

Federal Credit Programs

*Borrower Outcomes Matter More
than Volume*

WORKING PAPERS

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THE ECONOMICS OF FEDERAL CREDIT PROGRAMS

Michael E. Easterly

I. INTRODUCTION

The federal government has established a variety of credit programs over the past century to aid economic development, reward specific constituencies, and promote the provision of public goods. Over the intervening years, these programs have expanded both in volume and number to the point where they have become a substantial presence in financial markets and on the government's balance sheet.

The existence of these programs prompts an important question – why not leave such activities to the private sector? Economic theory points to several scenarios in which the market fails to produce a socially optimal outcome. The government can help in these situations because it possesses several characteristics that differentiate it from private-sector lenders. It does not have to make money, so it can fund activities that are socially beneficial even when not producing positive rates of return to private actors. It is also better able to bear risk than any private entity. Finally, when operating well, the government takes into account the welfare of society as a whole and thus can direct resource allocation toward activities that generate social benefits beyond their direct remuneration.

Government intervention into credit markets also brings costs. It can encourage excessive borrowing, harming borrowers and increasing the amount of risk in the economy. It distorts the provision of credit, either by discouraging lenders from entering markets or by reallocating credit to less valuable uses. In some cases, intermediaries may capture subsidies for themselves and fail to pass on benefits to their intended recipients. The subsidization of credit may also cause subsidized borrowers or sectors to expand to economically inefficient sizes, or, if the supply of that product is inflexible, prompt sellers in those sectors to raise prices. Furthermore, just as successful operation of credit programs can have benefits that extend beyond borrowers, poorly designed or executed programs can have negative consequences for parties that were not involved in the transactions.

Finally, federal credit programs can create political pressures that cause additional economic inefficiencies. By providing benefits to borrowers and owners of the assets that the borrowers purchase, they encourage these interests to organize to keep or expand their benefits. The cost of these benefits is often not transparent to others because framing transactions as credit can obscure the transfers that are taking place. Consequently lobbying may encourage policies and outcomes whose overall social costs exceed the benefits that the special interests capture.

This chapter discusses the economic theory behind federal credit programs, with a focus on their benefits and costs. After this introduction, Section II explores the economic justifications for government intervention. Section III details potential problems with government credit programs. Section IV concludes with a discussion of when and how the federal government can be most effective in providing credit.

Establishing and operating successful government credit programs are delicate undertakings, in which policymakers must weigh policy goals against economic costs and minimize market distortions. Programs must be carefully managed to target benefits to their intended beneficiaries while aligning incentives with the goals of the program. This balance is made more difficult by the political process, which can hinder reforms that might curtail access to credit by powerful constituents.

II. ECONOMIC REASONS FOR CREDIT PROGRAMS

Policymakers typically advocate for government issuance of credit when they determine that markets by themselves cannot provide socially optimal outcomes. Such failures may occur for a variety of reasons: because information needed to assess risk is costly or unavailable; because discrimination prevents creditworthy borrowers from getting loans; because a product provides benefits to the public in excess of the value to the parties involved in their sale or use; or because a financial crisis has caused private credit markets to collapse, such as during the Great Depression or the recent global financial crisis. In these cases, absent outside intervention, the public may forgo important benefits.

A. ASYMMETRIC INFORMATION

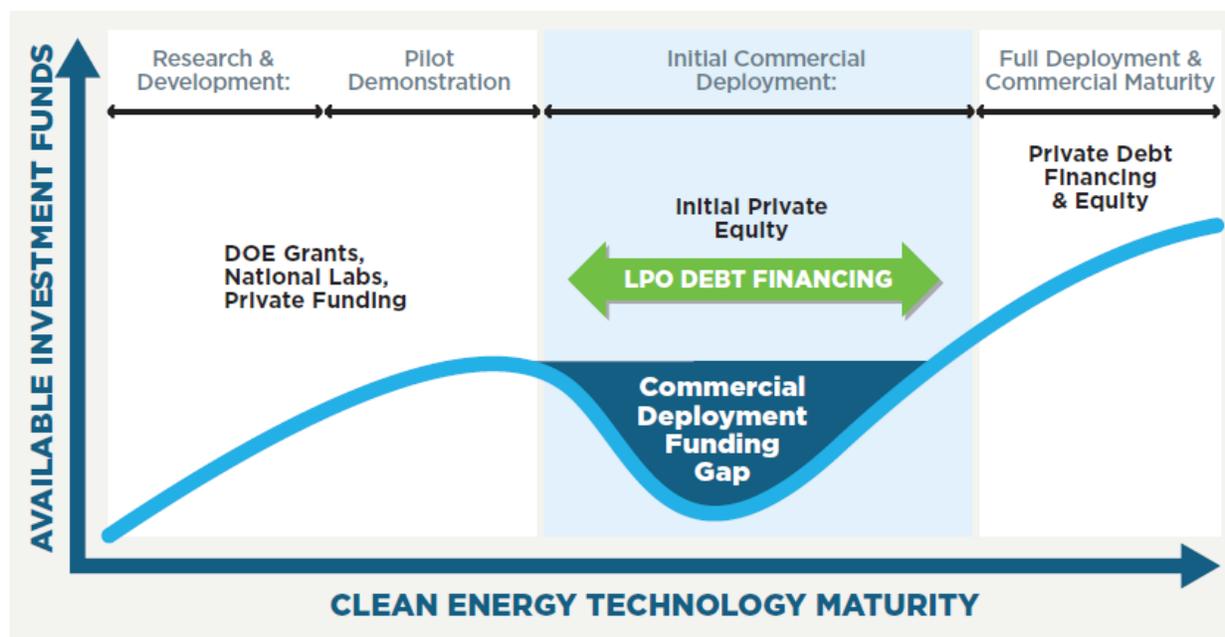
Sometimes lenders lack the information they need to evaluate prospective borrowers' creditworthiness properly. Students, for instance, lack credit histories, and their future earning power is subject to many unknowns. Having just gotten started in life, they lack assets, and their future incomes are not assets that can be bought, sold, or traded. Thus they have no collateral to pledge. Yet advances of funds can increase their lifetime earnings, supplying them with the means of paying back the loans. If lenders lack a method of screening for risk, many high-quality borrowers may not get loans.

The Department of Energy explains its Title XVII program for clean energy technology in these terms. However confident they may be in their innovations, entrepreneurs may find it difficult to convince lenders to support technologies that have yet to prove themselves in the market. This is especially true of the long-term, patient capital that innovators need to sustain the enterprise while working to expand a specific technology's acceptance in the market. As illustrated in Figure 1, the Department of Energy views its loan program as a means of "bridging the gap" between a technology's initial period of discovery and development, which is commonly financed by grants,

and the attainment of commercial viability, at which time the technology can attract private funding.¹

Figure 1
Market Gap

BRIDGING THE GAP



Source: Department of Energy Loan Programs Office, “LPO Financial Performance,” November 2014, 2.

Making matters worse is the fact that borrowers typically have more information about their future ability and willingness to pay, a situation known as “asymmetric information.” (Even students have a better idea of their level of financial responsibility than lenders.) In such cases, lenders cannot adjust for risk by raising interest rates. Higher rates deter the least risky borrowers to a greater extent than they do borrowers who believe they have a lower probability of repaying the loan. The higher-quality borrowers will exit the applicant pool. The pool of applicants becomes riskier, prompting further rate increases and further deterioration of the applicant pool. Lenders may react by excluding all borrowers, even the apparently creditworthy ones.²

¹ Department of Energy Loan Programs Office, “LPO Financial Performance,” November 2014, p. 2, available at https://energy.gov/sites/prod/files/2014/11/f19/DOE-LPO-MiniReport_Final%2011%2013%2014_0.pdf.

² Joseph E. Stiglitz and Andrew Weiss, “Credit Rationing in Markets with Imperfect Information,” *American Economic Review*, vol. 71, no. 3, 1981, pp. 393–410.

In such cases, a modest subsidy may be enough to return the market to a favorable outcome. The subsidy lowers the rate lenders can charge, making loans more attractive to safer borrowers. As safer borrowers return to the market, the average risk of applicants improves, and lenders can do a profitable business. So long as the subsidy is not large enough to encourage excessive indebtedness, the market reaches a stable equilibrium. Government intervention thus improves on the outcome attainable solely by the market.³

Credit programs that address information asymmetries may also provide important demonstration effects to the private market. By supporting untried enterprises or financial products, programs develop information about the viability of those lines of business that the private sector can observe and eventually use. Thus government plays a catalytic role. By taking on the initial risks, it lays the foundation for private entry.

The most prominent example of such an effect is the 30-year, amortizing mortgage. As the history chapter describes, private-sector intermediaries attempted to establish a market for mortgage insurance during the early decades of the twentieth century, but they failed during the Great Depression amid allegations of fraud and mismanagement. The Federal Housing Administration (FHA) stepped in and created a more enduring solution. It established a national market for mortgage insurance, first for 20-year mortgages and later for 30-year mortgages, by stipulating relatively uniform requirements for getting a mortgage and adopting minimum standards for home construction and enforcing them through on-site inspection. When it ran surpluses year after year, it demonstrated that 30-year, fixed-rate mortgages could be made safely and with minimal risk to lenders. As a result, private companies began entering the market in 1957.⁴

B. DISCRIMINATION

Credit markets have a checkered history with regard to racial and gender equality. Before the Civil Rights Movement, for instance, real estate professionals restricted lending in neighborhoods with predominantly African American populations or that they perceived as transitioning in that direction. Similarly, before the advent of automated credit modeling, bank loan officers made it difficult for women to access credit independently.⁵ These disparities in access resulted in inequitable opportunities for the independence and wealth-building that individuals could achieve with the help of credit.

Such discrimination has been described as economically irrational. By failing to extend credit to a borrower with the ability and willingness to repay because of her race or gender, a lender gives up a profitable business opportunity. In an efficient market, there ought to be lenders willing to

³ Deborah Lucas, “Credit Policy as Fiscal Policy,” *Brookings Papers on Economic Activity*, Spring 2016, available at <https://www.brookings.edu/wp-content/uploads/2016/03/lucastextspring16bpea.pdf>; *Budget of the US Government, FY 2017, Analytical Perspectives*, p. 307.

⁴ See background paper on “History of Federal Credit Programs” for further details.

⁵ See background paper on “History of Federal Credit Programs” and Louis Hyman, “Ending Discrimination, Legitimizing Debt: The Political Economy of Race, Gender, and Credit Access in the 1960s and 1970s,” *Enterprise and Society*, vol. 12, no. 1, March 2011, pp. 200–232.

capture that opportunity for their own benefit. However, discrimination can take place even in the absence of prejudice. When information costs are high, lenders may not find it worthwhile to engage in extensive underwriting. To the extent that easily observable personal characteristics associated with race, such as zip code, might correspond to harder-to-uncover information about economic opportunity, it may pay to deny loans based on those characteristics. Thus discrimination may be consistent with profit maximization, even though it excludes creditworthy borrowers from participating in the market.⁶

In such cases, a program of targeted credit may be a superior solution to regulation.⁷ Preventing discrimination carries high costs. Not only must government officials monitor more transactions, but they also must take into account more subtle forms of discrimination, such as offering minorities a more limited menu of loan options. Such practices are difficult to discover and even more difficult to prove in court. Preventing them also imposes compliance burdens on lenders, which raises costs for borrowers across the board. A loan program that fills the gap directly requires a lesser amount of resources to serve the same purpose.⁸

C. PUBLIC GOODS AND EXTERNALITIES

Some commodities that are valuable to society as a whole cannot be produced and sold profitably by the private sector. Most commonly, this situation arises because the good has benefits for people who do not buy it. The classic example is national defense. Regardless of whether he pays taxes, an individual is protected because providing security for most of the population entails providing security for all. Because of their ability to “free ride” on the contributions of others, individuals will refuse to contribute themselves, in spite of the benefits of the good for them. Extended across the entire population, this incentive not to contribute results in the good not being produced, as no one is compensated for producing it. Economists describe such a product as a “public good.”

The concept behind public goods is not absolute. There can be aspects of a good that can be consumed (and paid for) privately, while other aspects extend to the general public or portions thereof. These effects are typically referred to as “externalities.” Policy makers have advanced education and housing as examples of such externalities. The immediate purchasers may gain benefits in terms of increased future earnings or a stable residence and an opportunity to build

⁶ Anthony Pennington-Cross and Anthony M. Yezer, “The Federal Housing Administration in the New Millennium,” *Journal of Housing Research*, vol. 11, no. 2, 2000, p. 363.

⁷ Barry P. Bosworth, Andrew S. Carron, and Elisabeth H. Rhyne, *The Economics of Federal Credit Programs*, Brookings Institution Press, 1987, p. 62.

⁸ On the other hand, if disadvantaged borrowers have access only to federal credit while private credit serves more privileged borrowers, this could be a warning sign. In the late 1960s and early 1970s, for instance, the FHA helped accelerate the decline of urban neighborhoods by providing an expanded pool of credit available to purchase the residences of white borrowers fleeing the center cities. See, e.g., Calvin Bradford, “Financing Home Ownership: The Federal Role in Neighborhood Decline,” *Urban Affairs Review*, vol. 14, no. 3, 1979, pp. 313–335.

equity, but society gains better-educated citizens or more responsible neighbors.⁹ As with a public good, the social benefits of expenditures with positive externalities exceed their private returns.

Government can help in these situations. By providing a subsidy, it raises the private return from the investment to a level more consonant with its social return. A more socially beneficial amount of the good is produced because more people are willing to pay for it. In many cases, such goods are best funded through a direct transfer, such as a grant. However, credit may be called for in situations where acquisitions require large initial outlays but confer benefits only over time. The constraint in such situations is less the eventual profitability of the purchase than the limited resources of the purchaser.

Demonstration projects contain an element of a public good. Once contracts are standardized, information is more readily available, and instruments become more easily tradeable, anyone can take advantage of the resulting opportunity. Consequently, the entity that undertook such a project must share the benefits of its investment with all market participants.¹⁰ This diminishes the return it procures for itself by taking the initial risk in establishing the new market. Market participants may fail to invest in such activities on their own, which suggests a role for government.¹¹

D. COUNTERCYCLICAL BACKSTOP

In extreme cases, private financial markets collapse. Typically such crashes occur when a sudden shock causes financial market participants to question the value of assets, a process that can be self-reinforcing. As their balance sheets shrink, financial institutions must either raise equity, sell assets, or call in loans, at a time when there are few buyers in the market and others are trying to do the same. This further depresses asset prices and limits the amount of funds available for borrowing, starting a downward spiral.

The United States experienced such a collapse during the financial crisis of 2007-08. Mortgage originators withdrew credit from areas experiencing deteriorating economic conditions, as they have during previous recessions.¹² Providers of private student loans and home equity lines of credit withdrew from the market or increased their underwriting standards.¹³ Banks cut off lines

⁹ See, for example, see President William J. Clinton, “Remarks on the National Homeownership Strategy,” June 5, 1995: “You want to reinforce family values in America, encourage two-parent households, get people to stay home? Make it easy for people to own their own homes and enjoy the rewards of family life and see their work rewarded. This is a big deal. This is about more than money and sticks and boards and windows. This is about the way we live as a people and what kind of society we’re going to have.”

¹⁰ Deniz Anginer, Augusto de la Torre, and Alain Ize, “Risk-Bearing by the State: When Is It Good Public Policy?” *Journal of Financial Stability*, vol. 10, 2014, p. 84.

¹¹ Bosworth, Carron, and Rhyne, *Economics of Federal Credit*, 78.

¹² Brent W. Ambrose, Anthony Pennington-Cross, and Anthony M. Yezer, “Credit Rationing in the U.S. Mortgage Market: Evidence from Variation in FHA Market Shares,” *Journal of Urban Economics*, vol. 51, no. 2, 2002, pp. 272–94.

¹³ David Cho, “As College Costs Rise, Loans Become Harder to Get,” *Washington Post*, December 28, 2009, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/12/27/AR2009122702116.html>.

of credit for many small businesses.¹⁴ An economic contraction threatened to become much worse.

Federal credit programs stepped into the gap created by the private market's retreat. FHA's share of the national mortgage market increased from under 5 percent of the dollar volume in 2007 to more than 20 percent in 2009, and its share of home purchase loans surged from 6.6 percent to 56.4 percent.¹⁵ FHA also facilitated the migration of debtors from exotic loan products to mortgages with more predictable payments and instituted loss-mitigation programs intended to preempt a cascade of foreclosures that could have pushed the residential real estate market deeper into crisis.¹⁶

Government lending also likely stimulated the economy by easing liquidity constraints. Borrowed funds enable consumers to spend during the recession the income they expect to earn in more prosperous times, which has the effect of pulling demand forward and thus smoothing the business cycle. Deborah Lucas has estimated that under reasonable assumptions federal credit programs added around \$ 342 billion in stimulus in 2010, a figure commensurate with the effect of the American Recovery and Reinvestment Act during that year and nearly five times as much as the lending's direct effect on the federal budget.¹⁷

III. ECONOMIC HAZARDS OF CREDIT PROGRAMS

Even if a market imperfection exists and the government is well positioned to remedy it, government intervention may not yield net positive results. Federal credit programs provide an immediate benefit to borrowers, but they also alter the incentives of program participants and nonparticipants alike. Furthermore, because programs change the prices of certain forms of credit relative to others, they cause adjustments by other market participants. These distortions can lead to unintended consequences, including excessive risk-taking, displacement of private lending, asset price inflation, and the overprovision of subsidized goods. Federal credit programs are also less transparent than direct spending, which can cause additional inefficiency when policymakers and interest groups attempt to disguise subsidies as loans. Thus in addition to the explicit subsidy paid by taxpayers, government credit assistance imposes economic costs, which do not appear in the federal budget.

¹⁴ See, for example, Catherine Clifford, "Small Business Loan Total Drops by \$10 Billion," *CNN Money*, November 17, 2009, available at http://money.cnn.com/2009/11/16/smallbusiness/small_business_loans_evaporate/. The \$10 billion pertains only to the 22 banks that received the largest amounts of funding from TARP.

¹⁵ Robert A. Van Order and Anthony M. Yezer, "FHA Assessment Report" (George Washington University School of Business, February 2011), p. 4, available at <https://mediarelations.gwu.edu/files/downloads/FHA-Assessment-Report-February-2011.pdf>.

¹⁶ Edward Szymanoski et al., "FHA Single-Family Insurance Program: Performing a Needed Role in the Housing Finance Market," Department of Housing and Urban Development, Office of Policy Development and Research, Housing Finance Working Paper, December 2012, pp. 35–36, available at http://www.huduser.gov/portal/publications/pdf/FHA_SingleFamilyIns.pdf.

¹⁷ Lucas, "Credit Policy as Fiscal Policy."

A. TRANSACTIONAL DISTORTIONS

1. MORAL HAZARD

When the government guarantees a loan, it partially protects the lender from the cost of default. This protection changes the lender's incentives. The lender receives only a fraction of the benefit of decreasing defaults, but it bears the entire costs of the enhanced screening, monitoring, and collections necessary to bring about that outcome. As a result, it may discount the cost of default and either take more risk than it otherwise would or fewer precautions against the risks it can avoid.

A study of Small Business Administration loans in the 1980s illustrates that this phenomenon, known as "moral hazard," has real-life consequences. The researcher discovered that banks did not make greater profits on their government-guaranteed loans than they did on their regular business. Instead, defaults on SBA loans were more than ten times larger, which meant that the bank's credit losses on SBA loans and loans in their own portfolios were the same net of the guarantee. In other words, lenders compensated for the government's increased protection against default by making riskier loans.¹⁸

Moral hazard influences borrowers as well. Once a borrower receives a loan, he faces an asymmetric payoff structure. Payments on the debt come out of his pocket dollar for dollar, while the costs of default are less certain. To the extent that a debtor questions his creditor's ability or willingness to collect or feels less of a loss from the sanctions that the creditor has available, he may take actions that reduce his ability to repay or simply refuse to pay altogether. (In the mortgage industry this is known as "strategic default.")

