



Subsidy Cost of Federal Credit: Cost to the Government or Fair Value Cost?

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April 25, 2012

Congressional Research Service

7-5700

www.crs.gov

R42503

Summary

Since the mid-1980s, budget experts have debated whether the best method of measuring the subsidy cost of federal credit (direct loans and loan guarantees) is the cost to the government or the fair value cost. The cost to the government would reflect the actual budget cost measured by discounting of expected cash flows associated with each program at the interest rate on risk-free Treasury securities. The measure of the cost to the government would place the cost of federal credit on the same basis as a grant or a tax expenditure; consequently, policymakers would have an incentive to use the most appropriate means to cover the cost of a government program.

The fair value cost would equal the cost that the credit recipient would have had to pay to borrow on the private credit market. The fair value cost would include market risk and reflect the opportunity cost of shifting capital from the private sector to the public sector. Proponents argue that the social cost rather than the budgetary cost should be used to allocate resources between the public and private sectors. This debate has yet to be resolved.

The U.S. government uses federal credit to allocate financial capital to a range of areas, including home ownership, student loans, small business, agriculture, and energy. A direct loan is a disbursement of funds by the government to a nonfederal borrower under a contract that requires the repayment of such funds with or without interest. A loan guarantee is a pledge by the federal government to repay all or part of the principal or interest on any debt obligation of a non-federal borrower to a non-federal lender. At the end of FY2011, outstanding federal direct loans totaled \$838 billion and outstanding guaranteed loans totaled \$2,017 billion.

Before FY1992, federal credit programs were measured on an annual cash flow basis. A new federal direct loan was treated as a budget outlay in the current fiscal year, and repayments of principal and payments of interest were treated as offsetting collections (negative outlays) in the future fiscal years in which they occurred. In the year it was granted, a loan guarantee was a contingent liability, which means the federal government was only responsible for repayment in the event of a default. Congress and the executive branch debated options to convert the budgetary treatment of federal credit from cash flow accounting to accrual accounting, which would record the subsidy cost of federal credit over the entire life of a loan or loan guarantee. One of the primary decisions concerning accrual accounting was whether the subsidy cost of federal credit should be measured by the “cost to the government” or the “fair value” cost.

On November 5, 1990, the President signed P.L. 101-508, 104 Stat. 1388, the Omnibus Budget Reconciliation Act of 1990 (OBRA90), which included the Federal Credit Reform Act of 1990 (FCRA). Beginning with FY1992, FCRA changed the methodology in the unified budget for measuring and reporting the cost of federal direct loans and federal loan guarantees from cash flow to accrual accounting with the cost to the government used in measuring subsidy costs.

In the 112th Congress, six bills have been introduced that would provide for calculation of subsidy costs using fair value accounting: companion bills S. 1651/H.R. 3414 (Honest Budget Act), H.R. 3581 (Budget and Accounting Transparency Act of 2011), H.R. 3844 (Honest Budget Act of 2012), House Fiscal Year 2012 Budget Resolution (H.Con.Res. 34, 112th Congress), and House Fiscal Year 2013 Budget Resolution (H.Con.Res. 112, 112th Congress). This report presents a chronology of this still unresolved debate, which dates from the mid-1980s.

This report will be updated as issues develop and new legislation is introduced.

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Introduction

Since the mid-1980s, budget experts have debated whether the best method of measuring the subsidy cost of federal credit (direct loans or loan guarantees) is the cost to the government or the fair value cost. Federal credit is direct loans and loan guarantees. The cost to the government would reflect the actual budget cost measured by discounting of expected cash flows associated with each program at the interest rate on risk-free Treasury securities. The measure of the cost to the government would place the cost of federal credit on the same basis as a grant or a tax expenditure; consequently, policymakers would have an incentive to use the most appropriate means to cover the cost of a government program.

The fair value cost estimate would equal the cost that the credit recipient would have had to pay to borrow on the private credit market. The fair value cost estimate would include market risk and reflect the opportunity cost of shifting capital from the private sector to the public sector, thus reflecting the social cost of the programs. Proponents argue that the social cost rather than the budgetary cost should be used to allocate resources between the public and private sectors. This debate has yet to be resolved.

The U.S. government uses federal credit to allocate financial capital to a range of areas including home ownership, student loans, small business, agriculture, and energy.¹ A direct loan is “a disbursement of funds by the government to a nonfederal borrower under a contract that requires the repayment of such funds with or without interest.”² A loan guarantee is “a pledge with respect to the payment of all or part of the principal or interest on any debt obligation of a non-federal borrower to a non-federal lender.”³ At the end of FY2011, outstanding federal direct loans totaled \$838 billion and outstanding guaranteed loans totaled \$2,017 billion.⁴ Thus, at the end of FY2011, outstanding federal credit totaled \$2.855 trillion.

