed Student Loan program.

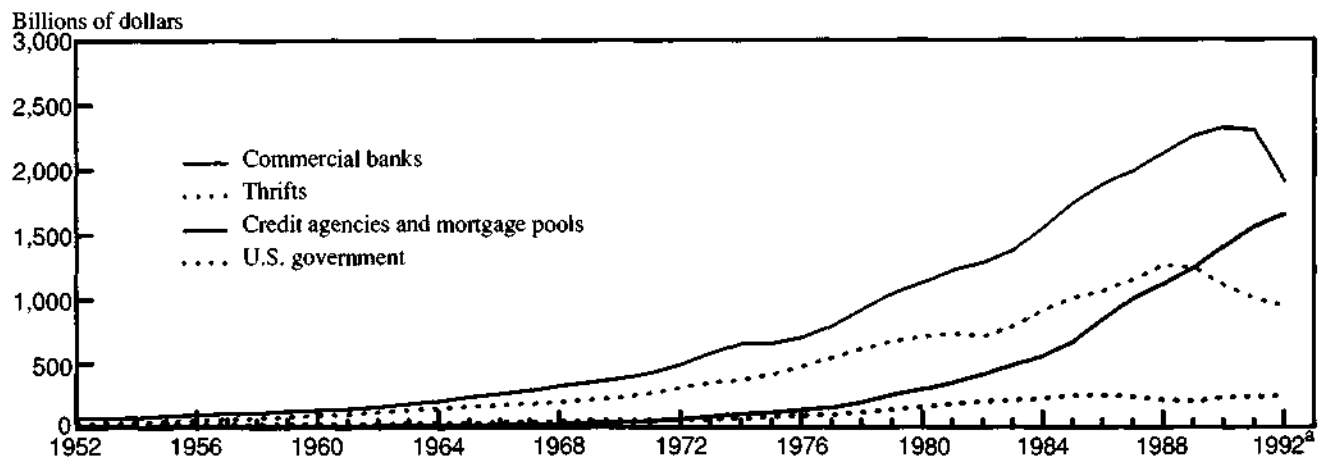
Government-sponsored enterprises (GSEs) consist of corporations and associations explicitly established by the legislative authority of the federal government. Like direct and guaranteed loan programs, these enterprises are typically designed to facilitate the funding of specific activities. Although privately held, GSEs are characterized by strong federal involvement, which often includes reserved appointments on governing boards, supervisory prerogatives, and implicit or explicit guarantees. The larger GSEs are familiar from their well-known and colorful acronyms, such as Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation).

FIGURE 2 PRIVATE DEBT AND FEDERALLY ASSISTED CREDIT



a. Data for 1992 are through the second quarter.
SOURCE: Office of Management and Budget.

FIGURE 3 COMPONENTS OF FEDERALLY ASSISTED PRIVATE DOMESTIC DEBT



a. Data for 1992 are through the second quarter.
SOURCE: Office of Management and Budget.

The final category, the one that has drawn the lion's share of recent public attention, is federally provided insurance. Like private insurance plans, federal insurance provides state-contingent payments to specifically identified individuals and businesses. Deposit insurance arrangements are the largest and most notorious of these programs. However, the face value of private pension coverage provided by the Pension Benefit Guaranty Corporation (PBGC) was actually larger in 1991 than that for thrift institutions.

Figures 1 and 2 reveal the magnitude of all federal credit and insurance programs over the postwar period.⁵ As figure 1 shows, the share of private credit assisted by the federal government has been declining for more than a decade. The data displayed in figure 2 indicate that

this is a result of both an acceleration in the growth of private credit following the 1981-82 recession and a marked deceleration in the growth of federally assisted credit issued after 1987. As shown by figure 3, the decline in federally assisted credit is largely due to a contraction in the amount held by depository institutions. Even accounting for this, about 40 percent of the face value of all private credit outstanding as of 1992 was assisted in some way by the federal government.

How Much Information Does the Deficit Provide?

