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AN ECONOMIC ANALYSIS OF THE FEDERAL GOVERNMENT'S CREDIT PROGRAMS

By

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Preface

An earlier form of this working paper was developed for a joint hearing by the Economic Stabilization Subcommittee of the Committee on Banking, Currency and Housing, the Tax Expenditure Task Force of the Committee on the Budget, and the Subcommittee on Oversight of the Committee on Ways and Means, U.S. House of Representatives.

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AN ECONOMIC ANALYSIS OF THE FEDERAL GOVERNMENT'S CREDIT PROGRAMS

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The arsenal of governmental power over the economy is extensive, including the authority to tax, the ability to spend the proceeds of that taxation, and the capability of issuing rules and regulations determining or influencing private behavior. One of the lesser known components of that arsenal is the government's power to provide credit to various individuals and organizations in the economy.

As will be demonstrated, most of the credit activities do not appear in the federal budget. Many do not involve any direct federal expenditure at all. Hence, they seem to be a rather painless way of achieving national objectives. In the main, the federal government is "merely" guaranteeing private borrowing or sponsoring ostensibly private institutions.

Is this use of the government's credit power a variation of the proverbial "free lunch?" Let us examine the costs as well as the benefits that may flow from this often overlooked aspect of governmental interaction with the private sector.

The Variety of Government Credit Programs

Over the years substantial numbers of credit programs have made their way through the legislative process of the federal government. These programs emerged on an ad hoc basis, with each program directed toward providing assistance in overcoming a specific problem at hand. As a result of this gradual but very substantial accretion, federal credit program subsidies are now provided to a great many and variety of sectors of

the American economy -- housing, agriculture, transportation, health, education, state and local governments, small business -- as well as to foreigners.[1/] The total amount of credit provided under federal auspices has risen substantially during the past decade.

There are three major uses of the federal government's credit power (see Table 1 for details).

Direct loans by federal departments and agencies. Direct loans extended by federal agencies, such as the two percent loans made by the Rural Electrification Administration, generally involve significant subsidies because the loans are made at interest rates below those available in the private sector. In many cases, the government also absorbs the administrative expenses and losses arising from loan defaults, thus further increasing the amount of the subsidy. Although not formally considered a federal credit program, the relatively generous progress payments made by the Department of Defense represent interest-free provision of working capital to government contractors on a very large scale. Direct loans are still an important form of federal credit aid, accounting for almost $28 billion of the total of $99 billion of federal and federally-assisted credit extended during the fiscal year 1975. However, in recent years direct loans have been exceeded in size by the various guarantee programs and lending activities of government-sponsored but privately-owned credit agencies.

Moreover, a rising share -- almost one-fifth in fiscal 1975 -- of these direct loans have been excluded from the budget totals. These are the lending activities of the so-called off-budget agencies of the federal government, such as the Rural Electrification Administration and the

Table 1

MAJOR FEDERAL CREDIT PROGRAMS, FISCAL YEAR 1975
(New Commitments, in millions)

Category and Agency	Direct Loans		Guaranteed Loans	Government Sponsored Enterprises	Total
	On Budget	Off Budget			
Aid to Business					
Commerce	$15	--	$699	--	714
Interior	22	--	--	--	22
Transportation	37	--	177	--	214
Export-Import Bank	--	$3,813	8,708	--	12,521
Federal Deposit Insurance Corporation	100	--	1,723	--	1,823
General Services Administration	--	--	72	--	72
Small Business Administration	520	--	1,365	--	1,885
U.S. Railway Association	--	34	--	--	34
Subtotal	694	3,847	12,744	--	17,285
Aid to Farmers					
Agriculture	6,329	1,060	8,577	--	15,966
Farm credit agencies	--	--	--	$20,910	20,910
Subtotal	6,329	1,060	8,577	20,910	36,876
Aid to Local Governments					
Housing and Urban Development	590	--	1,252	--	1,842
Justice	40	--	--	--	40
District of Columbia	232	--	--	--	232
Subtotal	862	--	1,252	--	2,114
Aid to Individuals					
Health, Education, and Welfare	543	--	1,388	--	1,931
Housing and Urban Development	11,779	--	4,791[1/]	--	16,570
Veterans Administration	524	--	3,602[1/]	--	4,126
Federal Home Loan Bank System	1,305	--	--	12,694	13,999
Federal National Mortgage Association	--	--	--	4,434	4,434
Student Loan Marketing Association	--	--	--	144	144
Subtotal	14,151	--	9,781	17,272	41,204