Federal credit is especially vulnerable in this regard. Policymakers make decisions about program structure for a variety of reasons, not all of which involve maximizing financial returns to the government. Furthermore, the government is susceptible to political pressure to go easy on collections and instead offer more opportunities for deferments, forbearance, and other concessions. Thus federal loans may "more closely resemble lending arrangements among family members," where the government has "no real choice but to accommodate his ever-changing life circumstances."¹⁹

The student loan program is a case in point. Default can result in severe consequences, including reduced credit scores, confiscation of tax refunds, and wage garnishments, but the consequences of late payments are less severe. Numerous options are available to reduce or delay payment, such as deferment, forbearance, and income-based repayment plans. Furthermore, the Department of Education directs servicers not to assess late fees unless the borrower has defaulted, and the penalties that are charged are less severe than other types of debt.²⁰ In a focus group organized by

¹⁸ Bosworth, Carron, and Rhyne, *Economics of Federal Credit*, p. 97.

¹⁹ Doug Criscitello, "Borrowing for Your College from Your Uncle Sam," *The Hill*, May 5, 2016, available at <http://thehill.com/blogs/congress-blog/education/278570-borrowing-for-your-college-from-your-uncle-sam>.

²⁰ Jason Delisle and Alexander Holt, "Why Student Loans Are Different: Findings from Six Focus Groups of Student Loan Borrowers," New America Foundation, 2015, p. 10, available at <http://eric.ed.gov/?id=ED558774>. Some borrowers report that they find such fees less onerous than making payments (*ibid.*, p. 13).

the New America Foundation, one struggling debtor described the calculations he or she made when prioritizing which bills to pay:

Outside of the credit report or, you know, they might call our references, but, like you said, if we don't pay our car, they'll come repossess it. ... If we don't pay our credit card bill, they would increase the percentage and then it goes to the credit reporter. If we don't [pay] our house note or a mortgage, then we go into foreclosure, you know. The student loan is, their leverage is ... they're not going to come get the degree because they don't want it.²¹

While a single quotation cannot be generalized to the entire population of student borrowers, it is suggestive given that as of January 1, 2016, more than 40 percent of debtors on federal student loans were not making payments or were behind on their obligations.²²

Moral hazard may show up downstream as well, in the strategies of vendors who produce or distribute the items being purchased. Such producers have an incentive to sign up marginal borrowers and sell lower-quality products because they bear few or in some cases none of the costs of default. Their incentives shift from providing the most competitive product to bringing in the most loans.

Consider the student loan program a few years ago. An undercover operation by the Government Accountability Office found that out of the fifteen for-profit schools it visited, nine provided “deceptive or otherwise questionable” information about the duration and costs of their programs; six practiced “hard-sell sales and marketing techniques”; and four encouraged applicants to falsify their student loan applications.²³ Meanwhile, there is suggestive evidence that, consistent with economic theory, for-profit schools dependent upon federal student loans invest less in instruction than institutions that receive less income from student loans, which diminishes the probability of for-profit schools’ students procuring gainful employment upon graduation.²⁴ While the

²¹ Delisle and Holt, “Why Student Loans Are Different,” p. 8. The quotations were anonymized, so the speaker's gender is unavailable.

²² Josh Mitchell, “More Than 40% of Student Borrowers Aren't Making Payments,” *Wall Street Journal*, April 7, 2016, available at <http://www.wsj.com/articles/more-than-40-of-student-borrowers-arent-making-payments-1459971348>.

²³ Government Accountability Office, *For-Profit Schools: Experiences of Undercover Students Enrolled in Online Classes at Selected Colleges*, GAO 12-150, October 31, 2011, available at <http://eric.ed.gov/?id=ED527057>.

²⁴ See, for instance, Senate Committee on Health, Education, Labor, and Pensions, *For-Profit Higher Education: The Failure to Safeguard the Federal Investment and Ensure Student Success*, Majority Committee Staff Report and Accompanying Minority Committee Staff Views, July 30, 2012), p. 99, available at <https://www.gpo.gov/fdsys/pkg/CPRT-112SPRT74931/pdf/CPRT-112SPRT74931.pdf>:

The amount that publicly traded for-profit companies spend on instruction ranges from \$892 to \$3,969 per student per year. Among all companies that received a document request, companies spent an average of \$2,050 on instruction per student in 2009. ... In contrast, public and non-profit schools, which by definition do not retain any revenue as profit and do not pay taxes, generally spend a higher amount per student on instruction, and spend a far lower amount on marketing and recruiting. For example, Northern Virginia Community College spends about \$4,068 per student per

Department of Education is presently addressing the problem through regulation and enforcement, the pursuit of such business models illustrates the vulnerability of credit programs to moral hazard.²⁵

2. ADVERSE SELECTION

Programs may also overestimate the extent of market imperfections and move into segments of the market where borrowers have access to private loans. This strategy becomes detrimental to the program's balance sheet when the private sector is capable of more precisely pricing risk. Riskier borrowers will self-select into government loans, where they pay the same rate as the average borrower of their type. The program will be left with a correspondingly worse (that is, riskier) portfolio.²⁶

Such appears to have been the case in the FHA's recent foray into higher-balance mortgages. In 2008, Congress raised the limit on the agency's mortgages from \$ 200,160 to \$ 271,050 in low-cost areas and from \$ 362,790 to \$ 729,750 in high-cost ceiling areas, and it renewed the increases in 2011. Economist Chen Miller found that following the change, average loan amounts and average loan-to-value ratios increased more in the high-cost areas than they did in the low-cost areas. She further determined that these increases occurred not because of higher house prices, but because borrowers chose to borrow more and extract more cash from refinancing. The rate of 90-day delinquencies within the first two years was 16 percent higher for loans above the pre-2008 limit than for loans below that threshold, and losses from default were 1.1 percent greater.²⁷

B. MARKET DISTORTIONS

1. MISDIRECTED BENEFITS

It can be very difficult to determine whether credit programs are meeting their intended purposes. Unlike business enterprises, government agencies lack a clear and simple bottom line. It may be difficult to measure policymakers' goals in establishing and maintaining a particular credit program. Furthermore, even when they find metrics that line up with their missions, programs must determine whether the same outcomes would have occurred in the absence of government intervention. Data for such a study may be nearly impossible to find. In the absence of clear

year on instruction. It devotes two-fifths of 1 percent of its budget to marketing, or about \$22 per student per year. Portland Community College in Oregon spends \$5,953 per student on instruction, and about 1.2 percent of its budget, or \$185 per student, on marketing.

²⁵ See, for instance, Department of Education, Program Integrity: Gainful Employment-Debt Measures, *Federal Register*, vol. 76, no. 113, June 13, 2011, pp. 34386–559; Department of Education, “U.S. Department of Education Takes Enforcement Action Against Medtech Colleges in Virginia, Maryland, and Washington, D.C.,” press release, July 26, 2016, available at <https://www.ed.gov/news/press-releases/us-department-education-takes-enforcement-action-against-medtech-colleges-virginia-maryland-and-washington-dc>.

²⁶ Bosworth, Carron, and Rhyne, *Economics of Federal Credit*, p. 41; Szymanoski et al., “FHA Single-Family Insurance,” p. 24.

²⁷ Chen L. Miller, “Two Essays on Real Estate Finance: 1) Effects of FHA Loan Limit Increases by ESA 2008: Housing Demand and Adverse Selection; and 2) Comparison of Two Affordable Housing Finance Channels” (George Washington University, 2017), pp. 1–57, available at <http://gradworks.umi.com/10/19/10196295.html>.

metrics of success, it can be tempting to use the number of constituents served or funds disbursed as proxies for the achievement of agency goals.

Such indeterminacy is all the more concerning because there are many ways that credit programs can fail to serve their intended purposes. Most obviously, money is fungible, so recipients can take out loans for goods and services that they would have purchased anyway. Likewise, lenders in guaranteed programs can simply replace funding for existing lines of credit with government credit and reallocate the newly-freed capital to other purposes. Both cases lead to no net increase in funding to the program's stated purpose, despite their costs to the taxpayer.

Who benefits from government lending programs and what form those benefits take depend not only upon the explicit terms of the policy, but on the structure of the underlying market. If a loan in the targeted market is similar to other assets in investors' portfolios, then borrowers will benefit from increased volume because even small increases in return will be enough to motivate investors to shift their holdings. If investors cannot substitute so easily, then those who do lend in the targeted market will capture most of the subsidy in the form of higher rates. On the other side of the transaction, if borrowers have many alternative sources of funds, then lenders will benefit from a sharp influx of new borrowers into the market. If borrowers have few options, then the subsidy mostly facilitates lower interest rates.²⁸

2. CROWDING OUT

If not designed carefully, government credit programs may end up displacing otherwise viable sources of private capital. The federal government has many advantages over the private sector as a financial intermediary: its reliance on the American taxpayer enables it to borrow more cheaply, regardless of the profitability of the purposes to which it dedicates the funds, and because of its access to taxpayer revenue, it can run at a loss almost indefinitely. These advantages can aid in the achievement of social ends, but they can also prevent the private sector from taking over the same activities.

The present mortgage market illustrates this principle. In the wake of the financial crisis, private intermediaries pulled out of the market, resulting in a large increase in government-guaranteed loans in mortgage securitizations. Since then, however, the economy has experienced 30 consecutive quarters of economic growth. Nevertheless, the government's role in the market has not receded. As of the third quarter of 2016, the FHA, VA, and GSE have a combined share of 98.19 percent of mortgage securitization volume, with the remainder taken up not by new lending, but by private-sector repackaging of past loans that have become delinquent. In contrast, outside the years that comprised the housing bubble, the government's share hovered around 80 percent.²⁹

²⁸ Barry P. Bosworth, Andrew S. Carron, and Elisabeth H. Rhyne, *The Economics of Federal Credit Programs* Brookings Institution Press, 1987, p. 33. Technically, this is known as the elasticity of supply and demand for funds.

²⁹ Laurie Goodman et al., "Housing Finance at a Glance: A Monthly Chartbook, January 2017," Urban Institute, January 23, 2017, p. 10, available at <http://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-january-2017>.

Capital markets add another layer to this conundrum. The infusion of government credit decreases interest rates in the target market. Lower interest rates diminish the return that private intermediaries gain from participating in the market. These decreased earnings in turn cause some market participants to exit the market, decreasing the amount of funds available from private sources. Thus government money “crowds out” private capital, offsetting the effects of the intervention to some extent.

Alternatively, arbitrage may diminish the effects of government lending. When the government funds a loan program, it borrows in the credit markets by selling a Treasury security. Government support causes the cost of funds in the target market to decrease, but at the same time, its increased demand for funds causes the return on Treasuries to increase. All a private intermediary needs to do is sell securities in the target market and buy Treasuries, thus taking advantage of the change in prices caused by government intervention while neutralizing its effects on the allocation of credit.³⁰ The arbitrageur benefits while society is no better off.

The magnitude of this effect depends upon the extent to which markets are integrated across different forms of credit. Some researchers who have studied the subject hypothesize that certain investors have a “preferred habitat” in which they will remain despite modest changes in the relative price of assets. Insurance companies, for example, generally have steady obligations that they must pay out over long periods of time, so they may favor long-term bonds with fixed interest rates. If such investors comprise a significant segment of the market, then the program will increase either the volume of credit or the interest rate. Conversely, if investors easily rebalance their portfolios into new asset classes, then the arbitrage effect will dominate.

Research by Barry P. Bosworth, Andrew S. Carron, and Elizabeth H. Rhyne found mixed results in the context of federal credit programs. According to their calculations, capital market participants do rebalance their portfolios in response to federal credit interventions – that is, they do enter and exit markets affected by federal credit to a significant extent. However, it takes nearly a year for the effect of their adjustments to materialize fully. The authors concluded that federal credit programs “have a largely transitory influence on the cost of credit to borrowers in that market.”³¹

3. PRIVATE-SECTOR INEFFICIENCY

If not properly targeted to a market imperfection, programs may make the economy less efficient. By intervening in credit markets on the behalf of a preferred purpose or constituency, the government is reallocating funds from projects that the private market values more highly. By design, federal credit programs take into account factors beyond efficiency, so they encourage or maintain enterprises that would not otherwise meet a market test. At the limit, government involvement in credit markets can resemble a *de facto* industrial policy. By favoring certain

³⁰ Bosworth, Carron, and Rhyne, *Economics of Federal Credit*, pp. 25–27.

³¹ *Ibid.*, Appendix I.

sectors, such as housing and education, with cheap credit, credit programs are favoring certain uses of capital over others.

Subsidies may also push market participants to more inefficient practices. When student loans operated as a guarantee program, the government directed payments to lenders to encourage participation. Because the amount of the subsidy was much greater than needed to attract them into the program, lenders dissipated a portion of their payments from the government in competition for borrowers through side payments and marketing costs that included revenue sharing with schools and paid travel costs and honoraria for financial aid administrators.³²

Furthermore, because credit programs generally do not service all participants in a market, they favor loan recipients over nonparticipants and thus distort competition within industries. Consider the Air Carrier Guarantee Loan Program (ACGLP). Established after the terrorist attacks of September 11, it provided loan guarantees to airlines to overcome an anticipated dearth of private capital during a period of uncertainty for the industry. Over the ensuing two years, it made six guarantees in support of \$ 1.74 billion in loans.

Whether the effect of the program was positive on net is subject to debate. While it did replace a private loan to America West that had failed to close after the attacks, the ACGLP likely interfered with the competitive dynamics of the industry. Prior to the attacks, consumers were beginning to use the Internet to compare prices and get lower fares. This development favored nimble, low-cost carriers over the legacy hub-and-spoke operators, who had less efficient cost structures. Critics argued that the less competitive carriers were using the program as a lifeline to prevent more onerous adjustments. Support for this assertion comes from the fact that most of the applications came not at its outset, but within two weeks of the program deadline. In fact, some have speculated that they arrived in response to a submission by US Airways.³³

4. EXTERNALITIES

Federal credit programs also affect individuals who do not participate. By increasing funds available to purchasers, credit programs enhance demand for a product. Depending upon how flexible the supply of that product is, this increased demand can either cause prices to increase or production to expand. Thus either purchasers in the market pay more, whether or not they utilize

³² Deborah Lucas and Damien Moore, “Guaranteed versus Direct Lending: The Case of Student Loans,” Chapter 7 in *Measuring and Managing Federal Financial Risk*, ed. Deborah Lucas, University Of Chicago Press, 2010, p. 168; Andrew M. Cuomo, testimony before the House Committee on Education and Labor, April 25, 2007, available at <https://www.gpo.gov/fdsys/pkg/CHRG-110hhrg34603/html/CHRG-110hhrg34603.htm>.

³³ Margaret M. Blair, “The Economics of Post-September 11 Financial Aid to Airlines,” *Indiana Law Review*, vol. 36, no. 2, 2003, pp. 367–95; Jonathan Lewinsohn, “Bailing out Congress: An Assessment and Defense of the Air Transportation Safety and System Stabilization Act of 2001,” *Yale Law Journal*, vol. 115, no. 2, November 2005, pp. 438–90.

government funds, or the market produces an inefficiently high quantity of goods, usually of lower quality.³⁴

While scholarship on the subject remains unsettled, a few scholars have found evidence that student loans increase the cost of schooling at some schools. Three economists at the Federal Reserve Bank of New York estimated that each dollar increase in student loan limits increased colleges' sticker prices on average by 70 cents for subsidized loans and 30 cents for unsubsidized loans, and the effect was greater for schools with higher tuitions.³⁵ Similarly, Stephanie Riegg Cellini and Claudia Goldin found that for-profit schools eligible for student aid charged about 78 percent more for tuition than comparable institutions that were ineligible.³⁶

Furthermore, poorly designed or poorly executed programs can cause damage beyond the targeted population. In housing, for instance, the consequences of default are not limited to the debtor. Foreclosures lower the prices of neighboring homes and increase the probability of default on their mortgages; increase crime; and decrease tax revenue.³⁷ This is the flip side of the externalities discussed in the section on economic benefits; loans can have a negative effect on people who are not parties to the loans.

In some cases, the consequences can be quite severe. In the late 1960s and early 1970s, for instance, policymakers sent the FHA on an ill-advised foray into lending to financially stretched borrowers in neighborhoods that the agency and the private sector had previously neglected. The subsequent overlending caused an estimated 400,000 foreclosures in US center cities. FHA-owned homes became “dope pads and hangouts for hoodlums,” and house fires increased so dramatically in some cities that many homeowners lost their insurance. Consequently, residents of affected neighborhoods found it impossible to sell their homes.³⁸ Thus by taking on too much risk, the program produced the opposite of the outcomes policymakers had intended it to achieve.

C. POLITICAL DISTORTIONS

1. OPACITY

The inefficiencies caused by federal loan programs may extend into the political process because credit can serve as a means by which policymakers provide benefits while obscuring the costs.

³⁴ According to economic theory, new entrants into the market should be less efficient than incumbents, so they must either charge higher prices or produce lower-quality goods.

³⁵ The authors also found that net tuition rose accordingly in the medium run. David O. Lucca, Taylor Nadauld, and Karen Shen, “Credit Supply and the Rise in College Tuition: Evidence from the Expansion in Federal Student Aid Programs,” Federal Reserve Bank of New York Staff Report, no. 733, July 2015, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2646076.

³⁶ Stephanie Riegg Cellini and Claudia Goldin, “Does Federal Student Aid Raise Tuition? New Evidence on For-Profit Colleges,” *American Economic Journal: Economic Policy*, vol. 6, no. 4, 2014, pp. 174–206.

³⁷ See Consumer Financial Protection Bureau, Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), *Federal Register*, vol. 78, no. 31, February 14, 2013, p. 10854, and cited sources.

³⁸ Don Ball, “Foreclosures Costing FHA Millions: Safeguards Started,” *Washington Post*, December 12, 1971, available at <http://search.proquest.com.proxy1.library.jhu.edu/docview/148000533/abstract/C8C16D476BA64829PQ/1>.

Framing a program as a loan rather than a grant gives the appearance of an exchange of value; the beneficiary pays the government back for its extension of funds, suggesting a mutually beneficial relationship. Thus credit avoids the appearance of an explicit transfer of resources from one constituency to another and thereby creating winners and losers. Furthermore, as they are for borrowers, the benefits of federal credit programs for politicians are immediate and concrete, while the costs are remote and uncertain.

Indeed, in higher education policy loans have often emerged as a substitute for proposals involving appropriations of taxpayer funds or tax expenditures (targeted tax breaks). President Eisenhower had wanted the National Defense Education Act to operate via a tax benefit, which would have limited the government's involvement in higher education, but Democrats argued that such a program would be too costly and established a student loan system instead. The Johnson Administration hoped that loans "would help diffuse the clamor for tuition tax breaks and solidify support" for the Higher Education Act of 1965. Increased lending during the 1980s and 1990s compensated for diminishing resources appropriated for Pell Grants.³⁹ To some extent, favoring loans over grants makes policy sense, as subsidizing individuals who gain above-average earning power would have regressive distributional effects. However, high default rates presently occurring among disadvantaged borrowers suggest that this argument has important limits.

Credit makes for an even more attractive policy tool because it can spread a given amount of benefits over a larger number of beneficiaries. The same \$ 4 billion can fund grants that put 40,000 students through college, or it can support a 4 percent subsidy on a \$ 100 billion loan program that serves one million borrowers. Thus policymakers get a bigger "bang for the buck" from credit programs in terms of the number of constituents benefited.