Of course, the face value of government credit and insurance programs gives an incomplete and misleading measure of their ultimate direct cost to the American taxpayer. An accurate picture requires an accounting of administrative expenses,

an assessment of interest subsidy, default, and insurance claim expenditures, as well as cost offsets such as fees and premiums. For example, to the extent that repayment obligations will be honored by the majority of borrowers, the dollar value of existing loan guarantees grossly overstates their direct costs. Abstracting from administrative expense, taxpayers incur such costs only when borrowers default or when the government provides special benefits to borrowers, such as the deferral of interest payments.

Recognizing this fact, the Office of Management and Budget (OMB) currently estimates the present value of future net cash flows of all federal credit and insurance programs and includes them in a table in the budget submitted to the President. Table 1 presents these cost estimates

TABLE 1 ESTIMATED COST RANGES OF FEDERAL CREDIT AND INSURANCE PROGRAMS (Billions of dollars)

	Expected costs ^a	Expected outlays, 1992-97
Direct loans		
Farmers Home Administration	11-15	3-4
Other	25-36	2-8
Total	36-51	5-12
Loan guarantees		
Guaranteed Student Loans	38-42	16-18
Other	9-27	3-12
Total	47-69	19-30
Federal insurance		
Deposit insurance		
Commercial and savings banks	34-51	4-20
Thrifts	55-60	10-12
Credit unions	0	0
Pension Benefit Guaranty Corp.	30-60	(3)-16
Other	2-3	1-2
Total	121-174	12-50
Government-sponsored enterprises		
Total	0-1	0
TOTAL COSTS	204-295	36-92

a. Present value.

SOURCE: Office of Management and Budget.

as provided in the mid-session review of the Bush Administration's fiscal year 1993 budget. The second column notes the expected subsidy outlays for fiscal years 1992-97, which include default expenditures. The first column gives the longer-range cost figures based on the definitions required for direct loans and loan guarantees by the Federal Credit Reform Act of 1990 (CRA). For these calculations, "[c]ost is defined as the present value, discounted at Treasury rates of comparable maturity, of the expected cash outflows from the Government minus the expected cash inflows to the Government."⁶

These cost measures are a significant conceptual departure from the traditional practice of recording cash flows. Under the simple cash-flow procedure, a direct loan to a farmer, for example, would increase the deficit dollar for dollar in the year in which the loan is made and reduce the deficit by the amount of repayment in the year that the loan obligation is retired. Under the cost definitions represented in table 1, the deficit would be calcu-

lated on the basis of the net expected costs, in present-value terms, at the time the loan is originated. Deficit calculations using this latter convention are clearly more informative about taxpayer burdens than those based on cash-flow accounting.

The CRA in fact mandated that budgeting for direct and guaranteed loans follow the present-value cost method represented in table 1, beginning with the budget process for fiscal year 1992. Cash flows, of course, remain relevant for determining current financing needs. A direct loan made to a farmer today must still be financed by current revenues or borrowing, even if the full cost of the loan to the government is eventually recovered. These cash-flow requirements are now reported in separate accounts that do not affect the outlay and deficit measures.⁷

The accounting policies implemented by the CRA have significantly improved the informational content of the reported deficit. However, these improvements are limited to loan and loan guarantee policies. Budgeting for insurance programs is still on a cash-flow basis.⁸ Although legislative extensions of this practice to all credit and insurance programs have been proposed by the outgoing Bush Administration, they have not been passed into law.

The failure to implement forward-looking accounting methods represents a serious impediment to constructive policy discussion and substantially vitiates the value of the deficit as an object on which to focus the debate. The substantial outlays associated with recent difficulties in the thrift industry perfectly illustrate the problem. These (and most prospective) costs largely arise from preexisting failures, the bulk of which have been anticipated for some time. From a policy perspective, these obligations are largely sunk costs. Although a substantial contributor to the magnitude of our record budget deficits, at the margin they are of little economic consequence.

■ The Sine Qua Non of Fiscal Policy: Is the Money Well Spent?

The weakness of the deficit as the focal point of fiscal policy goes far beyond issues concerning the direct taxpayer costs of government activities. A complete accounting requires an assessment of the allocative consequences of the incentives and disincentives attending government intervention. The issue, of course, is not whether such effects exist, but whether the intended or collateral impact of specific policies detracts from or adds to gains in efficiency or the attainment of other social goals to which the policies are directed. More simply, are total costs justified by total benefits?

