

TABLE XII-4. REVENUE GAINS FROM POSSIBLE REDUCTIONS IN TAX EXPENDITURES, FISCAL YEARS 1983 AND 1987 (In billions of dollars)

Tax Expenditure Reduction	1983	1987
<b>International Affairs</b>		
Phase out Domestic International Sales Corporations	0.1	0.9
<b>Energy</b>		
Modify tax treatment of foreign oil and gas income	0.2	0.7
Repeal percentage depletion allowance for oil and gas	0.8	2.4
Repeal expensing of intangible oil and gas drilling costs	3.5	9.6
Repeal residential energy tax credits	0.1	<u>a/</u>
Eliminate excise tax exemption for alcohol fuels	0.1	0.1
<b>Natural Resources and Environment</b>		
Eliminate capital gains treatment of timber	0.3	0.8
Eliminate tax exemption for pollution control bonds	<u>a/</u>	1.0
<b>Commerce and Housing Credit</b>		
Limit home mortgage interest deduction to \$5,000	1.8	8.8
Tax 10 percent of the capital gain on home sales	<u>a/</u>	0.4
Tax accrued interest on life insurance reserves	1.5	4.1
Terminate deductibility of consumer interest payments	1.2	9.6
Eliminate tax exemption for small issue industrial revenue bonds	0.1	2.5
Limit business meal and entertainment deductions to 80 percent of amount spent <u>b/</u>	0.3	0.7
<b>Community and Regional Development</b>		
Eliminate tax credits for rehabilitating older buildings	0.8	1.7

(Continued)

TABLE XII-4. (Continued)

Tax Expenditure Reduction	1983	1987
<b>Education, Training, Employment, and Social Services</b>		
Tax scholarship and fellowship income	0.1	0.4
Repeal extra parental personal exemption for students	0.3	0.8
Tax fringe benefits <u>b/</u>	0.5	1.6
<b>Health</b>		
Tax some employer-paid health insurance		
Income tax	2.0	6.0
Payroll tax	0.6	2.1
Tighten the medical expense deduction	0.4	3.8
Eliminate tax exemption for private hospital bonds	0.1	1.1
<b>Income Security</b>		
Eliminate extra tax exemption for the elderly and blind	0.8	2.8
Tax half of retirement benefits for Social Security recipients with incomes above \$20,000/\$25,000	1.6	3.1
Tax railroad retirement benefits	0.2	0.2
Tax workers' compensation benefits	1.5	6.7
Tax all unemployment insurance benefits	1.9	1.8
Repeal the casualty loss deduction	0.1	1.2
<b>Veterans' Benefits and Services</b>		
Tax veterans' disability compensation	0.8	2.5
<b>General Purpose Fiscal Assistance</b>		
Eliminate deductibility of state and local sales taxes	0.8	7.8
Limit tax credit for possessions corporations	0.2	0.6

a. Less than \$50 billion.

b. The deduction of business meal and entertainment expenses and the non-taxation of fringe benefits are not considered tax expenditures.

fiscal year 1983 and \$7.8 billion in fiscal year 1987. Increases in the tax base of this kind would not significantly reduce the incentive effects of the reductions in marginal tax rates enacted in 1981, since the amounts added to taxpayers' incomes in most cases would not push them into higher tax brackets. While enactment of a large number of base-broadening measures could push many taxpayers into higher brackets, this could be offset by further reductions in marginal tax rates.

Many tax incentives for particular kinds of business investment may have become less necessary or obsolete after the enactment of major increases in business depreciation allowances in 1981. The DISC export incentives, tax-exempt small issue industrial revenue bonds, the percentage depletion allowance for oil and gas, and the expensing of intangible oil and gas drilling expenses are examples of the kinds of provisions that could be reexamined in light of these new general business tax cuts.

Tax collections can be increased without a legislated increase in tax liabilities by improving the enforcement of existing tax laws. Providing the Internal Revenue Service with additional resources for audits and collections could bring in at least \$4 in new revenues for each \$1 spent. Instituting a system of withholding for independent contractors could increase tax collections by about \$600 million a year, while instituting withholding on interest and dividends could increase tax collections by \$3 to \$5 billion a year. None of these provisions would involve new taxes; they would simply improve the collection of taxes that are already owed.

#### Introducing New or Increased Taxes

Revenues could also be increased by new or increased taxes on energy, user charges, and selective or general taxes on consumption.

