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The budgetary arithmetics of loan guarantees and deposit insurance

A comment

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The main focus of Philippe Weil's paper is on the new U.S. budgetary treatment of direct loans and loan guarantees that began with the Credit Reform Act (CRA) of 1990. Weil's analysis raises fundamental questions about this new treatment. Research work like this is useful–whether or not one agrees with the recommendations–because of the importance of U.S. federal budget policy for economic performance in the United States and other countries.

The major change in budgetary treatment that Weil addresses is the charging of the subsidy cost, and only the subsidy cost, of loan guarantees and direct loans to the budget. Before the Credit Reform Act of 1990 the full amount of direct loans and none of the loan guarantees was charged to the budget when the loan program was enacted.

Two exceptions to this new treatment need to be stressed. First, old loans and old loan guarantees continue to be subject to the pre-1990 budget law. Effectively, "two regimes" are set up. One regime is for old loans and one for new ones. This "grandfathering" provision leads to an inconsistency of treatment, but the inconsistency will diminish over time as new loans grow relative to old loans. The second exception is that some items are not subject to the new treatment. For example, deposit insurance programs and the activities of government-sponsored agencies (Fannie Mae, Freddie Mac, etc.) are excluded.

The major point of Weil's paper is that these exceptions lead to an inconsistency that is misleading and distorting. He argues that in a world of perfectly rational agents, such budget accounting makes no difference. But since the real world seems to be myopic, he argues that the new budget treatment does affect decisions, and, in Weil's view, does so in an inappro-

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priate and distortionary way. Weil argues that the inconsistency should be eliminated—not by eliminating "grandfathering" or reducing the number of the excluded programs—but by repealing the whole law. He recommends that we return to the old precredit reform accounting.

I disagree strongly with this conclusion. While not perfect, and undoubtedly subject to modification as we learn about the new treatment over time, the credit reform introduces an important element of rationality to budget-making. It is important to assess the CRA within the context of the legislation that it is part of—The Omnibus Budget Reform Act of 1990—which reformed many aspects of budget legislation. The CRA was part of this act and cannot be treated in isolation.

First, let me comment briefly on the question of deposit insurance. Weil does some "back of the envelope" calculations of the charge to the budget from the subsidies implicit in the existing deposit insurance program. His calculations are larger than many other calculations, but in any case with existing premiums and pessimistic assessments of forbearance, the estimates will be high.

However, it appears that when Weil argues that, for consistency, the present value of these subsidies would be added to this year's budget, he misses the fact that old programs under CRA are grandfathered. I do not think he is arguing against grandfathering in principle. Hence, it would only be changes in the subsidy value of the program that would be included in the budget if it were treated consistently with loan guarantees. This would reduce the negative budget impact significantly–it could even make it positive.

This is not to say I think that deposit insurance or government-sponsored enterprises should be included in the CRA. More research on the matter is certainly appropriate, but it seems to me that Weil is setting up a straw man.

The more serious problem I have with his conclusion is that he considers the CRA independently of the overall 1990 budget-reform act. Probably the most important aspect of the 1990 budget law was the creation of caps on three components of discretionary spending–(1) domestic, (2) international, and (3) defense, and the "pay-as-you-go" rules linking new entitlement spending with taxes. According to the "pay-as-you-go" rules any new entitlement program has to be paid for with a cut in some other program or by an explicit increase in taxes. Otherwise, an across-the-board sequester in entitlements is called for. These rules changed how the 1992 budget decisions were made, both within the administration as the President's budget was put together and in the Congress as the budget was modified. Future budget deliberations will also be affected assuming the new budget law continues, and in particular, is not changed along the lines Weil is suggesting. In sum, the 1990 budget-reform act had a big impact on the budget process.

For example, within the international account there is a limited amount

of funds that can be spent. As the budget is put together and modified, there is a need to make continuous trade-off calculations between different programs. This means debates between different interest groups within and outside the government. For example, within the international account more aid to one country means less aid somewhere else. In my view this trade-off process itself brings rationality to the discussions.

In this context one can imagine how tempting it would be to exclude certain new proposals from this trade-off process. If loan guarantees, for example, were excluded the pressure to extend loan guarantees to beat the constraints of the budget caps would be huge. I think there would be an explosion of loan guarantees much larger than we have already seen. It is on this margin of the trade-off that there would be great distortions and inconsistencies. Similar examples occur in the domestic-spending categories.

For these reasons, I disagree with Philippe Weil's recommendations. In my view trying to remedy one inconsistency—as he recommends we do—would introduce other inconsistencies with far greater distortions.