The weak economy and expansionary monetary policy caused low nominal Treasury interest rates from FY2009 to FY2011. Consequently, the use of Treasury interest rates in the cost-to-the-government measure resulted in aggregate costs of federal credit of negative \$19 billion for FY2009, negative \$20 billion for FY2010, and negative \$41 billion for FY2011.⁵ These negative costs reduced the sizes of the federal deficits. In contrast, the aggregate cost of federal credit averaged \$3.1 billion annually for FY1998-FY2008.⁶ Arguably, these negative aggregate costs of federal credit over the past three fiscal years have contributed to the debate about changing to fair value budgeting. In the 112th Congress, six bills have been introduced that would provide for calculation of subsidy costs using fair value accounting: companion bills S. 1651/H.R. 3414 (Honest Budget Act), H.R. 3581 (Budget and Accounting Transparency Act of 2011), H.R. 3844

¹ For an overview of federal credit reform, see CRS Report RL30346, *Federal Credit Reform: Implementation of the Changed Budgetary Treatment of Direct Loans and Loan Guarantees*, by James M. Bickley.

² Section 502(1) of the Federal Credit Reform Act of 1990.

³ Section 502(3) of the Federal Credit Reform Act of 1990.

⁴ U.S. Office of Management and Budget, *Analytical Perspectives, Fiscal Year 2013, Budget of the U.S. Government*, Washington: GPO, 2012), p. 401.

⁵ Congressional Budget Office, *Fair-Value Accounting for Federal Credit Programs*, March 2012, p. 5.

⁶ *Ibid.*

(Honest Budget Act of 2012), House Fiscal Year 2012 Budget Resolution (H.Con.Res. 34, 112th Congress), and House Fiscal Year 2013 Budget Resolution (H.Con.Res. 112, 112th Congress).

Before FY1992, federal credit programs were measured on an annual cash flow basis. Under this arrangement, a new federal direct loan was treated as a budget outlay in the current fiscal year, and repayments of principal and payments of interest were treated as offsetting collections (negative outlays) in the fiscal years in which they were repaid. If a loan recipient paid a fee, this fee was also treated as an offsetting collection. Loan defaults reduced repayments of principal and interest, and therefore offsetting collections. Administrative expenses were reported as outlays. In a given fiscal year, the budgetary cost of a loan program, not the individual loans, was its net cash flow. This equaled new loans made plus any administrative expenses associated with these loans (rarely recognized in the loan accounts) less any loan fees, repayments of principal, and payments of interest. The federal acceptance of a contingent liability when a loan guarantee was provided was not included in the federal budget because no cash flow occurred. The administrative costs of a guarantee program were outlays in the fiscal year in which they occurred. Some guarantee programs charge fees to the recipient, and these fees were considered offsetting collections. Any federal outlays necessary to compensate lenders for any default losses covered by a federal guarantee were not shown in the budget until they were actually paid.

Using the old cash-flow method, it was often difficult for policymakers to accurately monitor and therefore make informed decisions about federal credit. In addition, administrators at agencies could understate costs by using various budgetary techniques. One of these was generating “savings” from the fees on increased volumes of new guarantees while ignoring the increase in expected losses and offsetting the (cash) cost of new direct loans with current year collections from old loans.

To remedy these problems, Congress and the executive branch debated options to convert the budgetary treatment of federal credit from cash flow accounting to accrual accounting (measuring the cost over the life of the loan or loan guarantee). One of the primary decisions concerned whether the cost of federal credit should be measured by the “cost to the government” or the “fair value” cost.

“Cost to the Government”

The cost to the government approach reflects the actual budget cost measured by “discounting of expected cash flows at the interest rate on risk-free Treasury securities (the rate at which the government borrows money).”⁷ For a loan program, these credit flows consist of “disbursements by the government (loan disbursement and other payments) minus estimated payments to the government (repayment of principal, payments of interest, and other payments) after adjusting for projected defaults, prepayments, fees, penalties, and other recoveries.”⁸ For a loan guarantee program, these credit flows are “estimated payments by the government (for defaults and delinquencies, interest rate subsidies, and other payments) minus estimated payment to the government (for loan origination and other fees, penalties, and recoveries).”⁹

⁷ Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees*, August 2004, p. 4.

⁸ U.S. Government Accountability Office, *Credit Reform; Review of OMB’s Credit Subsidy Model*, Report no. GAO/AIMD-97-145, August 1997, p. 4.