Again, federal credit and insurance programs provide an excellent example of the issues involved. By design, these programs direct borrowing and lending toward activities that might not be undertaken otherwise. In many cases, these activities may be desirable and underprovided in the absence of gov-

ernment intervention. For example, the inability to borrow against future labor earnings may cause an inefficient level of investment in human capital, justifying a role for federal loan guarantees for expenditures on education.

Intervention to correct market failures is not without risk, however. In the process of trying to eliminate one distortion, the design of policies and institutions can easily end up creating new distortions. Guaranteed Student Loans, for instance, do more than provide a missing market in funds for education. They also subsidize such expenditures through the deferral of interest payments. This subsidy element in itself distorts individual human-capital decisions. Good policy requires that we consider the allocative consequences of both intervention and nonintervention, and strike a balance between the costs of the different distortions attendant to each decision.

Consider the case of deposit insurance. On efficiency grounds, the rationale for deposit insurance is, at its core, the same as that for any intervention that distorts the decisions of individuals and businesses operating in free, decentralized markets: The existence of special characteristics that cause social returns to deviate from private returns.

In the case of the banking and thrift industries, as the argument goes, failures of individual firms may have spillover effects on healthy institutions that, in turn, may seriously harm the economy as a whole. The banking panics of the Great Depression are the examples most commonly deployed as evidence in favor of this argument. They are also the events that led to the creation of the Federal Deposit Insurance Corporation (FDIC) in 1934.⁹

By the measure of eliminating systemic bank runs, fans of the FDIC have a fairly strong case. But by now the collateral costs of federal deposit insurance have also become clear. To note just one well-known aspect of the problem, insurance removes the incentive for depositors to monitor the investment

activities of institutions in which their funds reside. Thus, the safeguard against imprudent management decisions that would otherwise be exerted by a shrinking deposit base is weakened, if not wholly absent. Although the legislated \$100,000 cap on insurance coverage was meant to overcome this problem by maintaining monitoring incentives for large depositors, "too-big-to-fail" policies, combined with the ability of large depositors to reduce exposure by spreading accounts over many institutions, has seriously undermined the intent of this limit.¹⁰

Beyond the potential direct costs of institutional failures is the more subtle cost of altering the risk structure of bank and thrift portfolios. For failing institutions, the incentive to roll the dice is obvious. But even for healthy institutions, the fact that the existence and form of deposit insurance make both insurance premiums and the cost of funds independent of risk likely induces a diversion of funds toward riskier projects than would otherwise be chosen. Direct government regulation through capital requirements and restrictions on asset bases is meant to overcome this problem, but such regulations are themselves another source of market distortion that may have unintended costs and consequences.

Indirect but important costs are a pervasive element of federal credit policies in general, as recognized in the following observations made by the OMB in its presentation of the budget for fiscal year 1993:

Three-fifths of all non-Federal credit outstanding has been assisted by Federal credit programs, Government-sponsored enterprises, or deposit insurance. The proportion of credit for housing that is federally assisted was 82 percent [in 1991]. Most credit for agriculture and education is also federally aided. The proportion of business credit that receives Federal support is much smaller. Indeed, the substantial Federal intervention on behalf of other borrowers draws credit away from business....¹¹

Such indirect costs can be substantial. By one estimate, the distortions created by credit subsidies can cost the government up to 50 cents per additional dollar of credit received by the targeted group, a result that would imply an annual efficiency loss approximate to the dollar amount these programs would add to the deficit through 1997.¹²

■ Conclusion

Federal credit and insurance programs share two important characteristics common to almost all of the programs that broadly constitute U.S. fiscal policy. First, they are long-lived, with revenue and expenditure streams that extend over many years. Second, a full accounting of their costs and benefits obliges us to consider carefully the allocative consequences of our interventions, even though these effects are not always easy to quantify. Neither of these characteristics is well considered when public discussion becomes fixated on current deficits and point-in-time expenditure.

Sound fiscal policy should be proactive rather than reactive, and broadly conceived rather than narrowly focused. Among other things, this requires that we not become obsessed with policy by-gones and that we consider carefully and intelligently the full implications of *specific* expenditure and tax decisions, not simply the rough difference between cash inflows and outflows in a given year. The OMB's newly adopted practice of budgeting in terms of long-run credit program costs is very much in this spirit, as is the recommendation in the 1993 budget to do the same with insurance costs. Full adoption of this proposal would provide more progress still.