Further, policymakers can spread benefits even more widely by drawing in more creditworthy borrowers to cross-subsidize less creditworthy borrowers.⁴⁰ Thus programs can expand without requiring additional appropriations from Congress. As discussed in the separate chapter on credit and the federal budget process, some analysts argue that credit programs will not lose their better (less risky) borrowers to the private sector because credit is underpriced in the federal budget.

Federal credit has further benefits embedded in its repayment terms. When a borrower falls into delinquency, even if she does not apply for official forbearance, she gets financial relief. This usually occurs at a time of financial stringency, such as a recession, when money is especially valuable to everyone. The opportunity to delay or end repayment is economically equivalent to a put option, and in the private sector it would be priced into the cost of a loan.⁴¹ For the most part,

³⁹ Suzanne Mettler, *Degrees of Inequality: How the Politics of Higher Education Sabotaged the American Dream* Basic Books, 2014, pp. 51–85.

⁴⁰ Robert A. Van Order and Anthony M. Yezer, "FHA Assessment Report," George Washington University School of Business, June 2011, p. 8, available at <http://business.gwu.edu/wp-content/uploads/2014/02/FHA2011Q2.pdf>.

⁴¹ A put option is the right but not the obligation to sell an asset at a specified price. Analogously, the availability of delinquency gives borrowers the ability to avoid a payment in exchange for whatever penalties the lender may charge.

however, the government does not factor this risk shift into its calculations, which creates an implicit subsidy.⁴² Borrowers understand this, even if they cannot express it in formal terms. At the aforementioned New America Foundation panel, for instance, participants held the view that “letting the loan go into delinquency status was a strategy for managing the debt.”⁴³

2. RENT-SEEKING

As the history chapter has shown, federal credit programs have a tendency to persist beyond their usefulness. Once started, they develop constituencies that become accustomed to a program’s benefits. That leads to beneficiaries mobilizing to perpetuate and sometimes to extend those benefits. Because small interest groups with much to gain personally are more easily organized than diffuse groups who do not lose much individually, lobbying is more likely than not to yield private benefits at the expense of the broader public.

A case in point is the FHA’s seller-funded down payment program. In 1996, legislation permitted mortgagors (homebuyers) in FHA programs to supplement their down payments with gifts or loans from family members. Subsequent agency guidance extended permissible sources to include borrowers’ employers, government agencies, and charitable organizations. Home sellers were not among these sources, but some exploited the program by routing donations to charitable organizations; this allowed the home sellers to raise prices and effectively capture the value of the gifts or donations. Meanwhile, borrowers purchased the homes with no equity, and default rates were correspondingly high, more than three times as much as other FHA loans.⁴⁴

Despite these results, efforts to curb the practice were consistently stymied. In September 1999, the FHA proposed a rule prohibiting charitable organizations from making gifts that derived directly or indirectly from home sellers. It withdrew the proposal sixteen months later after receiving 1,850 public comments opposing the rule, against 21 in favor. It tried again in 2007, when such loans had come to comprise 30 percent of its originations, but stakeholders persuaded a federal court to block implementation of the FHA’s proposed restrictions.⁴⁵ By the time Congress passed a law banning the practice in 2008, seller-funded down payments had cost the mortgage insurance fund \$ 15 billion.⁴⁶

Such results are not only inefficient in and of themselves. The potential for government benefits also creates incentives to engage in activities that, rather than adding to the total stock of goods and services, serve only to move resources from one interest group to another. Thus instead of

⁴² David Kamin, “Risky Returns: Accounting for Risk in the Federal Budget,” *Indiana Law Journal*, vol. 88, no. 2 2013, p. 749.

⁴³ Delisle and Holt, “Why Student Loans Are Different,” p. 10.

⁴⁴ Szymanoski et al., “FHA Single-Family Insurance,” pp. 4, 27; Van Order and Yezer, “FHA Assessment Report,” June 2011, pp. 8–9.

⁴⁵ Van Order and Yezer, “FHA Assessment Report,” June 2011, p. 9.

⁴⁶ Sarah Rosen Wartell and Mark A. Willis, “FHA: Reforms to Protect Taxpayers and Borrowers,” *Housing Policy Debate*, vol. 24, no. 3, 2014, pp. 656–57.

investing to make themselves more efficient in a competitive market, beneficiaries of federal credit programs may expend resources in competition for government-supported excess profits or windfalls, an activity that economists refer to as “rent seeking.” Rent-seeking is considered wasteful because it employs talented people in activities that provide no net social benefit.⁴⁷

Such perils are common to all government initiatives, whether they involve spending, regulation, or credit. However, because of the characteristics described in the previous section, credit programs are especially vulnerable. Policymakers may favor them even when a different type of intervention, such as a grant or regulation, may be more efficient and effective. Such obfuscation adds another layer of inefficiency because, in addition to creating a socially wasteful subsidy, the program conveys that subsidy through an economically inefficient mechanism.⁴⁸

IV. CONCLUSION

Federal credit programs provide a variety of benefits to society and to help overcome market gaps caused by asymmetric information and financial crises, provide demonstration effects to the private sector, remedy discrimination, and improve resource allocation. However, the failure of a market to provide a socially optimal outcome does not assure that government intervention will provide a better one. The government, after all, has no special advantages over the private sector in selecting creditworthy borrowers or operating more efficiently. Indeed, as a general rule it is arguably worse at these functions. Furthermore, government involvement in private markets can create distortions. Thus an ill-advised government program can make a bad situation worse. The identification of a market gap is not a sufficient condition for the establishment of a federal credit program.

The point is not that government credit programs are good or bad, or that they should be expanded or curtailed. Rather, programs must be carefully calibrated to meet defined policy goals and economic needs unmet by the private market, without extending too much credit.⁴⁹ When addressing market failure, policy makers should define and quantify the market imperfection in need of remedy. Potential sources of private credit should be identified and the reasons for their insufficiency carefully explained. The intervention must then be designed to target that imperfection precisely, without causing unnecessary distortions. Plans should be made so that a

⁴⁷ Gordon Tullock, “The Welfare Costs of Tariffs, Monopolies, and Theft,” *Economic Inquiry*, vol. 5, no. 3, 1967, pp. 224–32; Gordon Tullock, “Rent Seeking,” in *The New Palgrave Dictionary of Economics*, eds. Steven N. Durlauf and Lawrence E. Blume, 2nd ed., Nature Publishing Group, 2008, pp. 95–98.

⁴⁸ Tullock, “Rent Seeking.”

⁴⁹ Material for the following paragraphs inspired by Robert C. Vogel and Dale W. Adams, “The Benefits and Costs of Loan Guarantee Programs,” *The Financier*, vol. 4, no. 1, 1997, pp. 22–29; Office of Management and Budget, “Policies for Federal Credit Programs and Non-Tax Receivables,” Circular No. A-129, January 2013; MIT Golub Center for Finance and Policy, “Program Objectives: Understanding Mission and How Best to Achieve It,” presentation to Mission & Metrics: Finance Training for Federal Credit Program Professionals, Washington, DC, July 11, 2016, available at https://ocw.mit.edu/resources/res-15-002-mission-metrics-finance-training-for-federal-credit-program-professionals-summer-2016/sessions/session-1-program-objectives-understanding-mission-and-how-best-to-achieve-it/MITRES15-002SUM16_Session_1.pdf.

successful program can be handed off to the private sector and, if not, there should be clear reasons why the program should continue in spite of its lack of economic justification.

If certain borrowers are to be subsidized, they should be clearly identified and the program targeted accordingly. Just as important, there should be a clear rationale as to why credit is the chosen intervention. As this chapter has explained, credit can harm as much as it can help, and often the attractiveness of its political features overshadows its economic benefits. From a policy perspective, tax expenditures or outright grants may be superior means of providing subsidies to favored groups.

Program design should carefully manage adverse selection. To some extent, adverse selection is inherent to the functioning of a credit program, as the government is trying to solve a market imperfection by bringing new borrowers into the market. However, the objective should be to serve a “sweet spot” between borrowers who would otherwise be able to get credit in the private market and lending to uncreditworthy individuals for whom credit would amount to an added burden. Eligibility requirements should carefully define the population between these extremes to make sure that funds go where they are most needed.

Moral hazard should be minimized. Program design must align incentives of borrowers, lenders, and the sellers of the assets to be purchased with borrowed funds with those of the taxpayers who are subsidizing or backing the loans. All parties should have “skin in the game” in the sense that they benefit most when the asset is purchased and the loan is repaid.

Designing and – especially – managing efficient and effective credit programs is difficult. For many programs, political pressures tend to encourage overlending despite the potentially great costs to borrowers, taxpayers, and good policy. Initiating and executing a beneficial credit program requires active and continuing oversight and evaluation by all stakeholders and public officials.

THE HISTORY OF FEDERAL CREDIT PROGRAMS

Michael E. Easterly

I. INTRODUCTION

Federal provision of credit has a long history in the United States, but the government did not establish a permanent presence in financial markets until about a century ago. Beginning with a term-limited agency to help finance America's efforts in World War I, policymakers expanded the government's role into many sectors of the economy, including housing, education, agriculture, small business, and exports, and established them on a permanent basis. Over the course of that expansion, federal involvement has surged and ebbed, and policymakers' justifications for that involvement has shifted as well.

Early twentieth-century programs were advanced as temporary or emergency measures, responses to disruptions in financial markets caused by war or bank runs. Subsequently they became the means by which to pursue broader public policy goals, such as rewarding servicemen, increasing educational attainment, expanding homeownership, or promoting exports. Over time, credit programs became permanent parts of the nation's financial infrastructure, their operations taken for granted and their persistence supported by constituencies that had to come rely upon them.

This chapter recounts the history of federal credit programs from the perspective of public policy. Section I is this introduction. Section II describes one of the first programs, the War Finance Corporation, and how its development presaged those of the programs that followed. Section III shows how the government used credit to respond to the Great Depression and how many of the programs we know today emerged from those responses. In Section IV we see how many of the programs originally introduced as emergency measures became permanent parts of the federal infrastructure.

The second half of the chapter tracks the expansion, overextension, and eventual retrenchment of federal credit programs. In Section V, we see how policymakers found new uses for federal credit and expanded them accordingly. Section VI explains how ill-advised expansions led to policy failures at many agencies. Section VII describes the retrenchment that followed. Section VIII concludes.

The history of federal credit initiatives in the United States teaches several lessons. Such programs can and have successfully created new markets, thus broadening access to financial services and expanding the types of financing available, and they have served as countercyclical stabilizers against downturns in the private market. Once created, however, such programs have at times

expanded beyond their original mandate and the resolution of the problems they were intended to address, as lawmakers used them as substitutes for grant programs and other forms of direct spending, or to augment such programs. In some cases, policymakers have pushed programs beyond the point that they were equipped to handle, with deleterious consequences. Thus past experience has shown the importance of finding the balance between too little and too much credit.

II. PRECURSORS: WORLD WAR I

The ancestor of the federal government's current portfolio of federal credit programs came at a time of emergency. With its entrance into the World War I, America needed to reallocate resources to the war effort. The first federal credit agency, the War Finance Corporation, was intended to last only until the hostilities ended, but its effects were much more far-reaching. In addition to providing a precedent for subsequent uses of the federal government's balance sheet, it presaged many of the dynamics of the programs that followed by persisting beyond its originally scheduled termination date and expanding beyond its initial mandate.

America's entry into the First World War created new complications in the financial system. War bonds were absorbing funds in the capital markets, and the Federal Reserve lending was limited to loans secured by commercial paper. Policymakers feared that banks would be constrained from providing short-term financing to railroads, power plants, chemical firms, and other war-related enterprises.¹

In 1918 Congress created the War Finance Corporation (WFC), a wholly-owned government corporation, to finance these activities. As the secretary of war explained, credit allocation was its *raison d'être*. "The ordinary flow of capital, which in normal times is left free to seek its own investment, should during the war be so directed and conserved that these requirements shall be taken care of before funds shall be invested either in new enterprises or for the expansion of such old enterprises as are not necessary or contributory to the prosecution of war," he explained.²

The US Treasury provided its full capital stock of \$ 500 million.³ Instead of lending directly, the WFC was to funnel its funds through banks because, as the secretary of war explained, "The banks of the country would, no doubt, scrutinize with the utmost care both the loans themselves and the security therefor and would exercise their individual judgment upon the borrower's credit before assuming a liability for the amount of the loan," especially because the WFC would require them to advance 25 percent of the principal out of their own funds.⁴ The WFC's powers were to cease

¹ Testimony of Treasury Secretary William McAdoo before the House of Representatives Ways and Means Committee, February 18, 1918, pp. 3-4.

² *Ibid.*, p. 5.

³ *Ibid.*, p. 12.

⁴ *Ibid.*, p. 4.

six months after the end of the war, and the WFC was to wind down its affairs and terminate completely within 10 years.⁵

Once in operation, the focus of the WFC shifted. Except for the railroads, which the federal government had nationalized, few war industries needed its facilities, as banks found that loans from the Federal Reserve were in fact sufficient for their needs. Meanwhile, policymakers found other uses for its funds. Upon the encouragement of the secretary of the Treasury, the WFC made direct loans to cattle ranchers to help tide them over a drought that afflicted the South and West, which inaugurated increased support for the agricultural sector. After the war ended, this shift accelerated. Concerned about a possible collapse in foreign trade, Congress authorized the WFC to make loans on exports to foreign buyers, either directly or through banks, with agricultural producers the chief beneficiary. By its fourth year, the agency was devoting itself almost exclusively to financing the cultivation, harvest, and marketing needs of the agricultural sector.⁶

The WFC made its last loan in 1924, but a precedent had been established. The federal government had managed financial distress through the direct and indirect extension of credit for preferred purposes and to preferred constituencies. The WFC had also shown to politicians that credit programs provided a flexible and useful tool for responding to economic and political imperatives outside the regular appropriations process.

III. ESTABLISHMENT: THE GREAT DEPRESSION

The War Finance Corporation might have faded into obscurity but for another crisis that occurred less than a decade after its termination. The Great Depression crushed private financial markets, which in turn generated a self-perpetuating downward spiral. The federal government stepped in with a series of massive credit programs. These programs illustrated the beneficial effects of government intervention: they provided countercyclical support for financial markets and a demonstration effect for private lenders. Thanks to government intervention, financial markets avoided further collapse in the short term, and over the long term banks and other intermediaries learned that they could extend maturities and lend to a wider range of borrowers, which made for broader financial markets when prosperity returned.

Between August 1931 and January 1932, repeated depositor runs caused the failure of 1,860 banks across the United States and reduced deposits substantially at the ones that remained, causing credit to contract and prices to drop.⁷ The nation's financial system was failing and pulling the rest of the economy further into depression.

⁵ Ibid., p. 11.

⁶ W. G. McAdoo et al., *First Annual Report of the War Finance Corporation*, 7582 H. Doc. 1387, 1918, pp. 6–7; Henry C. Houston, George R. Cooksey, and Angus W. McLean, *Third Annual Report of the War Finance Corporation*, 7794 S. Doc. 341, 1920, pp. 1–8.

⁷ Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960*, Princeton University Press, 1971, p. 317.

For President Herbert Hoover, recovery depended upon getting banks to lend again. After a three-month dalliance with a privately-funded “bad bank,” he proposed that the Congress establish a Reconstruction Finance Corporation (RFC).⁸ In January 1932 Congress capitalized the RFC with \$ 500 million from the US Treasury and authorized it to issue obligations “fully and unconditionally guaranteed both as to interest and principal by the United States” for \$ 1.5 billion more, though the additional obligations had to mature no later than five years after issue. The RFC was authorized to make “fully and adequately secured” loans to a variety of financial intermediaries, including commercial banks, mortgage lenders, insurance companies, and livestock credit corporations, and it could lend directly. Its power to make loans sunset at the end of one year, but the president at his discretion could extend its term for up to an additional two years. The organization itself was to be liquidated within ten years.⁹ As events unfolded, however, the RFC was to last more than twice as long.

As historian James S. Olson has documented, the RFC was “a direct descendant of the War Finance Corporation.” Its chairman, Federal Reserve Board Chairman Eugene Meyer, had been a board member of the WFC, and he recruited five of its senior officers to the new organization. The RFC’s organizational structure also mirrored that of the WFC, both in terms of the division of responsibilities and the number of local offices. One of Meyer’s recruits drew up a list of bankers who had helped him with the WFC more than a decade earlier and offered to hire them.¹⁰

Econometric evidence suggests that RFC lending substantially reduced bank suspensions in its first half year of existence and slowed the contraction of the money supply.¹¹ However, commercial lending did not pick up, so in July, Congress turned to more direct aid for the economy. It passed the Emergency Relief and Construction Act, which set aside \$ 300 million of the RFC’s funds to provide loans to states to provide for relief programs. It also authorized the Corporation to make up to \$ 1.5 billion in loans to states, municipalities, or their instrumentalities for “self-liquidating” public works projects.¹²

Unfortunately, that same legislation required the RFC to publish the names of all of its borrowers. When yet another panic ravaged the banking system in late 1932, banks avoided drawing upon the RFC’s facilities for fear of appearing weak. In the month preceding Franklin D. Roosevelt’s inauguration, state governors ordered the suspension of withdrawals, a bank holiday that the new president quickly made nationwide. Days later, Congress gave the RFC the authority to purchase

⁸ James Stuart Olson, *Saving Capitalism: The Reconstruction Finance Corporation and the New Deal, 1933-1940* Princeton University Press, 1988, pp. 10, 14.

⁹ Reconstruction Finance Corporation Act, P.L. 72-2, 1932.

¹⁰ Olson, *Saving Capitalism*, pp. 14–15.

¹¹ James L. Butkiewicz, “The Impact of a Lender of Last Resort during the Great Depression: The Case of the Reconstruction Finance Corporation,” *Explorations in Economic History*, vol. 32, no. 2, 1995, pp. 197–216.

¹² Olson, *Saving Capitalism*, p. 19.

the preferred stock of any national bank or trust company and removed limits on the amounts it could loan to institutions in the process of liquidation.¹³

When bank lending still did not pick up, the RFC's powers expanded. A 1934 amendment to the RFC authorization permitted the agency to lend to "any business enterprise ... either directly or in cooperation with banks or other lending institutions through agreements to participate," so long as adequate security was provided, credit was not available from private sources, loans did not exceed \$ 500,000 to a single borrower or \$ 300 million in the aggregate, and maturities did not extend beyond five years.¹⁴ Subsequent amendments relaxed or eliminated all of these restrictions except the requirement that credit not be available elsewhere. In addition, the RFC was empowered to make disaster loans, purchase and sell gold (to stimulate inflation), and provide startup funding for the Works Progress Administration. The RFC also provided seed capital for the Federal Housing Administration, Fannie Mae, the Commodity Credit Corporation, the Rural Electrification Administration, and the Export-Import Bank, and it recapitalized the Farm Credit System and Federal Home Loan Bank system.¹⁵

From its inception until December 30, 1940, the RFC disbursed \$ 7.67 billion in loans, but its influence extended even further. While loans of longer maturities were not unknown prior to the Great Depression, banks were reluctant to make them. The RFC educated the private sector how to make "term loans," and banks began making more and more of them on their own.¹⁶

Meanwhile, credit in international markets had disappeared. The Depression had pushed the balance of payments for many countries out of alignment. To deal with the problem, some governments had restricted their foreign exchange payments. Bankers became wary of lending when repayment might be delayed. Short-term lending for exports went from \$ 100 million per year in the 1920s to \$ 4 million in 1934.¹⁷

To reestablish trade Roosevelt signed an executive order to create the Export-Import Bank (Ex-Im).¹⁸ He appointed as its director George N. Peek, the former head of John Deere and a vigorous advocate of the agricultural sector. Peek in turn reached out to the National Foreign Trade Council,

¹³ Emergency Banking Relief Act, P.L. 73-1 (1933).