⁹ *Ibid.*

The cost to the government concept would measure the subsidy cost in an equivalent budgetary method for a grant or a tax expenditure. Thus, a policymaker would not have any incentive to favor one type of assistance over another because credit, grants, and tax expenditures would all be measured by the cost to the government.

“Fair Value Cost”

An alternative would be to use the fair value cost, which would equal the cost that the credit recipient would have had to pay to borrow on the private credit market. In other words, the fair value cost is based on the price investors would be willing to pay to purchase federal direct loan assets or reinsure federal loan guarantees. The fair value cost includes market risk and reflects the opportunity cost of shifting capital from the private sector to the public sector.

On November 5, 1990, President George H. W. Bush signed P.L. 101-508, 104 Stat. 1388, the Omnibus Budget Reconciliation Act of 1990 (OBRA90). The legislation added a new title to the Congressional Budget Act, Title V, the Federal Credit Reform Act of 1990 (FCRA). Beginning with FY1992, FCRA changed the methodology in the unified budget for measuring and reporting the cost of federal direct loans and federal loan guarantees from cash flow to accrual accounting, using the cost to the government concept.

Whether the cost to the government or the fair value cost is most appropriate is still debated, however, and the question remains unresolved. This report gives a chronological examination of this debate since the 1980s.

Debate in Mid-1980s

In August 1984, the Office of Management and Budget (OMB) issued a revised version of its Circular A-70, *Policies and Guidelines for Federal Credit Programs*, which included the requirement that federal agencies calculate and transmit data to OMB on the subsidy cost of all of their direct loan and loan guarantee programs. The method used to measure subsidy costs was specified as comparing private financing terms with those of federal credit. Since 1984, these agency data were used to report subsidy costs in Special Analysis F, “Federal Credit Programs,” in the President’s budget documents.¹⁰

On December 12, 1985, the passage of the Gramm-Rudman-Hollings (G-R-H) Act, Balanced Budget and Emergency Deficit Control Act of 1985 (P.L. 99-177), 99 Stat. 1037, required that all new direct loans and loan guarantees be on-budget.¹¹ Prior to G-R-H, many new direct loans and loan guarantees were recorded off-budget. With the passage of G-R-H, Congress and the executive branch became more interested in possible budgetary reforms to improve the recording of federal credit in the budget. One of the major issues was measuring the subsidy costs of federal

¹⁰ Congress of the United States, Congressional Budget Office, *Credit Reform: Comparable Budget Costs for Cash and Credit*, December 1989, p. 21.

¹¹ Off-budget accounts are designated by law as excluded from the budget totals. For example, under current law, transactions of the Social Security trust funds and the Postal Service are off-budget. On-budget accounts are other than those designated by law as off-budget. The budget combines the on- and off-budget totals to derive unified totals for federal activity.

credit. This new interest prompted both proposed legislation and research in legislative and executive branch agencies and the academic community.

Proposed Credit Reform Legislation in 1987

In February 1987, the Reagan Administration proposed extensive credit reform in its FY1988 Budget.¹² The Administration's proposals were introduced in the House as H.R. 1754 and the Senate as S. 745, the Federal Credit Reform Act of 1987. Senators Lawton Chiles and Pete Domenici extensively revised the Reagan proposal. Their proposal was included as an amendment to H.J.Res. 324 to raise the debt limit as it passed the Senate on July 31, 1987, but was eliminated by the conference agreement.¹³

The Administration's proposal measured the subsidy cost as the dollar benefit to the borrower, while the Chiles-Domenici proposal measured subsidy cost as the dollar cost to the federal government. Furthermore, the two proposals differed in their methods of determining the value of subsidy costs.

The Administration proposed to sell most loans on private credit markets.¹⁴ The value of a loan's subsidy cost would equal the difference between its face value and its selling price. The Administration's proposal also sought to reinsure most loan guarantees with single payment policies, and government's payment for reinsurance would measure the subsidy cost. Thus, most credit subsidies would be measured objectively by market forces. For those credit programs for which loan sales and guarantee reinsurance would be inappropriate, the subsidy cost was to be estimated by the Secretary of the Treasury in consultation with the relevant agencies.

The Chiles-Domenici proposal neither required nor authorized the selling of direct loans and specifically forbade the reinsurance of federal loan guarantees. These stipulations reflected the belief that market transactions would have been inappropriate in measuring the subsidy cost to the federal government. Under the Chiles-Domenici proposal, a federal credit management agency would have been established in the Treasury Department, and this agency would estimate subsidy costs as cost to the government.