■ Footnotes

1. See *Economic Report of the President*, Washington, D.C.: U.S. Government Printing Office, February 1992. The corresponding dollar amounts for debt held by the public are \$2.7 trillion and \$3.4 trillion.
2. See *The Economic and Budget Outlook: An Update*, Congress of the United States: Congressional Budget Office, August 1992. These numbers reflect CBO estimates based on current policy. They do not include the effects of any new policies that might be implemented by the Administration of President-elect Clinton.
3. See Alan J. Auerbach, Jagadeesh Gokhale, and Laurence J. Kotlikoff, "Generational Accounts: A New Approach to Fiscal Policy Evaluation," Federal Reserve Bank of Cleveland, *Economic Commentary*, November 15, 1991, and the references cited therein.
4. As of 1991, funds lent through the Farmers Home Administration, the Rural Electrification Administration and Rural Telephone Bank, and the Agency for International Development accounted for approximately 30, 22, and 12 percent of the face value of federal direct loans outstanding.
5. The data shown in figures 1 through 3 were graciously provided by Christopher Lewis of the Office of Management and Budget.
6. See *Budget of the U.S. Government, Fiscal Year 1993*, Washington, D.C.: U.S. Government Printing Office, Part One, p. 270. These data are contained in Chapter 13, titled "Identifying Long-Term Obligations and Reducing Underwriting Risks."

7. These cash-flow requirements will, however, show up in total debt figures. For further discussion, see *Budget of the U.S. Government, Fiscal Year 1993*, Part One, Chapter 14, and Appendix One, Chapter 7.
8. Because GSEs are private entities, they do not enter budget totals, except in special unanticipated circumstances, such as the bailout of the Farm Credit System in the 1980s. I am grateful to Justine Rodriguez for bringing this point to my attention.
9. The formal theoretical case for deposit insurance, as it relates to banking panics, was made in an influential paper by Douglas W. Diamond and Philip H. Dybvig ("Bank Runs, Deposit Insurance, and Liquidity," *Journal of Political Economy*, vol. 91, no. 3 [June 1983], pp. 401-19). An informal explanation and critical assessment of the Diamond-Dybvig argument can be found in Charles T. Carlstrom, "Bank Runs, Deposit Insurance, and Bank Regulation, Part II," Federal Reserve Bank of Cleveland, *Economic Commentary*, February 15, 1988. For a critical review of other arguments for government-sponsored deposit insurance, see Charles T. Carlstrom, "Bank Runs, Deposit Insurance, and Bank Regulation, Part I," Federal Reserve Bank of Cleveland, *Economic Commentary*, February 1, 1988.
10. See the 1990 Federal Reserve Bank of Cleveland *Annual Report* for a discussion of the too-big-to-fail doctrine and related regulatory issues. It is reasonable to ask why the interests of shareholders are not sufficient to guard against imprudent management decisions even in the absence of monitoring by depositors. One explanation would be that the interests of management are not consistent with the maximization of shareholder wealth when managers

cannot be perfectly monitored. See Gary Gorton and Richard Rosen, "Corporate Control, Portfolio Choice, and the Decline of Banking," Board of Governors of the Federal Reserve System, unpublished manuscript, September 1992, for an analysis of the banking industry that pursues this line of inquiry.

11. See *Budget of the U.S. Government, Fiscal Year 1993*, Part One, p. 267. Note that the 60 percent estimate for the ratio of federally assisted credit outstanding in 1991 differs from the number indicated in figure 1. The discrepancy results from the fact that figures 1 through 3 are based on improved calculations that have been made available since the time this passage was written.

12. See William G. Gale, "Economic Effects of Federal Credit Programs," *American Economic Review*, vol. 81, no. 1 (March 1991), pp. 133-52.

David Altig is an economic advisor at the Federal Reserve Bank of Cleveland. The author thanks Michael Bryan, Jagadeesh Gokhale, and Susan Byrne (who also provided research assistance) for many useful comments. Special thanks are due to Christopher Lewis and Justine Rodriguez of the Office of Management and Budget, whose input and cooperation were invaluable.

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