¹⁴ US Statutes at Large (1934), 1105-1113, quoted in Hyo Won Cho, "The Evolution of the Functions of the Reconstruction Finance Corporation: A Study of the Growth and Death of a Federal Lending Agency" PhD dissertation, The Ohio State University, 1953.

¹⁵ Olson, *Saving Capitalism*, p. 45; Cho, "Reconstruction Finance Corporation," pp. 42-44, 52-53, 61-62, 65-66.

¹⁶ Neil H. Jacoby and Raymond J. Saulnier, *Term Lending to Business*, National Bureau of Economic Research, 1942, cited in Cho, "Reconstruction Finance Corporation," pp. 80-81.

¹⁷ William H. Becker and William M. McClenahan, Jr., *The Market, the State, and the Export-Import Bank of the United States, 1934-2000*, Cambridge University Press, 2003, pp. 17-18.

¹⁸ This account simplifies the events surrounding the establishment of the Bank considerably. It came about via the creation of two banks, one to finance trade with the Soviet Union and the other to assist exports first to Cuba, then to the entire world except the USSR. Part of the rationale for the founding of the first bank was leverage in getting the Soviets to repay pre-revolutionary debt taken on by Russia. The two banks merged the next year and never did any business with the USSR. For a more fulsome account, see *ibid.*, chapter 1.

which had been advocating for a government agency to finance exports for the past three years, and the American Bankers Association for advice.¹⁹

Meanwhile, an ambitious loan program for the rural poor emerged indirectly from the federal government's relief efforts. In Roosevelt's first 100 days, Congress had passed the Federal Emergency Relief Appropriation Act, which established the Federal Emergency Relief Administration to oversee grants to the states for public assistance. In densely populated areas, this took the form of job programs and direct relief, but administrators in the Rural Rehabilitation Division (RRD) had a different idea. Believing that farms were inherently self-sustaining, they opted for a program of "Supervised Credit." Loans for feed, fertilizer, livestock, and equipment were combined with periodic visits to help the farmers plan food production, budgets, and other aspects of farm management. Officials at the RRD argued that the program would be cheaper and more cost-effective than other forms of relief.²⁰

In 1937 a formal program began for addressing farm tenancy. Representatives of that population had been lobbying the Roosevelt Administration for years, and following the election, the president and elective representatives moved to address their concerns. In 1937, the Bankhead-Jones Farm Tenant Act established a low-interest loan program for the purchase and improvement of land by sharecroppers, tenants, and other agricultural workers. Appropriations for the bill had been whittled down in committee to such an extent that it became more practical to provide assistance come in the form of loans instead of grants.²¹

In the housing sector, a huge debt overhang, exacerbated by inflexible debt contracts, threatened recovery. At the time, mortgages lasted only five to ten years. Typically, they were rolled over at maturity, but if they were not, the mortgagor owed a large balloon payment. When the banking crisis hit, lenders refused to refinance, and borrowers were either unable or unwilling to pay. As defaults mounted, a vicious cycle set in: foreclosures would cause housing prices to decrease, which would leave more homeowners owing more than their houses were worth, which would lead to more defaults, and so forth. Foreclosures on nonfarm properties reached nearly 250,000 by 1932, more than triple the rate in 1926.²²

To stabilize the market, Congress created the Federal Housing Administration (FHA). The National Housing Act of 1934 created this government agency to administer a revolving fund that would insure mortgages against default. In exchange for a fee set by the FHA commissioner, lenders were insured against loss of principal on mortgages that defaulted, with recovery for unpaid interest contingent upon the amount received from sale of the foreclosed property. Section 203 of

¹⁹ Ibid., p. 26.

²⁰ Charles Kenneth Roberts, "The New Deal, Rural Poverty, and the South," PhD dissertation, University of Alabama, 2012, pp. 61–68.

²¹ Ibid., pp. 201–2.

²² Susan B. Carter et al., eds., *The Historical Statistics of the United States*, Millennium edition, Cambridge University Press, 2006, Table DC1255-1270.

the Act defined an eligible mortgage as having a principal of no more than \$ 16,000 and a loan-to-value ratio not to exceed 80 percent, and maturities were not to exceed 20 years. The loans were to be fully amortizing with payments not to exceed the mortgagor's (homeowner's) "reasonable ability to repay," as determined by the Commissioner.²³ The insurance fund was to insure only mortgages that were "economically sound."²⁴

Title III of the Act provided for the creation of national mortgage associations. Intended to be private entities, they were authorized to purchase and sell first mortgages, thereby creating a liquid secondary market for FHA-insured mortgages. The FHA commissioner was given the power to periodically examine the associations and had the power to liquidate, reorganize, or place under receivership any whose capital fell below 10 percent of assets or was otherwise operating in an unsafe or unsound manner.²⁵ After such organizations failed to materialize, the FHA requested the RFC in 1938 to create the Federal National Mortgage Association, later known as "Fannie Mae," as a demonstration project.²⁶

In its first annual report, the FHA announced its intention to accomplish "a thorough reform in the home financing structure" aimed at "develop[ing] practices that protect the borrowers against excessive charges" and "discourag[ing] the assumption of obligations above the borrower's reasonable capacity to pay."²⁷ But the FHA's innovations went well beyond the four corners of the mortgage contract. It established minimum standards for home construction, including for design, materials, water supply, and sewage disposal, and enforced these standards through on-site inspections. Appraisals were made by the FHA, either by in-house staff or appraisers it hired, which insulated estimates from pressure by developers, home sellers, or real estate agents. Subsequent legislation required that builders warrant that they had built the home in "substantial conformity" with the plans approved by the FHA and authorized the FHA to pay the home owner for any "substantial defects" that he might discover. Home buyers took eligibility for FHA loans as a proxy for home quality, which encouraged the private sector to adopt the same standards.²⁸

The FHA succeeded where the private market had failed. Building and loan companies had been experimenting with amortization for nearly fifty years through "direct reduction" contracts, with limited success. Implementing such arrangements required innovations in accounting and the

²³ National Housing Act of 1934, P.L. 479-73, 1934.

²⁴ Dwight M. Jaffee and John M. Quigley, "Housing Policy, Mortgage Policy, and the Federal Housing Administration," Chapter 5 in *Measuring and Managing Federal Financial Risk*, ed. Deborah Lucas, 2010, p. 105.

²⁵ National Housing Act of 1934, P.L. 479-73, 1934.

²⁶ Kenneth A. Snowden, "The Anatomy of a Residential Mortgage Crisis: A Look Back to the 1930s," National Bureau of Economic Research Working Paper 16244, July 2010, 27, available at <http://www.nber.org/papers/w16244>.

²⁷ "First Annual Report of the Federal Housing Administration," House Document No. 88, 74th Congress, 1st Session January 29, 1935, p. 4.

²⁸ Milton P. Semer et al., "Evolution of Federal Legislative Policy in Housing: Housing Credits," Chapter 1 in *Housing in the Seventies: Working Papers*, by Department of Housing and Urban Development, National Housing Policy Review, GPO, 1976, pp. 12–13.

management of credit risk that few of these associations could handle.²⁹ Furthermore, when the Great Depression hit, many building and loan associations went down with it. Private mortgage insurance firms had emerged after the turn of the century and by 1930 were insuring \$ 3 billion in mortgages. Some had begun marketing pass-through certificates on (i.e., selling shares in) pools of mortgages to investors. These firms, however, only insured shorter-term mortgages, and in the 1930s they had failed amid allegations of fraud and mismanagement. Their malfeasance was so flagrant that a legislative committee in New York, where nearly all were domiciled, recommended that the business be banned.³⁰

The FHA also shaped the market in less salutary ways. Seemingly innocuous standards, such as for lot size and for distance from streets and neighboring buildings, rendered many properties in more densely populated cities ineligible.³¹ More egregiously, the FHA adopted the private sector's biases against "undesirable racial elements" and their "ingress" into areas with homogeneous populations.³² Its 1939 underwriting manual required that appraisers record the "predominating racial characteristics" of neighborhoods with letters for "white," "mixed," "foreign," and "Negro." It also advised them to "investigate[]" nearby areas "to determine whether incompatible racial and social groups are present, for the purpose of making a prediction regarding the probability of the location being invaded by such groups," as "a change in social or racial occupancy generally contributes to instability and a decline in values."³³ Thus standards that had been applied on a local and *ad hoc* basis by the private sector became formal and uniform nationwide, enforced by on-site inspections by FHA representatives. The FHA ended up subsidizing the flight of more affluent and mostly white residents to the suburbs, to the detriment of center cities.³⁴

IV. CONSOLIDATION: THE POSTWAR PERIOD

World War II eventually raised the economy fully out of depression. However, despite the return to prosperity, government credit programs became only more entrenched. Policy makers found new uses for government credit, and the old programs did not go away. As with other forms of government support, organized interest groups had come to rely upon federal credit, and they made their voices heard in the halls of Congress. Once started, government credit programs remained,

²⁹ Jonathan D. Rose and Kenneth A. Snowden, "The New Deal and the Origins of the Modern American Real Estate Loan Contract," *Explorations in Economic History*, vol. 50, no. 4, 2013, pp. 549–53.

³⁰ Kenneth A. Snowden, "Anatomy of a Residential Mortgage Crisis," pp. 14, 20–21. The types of malfeasance would be very familiar to modern readers, as the insurers "violated underwriting standards, substituted bad loans for performing mortgages in their mortgage pools, and maintained inadequate guarantee funds to support their insurance policies" (*ibid.*, p. 20).

³¹ Kenneth T. Jackson, "Race, Ethnicity, and Real Estate Appraisal: The Home Owners Loan Corporation and the Federal Housing Administration," *Journal of Urban History*, vol. 6, no. 4, 1980, p. 436.

³² Stanley L. McMichael, *McMichael's Appraising Manual: A Real Estate Appraising Handbook for Field Work and Advanced Study Courses*, Prentice-Hall, 1931, p. 278, cited in Calvin Bradford, "Financing Home Ownership: The Federal Role in Neighborhood Decline," *Urban Affairs Review*, vol. 14, no. 3, 1979, p. 323.

³³ Federal Housing Administration, *Underwriting Manual: Underwriting Analysis under Title II, Section 203 of the National Housing Act*, GPO, 1934, §§ 937, 1850.

³⁴ Bradford, "Financing Home Ownership"; Jackson, "Race, Ethnicity, and Real Estate Appraisal."

and as we will see in this and the following section, expanded significantly despite original assurances that they would be limited in scope.

The initial stimulus was the cessation of hostilities. At war's end, the federal government was confronting the formidable task of demobilizing from the twin emergencies of depression and war. More than fifteen million soldiers were coming back to the States, with no jobs or homes waiting for them. Making matters worse, conscription had interrupted their opportunities to gain skills either through education or on-the-job experience.³⁵ Meanwhile, industry had to transition to a consumer economy, and there was no guarantee that economic depression would not return.

Congress responded with the Servicemen's Readjustment Act of 1944, more colloquially known as the GI Bill. Proposals circulating within Congress and the Roosevelt Administration for this measure had been relatively modest, but the American Legion expanded them and mobilized its grassroots network to spur the enactment of a broader program.³⁶ The final bill provided long-term unemployment benefits, health care, and disability allowances, but the most far-reaching provisions pertained to credit and educational subsidies. Veterans were entitled to apply for a guarantee of a loan to buy a home, acquire farm equipment or livestock, or start a business. Interest rates were not to exceed 4 percent, and maturities were limited to 20 years. The federal government would pay interest for the first year. Finally, the bill offered veterans \$ 500 per year for tuition, plus living expenses.³⁷ Consistent with its name, the act was intended to be short-term. Returning servicemen were required to apply for benefits within two years of separation from service or the termination of war, whichever was later.

However, that restriction did not last long. Real estate prices had risen so much during the war that the maximum allowed guarantee, \$ 2,000, was insufficient to buy a home. Twenty-year maturities required payments beyond the incomes of prospective purchasers. Furthermore, given the number of eligible veterans, policymakers feared that restricting transactions within the two-year limit would cause further house price inflation. Accordingly, amendments the following year extended eligibility to ten years and lengthened allowable maturities to 25 years.³⁸

Though not a loan program *per se*, the educational benefit established a substantial role for the government in higher education. Fifty-one percent of veterans took advantage of the opportunity, one-quarter of them for higher education.³⁹ This provided a significant stimulus for the educational sector. According to a Congressional investigation, it spurred the establishment of a hundreds of "fly-by-night ventures" offering "every course imaginable, attempting to break into

³⁵ Congressional Research Service, *GI Bill: 1944-1975* (Washington, DC, 1975), p. 3.

³⁶ Suzanne Mettler, *Degrees of Inequality: How the Politics of Higher Education Sabotaged the American Dream*, Basic Books, 2014, p. 57.

³⁷ Congressional Research Service, *GI Bill*, p. 5.

³⁸ Department of Veterans Affairs, *Legislative History of the VA Home Loan Guaranty Program*, August 23, 2006, p. 4, available at <http://www.benefits.va.gov/homeloans/documents/docs/history.pdf>.

³⁹ Mettler, *Degrees of Inequality*, p. 57.

the education and training field for the purpose of securing the GI dollar.” The Bill had included no means of weeding out bad actors and ensuring that program outcomes were favorable. “It is not surprising,” the committee report concluded, “that in a program of this magnitude there have been abuses, there have been errors, there have been extravagances, there have been isolated instances of corruption and larceny, and there has been administrative inefficiency.”⁴⁰

Nevertheless, the federal role in financing higher education increased in the late 1950s. In 1957 the Soviet Union launched Sputnik, the first artificial satellite, into space. The event raised concerns among policymakers that the nation was falling behind in educational attainment and technical skills. In response, Congress passed the National Defense Education Act (NDEA), a law whose preamble declared an ambitious target: “We must increase our efforts to identify and educate more of the talent of our Nation. This requires programs that will give assurance that no student of ability will be denied an opportunity for higher education because of financial need.”⁴¹

President Eisenhower had wanted the NDEA to operate via a tax benefit, which would have limited the government’s involvement in higher education. Democrats, however, argued that such a program would be costly and instead established a student loan system. Credit was to be extended directly from the government, repayable over ten years, to undergraduate and graduate students studying areas relevant to national defense.⁴²

The Cold War also bolstered the prospects of the Export-Import Bank. Europe was in dire need of funds to help with reconstruction, and the Bank had experience with large-scale loans. Accordingly, Congress gave it an extension of its charter and a 400 percent increase in its lending authority, and it rescinded restrictions on lending to countries that had defaulted on obligations to the US.⁴³ Subsequent to its work on reconstruction, Ex-Im financed projects in Afghanistan, Iran, Israel, Saudi Arabia, and Yugoslavia (which was distancing itself from the Soviet Union at the time), along with loans to the French government for military equipment to fight the communists in Vietnam.⁴⁴

Attempts to restrain the Bank’s private lending did not succeed. Eisenhower’s Treasury secretary argued that “there should be as little government lending as possible,” and he was especially interested in reducing Ex-Im’s draw on the Treasury. In January 1954 he pushed a resolution through the Bank’s advisory committee stating that the Bank was to focus on short- and medium-term loans and that as much as possible they be made via participations with private-sector intermediaries.⁴⁵

⁴⁰ “Report of the House Select Committee to Investigate Educational and Training Programs under the GI Bill,” 1951, quoted in Congressional Research Service, *GI Bill*, 6–7.

⁴¹ Matthew B. Fuller, “A History of Financial Aid to Students,” *Journal of Student Financial Aid*, vol. 44, no. 1, 2014, p. 15; National Defense Education Act, P.L. 85-864 (1958).

⁴² Fuller, “History of Financial Aid,” p. 15; Mettler, *Degrees of Inequality*, pp. 60–61.

⁴³ Becker and McClenahan, Jr., *Export-Import Bank*, pp. 62–65.

⁴⁴ *Ibid.*, pp. 81–82.

⁴⁵ *Ibid.*, pp. 89, 96, 107.

Exporters pushed back. Led by Westinghouse, they lobbied key members of Congress to roll back restrictions. The chair of the Senate Committee on Banking and Currency held a series of hearings in which supporters of the Bank (no opponents were scheduled) testified in its favor. A committee staff report relayed exporters' complaints that the bank was doing "relatively little" for US manufacturers and that the requirement that those who did get loans provide at least 25 percent of the financing "appears inappropriate and unduly burdensome." In August 1954, Congress passed a bill "reaffirm[ing] the status of the Export-Import Bank as an independent agency of the United States," reflecting congressional assertion of greater control over the Bank relative to the Treasury Department and the Executive Branch. In reporting out the bill, the Banking and Currency Committee stated that it was imposing "no legislative limitation upon the loan authority of the Export-Import Bank that would exclude it properly from making long-term, medium-term, or development loans."⁴⁶

Meanwhile, questions arose over the continuing relevance of the Reconstruction Finance Corporation. As economic growth resumed, bankers especially argued that credit markets no longer needed its support.⁴⁷ In renewing the agency's charter in 1948, Congress prohibited it from purchasing the stock in any bank, make loans to foreign governments, capitalize government agencies, continue to operate its home mortgage subsidiary, or have more than \$ 2 billion outstanding at any time. Presumably this was expected to reduce its lending, which had reached \$ 393 million for 1947. However, the RFC continued to grow, with new loans exceeding half a billion dollars in the fiscal year ending June 1950. It extended credit to a wide variety of concerns, including "a gambling casino, a rainbow trout fishery, night clubs, snake farms, swank resort hotels in Miami Beach, movie houses, and a grower of cactus plants for sale in dime stores."⁴⁸

The RFC was nearing its end. In addition to growing without any apparent constraint, it had become an attractive target for corruption. A Congressional subcommittee in 1951 issued a report finding significant favoritism and influence-peddling at the RFC, causing an uproar. The agency thereafter became an important symbol in Republican's 1952 to "clean up the mess in Washington."⁴⁹ Once in office, the new Republican majority abolished the agency and ordered that its operations be transferred to the US Treasury.

Nevertheless, there remained considerable enthusiasm for government support of credit for small business. Senator William J. Fulbright, who had chaired the investigation of the RFC, argued that in many areas in the South and West, such as his home state of Arkansas, small businesses found it difficult to obtain loans because of the small size of local banks. The RFC had been serving this

⁴⁶ Ibid., pp. 96–101.

⁴⁷ Barry P. Bosworth, Andrew S. Carron, and Elisabeth H. Rhyne, *The Economics of Federal Credit Programs* (Washington: Brookings Institution, 1987), p. 82.

⁴⁸ Jules Abels, *The Truman Scandals*, Henry Regnery, 1956, cited in Addison W. Parris, *The Small Business Administration*, F. A. Praeger, 1968, p. 14.

⁴⁹ Parris, *Small Business Administration*, pp. 15–18.

market through depression and war, and without it, Fulbright claimed, “hundreds of businesses in the South and West could [have] never expand[ed].”⁵⁰

Thus in the same legislation that abolished the RFC, Congress established the Small Business Administration (SBA). The legislation authorized the agency to draw upon a revolving fund at the Treasury not to exceed \$ 275 million. All loans were to “be of such sound value or so secured as reasonably to assure repayment,” and no loan could be made “unless the financial assistance applied for is not otherwise available on reasonable terms,”⁵¹ the latter provision being important in gaining the support of the American Bankers Association.⁵² The statute required that the SBA sunset after two years.⁵³

Almost immediately policymakers found these restrictions to be too binding. In 1955, the Small Business Administrator asked that his agency be extended for two years, and the Chairman of the Senate Small Business Committee countered with a proposal that the SBA become permanent, as “allow[ing] the agency to drift, uncertain of its future, would jeopardize the large investment on services and in appropriations already made.”⁵⁴ Funding constraints also evaporated. The SBA habitually depleted its revolving fund and made yearly requests for additional funds, which Congress routinely accommodated. Between 1953 and 1966, lawmakers appropriated an additional \$ 1.8 billion dollars for the agency, making the SBA “a *de jure* revolving fund agency but a *de facto* traditional agency.”⁵⁵

Meanwhile, under the umbrella of the FHA, the residential mortgage market had become financially integrated.⁵⁶ The agency itself was running substantial surpluses, demonstrating the viability of long-range, amortizing mortgages, and higher leverage. With this evidence of success, Congress moved to liberalize terms. In a series of statutes passed between 1938 and 1957, it progressively extended maximum maturities until they reached 30 years and increased maximum loan-to-value ratios to 97 percent for some mortgages. Congress also replaced the “economic soundness” requirement for mortgages with an “acceptable risk” test. The basis for the maximum

⁵⁰ Cho, “Reconstruction Finance Corporation,” pp. 281–82, 291–92, quoting “Resolution on Reconstruction Finance Corporation,” *Congressional Record*, vol. 99, no. 25, February 13, 1953, p. 1090.