¹² The information in this section is from the following source: archived CRS Report 87-939 E, *Credit Reform: Chiles-Domenici Proposal Contrasted with Reagan Proposal*, by James M. Bickley. A copy of this report is available from the author.

¹³ For explanations of these proposals, see Executive Office of the President, Office of Management and Budget, *Section-By-Section Analysis of the Federal Credit Reform Act of 1987*, Washington, March 1987, 17 p.; and U.S. Congress, House, *Increasing the Statutory Limit on the Public Debt*, Conference Report to Accompany H.J.Res. 324, 100th Congress, 1st Session, Washington, September 21, 1987, pp. 68-70.

¹⁴ For GAO's views on the federal government's proposed sale of loan assets, see Frederick D. Wolf, "Federal Government Credit Program: Privatization Through Loan Sales," *Public Budgeting & Finance*, vol. 8, no. 4, Winter 1988, pp. 74-80.

GAO's 1989 Report

In April 1989, the then-General Accounting Office issued a report titled *Budgetary Treatment of Federal Credit Programs*, which included analyses of credit reform proposals recommended by the Senate Budget Committee, CBO, OMB, and GAO.¹⁵ In the report, GAO stated the following:

The four proposals differ principally only on the method used to calculate credit subsidy costs. We [GAO] and the Senate Budget Committee propose measuring the direct budgetary costs of credit programs. In our recent reports, we recommend a “cost-to-the-government” model, which measures loan subsidy costs as the difference between the costs to the Treasury of making the loan and the expected receipts flowing back to the Treasury from the loan repayments—calculated on a present-value basis.

On the other hand, CBO and OMB prefer a market-valuation oriented measurement approach which calculates the economic benefit borrowers receive as a result of obtaining federal, rather than private sector, loans. OMB believes that the economic subsidy offered to borrowers is the most important aspect of federal credit, and it proposes putting this economic subsidy measure in the federal budget. OMB computes subsidy costs as the present value of the additional payments that a federal borrower would be required to pay for a similar loan from the private sector. CBO's preference for market-valuation subsidy costs is based on the assumption that government credit program costs appropriately measured are comparable to costs incurred by private sector financial institutions.

As stated in our prior reports, we [GAO] prefer the cost-to-the-government measure of credit subsidy costs because it measures future cash outlays. We believe that market-valuation subsidy costs will overstate the actual cost to the government. Subsidies measured in terms of market values will generally be larger than subsidies measured in terms of the cost to the government because they will include some costs, such as premiums for liquidity and risk (above and beyond expected default costs), which would not be reflected in budget outlays.¹⁶

CBO's 1989 Report

In December 1989, the Congressional Budget Office (CBO) published a report titled *Credit Reform: Comparable Budget Costs for Cash and Credit*, which provided an analysis of federal credit reform proposals.¹⁷ One chapter explained possible methods of calculating subsidy costs of federal credit,¹⁸ and discussed selecting the appropriate discount rate in determining costs. In examining the option of using Treasury borrowing rates, the report stated the following:

The bills, notes, and bonds issued by the Treasury are believed to be virtually free of default risk. Rates on such debt, therefore, contain no risk premium and are commonly considered risk-free. Use of a Treasury borrowing rate to discount future cash flows on a credit contract treats those payments as though they were certain to be received. If the government were to

¹⁵ U.S. General Accounting Office, *Budgetary Treatment of Federal Credit Programs*, Report No. AFMD-89-42, April 1989, 28 pp.

¹⁶ *Ibid.*, pp. 3-4.

¹⁷ This report satisfied the requirements of Section 212 of the *Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987* (P.L. 100-119), 101 Stat. 754, which directed CBO in consultation with GAO to study specified aspects of federal credit.

¹⁸ Congressional Budget Office, *Credit Reform: Comparable Budget Costs for Cash and Credit*, pp. 33-46.

use its own risk-free cost of borrowing to discount uncertain future cash flows, it would be the only financial institution to do so. An aversion to risk causes others, including federally insured banks and thrifts, to discount risky income at a higher than risk-free rate.