Table 1 (continued)

Category and Agency	Direct Loans On Budget	Direct Loans Off Budget	Guaranteed Loans	Government Sponsored Enterprises	Total
Aid to Foreign Governments					
Security assistance	437	--	616	--	1,053
Development assistance	478	--	26	--	504
Subtotal	915	--	642	--	1,557
Miscellaneous					
Federal Financing Bank 1/	--	--	--	--	--
All other	95	--	6	--	101
Subtotal	95	--	6	--	101
GRAND TOTAL	23,046	4,907	33,002	38,182	99,137

1/ Duplicate transactions have been eliminated.

Source: Compiled from Special Analyses, Budget of the United States Government, Fiscal Year 1977.

Export-Import Bank. These latter agencies are all part of the federal government, using federal funds and federal employees to carry on their activities. Their common characteristic is that in each case the Congress has passed a law stipulating that some or all of their financial transactions are not to be included in the budget. The justification often given is that these programs will ultimately generate offsetting revenues and hence be no burden to the taxpayer. However, this rationale is of dubious value. First of all, those revenues may not always equal the off-budget outlays. And, secondly, many government programs which are included in the budget also generate offsetting receipts. Thus, the off-budget treatment is a subterfuge for understating the size of the budget and a mechanism for diluting the effectiveness of the budgetary review process.

Loans guaranteed by federal departments and agencies. Loan guarantees now account for a major share of federal credit programs. The attractiveness of this mechanism to government policymakers stems largely from the fact that the loans themselves are made by private lenders and thus are excluded from the federal budget. Technically, all that the government does is to assume a contingent liability to pay the private lender if the private borrower defaults. Loans in this category include housing subsidy programs, some of which have experienced very high default rates in spite of their being backed by the security of real property. Other new programs generate higher risks because they frequently guarantee loans which require little or no collateral in connection with the guarantee.

During the last several years, however, an interesting but unexpected movement has occurred between this category and direct off-budget loans. This has resulted from the formation of the Federal Financing Bank. The

basic reason for the Bank's establishment was to consolidate the market borrowings of the rising number of federal credit agencies. Such consolidation, it was reasoned, should enable the various federal credit agencies to raise funds at lower interest rates and also provide the Treasury Department with greater control over the timing and amount of borrowings by these agencies. To a substantial extent, the Bank has served that purpose. However, its charter also gives it the authority to purchase many of the private loans which carry a federal guarantee. As a result, some of the effort to reduce the pressure on the budget via extending guarantees is being offset by rising federal borrowings to finance the repurchase of these guarantees. This involuted procedure is hard to defend on any rational ground.

Loans by federally-sponsored agencies, such as the Federal National Mortgage Association, the Federal Home Loan Banks, and the farm credit agencies. These ostensibly private institutions are not included in the total of federal spending. They raise their funds primarily through borrowing in the nation's capital markets. However, these privately-owned agencies possess various tax advantages and are able to borrow funds in the market at low interest rates because of the implicit government backing of their debentures and other issues.

The best known of these agencies, the Federal National Mortgage Association (Fanny Mae), has far more ties to the federal government than does the customary private corporation. The Secretary of Housing and Urban Development, for example, is given "general regulatory power" in the company's charter. The Secretary of the Treasury must approve each of its sales of securities. The President appoints one-third of the membership

of its board of directors. Loans made by Fanny Mae and the other federally-sponsored agencies have increased sharply over the past decade. They now comprise the largest single form of federal credit assistance to the private sector.