⁵¹ An Act to Create the Small Business Administration and to Preserve Small Business Institutions and Free, Competitive Enterprise, P.L. 83-163 (1953).

⁵² Bosworth, Carron, and Rhyne, *Economics of Federal Credit*, pp. 82–83.

⁵³ An Act to Create the Small Business Administration.

⁵⁴ Statement of Senator Thye (R., Minn.), *Congressional Record*, vol. 101 (1955), p. 7638, quoted in Mirit Eyal-Cohen, “Why Is Small Business the Chief Business of Congress?” *Rutgers Law Journal*, vol. 43, no. 1 (Fall/Winter 2011), p. 33.

⁵⁵ Parris, *Small Business Administration*, p. 118.

⁵⁶ Kenneth Snowden, “The Evolution of Interregional Mortgage Lending Channels, 1870-1940: The Life Insurance-Mortgage Company Connection,” Chapter 7 in *Coordination and Information: Historical Perspectives on the Organization of Enterprise*, eds. Naomi R. Lamoreaux and Daniel M. G. Raff, University of Chicago Press, 1995, p. 244.

insurable amount changed from long-range value to replacement cost, a less conservative measure.⁵⁷

V. EXPANSION: THE 1950S AND 1960S

With many now on a permanent basis, federal credit programs expanded. Agencies expanded in size and scope as policy makers found new uses for the government's balance sheet. Credit programs became a way for policymakers to extend federal largesse without appearing to increase the deficit.

The FHA became an active tool of social policy and the housing industry. Congress recruited the agency to support, and often subsidize, programs for urban renewal, affordable rentals, and home purchase assistance. Between 1954 and 1968, it passed amendments to the National Housing Act to encourage urban renewal housing (Section 220, passed in 1954); below-market interest rates for families displaced by urban renewal (Section 221, 1954); multifamily housing through mortgages at below-market interest rates (Section 221(d)(3), 1961); housing in "older, declining urban areas" where "one or more of the eligibility requirements ... could not be met" (Section 223(e), 1968); mortgages with low down payments and subsidized interest rates to low-income households (Section 235, 1968); subsidized loans for construction of multifamily housing (Section 236, 1968); and credit for mortgagors with bad credit (Section 237, 1968)

A "Special Risk Insurance Fund" was established for all these programs except 221(d)(3) and 221(d)(4) to compensate for higher-than-expected defaults and insulate the main FHA insurance fund from losses. The original single family mortgage insurance (203(b)) program moved downmarket as well, due to the more lenient terms approved between 1938 and 1957 and because of binding maximum loan limits. By 1969 FHA had transformed from a general-purpose insurer into a program designed largely to help lower-income households afford housing.⁵⁸

The Farmers Home Administration (FmHA) expanded as well. Beginning in 1949, legislation increased the credit facilities administered by FmHA at a crisp pace, adding housing loans to farmers (the Federal Housing Act of 1949); loans for farm water systems (the Water Facilities Act of 1954); emergency loans following natural disasters (the Disaster Loan Act of 1949); housing loans for nonfarm rural residents (the Federal Housing Act of 1961); loans for association grazing ranges and for resource conservation (the Farmers Home Administration Act of 1962); loans to low-income residents of rural areas, improvements to small farms, and for nonfarm businesses (the Economic Opportunity Act of 1964); housing loans to low-income families and developers of low-income housing, for farm labor housing, and for "self-help" homebuilding projects (the Housing Act of 1968); guaranteed loans by private-sector intermediaries for farming, housing, business, or

⁵⁷ James R. Barth, Joseph J. Cordes, and Anthony M. J. Yezer, "FHA Mortgage Insurance and High-Risk Mortgage Lending: Some Lessons for Policy," *Housing Finance Review*, vol. 2, no. 2 (April 1983), p. 97.

⁵⁸ Kerry D. Vandell, "FHA Restructuring Proposals: Alternatives and Implications," *Housing Policy Debate*, vol. 6, no. 2, 1995, pp. 312–14.

industry (the Rural Development Act of 1972); guaranteed loans to financially distressed livestock and poultry farmers (the Emergency Livestock Credit Act of 1974). To execute its new responsibilities, the FmHA established branch offices across the country.⁵⁹

Despite being in operation less than five years, the SBA also expanded. According to testimony at Congressional hearings and a series of analytical reports by the Federal Reserve, small businesses faced an “equity gap” – difficulty in getting long-term loans or equity capital from private financial intermediaries – and this financing deficit diminished their competitiveness with larger enterprises. Citing these findings, lawmakers passed new legislation, the Small Business Investment Act (SBIA).

The SBIA authorized the creation of small business investment companies (SBICs), privately owned and operated firms licensed by the SBA to provide patient capital to small businesses. Specifically, SBICs were to finance eligible firms through long-term loans and convertible debentures (unsecured bonds that could be converted into stock). Investors could start such firms with at least \$ 150,000 of their own capital. The law then permitted them to leverage up with two dollars of federal money for every dollar the principals invested. Congress sweetened the deal with special tax breaks. To wean the companies off of government support, the law stipulated that small businesses receiving capital from an SBIC had to buy shares of its stock equal to no less than 2 percent of the value of the funds.⁶⁰

As with the original SBA, these restrictions did not last long. Two years after passage of the SBIA, Congress rescinded its mandate that provision of equity be the SBICs’ primary function. Furthermore, because small businesses perceived capital purchases as little more than excess interest payments, Congress made their investments in SBICs voluntary. Amendments to the SBIA in the 1960s increased the amount of matching funds the SBA could provide to \$ 7.5 million per SBIC, far above the limit of \$ 150,000 in the original legislation. Congress also removed limits on the amount that an SBIC could lend to a single business and expanded the ability of commercial banks to participate in the program.⁶¹

In 1964, the SBA’s domain expanded even further. In that year six hurricanes caused \$ 2.5 billion in damages in Florida, Louisiana, Texas, Georgia. Alaska suffered a damaging earthquake, floods occurred in Montana and in the Ohio River valley, and California experienced forest fires. Congress directed the SBA to make immediate disaster loans of \$ 49.5 million, which they followed with a \$ 60 million supplemental appropriation. Rather than disappearing after the

⁵⁹ United States Department of Agriculture, “Federal Credit Programs for Agriculture: Background for 1985 Farm Legislation,” *Agricultural Information Bulletin*, November 1984, pp. 10–11, available at <https://naldc.nal.usda.gov/naldc/download.xhtml?id=CAT87212350&content=PDF>.

⁶⁰ Parris, *Small Business Administration*, pp. 156–57.

⁶¹ *Ibid.*, pp. 157–60.

emergencies passed, the set-asides remained. Two years later, Congress voted to continue to funding the program, and it eventually became permanent.⁶²

In 1965 the government extended the student loan program to nonmilitary ends. Under the umbrella of his expansive Great Society initiative, the Higher Education Act of 1965 (HEA) was to be a catalyst of economic opportunity for lower- and middle-income students who might otherwise be unable to afford college. The legislation included a grant program, later renamed Pell Grants, and a system for guaranteeing private-sector loans, both of which were subject to income limits, the latter being \$ 15,000 in family income. Policymakers hoped that the supply of cheaper credit would help quell continuing pressure for tax credits and that the income limits would help restrict the program to lower- and middle-income students.⁶³

Later in the decade, interest rates began to rise. To encourage lenders' continuing participation in the student loan program, Congress established a Special Allowance Fund to subsidize such loans. The fund compensated lenders on the basis of dollar volume outstanding. A committee of government officials was to determine the exact amount of the subsidy, which was not to exceed 3 percentage points.⁶⁴

In the fifteen years following the passage of the HEA, college costs rose sharply, leading to more pressure for government help. Expanding the student loan program and providing increased subsidies proved to be the path of least resistance. In its 1972 reauthorization of the HEA, Congress authorized the subsidization of interest payments by students during school through a program later renamed Stafford Loans. The Middle-Income Assistance Act of 1978 removed all income restrictions from the student loan program. To accommodate increased demand for loans, Congress lifted the cap on Special Allowance payments the following year.⁶⁵

In the 1970s, the Export-Import Bank was employed to deal with increasing international balance of payments deficits. Intensified competition from abroad, along with rising energy prices due to shocks to the international oil supply, caused American imports to exceed exports. Moreover, other countries were aiding their own exports with subsidies of their own, making US products less competitive in international markets. Presidents Nixon and Carter each made Ex-Im part of their export promotion policies.⁶⁶

Congress expanded Veterans Administration mortgage insurance through a series of bills passed following the Vietnam War. First it extended indefinitely the time in which veterans could utilize guarantees, and it extended coverage to new types of housing and to refinancing. A subsequent revision enabled beneficiaries to use the guarantee again if previous obligations had been settled.

⁶² Eyal-Cohen, "Small Business the Chief Business," pp. 20–21.

⁶³ Mettler, *Degrees of Inequality*, pp. 60–61; National Commission on Student Financial Assistance, "Guaranteed Student Loans: A Background Paper," Report No. 1, March 1982, p. 24, available at <http://eric.ed.gov/?id=ED228950>.

⁶⁴ National Commission on Student Financial Assistance, "Guaranteed Student Loans," p. 25.

⁶⁵ *Ibid.*, p. 26.

⁶⁶ Becker and McClenahan, Jr., *Export-Import Bank*, pp. 172, 182, 190–91.

A few years later, Congress increased the benefit, further expanded its scope, and increased eligibility. In 1992, the program was extended to reservists, partly as an incentive for what was expected to become an increasingly important part of the nation's military readiness. Thus Veterans' Administration mortgages changed from a one-time benefit, intended to manage a massive demobilization immediately after a major war, to a lifetime entitlement and a recruiting tool for an all-volunteer military.⁶⁷

Federal support for housing also expanded significantly in the late 1960's with expansion of federal backing of the secondary market for mortgage loans. At the Johnson Administration's request, Title VII of the 1968 Housing and Urban Development Act divided Fannie Mae into two parts. The Government National Mortgage Association (Ginnie Mae) was created as a government agency inside the newly-created Department of Housing and Urban Development with the mission of developing the pass-through mortgage certificate, which guaranteed principal and interest on pools of FHA, VA and Rural Housing mortgages. Fannie Mae was spun off in a sale to private investors and it was to specialize its secondary market functions primarily in non-government-backed mortgages.

VI. OVERLENDING: THE 1960S AND 1970S

By and large, federal credit agencies were unprepared for the new responsibilities placed upon them. Congress had expanded the size and scope of their missions without investing in corresponding capabilities. The combination of increased pressure to make loans and decreased experience with the types of loans Congress mandated led to ill-advised expansions of credit to borrowers unable or unwilling to pay back their debts. The results ranged from unfortunate to disastrous.

The SBA's Small Business Investment Company program was among the first to run into difficulty. In an effort to get the program started, the fledgling agency was generous in giving out licenses. It did little investigation into the character or qualifications of applicants.⁶⁸ Staff lacked the expertise to supervise the companies, and its accounting system could not provide current or accurate information on SBIC performance. As a result, SBA could not keep track of the status of its loans to SBICs or estimate potential losses. The SBA's Office of the Inspector General lacked sufficient staff to perform routine examinations. In any case, there were few penalties on the books for violating the agency's regulations.⁶⁹ As a result, the program was ridden with poor performance, conflicts of interest, self-dealing, and fraud.⁷⁰

⁶⁷ Economic Systems Inc., ORC Macro, and The Hay Group, *Evaluation of VA's Home Loan Guaranty Program: Final Report*, July 2004, chapter 2, pp. 1-6, available at http://www.benefits.va.gov/homeloans/documents/docs/final_report.pdf.

⁶⁸ Eyal-Cohen, "Small Business the Chief Business," p. 41.

⁶⁹ *Ibid.*, pp. 44-45.

⁷⁰ Parris, *Small Business Administration*, pp. 162-63, 191-95.

Meanwhile, FHA took on the ambitious Section 235 and 236 programs in the midst of an ill-advised reorganization. Department of Housing and Urban Development Secretary George Romney, attempting to fix what he saw as “the entire Rube Goldberg structure” of federal housing initiatives, redistributed many of FHA’s functions among HUD’s divisions. For all intents and purposes, this meant that there were no longer any FHA employees, as workers who belonged to the agency took on mission responsibilities beyond underwriting and lending. The reorganization also centralized all computer systems under the assistant secretary for administration, so officials had to make formal requests whenever they needed to increase FHA usage of the facilities.⁷¹

Operations in the neighborhoods that the FHA had been asked to serve were even more troubled. Having neglected them for decades, the FHA also lacked experience in underwriting loans in center cities. With little to guide them but a mandate to increase lending, the FHA took ill-advised risks. Its commissioner directed that FHA-approved lenders should reject applications in “only those instances where a property has so deteriorated or is subject to such hazards ... that the physical improvements are endangered or the livability of the property or the health of its occupants are seriously affected.”⁷²

Unscrupulous real estate agents took advantage. They bought up dilapidated properties, added cosmetic fixes, and then sold them for double or triple their cost. The buyers, frequently recruited by the same agents, were often poor, sometimes on public assistance, and new to homeownership. They did not anticipate the cost of maintenance and utilities, and no effort had been made to educate them about their obligations. When cracked foundations, faulty wiring, defective plumbing, and inadequate heating revealed themselves, the extra expenses exceeded their ability to pay, and they defaulted. In Detroit alone, ten thousand FHA-financed homes entered foreclosure, and by 1979, about 18 percent of Section 235 mortgages nationwide had been foreclosed or assigned.⁷³ Starting in 1973, the general insurance fund, which had been solvent in 1969, began requiring yearly infusions of about \$ 240 million from the Treasury in order to remain afloat. The Special Risk fund, despite being a much smaller program, required nearly the same amount of assistance.⁷⁴

After the passage of the Middle Income Student Assistance Act of 1978, the student loan program grew exponentially. Part of the rationale for removing income restrictions had been that the administrative cost of verifying earnings was too burdensome, but that decision had much more

⁷¹ Vandell, “FHA Restructuring Proposals,” pp. 321–24.

⁷² Letter from the Commissioner of FHA to all approved FHA mortgagees, August 2, 1968, quoted in Calvin Bradford, “Financing Home Ownership,” p. 326.

⁷³ House Committee on Banking and Currency, *Interim Report on HUD Investigation of Low- and Moderate-Income Housing Programs*, December 1970; Robert A. Van Order and Anthony M. Yezer, “FHA Assessment Report,” George Washington University School of Business, June 2011, p. 8, available at <http://business.gwu.edu/wp-content/uploads/2014/02/FHA2011Q2.pdf>.

⁷⁴ Vandell, “FHA Restructuring Proposals,” pp. 326–28.

far-reaching implications. Students could now apply for a loans without any notice or involvement by their parents.

Defaults surged a few years later. The Department of Education lacked a vigorous collection program, and borrowers took advantage. Bankruptcy laws for young adults were also fairly lenient at the time, giving borrowers another escape route. The combination of increased loans and inadequate servicing and collection practices proved to be costly. Defaults increased to nearly 15 percent of loans entering repayment in 1990, and payments out of the insurance fund hit \$ 2.4 billion, up from \$ 200 million in 1981.⁷⁵

In international markets, Ex-Im responded to increased political pressure with a stepped-up lending program. In the 1970s, it expanded its portfolio, increased the amount its risk participation in loans made in partnership with commercial banks, and reduced the interest rates it charged below its cost of borrowing funds, which was already below market due to its governmental status. In both cases, the Bank's financial performance suffered in subsequent years.⁷⁶

In the agricultural sector, a significant economic reversal was the impetus for an ill-advised episode of emergency credit. In the early 1970s, demand for farm products had soared because of government price supports and increased demand for exports. Inflation added to the sense of prosperity by raising agricultural prices and increasing the value of farmland. Farmers borrowed heavily to meet the demand.⁷⁷ Later in the decade, however, conditions in the agricultural sector reversed themselves. Interest rates soared and foreign demand for domestic agricultural products fell, leaving farmers squeezed between high costs and low prices.

In response, Congress passed the Economic Emergency Loan program. That legislation prompted the Farmers Home Administration to increase emergency lending by over \$ 3 billion between 1978 and 1982. At the same time, however, cost-cutting measures had limited the size of FmHA's staff, and the complexity of farming was increasing faster than the training of supervisors. As a result, many marginal loans were made without much oversight. Foreclosure moratoriums on FmHA loans between 1983 and 1988 and in 1993 made matters worse by depriving the agency of a significant means of enforcement.⁷⁸ Between 1989 and 1997, the Farmers Home Administration and its successor agency, the Farm Service Agency, wrote off \$ 15.2 billion in direct farm loans to more than 80,000 borrowers.⁷⁹

⁷⁵ National Commission on Student Financial Assistance, "Guaranteed Student Loans," pp. 31-32; Mettler, *Degrees of Inequality*, pp. 68-69.

⁷⁶ Becker and McClenahan, Jr., *Export-Import Bank*, pp. 142-54, 189-95.

⁷⁷ Bosworth, Carron, and Rhyne, *Economics of Federal Credit*, p. 112.

⁷⁸ Eddy L. LaDue, "Farm Lending Program Challenges for the Farm Service Agency," Cornell University Department of Agricultural, Resource, and Managerial Economics Working Paper SP 95-10, September 1995, p. 5, available at <http://studylib.net/doc/11951826/staff-paper-sp-95-10-september-1995-revised--12-95>.

⁷⁹ General Accounting Office, "Farm Service Agency: Information on Farm Loans and Losses," GAO/RCED 99-18, November 1998, p. 2.

By 1980, federal credit had grown to \$ 382.6 billion, (\$ 938 billion in 2015 dollars), which was equivalent to two-thirds of government outlays for that year.⁸⁰ Large losses at several federal credit programs served to make increasingly clear that the government’s credit portfolio was neither costless nor risk-free.

VII. CONTRACTION: THE 1980S, 1990S, AND EARLY 2000S

The 1980s and 1990s brought the rise, first in the presidency and then in Congress, of significant opposition to the continued growth and expansion of federal credit. The administrations of Ronald Reagan and George H. W. Bush, and the more conservative Congress brought in by the 1994 election, curtailed the scope of many credit programs, although none was abolished.