Windfall Profits or Excise Taxes on Natural Gas. Price controls on most domestic natural gas are due to be lifted on January 1, 1985, under the terms of the Natural Gas Policy Act of 1978 (NGPA). The deregulation of natural gas prices at the wellhead, whenever it occurs, will probably result in a substantial increase in gas prices and producer revenues and profits. In a decontrolled market, natural gas prices would most likely tend toward the heat-equivalent (Btu) price of the major fuels with which gas competes, most notably oil. The NGPA, however, has held prices below this

level. For example, industrial and utility boiler fuel sold for approximately \$5.50 per million Btus in the fall of 1981, while natural gas was delivered to these users for \$2.98. For residential users, home heating oil sold for \$9.00 per million Btus, while gas was delivered for \$4.60 in the same period. These differences suggest that substantial new gas industry profits would follow upon wellhead decontrol. These profits could be the focus of a windfall profits tax on natural gas at the wellhead.

The revenues raised by such a tax, and the duration of the tax, would depend upon the adopted definition of "windfall" income. One option for such a tax would be to allow the deregulation of all wellhead gas prices on January 1, 1983. This option would create a "windfall tax base," that is, new revenues to natural gas producers in excess of those they would have received under NGPA, of up to \$30 billion in 1983 and \$40 billion in 1984. Applying to this base a windfall profits tax similar to that on oil could produce as much as \$12 billion in revenues in each of these years. This figure must be regarded as a maximum, however, since prices might not increase as rapidly as this calculation assumes. In addition, higher profits for natural gas producers might lead to reduced profits and incomes in other sectors of the economy, especially if tight monetary policy holds down overall nominal GNP. These lower incomes would result in offsetting reductions in corporate and individual income taxes in those other sectors. Taking all these factors into account, the net revenue gain from decontrol and a windfall profit tax on natural gas could be as low as \$1 billion in 1983 and \$6 billion in 1984.

If the tax was not limited to the period of accelerated decontrol, it could raise large amounts of revenue in the period after 1984. For example, an excise tax of \$0.60 per thousand cubic feet--unrelated to any windfall--would raise approximately \$11 billion per year after 1984.

A windfall profits tax on natural gas would differ from the existing crude oil windfall profits tax in several respects. The most important difference is that, unlike the oil tax, a windfall profits tax on all gas would raise the price of gas to consumers. In the oil case, producers were forced to absorb the tax because of the competitive pressure exerted by large imported supplies that entered the United States at the market price. No such source of competitive gas exists. Domestic gas price increases are checked only by the possibility of long-term switching to other fuels, most

probably to oil. Thus, a tax on all gas would be borne by producers and consumers, with a possible inflationary impact over and above that of natural gas decontrol alone.

In the absence of a windfall profits tax on natural gas, decontrol would increase producer revenues substantially, and with them corporate and personal income tax revenues from the natural gas industry. These tax increases could, however, be partly or wholly offset by effects elsewhere in the economy. Corporate profits and personal income outside the gas industry might decrease as the composition of national output changed in response to higher gas prices. Inflation could increase during the adjustment to higher gas prices, possibly also dampening growth. This could reduce federal tax revenues in general, and perhaps also increase those automatic transfer payments that are associated with reduced GNP growth or tied to measures of inflation. Thus, it is not clear that decontrol of natural gas alone--in the absence of a windfall profits or excise tax--would increase total federal tax revenues or reduce the deficit in the short run. In the long run, decontrol would increase economic efficiency, thus increasing both real GNP and federal revenues.

Tariff on Imported Oil. A tariff or fee on imported oil would reduce U.S. dependence on foreign oil sources by inducing further energy conservation and the substitution of other fuels for oil. The adoption of such a fee would raise the price of domestic oil by the amount of the fee, since domestic oil prices are effectively set by the price of imported oil. Thus, an import fee would raise revenues both from the fee and the additional windfall profit taxes paid by producers of domestic oil.

A fee of \$5.00 per barrel would produce approximately \$17.5 billion in annual revenues from these two sources, assuming imports of 5.5 million barrels per day and domestic production of 8.5 million barrels per day. Of this total, \$10 billion would come from fee collections, and \$7.5 billion from higher windfall profits tax collections from the domestic industry. Such a fee would result in an increase of approximately 12 cents per gallon in the price of refined products, including gasoline and heating oil, although some of the increase would be passed back to refiners, producers, and manufacturers who use oil as an input into production. To the extent that their profits were reduced, the revenues raised by the fee would be offset by reduced income tax collections. Beyond this, if tight monetary policy prevented overall nominal GNP from rising, the price increases resulting from the fee

would be absorbed in the form of lower real incomes throughout the economy, resulting in further offsetting reductions in income tax collections. The net increase in revenues could thus be significantly less than the gross amount collected from the fee and higher windfall profit taxes. It is estimated that a fee of \$5.00 per barrel could reduce U.S. oil consumption by approximately 300,000 barrels per day within one year.