Those who recommend that the government use a risk-free rate to discount risky future income argue that the risk-free rate reflects what the government actually pays to provide credit assistance. GAO, for example, has advocated valuing federal loans by using Treasury borrowing rates to discount receipts, minus losses from defaults. Using a risk-free Treasury rate for discounting supports a budget policy that recognizes only costs paid in cash.¹⁹

The report also considered the option of using market rates:

Others recommend that the government select a discount rate equal to the rate that the government would receive by investing in other equally risky assets. They maintain that the use of such a rate is necessary to capture the opportunity costs of credit or the value of alternatives forgone. The use of rates that account for risk is also necessary to distinguish the cost of assets with equal expected income but different degrees of risk.²⁰

The report indicated major data deficiencies in making subsidy cost calculations. “In general, federal agencies do not have access to historical data on the characteristics of borrowers, on the financed project, or on the cash flows for individual loans and guarantees.”²¹

Federal Credit Reform Act of 1990

On November 5, 1990, the President signed P.L. 101-508, 104 Stat. 1388, the Omnibus Budget Reconciliation Act of 1990 (OBRA90). The legislation added a new title to the Congressional Budget Act, Title V, the Federal Credit Reform Act of 1990 (FCRA). Beginning with FY1992, FCRA changed the methodology in the unified budget for measuring and reporting the cost of federal direct loans and federal loan guarantees from cash flow to accrual accounting.

The four stated purposes of FCRA (Section 501) were to

- (1) measure more accurately the costs of federal credit programs;
- (2) place the cost of credit programs on a budgetary basis equivalent to other federal spending;
- (3) encourage the delivery of benefits in the form most appropriate to the needs of beneficiaries; and
- (4) improve the allocation of resources among credit programs and other spending.

FCRA required the budgetary cost of federal credit to be measured for any one year as the net present value of the cost to the government of credit subsidies in the fiscal year the credit is provided.

¹⁹ Ibid., pp. 39-40.

²⁰ Ibid., p. 40.

²¹ Ibid., p. 36.

Although FCRA specified the use of the cost to the taxpayer in measuring credit subsidies, some public finance professionals, including some experts at CBO, continued to advocate a shift to the use of fair value cost.

CBO's 2004 Report

In August 2004, CBO issued a report on federal credit subsidies that examined two ways of including the market price for risk: risk-adjusted discount rates and options-pricing methods.²²

The risk-adjusted discount rate (ADR) method “adds a spread—the difference between the interest rate on a Treasury security and the rate on a risky security—to Treasury rates and uses the resulting adjusted rate to discount expected cash flows associated with a loan.”²³ The ADR method results in a higher discount rate for both costs and revenues and, with a few exceptions for negative subsidies, raises the net cost of credit programs.

“An option is a marketable security which allows the owner to buy (or sell) another security at a stipulated price on or before a specified date.”²⁴ “The general ideal behind options-pricing methods is that assets with the same payoffs must have the same price; otherwise, investors would have the opportunity to earn a risk-free profit by buying low and selling high.”²⁵ An options-pricing method is likely to be more accurate than the ADR method, but only when the necessary data and model are available.²⁶ Options-pricing models are seldom used to value credit provided to individuals; instead the use of the ADR method is usually appropriate.²⁷ Options-pricing methods are usually better than ADR methods in valuing credit provided to commercial enterprises.²⁸ The best method to use varies for other credit programs, such as “loan assistance to sovereign states, municipalities, and special-purpose enterprises.”²⁹

As an example of the process, CBO applied a type of options pricing—the binomial pricing method—to calculate the risk-adjusted cost of extending federal loan guarantees to Chrysler in 1980 and to America West Airlines (AWA) in 2002. CBO computed that the market-value loss of the Chrysler loan guarantee was \$239.0 million instead of the Treasury-rate loss of \$107.6 million.³⁰ CBO also found that the calculated market-value loss was \$26.3 million for the AWA loan guarantee instead of a gain of \$47.4 million using Treasury interest rates.³¹

²² Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees*, August, 2004, p. 4.

²³ *Ibid.*, p. 7.

²⁴ Robert C. Radcliffe, *Investment: Concepts, Analysis, and Strategy* (Glenview, Ill.: Scott, Foresman and Company, 1982), p. 348.

²⁵ Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees*, p. 8.

²⁶ *Ibid.*

²⁷ *Ibid.*

²⁸ *Ibid.*

²⁹ *Ibid.*, p. 9.

³⁰ *Ibid.*, pp. 12-19.

³¹ *Ibid.*

President's 2010 Fiscal Commission

In 2010, President Barack Obama established the National Commission on Fiscal Responsibility and Reform “to address the nation’s fiscal challenges.”³² In December 2010, the commission issued its report that included a recommendation to “Review and Reform Budget Concepts.” This recommendation stated that

Current scoring rules and definitions cause policy makers to undervalue some policies and overvalue others. The Commission recommends a complete review of all budget scoring practices (“budget concepts”) by the budget committees, the Congressional Budget Office, and the Office of Management and Budget. Changes should aim to more accurately reflect the true cost of government liabilities, including by considering accrual accounting, risk-adjusted credit reforms, and similar concepts.³³

Thus, the President’s fiscal commission arguably endorsed considering a change to fair value accounting for credit programs.