The FHA was not eliminated, but its scope was reduced. The Community Development Act of 1981 established targets for low-income borrowers, but increased focus failed to get the agency to right itself. The FHA had inadequate financial controls, implemented lax underwriting standards, and failed to sanction lenders with high loss rates. A series of regional recessions across the nation increased defaults.⁸¹ In 1985, the FHA’s accounting had deteriorated to such an extent that the General Accounting Office announced that it was unable to perform its statutorily mandated audit of the agency’s finances. In 1987 it hired Price Waterhouse, which also found FHA’s accounting to be inadequate, though it did find enough evidence of weakness to predict substantial losses ahead. In a subsequent audit the accounting firm found that the FHA’s reserves had dwindled from 5 percent of insurance in force to less than 1 percent.⁸²

The scandal brought legislation placing new controls on the FHA. The Housing and Urban Development Act of 1989 authorized the FHA’s Mortgagee Review Board to discipline or remove lenders that did not obey FHA rules; established the Offices of the Chief Financial Officer and FHA Comptroller; and required annual audited financial statements from the agency.⁸³ The following year, the Cranston-Gonzales National Affordable Housing Act instituted a target level of capital for the agency equal to 2.0 percent of insurance in force and mandated an overall increase in premiums. It also required higher premiums on loans with higher loan-to-value ratios. As a

⁸⁰ *Budget of the United States Government, FY 1982*, House Document, pp. M3, 18; Samuel H. Williamson, “Seven Ways to Compute the Relative Value of a U.S. Dollar Amount, 1774 to present,” *MeasuringWorth.com*, April 2016.

⁸¹ Anthony Pennington-Cross and Anthony M. Yezer, “The Federal Housing Administration in the New Millennium,” *Journal of Housing Research*, vol. 11, no. 2, 2000, p. 360; Kerry D. Vandell, “FHA Restructuring Proposals,” pp. 330–31.

⁸² Vandell, “FHA Restructuring Proposals,” pp. 330–31.

⁸³ Edward Szymanoski et al., “FHA Single-Family Insurance Program: Performing a Needed Role in the Housing Finance Market,” Department of Housing and Urban Development, Office of Policy Development and Research, *Housing Finance Working Paper*, December 2012), p. 19, available at http://www.huduser.gov/portal/publications/pdf/FHA_SingleFamilyIns.pdf.

result, FHA premiums became significantly higher than private mortgage insurers' for the first time.⁸⁴

These measures helped return the FHA to solvency in the 1990s, but they also cost it market share.⁸⁵ Technological innovation also limited its growth. In the private sector, automated underwriting systems streamlined the process of evaluating credit risk, and new pricing models enabled lenders to charge rates customized to borrowers' level of risk. Instead of rationing credit, private originators, along with Fannie Mae and Freddie Mac, began serving borrowers that were formerly the domain of the FHA.⁸⁶ Meanwhile, the FHA was slow to adapt to automated underwriting, and it resisted the use of risk-based pricing. Mortgage brokers found the agency's rules cumbersome and costly and increasingly turned toward other sources of credit. Limits on the maximum size of FHA loans did not keep pace with house price appreciation, so an increasing number of purchases were ineligible for agency loans. By 2006, the FHA's share of originations had shrunk to less than 2 percent, down from 20 percent in 1970.⁸⁷

The Farmers Home Administration contracted as well. Labeled a "high-risk agency" by the General Accounting Office, it and its successor organization, the Farm Service Agency, reduced its direct loan portfolio from \$ 23.3 billion in 1989 to \$ 9.7 billion at the end of the 1997 fiscal year. The agency also shifted toward a greater reliance on guaranteed loans.⁸⁸ Legislation establishing the Farm Service Agency restricted the extent to which borrowers who had defaulted on earlier government loans could gain new credit from the agency.

At Ex-Im, reforms weakly implemented in earlier decades began to bear fruit. Between the two oil price shocks of the 1970s, Congress had directed the Bank to pursue agreements with export credit agencies of foreign governments to jointly limit subsidies.⁸⁹ International agreements in the early 1980s led to increased minimum interest rates on aircraft loans. Furthermore, as market interest rates declined over the first half of the decade, private financing became more attractive to exporters. As a result, Ex-Im loans on aircraft decreased from more than \$ 2 billion in the 1980 and 1981 fiscal years to \$ 200 million in 1982. Ex-Im's negative interest rate spreads declined to

⁸⁴ Jaffee and Quigley, "Housing Policy, Mortgage Policy," p. 117; Szymanoski et al., "FHA Single-Family Insurance," pp. 3, 19.

⁸⁵ Pennington-Cross and Yezer, "New Millennium," p. 360.

⁸⁶ Sarah Rosen Wartell, "Single-Family Risk Sharing: An Evaluation of Its Potential as a Tool for FHA," Millennial Housing Commission, 2002, pp. 26, 38, available at <http://govinfo.library.unt.edu/mhc/papers/wartell.doc>; Snowden, "Anatomy of a Residential Mortgage Crisis," p. 30.

⁸⁷ Jaffee and Quigley, "Housing Policy, Mortgage Policy," p. 106; Snowden, "Anatomy of a Residential Mortgage Crisis," p. 30; Wartell, "Single-Family Risk Sharing," pp. 26, 38–39, 52; Szymanoski et al., "FHA Single-Family Insurance," p. 22.

⁸⁸ Testimony of John W. Harman, Director of Food and Agriculture Issues, Resources, Community, and Economic Development Division, General Accounting Office, before the House Committee on Agriculture, Subcommittee on Conservation, Credit, and Rural Development, January 25, 1990, available at <http://www.gao.gov/assets/110/102964.pdf>.

⁸⁹ Becker and McClenahan, Jr., *Export-Import Bank*, pp. 171–72.

an average of less than 1 percent, and by 1985, about 80 percent of export credit agencies' subsidies had been eliminated.⁹⁰

A particularly colorful campaign was waged against the Small Business Administration. David Stockman, the Reagan Administration's director of the Office of Management and Budget, told the Senate Small Business Committee that the agency "conducts a \$ 3 [billion] to \$ 4 billion annual lending program which indiscriminately sprays a faint mist of subsidized credit into the weakest and most prosaic nooks and crannies of the nation's \$ 4 trillion economy. In the process, it serves almost no rigorously defined public policy purpose." The Reagan Administration proposed ending the whole agency, but although the SBA's budget was cut that year, the agency was not eliminated.⁹¹

Student loan programs were a notable exception to the trend toward contraction or slower growth of federal credit programs in the 1980s and 1990s. With budget deficits growing, it became difficult to win agreement in Congress on increases in grants that could keep pace with rapidly rising college tuitions. Expanding student loans seemed like a low-cost way of filling this gap. While grants dwindled in real terms, Congress increased borrowing limits and established unsubsidized loan programs for students with no demonstrated financial need.⁹²

Subsidies for lenders, however, did decrease. Congressional investigations in the 1990s and 2000s revealed that guarantees on student loans had paid off handsomely for lenders, administrators, and schools but had not delivered corresponding benefits for students. Beginning in 1993, the Department of Education implemented a direct loan program, which has since become the sole source of student loan funding.⁹³

VIII. CONCLUSION

With the onset of a severe housing collapse in 2007 and the failure of Lehman Brothers in 2008, the U.S. economy experienced the worst financial crisis since the Great Depression. Private-sector lending plummeted, going from \$ 24 trillion in the second quarter of 2008 to \$ 21 trillion in the fourth quarter of 2010.⁹⁴ As in the Great Depression, federal credit became an important policy tool for reversing financial contraction and reviving the economy. In 2008, the combined share of FHA and VA mortgage guarantees surged from less than 3 percent of the market to more than 20

⁹⁰ Ibid., pp. 204-07.

⁹¹ "Congress Staves Off Reagan Plan to Ax the Small Business Administration," *CQ Almanac*, 1985, p. 412.

⁹² Mettler, *Degrees of Inequality*, pp. 67-68.

⁹³ Ibid., pp. 68-69; Fuller, "History of Financial Aid to Students," p. 21. The shift has not been linear. In 1998, for instance, Congress increased subsidies for lenders after the Consumer Bankers Association threatened its members would stop lending under the current formula. See Mettler, *Degrees of Inequality*, pp. 76-77.

⁹⁴ Board of Governors of the Federal Reserve System (US), All Sectors; Total Loans; Liability [ASTLL], retrieved from FRED, Federal Reserve Bank of St. Louis; available at <https://fred.stlouisfed.org/series/ASTLL>, October 14, 2016

percent of total mortgage originations.⁹⁵ Federal student loans crested above a trillion dollars. In the past eight years, overall federal credit has increased from \$ 1.7 trillion to \$ 3.4 trillion.

Since then, some programs have experienced a reckoning. The FHA, for instance, has had to draw funds from the Treasury to cover losses. The government continues to play a dominant role in mortgage markets. Meanwhile, borrowers have begun to struggle to with their student loans, which has prompted Congress and the Obama Administration to add to the menu of income-based repayment plans. These modifications are expected to generate significant losses in future years.

These developments fit a pattern that has played out over the past century. Credit programs serve vital roles in responding to emergencies but fail to recede after the crises pass. The temptation then arises to expand the programs to achieve new policy goals, leading to credit losses. Reconsideration and retrenchment follow.

What happens next remains to be seen. Will federal credit programs continue to expand, contract, or shift to a steady state? Already programs are instituting reforms, as described in the main report. Will these reforms gain support from Congress, the president, Treasury, and the Office of Management and Budget? An opportunity is presenting itself to write a new history of federal credit programs. Will policymakers take advantage of it?

⁹⁵ Jaffee and Quigley, "Housing Policy, Mortgage Policy," p. 106.

CREDIT PROGRAMS AND THE FEDERAL BUDGET PROCESS

Alan B. Rhinesmith

I. INTRODUCTION

A critical element in explaining the major characteristics of current federal credit programs and the course of their development in recent decades has been their treatment in the federal budget. This chapter reviews that evolution and discusses several ongoing issues in that treatment.

Credit support is only one of several tools the federal government can employ to accomplish public policy objectives. Direct government spending to provide a service or extend grants, subsidies or assistance payments is perhaps the most straightforward policy tool the government has. The government can also use its power to tax and regulate economic transactions to support particular policy objections or favor certain sectors of the economy. Credit is yet another policy instrument in the government's tool kit. Extending or guaranteeing loans is an especially enticing but complicated tool to use. In particular, it can be difficult to measure and account for the resources expended by the government in supporting credit transactions. Direct loans can be made for various terms and at a range of interest rates. Guarantees entail some possibility of loss of principal and interest but projections of the expected amounts of potential losses depend upon a number of risk factors. Such complexities make credit an inherently challenging policy instrument both to measure and control in the federal budget process.

A key consideration in the choice of policy instruments is how each approach is treated (or not) in the federal budget. The competition for government resources has only intensified in recent years as spending on entitlement programs such as Medicare and Social Security continues to increase at rates in excess of the growth of the overall economy and federal revenues.¹ In such a budget environment programs that can provide large amounts of financial assistance at seemingly low cost to the federal budget become especially attractive. Credit programs can often appear uniquely suited to fill this "niche". But this is not actually a recent development. Rather, as we will see, credit programs have been used to support government policy objectives while frequently evading budget discipline and financial controls since they first began to be used as instruments of government policy in the early Twentieth Century. Yet as the main Report suggests, failure to

¹ See Congressional Budget Office, "The 2017 Long-Term Budget Outlook," March 2017, p. iii ("In CBO's projections, deficits rise over the next three decades—from 2.9 percent of GDP in 2017 to 9.8 percent in 2047—because spending growth is projected to outpace growth in revenues. ... In particular, spending as a share of GDP increases for Social Security, the major health care programs (primarily Medicare), and interest on the government's debt").

restrain the growth of federal credit may ultimately do real damage to borrowers and impose excessive costs on taxpayers in the long run -- a situation which may be arising today.

The use of credit as a tool to achieve public policy objectives is further complicated by the multiple dimensions of the federal government's relationship with the financial markets. The federal government has a very important role in regulating the banks and other financial institutions on which all economic actors – individuals, private firms and governments – must rely for credit. As demonstrated in the financial crisis of 2008-09, the federal government has periodically found it necessary to intervene in financial markets to ensure their stability and prevent collapses that would produce severe contractions in the overall economy. The federal government is also a large borrower in the financial markets, conducting regular auctions of Treasury securities to finance its own operations. At the same time, the Federal Reserve System conducts monetary policy through the purchase and sale of federal debt instruments. Given multiple reasons for federal involvement in the credit markets, there is ongoing potential for different government agencies and programs to operate at cross purposes in their interactions with the financial system. This, in turn, underscores the need for a budget process that is transparent and accountable to policymakers as they seek to use credit to support certain economic sectors while at the same time assuring the stability of the banking system and the broader economy.

All of these factors argue for some caution in the use of credit as an instrument of public policy. Nevertheless, as we have seen, the U.S. government has undertaken numerous programs that rely on government supported credit transactions to accomplish their objectives, making their budget treatment an especially important consideration.

II. HISTORY/OVERVIEW

A. INITIAL BUDGET TREATMENT OF CREDIT INITIATIVES

A formal, centralized and structured federal budget process in the Executive Branch traces its origins to the post World War I era. Prior to that time control of federal spending was mainly exercised by the Congress, which received “estimates” of Executive Branch spending needs directly from the agencies themselves.² The Treasury Department oversaw the process only to assure that the agencies’ spending was governed by congressional appropriations, the obligations incurred by the agencies were paid and accounting records were kept. While this system worked sufficiently well throughout the Nineteenth Century, its inadequacies became apparent early in the Twentieth Century as customs revenues declined, a constitutional amendment authorizing a federal income tax was ratified and federal expenditures grew in conjunction with a rapidly growing and

² See Frederick C. Mosher, *A Tale of Two Agencies*, Louisiana University Press, 1984: “[T]he heads of the departments and agencies by and large were no better staffed or inclined to review and modify the estimates of their constituent bureaus than was the president. Most of the estimates in the nineteenth and early twentieth centuries were products of the bureaus, untarnished by secretarial, presidential, or Treasury review. They might as well have gone directly from the bureaus to the congressional committees; in fact, many of them did.”

urbanizing America. Recommendations for a national budget for the Executive Branch were first initiated during the administration of President Taft. Although President Wilson did not share Taft's enthusiasm for budget reform, the surge in federal spending and debt during World War I made clear the need for improvements in the financial administration of the federal government.³ Congress finally acted with passage of the Budget and Accounting Act of 1921, creating a federal executive budget process, the Bureau of the Budget in Treasury, and an independent General Accounting Office.

During the same period as the government was adopting a more systematic national budget process (that is, the early twentieth century), and as discussed in the separate chapter on the history of federal credit programs, the federal government began to use credit to assist certain borrowers and sectors of the rapidly growing U.S. economy. The budget treatment of these government credit support initiatives has also been an ongoing source of complication and even contention in the federal budget process since that time.

The War Finance Corporation (WFC) is an early example of a recurring tension in the federal government's use of credit as an instrument of public policy. In the era of the First World War and its aftermath, the federal government channeled its support for credit to particular sectors of the economy through the banking system, as well as making direct loans to America's allies. During the War, Congress established the War Finance Corporation (WFC) – initially funded with \$ 500 million from the Treasury – to make loans to banks.⁴ These loans were collateralized by the banks' loans to firms (utilities, mining and chemical companies, railroads) vital to the war effort. Although it preceded the adoption of a more formal budget process, this arrangement allowed Congress to provide credit to certain industries without making direct appropriations.⁵ Congress also avoided putting such federal credit support efforts in direct competition with the banking sector.

Hence, the attraction of using credit to support public purposes without a full accounting in the government's financial processes got an important toehold with the precedents established by the WFC. Indeed the issue of the status of the WFC relative to the government's financial accounts arose in a Supreme Court decision in 1927 that confirmed that the WFC's transactions were not

³ Mosher, *Tale of Two Agencies*, p. 25 (“But the war, with its tremendous expenditures and debt, magnified the enthusiasm among the public and particularly in the Congress for any measures that promised reduction of alleged governmental extravagance and taxes, and this was exactly what the supporters of a budget system offered”).

⁴ More technically, the WFC operated essentially as a revolving fund. See Woodbury Willoughby, *The Capital Issues Committee and the War Finance Corporation*, The Johns Hopkins Press, 193, p. 55 (“The funds with which, the corporation conducted its operations were, in the first place, derived from the subscriptions of the Treasury to the capital stock which was called in installments when and in the amounts needed up to \$500,000,000. Capital obtained in this way was used as a revolving fund from which to make advances and purchase government obligations”).

⁵ See James L. Butkiewicz and Mihaela Solcan, “The Original Operation Twist: The War Finance Corporation's War Bond Purchases, 1918–1920,” *Financial History Review*, vol. 23, no. 1, p. 23 (“In conjunction with the war financing provision, the WFC was also authorized to trade and deal in federal debt securities. The WFC was created as an off-budget agency”).

included in the government's books.⁶ After the war, ongoing concern about boosting exports and the depressed prices of U.S. farmland prompted the Congress to continue the operations of that organization. As the WFC was wound down beginning in 1924, Congress continued credit support for agriculture through the creation of the Farm Intermediate Credit Bank system.⁷ It was not surprising that agriculture was perhaps the first instance of a federal credit program to serve a particular sector of the economy. As historian James Olsen observes, "The success of the War Finance Corporation during World War I had built the public faith in federal credit operations and during the 1920s the government had moved into the agricultural credit markets when the farm depression all but destroyed thousands of rural banks."⁸

In the 1930's, the federal government's efforts to counteract the impacts of the Great Depression led to the creation of a large array of new government credit support programs, particularly for housing and farm lending. Key to this development was the creation in 1932 of the Reconstruction Finance Corporation, an independent wholly owned government corporation modeled on the WFC and financed by its own debt issuances. During the Hoover Administration, the RFC was initially focused upon making loans to banks that the Federal Reserve had resisted making. The Roosevelt Administration greatly expanded the role of the RFC, using it to finance public works projects and to provide initial funding for a number of new federal financing agencies, including the Farm Credit Administration, the Federal Farm Mortgage Corporation, the Rural Electrification Administration, the Federal Home Loan Bank system, the Home Owners Loan Corporation and the Federal Housing Administration. In short, as financial historian James Olson explains "[t]he Reconstruction Finance Corporation was the capital bank for the New Deal."⁹

The budget treatment of the RFC was a critical reason for Roosevelt Administration's heavy reliance upon it to finance its New Deal programs. Olson quotes longtime Federal Reserve Board secretary Chester Morrill to make this point very aptly:

[I]t became apparent almost immediately, to many Congressmen and Senators, that here was a device which would enable them to provide for activities that they favored for which government funds would be required, but without any apparent increase in appropriations, and without passing an appropriations bill of any kind to accomplish its purposes. After they had done that, there need be no more

⁶ *United States ex rel. Skinner & Eddy Corporation v. McCarl, Comptroller General*, 275 U.S.1, 48 S.Ct. 12, 72 L. Ed. 131, decided Oct. 10, 1927 ("Indeed, an important, if not the chief, reason for employing these incorporated agencies was to enable them to employ commercial methods and to conduct their operations with a freedom supposed to be inconsistent with accountability to the treasury under its established procedure of audit and control over the financial transactions of the United States").

⁷ Although the establishment of Federal Intermediate Credit Banks in 1923 represented a major step in the provision of operating capital loans for farmers, this was not the first congressional action to provide credit to the agricultural sector. The Federal Farm Loan Act had provided for the creation of the federally supported Land Banks in 1916. See Hoag, W. Gifford, *The Farm Credit System: A History of Financial Self-Help*, The Interstate, 1976, p. 1.

⁸ Olson, James S., *Saving Capitalism* (Princeton: Princeton University Press, 1988), pg. 86.

⁹ *Ibid.*, p. 44.

appropriations and its activities could be enlarged indefinitely, as they were almost to fantastic proportions.¹⁰

The transactions of the RFC in support of housing, agriculture and other credit programs were disclosed in the RFC's own separate budget schedule ("supporting statements") and not considered to be financed through congressional appropriations or funds "payable from the Treasury." In effect, this meant that the RFC's transactions were not included in the main budget presentation or counted as part of government spending totals. Once they were stood up, the major credit programs (e.g., Farm Credit, HOLC, FHA) initiated under the RFC became self-financing out of premiums and other receipts, meaning again that their credit transactions typically had no effect upon the main administrative budget for the overall federal government.