Impacts on Total Saving and Investment

The conclusions of the empirical literature on the impacts of federal credit programs on saving and investment are clear. These programs do little if anything to increase the total flow of saving or investment in the American economy. They mainly change the share of investment funds going to a given industry or sector of the economy and, in the process of doing so, exert upward pressures on interest rates as investment funds are bid away from other sectors.

In commenting on existing programs of federally-assisted credit to the private sector, Dr. Henry Kaufman, the distinguished economist with the investment house of Salomon Brothers, has written: "Federal agency financing does not do anything directly to enlarge the supply of savings... In contrast, as agency financing bids for the limited supply of savings with other credit demanders, it helps to bid up the price of money."2/

In referring to borrowing by the federal government and its agencies, Dr. Albert Wojnilower has made a similar observation:

> "Because these governmental borrowers need have few if any worries about creditworthiness or meeting interest payments, they can preempt as much of the credit markets as they choose. As a result, the Federal sector has become one of the most relentless sources of upward pressures on interest rates."3/

Even the supporters of proposed credit subsidies for energy development admit to this effect. The following is taken from the statement to

the House Science and Technology Committee by Assistant Secretary of the Treasury Gerald Parsky, who was testifying in favor of financial incentives for synthetic fuel demonstration plants:

> "Such incentives increase the demand for capital while having little or no effect on the overall supply of capital. They tend to cause interest rates to rise and channel capital away from more economic to less economic uses."

In a comprehensive study of federal credit programs for the prestigious Commission on Money and Credit, Warren Law of Harvard University concluded that they have created inflationary pressures in every year since World War II.[4/] Professor Patricia Bowers has noted what she terms "costs" of federal credit programs. One cost arises from the fact that, given the availability of funds, an increase in credit for housing means lesser amounts for other borrowers. The two borrowing groups most adversely affected by tight credit are state and local governments and small businesses. A further cost is that the operations of the federal credit agencies tend to increase the level of interest rates above the level that would have prevailed if they had not entered the credit markets.[5/]

This phenomenon occurs for a variety of reasons. The total supply of funds is broadly determined by household and business saving and the ability of banks to increase the money supply. This is the basic limit on the availability of funds referred to by Professor Bowers. The normal response of financial markets to an increase in the demand for funds by a borrower, such as is represented by a federal credit program, is an increase in interest rates so as to balance out the demand for funds with the supply of saving. But the federal government's demand for funds is "interest-inelastic" (the Treasury will generally raise the money that it

requires regardless of the interest rate) and the interest-elasticity of saving is relatively modest. Thus, weak and marginal borrowers will be "rationed" out of financial markets in the process while the Treasury and other borrowers pay higher rates of interest. The General Accounting Office has noted this shortcoming in its analysis of the proposed Energy Independence Authority:

> "The EIA's...guarantees would make projects it assists financially more attractive to private capital than conservation projects not backed by Federal guarantees. Thus, both its loans and its guarantees will siphon private capital away from those conservation projects which might have been able to obtain private financing in the absence of EIA operations."

Government credit programs thus can have very different impacts on resource allocation than is the case with typical government tax and expenditure actions. Taxation, for example, most heavily affects current consumption. As Norman H. Jones, Jr. has pointed out, if the Congress were to decide to promote more investment in synthetic fuels production through direct expenditures, most of the funds to finance these outlays would be pulled away from current consumption via taxation.[6/]

But if the energy development were to be supported by deficit financing or government credit guarantees, the resources would be supplied at the expense of other capital demands. And as pointed out earlier, that would likely hit housing and small business loans disproportionately hard.