House FY2012 Budget Resolution

On April 11, 2011, Representative Paul Ryan, chairman of the House Committee on the Budget, introduced the Fiscal Year 2012 Budget Resolution, H.Con.Res. 34, 112th Congress. This resolution passed the House by a yeas to nays vote of 235 to 193 but was rejected in the Senate by a yeas to nays vote of 40 to 57.

Section 408, “Fair Value Estimates,” requires that any CBO estimate prepared for a measure under the Federal Credit Reform Act shall also provide, as a supplement, and to the extent practicable, upon the request of the chairman or ranking Member of the Committee on the Budget, an estimate of the current actual or estimated market values representing the “fair value” of assets and liabilities affected by such measure. Section 408 also authorizes the chairman to use such estimate to determine compliance with the Congressional Budget Act of 1974 and other budgetary enforcement controls. Thus, this budget resolution was supportive of fair value accounting.

Budget and Accounting Transparency Act of 2011

On December 7, 2011, Representative Scott Garrett introduced H.R. 3581, the Budget and Accounting Transparency Act of 2011.³⁴ On February 7, 2012, the House passed H.R. 3581 by a yeas to nays vote of 245 to 180. On February 9, 2012, the act was referred to the Senate Committee on the Budget. This act includes a provision that would amend FCRA by requiring the calculation of the subsidy cost of federal credit be accounted for on a “fair value” basis.

³² The National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, Washington, December 2010, 65 p.

³³ *Ibid.*, pp. 57-58.

³⁴ The provisions concerning fair value account in S. 1651, H.R. 3414, and H.R. 3844 were similar to H.R. 3581, but only H.R. 3581 has seen floor action.

Report of the Center on Budget and Policy Priorities, 2012

On January 24, 2012, the Center on Budget and Policy Priorities (CBPP)³⁵ issued a report opposing H.R. 3581 titled *House Bill Would Artificially Inflate Cost of Federal Credit Programs*.³⁶ The authors argue that the addition of a risk component would overstate the federal costs of credit programs and force policy makers to offset phantom costs with phantom offsets in order to avoid overstating the size of the federal deficit.³⁷ The authors maintain that H.R. 3581 has “the four flaws,” alleged negative characteristics that are identified below.

CBPP Criticism of H.R. 3581

- Government May Be Less Risk Averse than Individuals

The authors argue that “individuals are risk averse in part because their financial assets are likely to be needed at specific times, even when the value of those assets has declined.”³⁸ In contrast, the Treasury can borrow inexpensively when the times are bad.

- Risk Aversion Is Not a Budgetary Cost

The authors assert that “adding a risk-aversion adjustment to the spending side of the budget would add an extra ‘cost’ that the government does not actually incur—and that doesn’t need to be covered by additional taxes or borrowing.”³⁹ Thus, a risk-aversion adjustment would be a *phantom cost*.⁴⁰

- Proposal Does Not Treat All Programs the Same

The authors maintain that “when allocating public funds, the budget must reflect costs comparable across all programs.”⁴¹ But the Budget and Accounting Transparency Act of 2011 “would make credit programs appear more expensive to the Treasury than they truly are without making similar adjustment for other programs whose actual costs also are uncertain.”⁴²

- Phantom Costs Require Phantom Offsets

The authors declare that the phantom cost from the risk-aversion adjustment causes proponents “to tacitly or explicitly advocate accompanying that adjustment with a *phantom offset*.”⁴³ The authors state that the Budget and Accounting Transparency Act of 2011

³⁵ The conservative Heritage Foundation refers to the Center on Budget and Policy Priorities as a “liberal” think tank.

³⁶ Jim Horney, Richard Kogan, and Paul Van de Water, *House Bill Would Artificially Inflate Cost of Federal Credit Programs*, Center on Budget and Policy Priorities, Washington, January 24, 2012, 9 p.

³⁷ *Ibid.*, p. 1.

³⁸ *Ibid.*, p. 6.

³⁹ *Ibid.*

⁴⁰ *Ibid.*

⁴¹ *Ibid.*, p. 7.

