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House "Budget Transparency" Bill Would Make Budget More Opaque

By Paul N. Van de Water and Joan Huffer

The House Budget Committee may soon consider the proposed "Budget and Accounting Transparency Act" (H.R. 1872), which is identical to a bill that the House passed last year (H.R. 3581). The bill would implement what proponents call "fair-value accounting" for federal credit programs. In fact, the proposal is neither transparent nor fair. As former Congressional Budget Office Director Robert Reischauer has written, the proposed legislation "would . . . make budget accounting less transparent and straightforward." (See box.)

H.R. 1872 would change the accounting for credit programs such as Federal Housing Administration and veterans' mortgage guarantees, student loans, small business loans, and rural electric loan guarantees by adding an *extra amount* to their recorded budgetary cost. This extra amount would reflect what private lenders would charge if they, rather than the federal government, issued the loans or loan guarantees.

The proposal is *not* based on a contention that current estimates of federal credit programs understate their cost to the government. Therefore, the proposal would distort the budget by making federal credit programs appear more expensive than their actual cost to the government. It would also undercut one of the key purposes of the budget, which is to provide a meaningful comparison of the cost to the federal Treasury of different programs.

The bill also would make federal loan programs likelier targets for deficit reduction measures, since they would appear to cost more than unbiased projections show they actually would cost. In the area of student loans, for example, this could result in higher costs for borrowers or less access to loans. The size of the student loan program and how much of the cost students should bear are valid policy questions, but policymakers should not distort these issues by artificially inflating the program's cost.

Current and Proposed Accounting for Credit Programs

Accounting for federal loan programs follows the rules established in the Federal Credit Reform Act of 1990. Under those rules, the budget displays the expected total net costs of direct loans or loan guarantees up front when the government issues them. (Previously, the budget displayed the cost of loans on a year-by-year basis over the course of the loans' lifetimes.) The total net cost of loans and loan guarantees includes all expected defaults, late repayments, and variations in market conditions.

Any estimate of the expected cash flows for a loan or loan guarantee is variable — that is, it is uncertain. When a loan or guarantee is issued, we cannot know exactly how much will be repaid or how many borrowers will default, so the actual cost to the government for a year's worth of new loans may ultimately be higher or lower than the estimate. (Economists often use the word "risk" to express this concept of "variability around [a loan's] expected value." But this does *not* mean "risk of default," which is already built into the estimated loan costs included in the budget.)

Proponents of so-called "fair-value accounting" argue that the government should treat this variability in the same way that private investors treat it. Market participants — such as banks — are "loss averse" or "risk averse." If an asset has a 100 percent *certainty* of being worth $35,000, for example, they would be willing to pay $35,000 for it. But if an asset has an *expected value* of $35,000 but some degree of variability around that expected value, they will pay less for it, even if the asset is just as likely to be worth $40,000 as $30,000. This is because investors are more averse to losing $5,000 than they are enthusiastic about gaining $5,000, and they adjust the price they are willing to pay accordingly.

Following this theory, H.R. 1872 would add an extra amount to the cost of federal credit programs — beyond the best estimate of what the programs will cost, after factoring in potential defaults — in order to reflect what private lenders would charge to bear the uncertainty around the expected value of the cash flows that they would receive.

Why the Proposal Is Misguided

The concerns for the federal budget, however, are different from the concerns of private-sector investors. The federal budget is a straight record of the cash flowing into and out of the Treasury; the deficit or surplus equals the difference between the money actually spent and the money actually collected. That is what the existing credit rules ask the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) to estimate. If the estimates are unbiased and take all possible factors into account, including expected defaults and their likelihood, then the overestimates and underestimates should net to zero over the long term. Adding a penalty because *private* investors are loss averse should have nothing to do with *government* budgeting and accounting.

Forthright proponents of "fair-value accounting" *do not claim that CBO and OMB underestimate the cash flows associated with federal credit programs* or that those estimates are somehow biased. Rather, they contend that even with no bias at all, estimates of financial transactions with variable outcomes should be treated as costing more because taxpayers should regard a program with an uncertain cost as more costly than a program with a certain cost of equal size.

One provision of H.R. 1872 implicitly acknowledges that adding a loss-aversion penalty distorts the budget process. The bill would overstate spending and deficits by the amount of the loss-aversion penalty — but it would then *remove* the overstatement when calculating the federal debt. Since the penalty would not represent an actual cost to the federal government, it would not increase cash disbursements or government borrowing and hence would not increase federal debt. This *ad hoc* adjustment highlights how dubious it would be to treat money that the government *does not spend* as though it were spent.

It is worth noting that there is uncertainty about how much practically *all* policies will cost or save — proposals for tax cuts or tax increases, Medicare proposals, and proposed amendments to any open-ended program, such as Social Security or unemployment compensation. Yet H.R. 1872 would impose a variability penalty *only* on loan programs. As a result, their cost would be recorded in a way that would make it more difficult to compare them with other programs, undercutting one of the main purposes of credit reform.

It is true that the private sector would charge more to run a credit program, such as student loans, than it actually costs the federal government, both because the private sector is loss averse and because it wants to ensure a profit for investors. *But it is equally true that the private sector would charge more to run Social Security or unemployment insurance or Medicare for exactly the same reason*. Yet we don't say that Social Security costs more than the actual benefits paid plus its administrative costs, or that a tax cut costs more than the amount of revenue it forgoes — because it doesn't.[1]

Reischauer "Strongly Opposes" House Bill

January 23, 2012

The Honorable Chris Van Hollen
1707 Longworth H.O.B.
Washington, D.C. 20515

Dear Representative Van Hollen,

I am writing in response to your request for my views on the desirability of adopting "fair value accounting" of federal direct loan and loan guarantee costs in the budget as proposed in H.R. 3581. I strongly oppose such a change.

The accounting convention used since enactment of the Credit Reform Act of 1990 already reflects the risk that borrowers will default on their loans or loan guarantees. Under Credit Reform, costs already are based on the expected actual cash flows from the direct loans and guarantees (with an adjustment to account for the timing of the cash flows). 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. Under the proposal, this extra cost would be the difference between the currently estimated cost of direct loans and loan guarantees to the federal government and the cost of those loans and loan guarantees if the private market were providing them.

A society's aversion to risk may be an appropriate factor for policymakers to take into account in a cost-benefit assessment of any spending or tax proposal but adding a cost to the budget does not make sense. Nor is it clear that the cost of societal risk aversion should be based on individual or institutional risk which is what the private market reflects. Inclusion of a risk aversion cost for credit programs would be inconsistent with the treatment of other programs in the budget (many of which have costs that are at least as uncertain as the costs of credit programs—for instance, many agriculture programs and Medicare)—and would add a cost element from a traditional cost-benefit analysis without adding anything based on the corresponding benefit side of such an analysis. It would also make budget accounting less straightforward and transparent.

H.R. 3581 represents a misguided attempt to mold budget accounting to facilitate a cost-benefit analysis, with the result that neither the budget nor the cost-benefit analysis would serve their intended purposes well.

I would be glad to discuss these issues in more detail if you would like.

With best wishes.

Robert D. Reischauer

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[1] For a more detailed analysis of "fair-value accounting," see Richard Kogan, Paul Van de Water, and James Horney, *House Bill Would Artificially Inflate Cost of Federal Credit Programs*, Center on Budget and Policy Priorities, June 18, 2013, http://www.cbpp.org/files/1-23-12bud4.pdf.