Important insights into the effects of federal credit programs on capital markets have been provided by Bruce MacLaury, the President of the Federal Reserve Bank of Minneapolis and a former deputy undersecretary of the Treasury:

> "The more or less unfettered expansion of Federal credit programs and the accompanying deluge of agency direct and guaranteed securities to be financed in the credit markets has undoubtedly permitted Congress and the Administration to claim that wonder of wonders -- something for nothing, or almost nothing. But as with all such sleight-of-hand feats, the truth is somewhat different."7/

Dr. MacLaury goes on to point out that there are extra costs associated with introducing new government credit agencies to the capital markets. These costs involve selling issues that are smaller than some minimum efficiently tradeable size, and selling securities that only in varying degree approximate the characteristics of direct government debt in terms of perfection of guarantee, flexibility of timing and maturities, "cleanness" of instrument, et cetera. As a result of such considerations, the market normally charges a premium over the interest cost on direct government debt of comparable maturity. That premium ranges from ¼ of one percent on the well-known federally-sponsored agencies such as Federal National Mortgage Association to more than ½ percent on such exotics as New Community Bonds. In general, if cost of financing were the only consideration, it would be most efficient to have the Treasury itself provide the financing for direct loans by issuing government debt in the market.

Reduced efficiency occurs in the economy by providing a federal "umbrella" over many credit activities without distinguishing their relative credit risks. A basic function that credit markets are supposed to perform is that of distinguishing different credit risks and assigning appropriate risk premia. This is the essence of the ultimate resource-allocation function of credit markets. As an increasing proportion of

issues coming to the credit markets bears the guarantee of the federal government, the ability of the market to differentiate credit risks inevitably diminishes. Theoretically, the federal agencies issuing or guaranteeing debt would perform this role, charging as costs of the programs differing rates of insurance premia. In practice, all of the pressures are against such differential pricing of risks.[8/] This is a hidden cost of federal credit programs.

Professor Henry Jacoby of the Massachusetts Institute of Technology discussed these concerns before the House Committee on Science and Technology while advocating a limited program of loan guarantees for synthetic fuel development:

> "The problem with loan guarantees is that they tend to hide the true cost of the technology that is being demonstrated...Thus the guarantee carries a hidden subsidy which masks the real economic cost of the energy produced - or saved - and clouds the issue of what the 'commercial' status of the technology would be without the guarantee."

Impacts on Sectors of the Economy

The very nature of federal credit assistance is to create advantages for some groups of borrowers and disadvantages for others. The literature provides clear answers on who will tend to be rationed out in the process. It is unlikely to be the large well-known corporations or the U. S. Government. It is more likely to be state and local governments, medium-sized businesses, private mortgage borrowers not under the federal umbrella, and consumers, thereby contributing to additional economic and financial concentration in the United States.

The competition for funds by the rapidly expanding federal credit programs also increases the cost to the taxpayer by raising the interest

rate at which the Treasury borrows its own funds. As shown in Table 2, there has been a massive expansion in the size and relative importance of federal government credit demands over the past decade. In 1960, the federal share of funds raised in private capital markets, using the Federal Reserve System's flow-of-funds data, was about 12 percent. By 1970, the government's share had risen to 23 percent, and reached 36 percent in 1975.

Virtually every session of the Congress in recent years has enacted additional federal credit programs. Since 1960, the Federal National Mortgage Association (Fannie Mae) has been joined by the Government National Mortgage Association (Ginne Mae), Student Loan Marketing Association (Sally Mae), and, most recently, the U. S. Railway Association (Fannie Rae).

Subsidies in Credit Programs

Substantial subsidy elements exist in most federal credit programs, which of course make these activities especially attractive to the recipients of the benefits. The subsidy element is fundamental, in that the basic purpose of the government involvement in credit activities is to provide certain categories of borrowers with credit on terms that are more favorable than those available in private markets.9/

As stated by the President's Commission on Budget Concepts:

> "Most Federal loan programs contain at least some element of subsidy. In fact, if this were not true, a serious question could be raised about the appropriateness of such activities being conducted by the Federal Government rather than by private financial institutions. To the extent that Federal loans include a subsidy element by lending at more favorable interest rates than the cost of money to the Government (or the even higher cost of money obtained through private sources) they are at least in part grants or transfer payments rather than loans."10/

Table 2

IMPACT OF FEDERAL GOVERNMENT ON CREDIT MARKETS
(fiscal years, dollars in billions)

	1960	1965	1970	1975
A. Federal borrowing (budget financing)	$2.2	4.0	3.8	50.9
B. Federally-assisted borrowing (outside of budget)	3.3	6.8	12.6	13.9
C. Total (A + B)	5.5	10.8	16.4	64.8
D. Total funds advanced in credit markets	43.4	69.6	90.5	177.9
E. Federal portion (C ÷ D)	12.7%	15.5%	18.1%	36.4%

Source: Federal Reserve System flow-of-funds accounts, Treasury Department data.