The RFC was terminated in 1957 and, as we have seen in the history of credit programs chapter, there were only a few new credit programs initiated in the decades after the New Deal era. There was, during that period, some consolidation of credit programs into the main (administrative) budget in which government total expenditures were tabulated. Yet proponents of credit programs were also able to come up with new practices to avoid adding to total federal expenditures and the federal deficit.

One particular device was to sell loans. The federal budget was at the time and remains today measured and recorded largely in terms of the cash flows of the government's component entities.¹¹ Hence credit transactions were factored into the budget totals only as loans were disbursed, repayments and interest was received and payments on guaranteed loans that defaulted were made. Loans were held on the government's books as assets and if they were sold, the entire amount of the proceeds of such sales were reflected on the government's books as receipts that served to offset other government outlays. Hence, loan asset sales could be used to minimize the overall impact of a credit program on total government expenditures. Because the government was typically obligated to make up any losses or defaults on such loans even after they had been sold to private parties, the practice of selling loan assets was frequently cited as an abuse of the cash flow budget as a true measure of the financial impact of credit programs upon federal taxpayers.¹²

Even more contentious was the practice of selling "participations," or shares, in pools of loans and having the receipts thus produced counted as an offset to expenditures. Here again, delinquencies or defaults on loans in the pool that backed the participation certificates did not expose the buyer

¹⁰ Ibid., p. 43.

¹¹ As discussed later in this paper, with the passage of the Federal Credit Reform Act of 1990, federal credit programs were put on an accrual accounting basis and became the major exception to government's practice of budgeting on a cash basis.

¹² The 1967 Budget Concepts Commission (discussed below) noted, after discussing the growth in loan participation certifications then occurring, that "anyone looking at recent budget presentations could have been left with an erroneous impression as to the extent of increase in direct loans outstanding." See Report of the President's Commission on Budget Concepts, GPO, 1967, p. 54.

of the participation certificate to losses. Hence, critics of this practice argued strenuously that such sales were, in fact, merely an inferior form of federal borrowing (compared to Treasury debt) that should not be recorded as producing receipts to the relevant agency's credit program nor to the federal budget totals.

In the mid-1960's, the Johnson Administration compounded the loan sales problem. The Federal National Mortgage Association (FNMA) had been created in 1938 as a wholly owned government corporation by the RFC to assist the nascent FHA by buying mortgages that FHA had insured.¹³ At the time, FNMA's transactions were treated in a separate trust funds accounting tabulation and not in the main budget.

Seeking to decrease the recorded deficit and reduce pressure for a tax increase to finance its Viet Nam War and Great Society ("guns and butter") efforts, the Johnson turned to FNMA to conduct an aggressive program of loan participation sales. FNMA created pools of loans not only of its own mortgages but also of loans originated by numerous other credit programs ranging from Farmers Home to Education to SBA. The 1968 Budget projected receipts of \$ 4 billion and \$ 5 billion in 1967 and 1968, respectively, produced from such sales. This ploy served to reduce the deficit when the administrative and trust fund budgets were combined. But the result was heightened scrutiny of the budget from members of Congress, the press and other critics of the Johnson Administration's conduct of the war in Viet Nam and its Great Society initiatives concerning whether certain practices such as loan sales were serving to disguise the real fiscal situation of the federal government

B. CREDIT PROGRAMS AND THE 1967 BUDGET REFORMS

The 1968 Budget, released in January 1967, acknowledged ongoing confusion and controversy in the way the federal government was tabulating and presenting its budget transactions. In his budget statement President Johnson announced his intention "to seek advice on this subject from a bipartisan group of informed individuals with a background in budgetary matters" and in March he appointed a Commission on Budget Concepts. The budget treatment of housing and other loan sales transactions had effectively precipitated a larger set of questions about whether the federal budget was accurately measuring the resources being used by the government and presenting budget transactions fairly and clearly to the public.

As we have seen, in the early Twentieth Century when federal credit programs began operations they were largely kept out of the main or administrative budget. By 1967 most credit programs had been moved "on budget" and included in the \$ 135 billion administrative budget, but another \$ 45 billion in spending continued to be tracked in a separate trust fund budget. The latter included FNMA. When the 1967 Budget Concepts Commission issued its report in October,¹⁴ it

¹³ In 1944, Congress created a separate mortgage insurance program for Veterans in the Serviceman's Readjustment Act and FNMA's charter was expanded to include authority to purchase these mortgages as well.

¹⁴ Budget Concepts Commission, p. 54.

recommended that that practice be terminated and the trust fund agencies be included in a single or “unified” federal budget.

The Johnson Administration accepted most of the Commission’s recommendations. It agreed that loan participation sales should be treated as a means of financing, similar to Treasury borrowing, and not as an offset to spending. It also agreed to create a single or unified federal budget, effectively consolidating into one budget (and one bottom line total) many of the accounts, such as that for FNMA, that were included in the separate trust funds budget. But the Johnson Administration sought to avoid adding FNMA’s \$ 2.5 billion in spending to the federal budget totals.¹⁵ While not directly opining on the treatment of FNMA at that time, the Commission did address the status of two similar federal lending organizations supported by the RFC: the federal land banks and the federal home loan banks. Because they had evolved to be 100 percent privately owned, the Commission recommended that these “government sponsored enterprises,” as they were now called, be excluded from the budget. Thus, the Johnson Administration soon recommended and Congress subsequently passed legislation to transform FNMA (“Fannie Mae”) into a similar privately owned stock corporation – a GSE – while retaining several key attributes of a federal agency.

The status of a credit agency as a GSE subsequently became a favored vehicle for federal policymakers to provide credit support to certain economic sectors – particularly housing, education and agriculture – while avoiding acknowledging any taxpayer exposure in the budget. Additional GSE’s to support housing (FHLMC or “Freddie Mac”), education (SLMA or “Sallie Mae”), agriculture (FAMC or “Farmer Mac”) and others were created in the years that followed. More recently the federal taxpayers have had to come to the rescue of these enterprises. The Farm Credit System was rescued in 1987 and the rescue of Fannie Mae and Freddie Mac in 2008 required \$ 187.5 billion in Treasury outlays.

The 1967 Budget Concepts Commission paid considerable attention to the budget treatment of federal lending activities. The scope of its recommendations extended well beyond addressing the budget treatment of sales of loan participation agreements and the status of government sponsored enterprises. The Commission’s recommendations were made in the context of maintaining, with a few exceptions, a unified cash expenditure budget.¹⁶ One such exception was the proposal to transition credit programs (and others) to an accrual basis. As discussed below, that recommendation took years to implement.

¹⁵ Removing FNMA’s transactions from the federal budget also meant that its debt did not count as part of total federal debt outstanding. See Raghuram G. Rajan, *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, Princeton University Press, 2010, p. 33

¹⁶ There was considerable confusion at the time about what particular tabulation or concept was meant by reference to “the federal budget.” The Commission recommended a single unified budget concept be adopted and that the “terms *administrative budget*, *consolidated cash budget*, and *national income accounts budget* should all disappear” (Budget Concepts Commission, p. 14).

In the meantime, direct loan, loan guarantee and insurance programs were to remain on a cash basis. Hence, direct loans produced immediate outlays and thereby increased the federal deficit in the short run. There was no recognition of the probability of ultimate repayment and therefore future budget inflows in the years after the direct loan was disbursed (except, of course, to the extent of actual loan repayments occurring immediately in the budget year). Rather, the budget reflected such offsetting or “negative” cash flows only over the longer term as loans were repaid with interest. Loan guarantees had the opposite effect, with initial receipts produced by fees imposed on guarantee transactions serving to reduce spending at the time of loan origination and outlays (and deficit increases) occurring only over the longer term as claims on defaulted loans were paid. There was no requirement to set aside and include in the budget outflows any funding for a contingent reserve to cover loan guarantee claims. Thus, in terms of minimizing federal spending and deficits, budgeting on the basis of cash flows favored loan guarantee programs.

The Commission noted at the time of its report that with respect to government guaranteed and insured loans there was “an increasing trend toward providing such incentives to private credit, instead of making direct loans, to further public programs.”¹⁷ The Commission further acknowledged that “inclusion of direct loans in the budget, particularly with separate identification and emphasis, may operate toward further expansion of guaranteed and insured loans not warranted by program considerations.”¹⁸

The Commission’s concern about potential rapid growth in federal loan guarantee programs proved to be well founded. Once again the treatment of federal programs in the budget was a key factor in substantive government credit policy decisions. As guaranteed lending for housing (including FHA insurance), education, small business, rural development and other purposes continued to grow, concerns arose in the Congress and the Treasury Department about whether the federal government involvement in the credit markets was at working at cross purposes. Treasury was borrowing by conducting auctions of various debt instruments (for example, notes and bonds) while other agency borrowers were also in the same market – sometimes on the same day – selling securities that also had full or partial backing of the U.S. Government. This led to concerns that the resulting competition for funds was undermining optimal pricing of all these debt instruments.

A further problem arose from the fact that the Budget Concepts Commission had not shut the door completely to loan asset sales, allowing sales of individual loans, even with a federal guarantee, to be scored as a budget receipts. Congressional appropriations committees also eroded the rules precluding sales of loan pools, particularly for agriculture related loans.

The Treasury Department attempted to solve these problems with the creation in 1973 of the Federal Financing Bank as a separate office in the Department. This organization was authorized to buy the guaranteed debt of other federal agency programs, thereby converting guaranteed loans into direct lending. The FFB was also authorized to buy direct loans made by other agencies.

¹⁷ Ibid., p. 21

¹⁸ Ibid., p. 49

Proponents of the creation of the FFB believed it would be able to coordinate and consolidate federally sponsored transactions in the financial markets. But in creating the FFB Congress directed that it be treated as an “off budget” entity. This meant that its outlays to purchase direct and guaranteed loans were not included in the budget totals. Consequently, what some observers had viewed as an attempt to mitigate the adverse impacts of the growth in federal loan guarantees became a large federal direct loan program outside the federal budget. Once again the tension between controlling and expanding federal credit had played out in favor of supporting significant credit program growth outside the discipline of the federal budget process.

The Budget Concepts Commission had recommended that federal direct lending be broken out separately and clearly identified within the unified federal budget. In the 1980’s the Office of Management and Budget took further steps to measure and control the continuing growth of federal credit by creating a separate “credit budget.” The President’s budgets began to propose, and the congressional authorizing committee enacted, statutory language within appropriations bills setting annual limits or ceilings on the totals amount of direct loans and guarantees any specific programs could undertake. Such limitations continue to be enacted annually for most discretionary direct loan and loan guarantee programs. Significantly, entitlement programs such as education loans were not made subject to such limitations. Moreover, the limitations were routinely set at levels that did not bind the agencies and they have had virtually no effect on federal outlays or the deficit.

C. THE FCRA ERA

As noted above, the 1967 Budget Concepts Commission called for federal direct loans to be included in the unified budget totals. It also called for the federal government to take an additional very significant step: it recommended that the (main) expenditure budget include only the “subsidy value” of the loan transactions “since such subsidies are much more like grants than loans” and that a tabulation totaling all direct lending on an unsubsidized basis be separately published. Furthermore, the Commission recommended that the subsidy values be calculated on a capitalized basis.¹⁹ The Commission recognized that this would be a complicated undertaking but suggested that it might be possible to present the budget with separate capitalized (accrual) subsidy amounts for direct loan in the 1970 Budget.

In fact, federal budget officials and staffs struggled with this recommendation for 23 years, working on many of the technical details as to how this step might actually be implemented. Finally, in the budget summit agreement between Congress and the George H.W. Bush

¹⁹ Ibid., p. 47. A positive subsidy in a loan transaction can be conveyed in numerous ways, such as reducing the loan principal amount that must be repaid, charging the borrower a lower interest rate than the lender’s cost of financing, or forgiving some portion of the principal and/or interest due over some period of time. “Capitalization” is the process of calculating a single lump sum value for such subsidies and involves taking the discounted present value of all these subsidy provisions. Discounted present values reflect the time value of money, i.e., a dollar today is worth more than a dollar received at some point in the future; the higher the discount (interest) rate used in this process, the lower will be the present value amount that results.

Administration in the fall of 1990 a budget “credit reform” proposal was adopted and legislation coming out of that agreement included the “Federal Credit Reform Act of 1990” (FCRA). Credit programs were first presented in the budget on a credit reform basis in the 1992 Budget transmitted to Congress in January 1991.

Putting programs on a capitalized or accrual basis for budgeting purposes was a major departure from the cash flow measures used for most of the federal budget. It required that the full amount of the subsidy involved in any direct or guaranteed loan be calculated and accrued upfront and then carefully tracked in the financial accounting systems of the agency beginning at the time the credit transaction is undertaken. Projections of annual cash flows over the life of the relevant loan must be discounted by an appropriate interest rate. Such projections were especially sensitive to the choice of interest rate used in the calculation. The process therefore caused considerable controversy with the stakeholders involved in each federal credit program. It was also complicated by the need to reconcile the subsidy measurement calculation to be used in the official budget with the actual cash flows as they occur with respect to any given federally supported credit transaction.

The move to require that federal agencies develop and execute the budgets for virtually all federal direct loan and loan guarantee programs on a credit reform basis has had a profound impact.²⁰ One important result of the adoption of credit reform has been the way that it has enabled the Congress and the cognizant agencies to minimize the budget impact of many of these credit programs by encouraging actions to reduce defaults and raise fees, thereby lowering their credit subsidy calculation. Indeed, for the two largest programs, FHA and student loans, the subsidy calculations have been negative for a number of years, meaning that they are currently scored in the budget as net money makers for the government. This has made these programs attractive offsets for other federal spending. FHA has routinely been used to reduce the federal deficit impact of HUD spending. And when the federal student loan program was revised from a guaranteed lending to a direct loan program, the projected present value of the savings produced served as a \$ 19 billion offset to the initial costs of implementing the Affordable Care Act when it passed Congress in 2010.²¹

III. ISSUES

The 1990 credit reform legislation introduced major improvements in the way in which federal credit programs are measured and recorded in the federal budget. It represents a significant milestone in the history of the federal government’s use of credit as a tool for program delivery. It continues to be refined by the Office of Management and Budget, the Treasury Department and the credit program agencies in terms of the sophistication of the methodologies employed to develop subsidy estimates. In many cases it has caused agencies to significantly improve their

²⁰ As noted later in this chapter, at the time of passage of the FCRA the Congress considered but ultimately declined to include federal insurance programs under the requirements of that Act.

²¹ See letter from CBO Director Douglas Elmendorf to House Speaker Nancy Pelosi, March 20, 2010, available at <https://www.cbo.gov/sites/default/files/111th-congress-2009-2010/costestimate/amendreconprop.pdf>.

accounting systems and program performance data collection and analysis. But credit reform did not eliminate certain underlying problems in the accounting and budget treatment of credit programs and it did, at the same time, introduce several new and ongoing controversies.

A. ACCURACY OF ESTIMATES

Credit subsidy estimates rely upon projections of the cash flow inflows and outflows of each year's cohort of direct loans or loan guarantees.²² This in turn requires accurate data and accounting records in order to track the performance of the individual loans and aggregate such data in a consistent and readily accessible manner. Cash flow projections must reflect not only contractual loan disbursements and collections but also incorporate such factors as prepayments, delinquencies and defaults. To make such projections agencies can choose several methodologies.

Simpler projections involve estimating loan performance based upon recent experience. More sophisticated projections involve adjusting past experience for changes in the conditions of the overall economy, the path of economic growth and employment and changes in interest rates. Loan recipients may be categorized in segments with similar performance characteristics. Still more complex projections can be made using econometric models that incorporate additional variables such as fluctuations in the collateral backing housing or business loans or the prospects for employment of student loan recipients or homeowners. Cash flow projections also need to incorporate any loan sales the agency anticipates undertaking as well as collections from disposition of collateral acquired on defaulted loans.

The cash flow projection process is also affected by the size and composition of a programs' loan portfolio. Programs with many loans, such a mortgages or student loans, produce a rich trove of data on which to model cash flows. Other programs that provide credit using only a few very large heterogeneous loans made only periodically, such as Maritime Guaranteed Loan (Title XI) ship construction loans or the Department of Energy's Title XVII Innovative Technology Loan Guarantee Program for renewable, nuclear and other large-scale energy projects, face difficult and perhaps greater challenges in developing a basis for estimating expected cash flows.

Initial subsidy estimates recorded in the budget must be reevaluated each year through a comprehensive re-estimation process for each outstanding cohort of loans. Re-estimates are separately computed for the impacts of interest rate changes and technical factors such as default rates actually experienced relative to those initially projected. Downward re-estimates – meaning that the subsidy for a particular cohort was overestimated -- do not present a problem in terms of necessitating new appropriations or financing resources. For the opposite situation, Congress recognized the need for some resource to finance instances in which the initial estimates are too low and additional appropriations or “obligational authority” is needed to keep any one year's cohort of loans fully paid for in the budget over the lifecycle of the loan. The solution was to

²² “*Cohort* refers to the fiscal year of obligation for direct loan obligations, or loan guarantee commitments of a program” (Office of Management and Budget, Circular A-11, 2016, Section 185 – Federal Credit, p. 6).

provide the agencies with permanent indefinite appropriations, in effect a financing resource that is automatically available to cover such situations without further action by the Congress.

The continuing use of permanent indefinite authority to cover underestimates of the lifetime subsidy requirements of individual loan cohorts raises the potential for a systematic bias in the initial credit subsidy calculation. That is, agencies may have an incentive to “low ball” their initial program cost subsidy estimate knowing that additional subsidy authority beyond what Congress appropriated for that year is available without cost in the course of the re-estimating process.

In practice both OMB and the Government Accountability Office (GAO) have found that, on average, there has not been such a bias in subsidy estimates, at least not so far. OMB reported in the FY 2015 Budget, released in March 2014, that for the 21 years that credit reform has been in place, net lifetime subsidy re-estimates for direct loans and guarantees have totaled \$ 17 billion upwards, meaning credit subsidies had been underestimated by that amount.²³ This represented less than one percent of the combined total (face value) of the loans and guarantees made over that period.²⁴

More recently, the GAO undertook an analysis of credit subsidy re-estimates for loan cohorts originated in fiscal years 2001 through 2014.²⁵ Their overall finding was that for this 14 year period total direct loan and guaranteed loan subsidies had been underestimated by \$ 3.1 billion and \$ 39 billion, respectively. These underestimates likewise represent less than one percent of the total amounts of loans disbursed or guaranteed over the period.²⁶ GAO’s analysis provides some interesting patterns among individual programs, however.

For direct loan re-estimates, the Department of Education’s Direct Student Loan Program was the source of \$ 15.4 billion in upward subsidy re-estimates during the 2001-2014 period; the education related loan category (including education loans made by the Department of Veterans Affairs) also experienced the widest fluctuations in re-estimates during that period. These underestimates were largely the result of changes in interest rates between the time of initial loan obligation and subsequent actual disbursements and repayments. Direct student loan subsidy estimates were also underestimated because of the impact of greater borrower use of income driven repayment plans, public service loan forgiveness initiatives and rising borrower defaults.

Offsetting the impact of the underestimates for direct student loan subsidies was an extraordinary initiative of the Treasury Department to purchase \$ 226 billion in mortgage-backed securities (MBS) as part of the federal government’s efforts to counteract the adverse impact of the 2008-09

²³ *Budget of the US Government, FY 2015, Analytical Perspectives*, p. 338

²⁴ *Ibid.*

²⁵ Government Accountability Office, *Credit Reform: Current Method to Estimate Credit Subsidy Costs Is More Appropriate for Budget Estimates Than a Fair Value Approach*, GAO-16-41, January 2016.