⁴² *Ibid.*

⁴³ *Ibid.*

creates a phantom downward “means of financing” offset that, over time, would prevent the debt from being too high even though the annual deficits would consistently be overstated. One result of this approach is that the sum of deficits over time would diverge more than it already does from the amount of debt held by the public.⁴⁴

Although the authors believe that a risk-aversion cost should not play a part in budget accounting, it “should play a part in the *cost-benefit analysis* that policymakers should undertake in deciding whether a government program constitutes wise public policy.”⁴⁵

Furthermore, in response to a request from Representative Chris Van Hollen, Robert D. Reischauer, a member of the CBPP board of directors and president emeritus of the Urban Institute, sent a letter expressing his strong opposition to the use of fair value accounting in proposed H.R. 3581. He stated that

H.R. 3581 proposes to place an additional budgetary cost on top of the actual cash flows. This additional cost is supposed to reflect a cost to society that stems from the fact that, even if the cash flows turn out to be exactly as estimated, the *possibility* that the credit programs would cost more (or Less) than estimated imposes a cost on a risk-averse public.⁴⁶

Criticism of CBPP Report by Phaup

Professor Marvin Phaup, a research scholar and professorial lecturer at the Trachtenberg School of Public Administration and Public Policy at George Washington University, wrote a comment on CBPP’s release on H.R. 3581.⁴⁷ Professor Phaup made the following five points.⁴⁸

- H.R. 3581, he asserted, would remove “phantom” budgetary gains to the government from direct lending and loan guarantee programs. Those illusory gains mislead policy makers about the costs of their policy decisions.
- What he described as illusory gains on federal credit also encourage budget gimmickry. For example, FCRTA would permit the government to balance its budget immediately on paper by issuing large amounts of Treasury debt and using the proceeds to invest in an equally large portfolio of risky loans. In his view, this result would be absurd because in issuing a dollar of debt and buying a dollar of risky loans at market prices, the government’s net financial position is unchanged.
- According to Professor Phaup, if the current practice of using the prices of Treasury securities to value risky loans rather than the market value of the risky securities themselves were extended to other assets, then the government could—

⁴⁴ Ibid., p. 8.

⁴⁵ Ibid.

⁴⁶ Center on Budget and Policy Priorities, “Reischauer ‘Strongly Opposes’ House Bill to Inflate Cost of Federal Credit Programs,” Robert D. Reischauer letter to Representative Chris Van Hollen, January 24, 2012.

⁴⁷ Marvin Phaup, *Fair Market Values and the Budgetary Treatment of Federal Credit: Comment on CBPP’s Release on H.R. 3581*, manuscript, George Washington University, March 2012, 5 pp. Available at <http://www.tspppa.gwu.edu/docs/Fair%20Market%20Values%20and%20the%20Budgetary%20Treatment%20of%20Federal%20Credit%20MP013012Final.pdf>.

⁴⁸ Ibid., pp. 1-2.

with the same logic—direct the Treasury to buy a ton of lead, value it at the price of gold, and record the gain as deficit reduction.

- The cost of market risk, he maintains, should be a budget cost because it is a cost to government stakeholders and its absorption by some yields an unrecognized subsidy to others. CBPP would include this cost in cost-benefit analyses where the purpose is to decide if a federal activity produces a net gain but not in the budget. Budgeting without an evaluation function, however, he considers to be little more than a redundant projection of Treasury’s borrowing requirements.
- Finally, he suggests that the cost of market risk should not be excluded from the budget on grounds that the money isn’t paid out by the government. Both the Universal Service Fund and the United Mine Workers of American Benefit Funds are included in the budget, even though the money is untouched by federal hands.

Analysis of Fair Value Budgeting in FY2013 Budget

In the President’s Budget for FY2013, the Office of Management and Budget selected “Fair Value Budgeting for Credit Programs” as a topic for in-depth analysis.⁴⁹

OMB compared and contrasted the current cost to the government with fair value budgeting, which would reflect social costs. OMB found that

The current FCRA method for estimating cost provides a different measure of cost than the fair value method, which takes different risks and costs into account. To calculate fair value, cash flows unadjusted for expected losses would be discounted with a market rate that reflects the characters of the cash flows of the loan or loan guarantee (comparable market rate), instead of Treasury rates. The comparable market rate would differ from the maturity-matched Treasury rate in most cases and vary across credit programs, and even across individual loans and guarantees in some cases.