To the extent that subsidies help to achieve social goals, by shifting resource use to patterns closer to the society's priorities, they can be regarded as beneficial. At the heart of a subsidy is a political decision to favor some at the expense of others. Because a credit subsidy involves a balancing of interests, it would be useful to have fairly well-developed notions regarding the incidence of benefits and costs of any specific program in question. In light of the variety of credit programs, it is simply not possible to make firm statements with broad applicability. We must rely on available data and analyses.

In an intriguing study of the home mortgage purchase program of the Government National Mortgage Association, George Von Furstenberg has shown that the principal result of that government credit program has not been to increase the volume of resources going into housing. Rather, the credit program has mainly provided arbitrary subsidies to many homeowners who otherwise would have had to pay more for their home mortgages. In addition, many of them could have obtained private financing in the absence of the government subsidy.[11/]

Most frequently the improved terms take the form of an interest rate that is lower than the rate charged to private borrowers. Also, the length of the loan and the loan-to-value ratio may be more favorable. In addition, subsidies may result from inadequate fees or premiums which do not cover administrative costs and losses on credit guarantees. At the heart of a subsidy is a political decision to favor some at the expense of others.

Credit program subsidies may be discussed in terms of (1) the benefit to the borrower, (2) the "opportunity cost" to the government, or (3) the out-of-pocket or "cash cost" to the government. The benefit-to-

borrower concept is perhaps the most attractive to the economist as a measure of the impact of federal credit aid on demand and on the allocation of resources. Yet the benefit concept poses the most formidable measurement problems. Some lenders may use the insurance and guaranty programs simply because they are there, making loans that they would have made in any case, though on somewhat more stringent terms. In contrast, guaranteed loans to submarginal borrowers may be, in principle, as income-generating as government transfer payments.

There is no conclusive method of measuring the extent to which loans under some guarantee programs might have been made without the government guarantee. This is particularly true of guaranteed loans at market rates of interest, such as the regular mortgage insurance program of the Federal Housing Administration and the Export-Import Bank guarantees. It is not clear in such self-supporting programs whether there is a substantial benefit to the borrower or whether in many cases the borrower would have been able to obtain nonguaranteed credit on essentially similar terms.

On the other hand, many loans would clearly not have been made without the government guarantee. An extreme example is the loan guarantee program for public housing, where virtually all of the principal and interest payments are made by the federal government. That is, the rental income from public housing projects barely covers current operating and maintenance expenses, and in some projects not even those expenses are covered. Thus the public housing bonds are ultimately retired almost entirely from annual debt service contributions by the federal government.

Consequently, the credit program subsidy for a $10 million bond-financed public housing project is approximately $10 million, and the

benefit to the borrower is equivalent to a $10 million cash grant. It will not be attempted here to measure the "opportunity costs" to the government of using its resources for federal loan programs. That is, given limited resources, what would be the return to the government (or to the private sector) from investment in alternative projects?

Table 3 attempts to measure only the value of the interest rate subsidy that accrues to federally-assisted borrowers. The subsidy is defined as the difference between the interest rate that the borrower pays under government assistance and the rate that would have to be paid for a comparable private loan. These interest differentials arise in several ways. The interest rates used in the government credit program may be set by law below those prevailing in private markets. Alternatively, the interest rates may be set at the Treasury's borrowing costs, providing private borrowers credit at low rates otherwise available only to the federal government. In the case of the loan guarantees, the guarantee provides an implicit subsidy by eliminating the risk to the lender of loss through default. This ordinarily enables the borrower to obtain the lower interest rate which is usually associated with less risky investments.