²⁶ *Ibid.*

financial crisis.²⁷ Treasury’s MBS direct loan program ran from September 2008 through December 2009 but, because of its scale, interest rate changes occurring over the period it operated served to produce \$ 12 billion in “profits” for the federal budget.²⁸ This major subsidy downward re-estimate was really an anomaly, however, as highlighted by the fact that the Federal Reserve System also conducted a program of mortgage-backed securities purchases during roughly the same time. However, the Federal Reserve is administratively excluded from the federal budget and, consequently, the impact of a similar favorable interest rate adjustment upon its \$ 1.25 trillion MBS purchase program is not reflected in credit subsidy estimates or re-estimates in the federal budget.²⁹ Had the one-time impact of Treasury’s MBS purchase program been excluded from the budget totals – as the Federal Reserve’s program was excluded – the overall perspective on the accuracy of federal direct loan program credit subsidy estimates during the 2001-2014 period would have changed. In particular, the over \$ 15 billion underestimate of the Direct Student Loan Program credit subsidies during the period stands out as perhaps a more serious concern when its budget impact is not offset by the one-time Treasury financial recovery program.

As for loan guaranteed re-estimates, the Department of Housing and Urban Development’s FHA Mutual Mortgage Insurance Fund was the largest source of underestimates during the period analyzed by the GAO. The MMI loan guarantee program incurred a string of losses for the period 2008-2012 as FHA’s mortgage loan guarantee program was hit by impact of the collapse in housing prices and the resulting spike in mortgage defaults during the financial crisis. Credit subsidies for the full period studied (2001-2014) were underestimated by \$ 75.3 billion. A large swing in the other direction for the Department of Education’s Federal Family Education Loan (FFEL) program served to offset this figure and helped reduce total upward re-estimates for the federal government as a whole to the \$ 39 billion amount mentioned above. Disaggregation of the GAO’s findings suggests that the main housing and education loan programs of the federal government need to be monitored carefully in terms of the accuracy of their credit subsidy estimates.

The FFEL program was terminated as of July 1, 2010, although there are still over \$ 250 billion in FFEL loans being serviced. Further, a more recent GAO report on the income-driven repayment segment of the direct student loan program found that subsidy estimates for loans originated in 2009 through 2016 had more than doubled. Hence, given the recent experience with credit subsidy re-estimates of the Department of Education’s loan programs and the fact that rapid program growth is occurring in those programs with a recent track record of underestimating program costs, there may be reason to be concerned about whether the budget is accurately reflecting their cost to taxpayers.

In terms of overall government-wide totals, credit program subsidy estimates made by Executive Branch agencies appear to have been fairly accurate in aggregate terms. There is no evidence to

²⁷ *Budget of the US Government, FY 2013, Appendix*, p. 1080.

²⁸ Department of the Treasury, “The Financial Crisis Five Years Later,” September 2013, p. 22.

²⁹ *Budget of the US Government, FY 2014, Analytical Perspectives*, p. 28.

support assertions that agencies may be able to “game the system” because underestimates do not come at a meaningful cost to program beneficiaries and agency budgets. Nevertheless, it may still be worth considering revisions to the process that would limit access to such financing. As noted above, the re-estimate process already distinguishes between interest rate changes and other, technical sources of re-estimates. To give agencies further incentive to improve the accuracy of their estimates policymakers could consider requiring that some share of the cost of technical re-estimates be paid out of new program origination appropriations. But while such a practice could encourage many credit agencies to continue to sharpen the estimating skills of discretionary program agencies, it would not be effective in the case of entitlement programs such as student loans.

B. ADMINISTRATIVE EXPENSES

With the enactment of FCRA, Congress and the George H.W. Bush Administration put into effect the 1967 Budget Concepts Commission recommendation to treat credit programs in the budget on an accrual basis. In specifying what costs were to be included in the subsidy calculation, however, FCRA, excluded the cost of administering credit programs. Instead, Congress retained authority over the administrative costs of credit programs by requiring that such agency expenses continue to be separately appropriated. This separate treatment and close oversight of administrative expenses has allowed Congress to retain control over all agency spending required to operate and manage federal credit programs. Such budgetary controls apply even in the case where the credit program being administered is an entitlement, such as student loans, that does not receive annual appropriations to cover its (separate) credit subsidy spending.

Separate treatment for administrative expenses means that credit program budgets are not calculated on a consistent basis with respect to direct versus guaranteed loans. Agencies operating direct loan programs do not include any of their operating costs in the subsidy rate and do not attempt to recoup such costs in their fees imposed upon borrowers. Loan guarantee programs, on the other hand, involve transactions initiated and managed by the private sector and therefore almost certainly incorporate their private sector operating costs in the fees and interest earnings retained by the lender. Of course other administrative costs of loan guarantee programs, including lender oversight, claims processing and the disposition of acquired collateral, continue to be paid out of agency budgets. The failure to include some or all of the expenses of administering federal credit programs distorts the federal budget process by understating credit subsidy costs.³⁰

In this respect, credit reform was incomplete and it may be desirable to consider alternative methods of financing and overseeing administrative expenses. For example, rather than being

³⁰ More precisely, what is missing in the credit subsidy calculation is the incremental cost to the government of originating a loan or loan guarantee. See Deborah Lucas and Marvin Phaup, “Reforming Credit Reform,” *Public Budgeting & Finance*, vol. 28, no. 4, 2008, p. 100 (“[T]he subsidy cost of a loan or guarantee implicitly assumes some level of servicing and collection effort that is obligated when the government extends credit”).

separately appropriated, administrative costs could be collected in fees or implicitly in the interest rates paid by the borrower.³¹

Regardless of how the total program costs (FCRA subsidy amounts plus administrative expenses) are funded, whether through appropriations, use of receipt sources, or some combination of the two, policymakers should consider giving credit program agencies increased discretion in how they administer credit programs. As discussed in the main Report, in an era of growing budgetary pressure, the ability of program managers to make optimal trade-offs between spending to execute or guarantee loan transactions and investments to make improvements in administrative practices will be increasingly important.

C. THE DISCOUNT RATE AND THE RISK PREMIUM (“FAIR VALUE”) DEBATE

One critical issue in the implementation of credit reform about which debate continues is the proper discount rate to use in calculating the subsidy costs under the FCRA procedures. The FCRA calls for the use of Treasury cost of borrowing in calculating subsidy rates and amounts and this approach continues to be supported by GAO, the Obama Administration and others. An alternative approach, known as “fair value,” would add a market risk premium to the Treasury rate and use the resulting higher interest rate as the discount rate to calculate credit subsidies. This measure would raise the cost of most federal credit programs. It is supported by CBO and has been the focus of numerous CBO reports since 2004.³² Its usage was mandated for the first time in the legislation creating the Troubled Asset Relief Program (TARP) in 2008.³³ It has recently received further support in Congress in the budget process reform proposals under consideration by the House Budget Committee.³⁴

This discussion will not presume to resolve this debate. Nevertheless, it is an important issue to consider because of the significant impact on the budget process, and the “scoring” in the budget of all federal credit programs, that the choice of the FCRA interest rate can have.

From a practical standpoint, much of the debate about the proper interest rate revolves around the purpose and use of the federal budget. Defenders of the current practice argue that the federal budget is primarily a compilation of the costs of federal programs that measures, in the aggregate, the fiscal position of the United States and the macroeconomic impact of its spending. Proponents of the fair value methodology argue that the budget process is also about making resource

³¹ Congress could continue to exercise close oversight by imposing, through appropriations language, obligation limitations upon the program agency’s authority to use program funds to cover administrative expenses. But that would likely continue to undercut agency incentives to make optimal resource tradeoffs, for example, in cases where increased administrative spending on IT and other investments, for example, in the short run would produce long term efficiencies.

³² See in particular Congressional Budget Office, “Estimating the Value of Subsidies for Federal Loans and Loan Guarantees,” August 2004.

³³ Emergency Economic Stabilization Act of 2008, P.L. 110-343, § 123 (Credit Reform).

³⁴ See House of Representatives, Committee on the Budget, “Proposed Rewrite of the Congressional Budget Process – Summary of Selected Provisions,” November 30, 2016, p. 5.

allocation decisions and therefore the price of a program is critical to determining how much support it should receive relative to other competing claims on those resources.

Interestingly, the 1967 Budget Concepts Commission took the position that the federal budget is intended *both* as a measure of the government's fiscal position and as a critical tool in making resource allocation decisions. Thus, the Commission's report states that "the budget must serve simultaneously as an aid in decisions about both the efficient allocations of resources among competing claims and economic stabilization and growth."³⁵ The Commission's acknowledgement of the dual purposes of the budget underscores the dilemma confronting the executive and legislative branch overseers of the ongoing impact of credit reform: the choice of one interest rate methodology is implicitly a choice to favor one budget objective over the other. It is therefore worth considering both positions – that in favor of the status quo Treasury interest rate approach and that in favor of a change to using Treasury rates adjusted for market risk -- in greater detail.

Proponents of the current practice of using Treasury interest rates to discount cash flows and calculate credit subsidy values argue that the budget should be calculated using actual costs to the federal government and should not include costs that are not actually paid by the government in the course of its transactions with the American public and the (private sector) economy. They contend that the single overriding purpose of the budget is "to gauge the federal government's fiscal position."³⁶ For policymakers to measure the government's aggregate fiscal impact relative to its budget constraint, that is, its revenue sources over the long term, the constituent parts of the budget must be "measured in a way that reflects their effect on the federal fiscal position."³⁷

Further, adherents of the current Treasury interest rate methodology argue that incorporation of a risk premium in the interest rate used to discount credit program cash flows would weaken the usefulness of the budget by injecting "social cost" considerations in a process that is not intended to and cannot well serve such deliberations. Analysis of the broader social cost of a program should at the same time consider its benefits, they argue. Cost-benefit analysis is important, they acknowledge, but it is not the primary objective of the budget process. To add a risk premium to the discount rate in an attempt to make the budget useful in such cost-benefit analysis would be to conflate two separate objectives: 1) promoting a clear understanding of the government's fiscal position and assuring its fiscal accountability; and 2) measuring performance in producing social benefits relative to the costs of government programs.

Supporters of the Treasury interest-rate approach also argue that adjusting the Treasury rate to include a market risk premium as well is simply not feasible and would greatly complicate budget calculations and accounting. As we have seen, the current methodology already entails a laborious

³⁵ Budget Concepts Commission, p. 12.

³⁶ David Kamin, "Risky Returns: Accounting for Risk in the Federal Budget," *Indiana Law Journal*, vol. 88, no. 2, p. 739.

³⁷ *Ibid.*, p. 747

and protracted re-estimation process that ultimately allows budget estimates based upon an accrual accounting approach to be reconciled with the actual cash flows generated over the life of a loan. The financing of loans to private sector borrowers and their repayments as well as other cash flow transactions that occur during the life of a particular loan or loan guarantee reflect the actual cost to the government of Treasury cash borrowings used to finance those transactions. To incorporate an additional risk premium into the critical interest rates used in making budget estimates and reconciling them to actual results realized injects unnecessary further complexity into the process. The added sums included in a credit subsidy estimate of a loan transaction must be subsequently backed out of the cash flows, making for a very complicated re-estimation process. Moreover, the Treasury adjusted interest rate used in the process cannot be tied to any actual market transactions like the cost of Treasury borrowing and there is therefore no “true” market adjusted interest available to be used in correcting the initial estimates for the actual budget execution interest rate in the re-estimation process.³⁸

It is interesting to note that the Budget Concepts Commission recommended that “the full amount of the interest subsidy on loans compared to Treasury borrowing costs be recorded and specifically disclosed in the expenditure account of the budget.” But the Commission went on to say that there is a “further subsidy involved in the fact that federal loans have larger element of risk than Treasury borrowing.” The Commission recommended that the budget include an allowance for losses for each loan to allow for an accounting for such additional risk.³⁹ Presumably such allowances or reserve accounts for federal credit programs could be used only in the event of macroeconomic or economy-wide events; amounts outlaid to such accounts would nevertheless be included in the budget totals every year and would correspond to (some fraction of) the annual volume of new lending the agency undertook.⁴⁰

A more sophisticated solution to the problem of how to adjust credit subsidy amounts for this additional or larger element of risk identified by the Budget Concepts Commission is the fair value approach. The fair value interest rate approach involves adjusting the appropriate Treasury interest rate to include an added risk premium and then using that risk-adjusted rate in making credit subsidy calculations.

Policy analysts and academics who favor the fair value methodology argue that budgets are also about resource allocation decisions. One of the explicitly stated purposes of the Federal Credit Reform Act is to “improve the allocation of resources among credit programs and between credit and other spending programs.” Public policymakers must make difficult choices both about the relative amounts of government spending versus private sector investment and consumption, and

³⁸ For a fuller discussion of the Obama Administration’s critique of the fair value position, see *Budget of the US Government, FY 2013, Analytical Perspectives*, pp. 393-399, and *Analytical Perspectives, FY 2015*, pp. 337-340.

³⁹ Budget Concepts Commission p. 52.

⁴⁰ This arrangement is similar to proposals to budget for natural and other disasters on an *ex ante* basis by requiring annual outlays to reserve accounts for expected or average amounts of disaster spending. See Marvin Phaup and Charlotte Kirschner, “Budgeting for Disasters: Focusing on the Good Times,” *OECD Journal of Budgeting*, vol. 2010, no. 1, 2010, pp. 8-9.

about the preferred methods of accomplishing government objectives using grants, loans, tax expenditures and other tools. Furthermore, in making credit and capital investment decisions, the private sector uses market comparable interest rates that include risks over and above the (risk-free) Treasury rate for the time period involved. In the course of making its budget decisions among competing priorities, the government uses market prices to determine how much to spend on a wide array of public purposes, such national defense, housing subsidies and grants to state and local governments for particular purposes. Consistency would argue that in employing credit to accomplish public purposes the government should be using market comparable prices, that is, market interest rates, as well.

Using full market comparable interest rates could also have the advantage of largely eliminating any need to budget for administrative expenses separately from the credit subsidy amount. Direct loan interest rates would be higher and the ensuring repayments would include an implicit amount required for the private sector to undertake the loan transaction. Similarly, loan guarantees would be more costly and such higher costs could either be charged to the beneficiary or appropriated to the guarantee program, but a separate appropriation for administrative costs would be redundant. Congress could still exercise control over the cognizant agency's spending on program operations through a statutory obligation limitation.

Fair value proponents recognize, however, that the correct interest rate to use in implementing their approach would not necessarily be based upon full comparability with the interest rate charged by the private sector for loans of comparable terms and duration. Rather, they argue the proper approach to derive the interest rate to be used for federal credit reform budgeting purposes is to adjust comparable Treasury rates only for risks that cannot be diversified, i.e., what might be called catastrophic risks.

The point here is that the size of the adjustment to Treasury rates advocated by fair value proponents should not be overstated. Risks that *can* be diversified should be insurable in private markets. The fact that market interest rates in most cases do actually reflect a premium for diversifiable risks is a result of market imperfections or "market incompleteness." In undertaking credit transactions the government can spread risk such diversifiable risks broadly – in effect performing an insurance like function – and this means that they should not be a factor in government resource allocation decisions.

Theoretically, the proper interest rate to be used in fair value adjustments to the Treasury rates currently used under FCRA could be derived by carefully disaggregating actual market interest rates observed in the credit markets. This adjustment process would identify the extraordinary risk element embedded in market interest rates that reflects risk that even the government cannot eliminate. Such risk arises from macroeconomic fluctuations or "exogenous shocks" like financial crises that affect all participants in the marketplace and that cannot be offset by engaging in insurance contracts with unaffected parties. Therefore, argue fair value advocates, to be

conceptually accurate, Treasury interest rates should be adjusted for such non diversifiable risks to produce “market rates” for credit subsidy estimating purposes.⁴¹

In the view of the fair value school, to leave out such a risk premium charge understates the full economic cost of the government’s use of credit in the competition for budget resources, particularly when other government programs must use market prices. This effectively biases resource allocations decisions in favor of government credit programs and may be contributing to their overuse.

While it is true that the use of such market-risk adjusted interest rates further complicates the budget calculations for federal credit programs, implementation of credit reform successfully overcame many such issues and this should be viewed only as yet one more technical challenge. Credit reform was already a significant departure from the cash flow budget treatment of credit programs that prevailed up until FCRA was enacted and the adoption of fair value methodology is only one more feature among the differences between a cash flow and an accrual budget. Hence, advocates of the fair value approach to credit reform are do not find the technical implementation issues raised by GAO and OMB sufficiently persuasive to warrant not adopting what they view as the proper discount rate procedure.⁴²

D. CROSS SUBSIDIZATION

As currently treated in the federal budget using Treasury discount rates, the major federal housing and education credit programs are producing budget savings and serving to reduce the recorded federal deficit. And as noted in the main Report, under credit reform federal credit program managers have had a strong incentive to keep subsidy costs low to serve as many individuals or businesses as possible. This means they must raise interest rates and/or impose fees. If such interest rates and fees are imposed on a uniform basis, then the question arises whether some portion of loan beneficiaries is being “overcharged” in order to permit the government to serve riskier borrowers, a practice known as cross subsidization.

A system of risk-based pricing, by comparison, would adjust the fees and interest rates borrowers pay to more closely reflect the risk they pose to the federal credit program. While such a policy would arguably improve program targeting, it could also lead to riskier or “needier” borrowers leaving the program, defeating the public policy purpose of providing credit to such borrowers. Alternatively, if the program were more effectively targeted to the intended, or “needier,” beneficiaries and less risky borrowers were excluded, the program might not generate sufficient income or have lower overall losses to allow it to operate at a low or zero total subsidy. In either case, in the absence of cross subsidization, Congress might decide that credit is not the preferred

⁴¹ For further discussion see CBO, “Estimating the Value,” p. 5 (“[M]arket risk cannot be eliminated by diversification because it results from an aggregate change in asset values”).

⁴² Yet another option for recording federal loans and loan guarantees transactions in the budget has recently been presented by economist and former CBO Deputy Director Donald Marron. See Donald B. Marron, “The \$300 Billion Question – How Should We Budget for Federal Lending Programs?” Urban Institute, September 2014.

mechanism for achieving the desired public policy outcome. Indeed, policymakers might then decide that the intended beneficiaries could be better served by a direct spending grant or refundable tax credit program.

E. SHOULD INSURANCE PROGRAMS BE INCLUDED UNDER CREDIT REFORM?

One final issue concerning budgeting for credit programs concerns whether federal insurance programs, such as those for bank deposits, pension benefits and floods, should also be budgeted on an accrual basis and their subsidy cost or income be included in the budget on a credit reform basis. The current financial situation of the Pension Benefit Guarantee Corporation highlights the issue. The Obama Administration's 2017 Budget reported that the liabilities of the PBGC exceed its assets by \$ 76 billion. As with Fannie Mae and Freddie Mac in 2008, U.S. taxpayers could well be liable for much or all of this cost yet this significant financial exposure goes unacknowledged in the federal budget. Budgeting for the PBGC on an accrual basis as is done under FCRA would cause some annual amount of annual spending on PBGC's pension guarantees to be recorded in the budget totals and add to the federal deficit.

Including federal insurance programs under credit reform was considered at the time of passage of the Federal Credit Reform Act in 1990 but Congress ultimately declined to do so and a subsequent proposal by the George H.W. Bush Administration to expand the scope of credit reform for this purpose was rejected. The House Budget Committee has recently recommended such an expansion of accrual budgeting for insurance and retirement programs (except Social Security).⁴³ We note here only that the complexity of taking this step, given the need to make actuarial projections of the expected claims for insurance over long periods of time, and then to measure and record them in the budget on an accrual basis, could prove very challenging to the agencies operating these programs.

⁴³ House Budget Committee, "Proposed Rewrite of the Congressional Budget Process," p. 5.

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