Fair value is conceptually appealing in that it reflects closely the preferences of market participants. It is debatable, however, whether fair value estimates for credit programs also represent the preferences of taxpayers and the society as a whole. In addition to this conceptual issue, several practical and implementation issues would need to be carefully considered in evaluating fair value proposals. Key issues include: how to develop accurate estimation methods; comparability of cost estimates across programs; and whether agencies would be able to implement fair value, particularly given limited administrative resources. A fair value proposal that does not address these conceptual and practical issues would probably fail to improve resource allocation and could even be counter-productive.⁵⁰

OMB stated that the market interest rate on a private loan depends on seven factors, with only the first two of the following being reflected in the Treasury rate.⁵¹ These seven factors were identified by OMB:

- time preference (present versus future, included in FCRA cost estimate)

⁴⁹ U.S. Executive Office of the President, Office of Management and Budget, *Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2013*, U.S. Govt. Print Off., Washington, 2012, pp. 393-399.

⁵⁰ *Ibid.*, p. 393.

⁵¹ *Ibid.*, pp. 393-395.

- expected loss from default (included in FCRA cost estimate)
- compensation for uncertain returns—uncertainty premium
- compensation for lower liquidity—liquidity premium
- cost of administering the loan (This cost is not included in an FCRA cost estimate but is relevant to taxpayers. It is currently recorded on a cash basis.)
- tax rate on interest income
- contract terms determining lenders' and borrowers' rights

CBO Issue Brief on Fair-Value Accounting

In March 2012, CBO released an issue brief titled *Fair-Value Accounting for Federal Credit Programs*. CBO indicated its support for fair value accounting:

FCRA cost estimates understate the cost of federal credit programs to the government because of the requirement that Treasury rates be used for discounting. Using comprehensive cost measures for budgeting, and accounting for credit on a basis that is equivalent to that for other federal programs—stated objectives of FCRA—would be better accomplished if the cost of extending federal credit was assessed at market prices rather than on a FCRA basis.⁵²

CBO acknowledges that fair value accounting involves implementation issues. “Because most public-sector credit programs have no exact analogue in the private sector, estimating their fair value usually involves approximation.”⁵³ Fair value accounting would result in additional effort and expense.⁵⁴ Fair value estimates would be more volatile “over time because the cost of market risk is not constant.”⁵⁵ Finally, “fair-value estimates might be less transparent than FCRA estimates and thus more dependent on the judgment of agencies and analysts responsible for the programs.”⁵⁶ CBO maintains that these concerns, however, can “be addressed in various ways.”⁵⁷ For example, expert advice from private-sector accounting firms with experience in fair-value accounting could lessen the volatility of estimates, and the establishment of federal guidelines for estimation procedures could make estimates more transparent.⁵⁸

CBO indicates the fair-value accounting is currently applied in a few cases. For example, the Emergency Economic Stabilization Act of 2008 (P.L. 110-343), 122 Stat. 3765, specified that the estimated cost of the Troubled Assist Relief Program be calculated using a discount rate adjusted for the market cost of risk.⁵⁹ CBO also has made studies for Congress about the cost of some

⁵² Congressional Budget Office, *Fair-Value Accounting for Federal Credit Programs*, p. 5.

⁵³ *Ibid.*, p. 10.

⁵⁴ *Ibid.*

⁵⁵ *Ibid.*

⁵⁶ *Ibid.*

⁵⁷ *Ibid.*

⁵⁸ *Ibid.*, p. 2.

⁵⁹ *Ibid.*

federal credit programs using fair value account versus the current cost to the government under FCRA.⁶⁰

CBO states that under FCRA, the total subsidy cost of federal credit averaged \$3.1 billion annually from FY1998 to FY2008.⁶¹ But the total subsidy cost of federal credit was negative \$19 billion for FY2009, negative \$20 billion for FY2010, and negative \$41 billion for FY2011.⁶² These data suggest that a change to fair value accounting could significantly affect the deficit.

House FY2013 Budget Resolution

On March 23, 2012, Representative Paul Ryan introduced the Fiscal Year 2013 Budget Resolution, H.Con.Res. 112, 112th Congress. The fair value provision was similar to that in the House FY2012 Budget Resolution. On March 29, this budget resolution passed the House by a 228 to 191 vote. Section 507(a) titled “Fair Value Estimates”

requires the Congressional Budget Office, upon the request of the chair or ranking member of the Committee on the Budget, to make a supplemental estimate of the current actual or estimated market values representing the “fair value” of assets and liabilities affected by a measure as part of any estimate prepared for the measure under credit reform requirements of the Federal Credit Reform Act.

Authorizes the chair to use such estimate to determine compliance of the measure in question with the Congressional Budget Act of 1974 and other budgetary enforcement controls.⁶³

Debate about fair value budgeting has yet to be resolved.

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⁶⁰ Ibid., p. 11.

⁶¹ Ibid., p. 5.

⁶² Ibid.

⁶³ This description of Section 507(a) is from the LIS summary written by CRS.