As an estimate of the interest rates that would be available to private borrowers in the absence of federal credit programs, a 10 percent rate has been assumed here. That figure is considered to be a reasonable estimate of the average private sector cost of borrowing. Because interest subsidies occur throughout the life of a loan, the calculation of interest subsidies requires the conversion of a stream of payments into a single "present value." This capitalization is performed by discounting future subsidies by 10 percent a year before accumulating them into a

Table 3

INTEREST SUBSIDIES IN FEDERAL CREDIT PROGRAMS
(Fiscal Year 1975, Dollars in millions)

Agency and Program	Borrower Loan Terms		Annual Subsidy Per $100 million	Commitments	Cumulative Subsidy
	Percent	Years			
Direct Loans					
Funds appropriated to the President:					
International security assistance	6.0	10.0	2.5	437	69
International development assistance	4.0	40.0	5.2	478	243
Agriculture:					
Price support	7.1	2.1	1.6	1,101	33
CCC: Public Law 480	2.3	33.0	6.1	747	436
Farmers Home Administration	5.2	33.7	4.1	4,481	1,758
Rural Electrification Administration	5.5	35.0	3.9	1,241	398
Health, Education, and Welfare:					
Education and health education	3.0	15.0	4.6	380	133
Medical facilities	6.7	25.0	2.7	30	7
Housing and Urban Development:					
Urban renewal	6.8	.7	1.8	493	6
Low-rent public housing	---	1.5	8.4	82	9
Federal Housing Administration	9.5	40.0	.5	842	39
Government National Mortgage Assn.	8.5	27.0	1.2	11,779	1,371
Housing for elderly	9.8	40.0	.2	---	---
Veterans Administration:					
Insurance policy loans	5.0	15.0	3.4	152	40
Education loans	6.5	6.0	2.1	1	*
Housing	9.0	29.4	.9	369	30
District of Columbia	8.0	30.0	1.7	232	38
Export-Import Bank	8.1	6.0	1.1	3,813	191
Federal Financing Bank (net)	7.8	5.0	1.3	1,125	57
Federal Home Loan Bank Board	8.0	30.0	1.8	1,305	219

Table 3 (continued)

Agency and Program	Borrower Loan Terms Percent	Borrower Loan Terms Years	Annual Subsidy Per $100 million	Commitments	Cumulative Subsidy
Direct Loans					
Small Business Administration:					
Business and investment loans	6.9	8.7	1.9	279	31
Disaster loan fund	5.3	11.0	3.0	241	48
United States Railway Association	7.5	20.0	2.5	---	---
Total--Major subsidized direct loans					5,156
Guaranteed Loans					
Health, Education, and Welfare:					
Health maintenance organizations	7.0	20.0	2.3	---	---
Medical facilities	6.7	25.0	2.7	89	22
Student loan insurance	4.4	13.0	3.7	1,299	345
Housing and Urban Development:					
Urban renewal	4.6	.7	6.5	493	21
Low-rent public housing	---	41.5	7.8	741	566
Mortgage insurance (subsidized)	5.0	40.0	4.4	476	206
Interior: Indian loans	8.0	20.0	1.5	---	---
Department of Transportation: WMATA	6.3	40.0	3.3	177	58
Total--Major subsidized guaranteed loans					1,217
Agency Debt Issues Financed By Federal Financing Bank					
Tennessee Valley Authority	8.0	3.0	1.1	1,435	41
U.S. Postal Service	8.0	3.0	1.1	1,000	29
Total--Debt issue subsidies					70
Grand total					6,443

* Less than $0.5 million. Source: Same as Table 1.

single amount.

The results are shown in Table 3. On the basis of the assumptions made here, federal credit extended in the fiscal year 1975 will generate $6.4 billion of subsidies during the life of the loans made during that twelve month period. That amount is equal to about 7 percent of the total federal and federally-assisted credit provided during that year. The proportion of subsidy to total amount of the loan, however, varies substantially from program to program. Unlike subsidies in other federal spending programs, credit subsidies tend to be hidden. Hence, their magnitude remains generally unknown to either the public or to most governmental decision-makers.