An increase in oil prices, whether resulting from a fee or from market forces, requires some adjustment in the economy. Such an adjustment would not be without cost. Industries and regions dependent on oil would be most heavily affected. In the automobile industry, for example, higher gasoline prices could increase somewhat the demand for smaller, more fuel-efficient cars, and could lead to further erosion of the market share of U.S. automobile manufacturers.

The magnitude of the adjustment costs might depend on the manner in which the oil import fee was instituted. Raising the fee gradually to some target level over time, for example, would enable oil users to make anticipatory adjustments through conservation or fuel-switching, thereby reducing their transition costs. The benefits of an oil import fee would be increased substantially if it was instituted multilaterally by the major importing nations, since it would reduce worldwide oil consumption by a greater amount than would a fee adopted by the United States alone. The larger demand reduction would exert greater pressure on producers to lower oil prices, and, in turn, the final product prices paid by consumers, thus providing many of the same benefits as a unilateral U.S. fee while reducing the inflationary consequences of this option.

Excise Taxes. Doubling current excise taxes on cigarettes, alcohol, telephones, and gasoline could increase revenues by \$12 to \$14 billion a year (see Table XII-5). Some of these taxes have not been raised in many years, so increases might be justified simply on those grounds. In addition, the reduction in consumption that might result from higher excise taxes could in some cases serve broader social purposes--reduced dependence on foreign oil in the case of gasoline taxes, for example, and the concern for public health in the case of alcohol and tobacco taxes. The measure would, however, increase federal influence over the allocation of resources by selectively making some consumer goods more costly than they would otherwise be. These excise taxes also fall more heavily, as a proportion of income, on those with lower incomes than on those with higher incomes.

TABLE XII-5. GROSS REVENUE INCREASES FROM DOUBLING EXISTING EXCISE TAXES (By fiscal year, in billions of dollars)

	1983	1984	1985	1986	1987
Liquor (\$21/gallon)	3.3	3.5	3.5	3.7	3.7
Beer (\$18/barrel) and Wine (34 cents/gallon)	1.3	1.3	1.4	1.6	1.7
Cigarettes (16 cents/pack)	1.8	1.8	1.9	2.1	2.3
Telephones (2 percent)	0.8	0.8	1.8	2.0	2.2
Gasoline and Diesel Fuel (8 cents/gallon)	<u>3.2</u>	<u>4.6</u>	<u>4.5</u>	<u>4.4</u>	<u>4.4</u>
Total	10.4	12.0	13.1	13.8	14.3

NOTE: All taxes shown above are double the present rates and assumed to become effective on January 1, 1983. The one percent telephone excise tax is scheduled to expire as of January 1, 1985, under present law. The net increase in budget receipts would be smaller than the amounts shown above because of offsetting reductions in individual and corporate income taxes.

--Liquor. The liquor tax of \$10.50 per gallon has not been changed since 1951. Doubling it to \$21.00 would raise about \$3.5 billion a year and put the tax at about 45 percent of the product price, slightly more than the 43 percent that the \$10.50 tax represented in 1951. Estimates of the resulting decline in liquor consumption range from zero to almost 60 percent.

--Beer and Wine. The excise taxes on beer and wine were also last raised in 1951. Doubling them would raise about \$1.3 billion a year in new revenue. Since the taxes comprise a very small share of the total price, the increases would have an insignificant effect on consumption.

--Cigarettes. The 8 cents-per-pack tax on cigarettes has also not been raised since 1951. Doubling it would raise about \$1.8 billion a year in new revenue. A 16 cents-per-pack tax would represent 24 percent of the per-pack cost, less than in 1951 when 8 cents represented 37 percent of the cost per pack. Most studies indicate that cigarette consumption does not decline very much in response to increases in the price, except among young people. One recent study suggests that an 8 cents-per-pack increase (12 percent of the total price) could result in up to a 30 percent decrease in the number of teenage smokers.

--Telephones. With a few brief exceptions, the excise tax on telephone service remained at 10 percent from 1932 until 1973, when it began to be reduced by 1 percent a year, with expiration scheduled for January 1, 1983. As a result of 1981 legislation, it will remain at 1 percent through 1984, after which it is scheduled to expire. Increasing the tax to 2 percent and continuing it beyond 1985 at that level would raise about \$0.8 billion in new revenue in 1983 and \$2.2 billion in 1987.

--Gasoline. The excise tax on gasoline was increased from 3 to 4 cents per gallon in 1959, and it has remained at that level since then. Doubling the current 4-cent-per-gallon tax would raise about \$4.4 billion a year, although offsetting reductions in corporate and individual taxes would hold the net increase in revenues to about \$3.3 billion a year. The higher price would result in a small decrease in fuel use--estimated at about 40,000 barrels a day--which would reduce state fuel tax receipts by about \$60 million a year. In general, with the price of gasoline at about \$1.35 a gallon, a 4-cent increase would have only a modest economic impact.