The Foreseeable Trend

The upward trend in the size and number of federal credit programs shows no signs of slowing down. During the last few years, the Congress has approved a new loan guarantee program to assist industry in the commercial development of energy from geothermal resources (the Geothermal Energy Research, Development, and Demonstration Act of 1974), voted credit to the nation's largest city (the New York City Seasonal Financing Act), and authorized the Federal Energy Administration to guarantee loans for new underground coal mines (the Energy Policy and Conservation Act). In addition, several congressional committees have held hearings on proposed legislation to provide as much as $100 billion for credit assistance via an Energy Independence Authority. In November 1976, the governors of seven northeastern states called for the creation of a Regional Energy Development Corporation, which would use federally guaranteed bonds to finance coal development and other projects to foster regional growth.

In December 1975, the Farmers Home Administration (an agency of the U.S. Department of Agriculture) expanded its credit operations to provide up to a 90 percent guarantee on private loans that companies obtain for use on plants in rural areas. There has been little if any offsetting reductions during recent years in the scope of existing federal credit activities.

The future expansions in government credit programs are also likely to be qualitatively different from existing loan and guarantee activities. Currently, the major loan guarantee programs, such as those of the Federal Housing Administration, are secured generally by readily marketable assets, such as real estate, inventories, and production equipment. The individual loan risks are small; broadly diversified portfolios reduce the risks for the program as a whole.

But many of the proposed new loan guarantee programs, especially in the energy area, have very different risk characteristics. According to Norman H. Jones, Jr., the typical project whose financing would be guaranteed would be far larger, in both absolute size and relative to the total credit program. This would clearly be the case for a $1 billion project in a $6 billion synthetic fuel program. New energy developments involve substantial technical uncertainty and doubt as to the costs and profitability of the project, even in the event of technical success. Moreover, the assets to be pledged as collateral would be highly specialized and perhaps not readily marketable.[12/]

Thus the relative and absolute risks involved in some of the proposed extensions of government credit power might be much greater than in the past. The same might also be true in the case of long-term credit extensions

by the federal government to municipalities facing severe financial pressures. The point being made here is not to oppose automatically every proposed extension of governmental credit. Rather, the concern is with understanding the full extent of the contingent liability that is being assumed, contingent liabilities which could result in federal assumption of large amounts of unpaid debts. In such event, the guarantee mechanism would become a major subsidy, which the Congress might or might not wish to vote for were it deciding the matter directly.

Summary

Contrary to the popular view, government credit programs are not costless, either to the Treasury or to citizens in general. Three distinct costs of these government programs can be identified:

1. The economic cost. As they do little if anything to increase the total supply of investment funds in the economy, government credit programs take credit away from some unsubsidized borrowers. An economic cost results from the operations of federal credit programs to the extent that the contribution to society of the credit recipients is less than that of the unsubsidized borrowers who were rationed out of the market.
2. The initial fiscal cost. Government credit programs increase the total size of government-related borrowings -- a broad category which ranges from the Treasury's own securities to the private issues which are guaranteed by federal government agencies. To a considerable extent, the investment community looks upon all of these items as government-related, although individual investors may distinguish between Treasury securities and issues of the credit agencies. As a result

of these interdependencies, an expansion in the total volume of government-related credit results in a higher level of interest rates being paid by that entire category. The fiscal cost to the government arises because some portion of those higher interest rates (the part servicing the public debt) is a direct charge to the federal budget.

3. The ultimate fiscal cost. When defaults occur on the part of the borrowers whose credit is guaranteed by the federal government, the Treasury winds up bearing the ultimate cost of the credit. In such cases, government credit programs become a form of backdoor spending, whereby federal expenditures are incurred in the absence of direct appropriations for the purpose.

Several ways have been suggested to deal with the various problems that arise from the expansion of federal credit programs. One general approach is to require that all proposals to create new federal credit programs or to broaden existing ones be accompanied by a detailed analysis. This appraisal would result in a quantification of the subsidy by showing the relationship between (a) the interest rate actually charged to the borrower participating in the federal credit program, (b) the rate which would be charged by competitive and efficient private lenders, and (c) the rate necessary to cover the government's costs, including the possibility of default.

One way of controlling federal credit programs is to impose a ceiling on the total borrowing of federal and federally-sponsored credit agencies, both those "in" and those "out" of the budget -- thus restricting their ability to extend credit. In addition, the Congress could enact a ceiling on the overall volume of debt created under federal loan

guarantees. It would be important to establish procedures to permit review of commitments far enough in advance to permit evaluating their likely impact when the commitments become actual loans.

A variation of the first approach is to establish controls over the total volume of federally-assisted credit directly. Even though no immediate impact on the federal budget may be visible in most cases, the influence on the allocation of resources -- and on the composition of income and employment -- may be very considerable. At present, many of these federal credit programs tend to have virtually a blank check on the nation's credit resources. Under this second method, they would no longer be treated as a "free good."

A third method of controlling federal credit programs more effectively is to require these credit programs to be reviewed and coordinated along with other federal programs in the preparation of the government's annual budget and economic plans. At the present time, numerous federal credit programs -- guaranteed and insured loans, and loans by federally-sponsored enterprises -- escape regular budget and program review.

Perhaps the most fundamental proposal for dealing with the problem of federal credit does not relate to these credit programs at all, but with the underlying conditions of which they are symptoms. Hence, if we can create an economic climate more conducive to private saving and investment, that will reduce the need for private borrowers to seek federal credit assistance. The creation of that climate may require a tax system which tilts in favor of saving rather than consumption and a fiscal policy which avoids the large Treasury deficits whose financing competes with private borrowers. Until these fundamental changes are achieved, continued pressures for expansion of federal credit programs seems likely.

Footnotes

1/ Detailed information on individual credit programs is presented in Special Analysis E, Special Analyses, Budget of the United States, Fiscal Year 1977, Washington, Government Printing Office, 1976, pp. 88-115.

2/ Henry Kaufman, "Federal Debt Management: An Economist's View from the Marketplace," in Federal Reserve Bank of Boston, Issues in Federal Debt Management, p. 171.

3/ Albert M. Wojnilower, "Can Capital-Market Controls be Avoided in the 1970's," in Michael E. Levy, editor, Containing Inflation in the Environment of the 1970's, New York, Conference Board, 1971, p. 42.

4/ Warren A. Law, "The Aggregate Impact of Federal Credit Programs on the Economy," in Commission on Money and Credit, Federal Credit Programs, Englewood Cliffs, Prentice-Hall, 1963, p. 310.

5/ Patricia F. Bowers, Private Choice and Public Welfare, Hinsdale, Dryden Press, 1974, pp. 494-496. See also Alan Greenspan, "A General View of Inflation in the United States," in Conference Board, Inflation in the United States, New York, The Board, 1974, p. 4.

6/ Norman H. Jones, Jr., "Loan Guarantees: Backdoor Financing," Public Interest Economics, December 15, 1976, p. 4.

7/ Bruce K. MacLaury, "Federal Credit Programs -- the Issues They Raise," in Federal Reserve Bank of Boston, Issues in Federal Debt Management, p. 214.

8/ Ibid., p. 217.

9/ These issues are examined in depth in Murray L. Weidenbaum, Subsidies in Federal Credit Programs, Washington, American Enterprise Institute for Public Policy Research, 1972.

10/ Report of the President's Commission on Budget Concepts, Washington, Government Printing Office, October 1967, p. 51.

11/ George M. Von Furstenberg, "Distribution Effects of GNMA Home Mortgage Purchases, and Commitments Under the Tandem Plans," Journal of Money, Credit and Banking, August 1976, pp. 373-389.

12/ Jones, op. cit., p. 4.

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