While such a tax increase could be added to general revenues to help reduce the deficit, gasoline taxes have traditionally been viewed as user charges and assigned to the Highway Trust Fund. The current \$4.4 billion in receipts provides about two-thirds of the taxes paid into this fund. Higher fuel prices and greatly improved fuel economy have reduced the revenues from the tax in recent years to the point that outlays from the Highway Trust Fund exceeded revenues by over \$1 billion in 1981. At the same time, preliminary results of a new federal highway cost allocation study indicate that automobile users currently pay a higher share of highway taxes than is warranted by the costs they impose on the highway system, while the heaviest types of trucks pay less than the costs they

impose. An increase in gasoline taxes might have to take into account some of these funding and allocation issues.

--Luxuries. Excise taxes on "luxuries"--furs, jewelry, luggage, and toilet preparations--were enacted during World War II and repealed in 1965. A 10 percent excise tax on these items would raise about \$2.5 billion a year, with about \$1 billion each coming from jewelry and toilet goods, and the rest from furs and luggage. A 10 percent excise tax on luxury cars could raise about \$1 billion a year, while a 10 percent tax on expensive boats could raise around \$100 million a year.

User Fees. Revenues could also be raised by imposing fees on some federal government services that are now provided free of charge or at less than their cost. In effect, the government is transferring income and resources to the beneficiaries of these services. User fees could require the cost of services to be paid by those who use them. The Administration proposed a number of new and increased user fees last year to cover the costs of airports and airways, ports, waterways, Coast Guard services, grain inspection, and the like. The Congress has not given final approval to any of these proposals. It should be noted that the proposals often did not increase fees by the full amounts necessary to cover the costs of the services provided. Chapters V and VII of this report and Appendix B contain a number of options that would require users to pay some or all of the costs of the services provided. Some of these are listed in Table XII-6, along with the revenues they would raise in 1983 and 1987.

Value-Added Tax or Sales Tax. A national value-added or sales tax that applied to a comprehensive range of goods and services would distort the allocation of consumption resources less than the kinds of selective excise taxes discussed earlier. Such a tax could be viewed as simply an incremental change to the present tax system if it was established at a relatively modest level and did not substitute for any of the current major sources of tax revenue. A large-scale value-added tax, however, would verge on the kind of fundamental change discussed in the next section.

Large additional revenues could be raised by a national value-added or sales tax. For every percentage point, such a tax would raise from \$10 to \$15 billion in revenue, depending on how comprehensive it was. A national sales tax--if modeled after existing state and local sales taxes--would be levied at the retail level. A value-added tax (VAT), by contrast, would be imposed at

TABLE XII-6. POTENTIAL REVENUE INCREASES FROM SELECTED USER FEES,  
FISCAL YEARS 1983 AND 1987 (In billions of dollars)

User Fee	1983	1987
Increase Aviation User Fees <u>a/</u>	0.7	1.2
Finance the Strategic Petroleum Reserve with a Petroleum Tax <u>b/</u>	2.9	2.9
Increase Waterway User Charges <u>b/</u>	0.7	0.9
Levy User Charges for Deep-Draft Navigation Expenses <u>b/</u>	0.5	0.7
Levy User Charges for Certain Coast Guard Activities <u>b/</u>	0.7	1.1

a. January 1, 1983 effective date.

b. October 1, 1982 effective date.

each stage of the production, distribution, and sales process on the amount of "value added" at each stage, and passed on in the form of a higher price to the next purchaser. If, for example, raw materials were purchased for \$10, a value-added tax of 10 percent would require the purchaser to pay \$1 in tax to the seller, who would remit it to the government. If the purchaser then processed these materials, adding enough to their value to sell them to a distributor for \$20, he would collect a \$2 value-added tax from the distributor, take a credit for the \$1 tax he had paid earlier, and pay the \$1 remaining to the government. If the distributor sold the goods for \$30, he would collect a \$3 value-added tax from the purchaser, take a \$2 credit for the VAT he had paid earlier, and send the remaining \$1 to the government. The final consumer would pay a tax of 10 percent of the full price, but since he would be unable to pass it on to anyone the result would be the same for him as an ordinary sales tax of 10 percent.

While never used in this country, value-added taxes are common in Europe, where they have taken the place of unpopular "turnover"

sales taxes that allowed no credit for taxes paid at earlier stages in the chain of distribution. The main argument for a national value-added or sales tax in the United States is that it would tax consumption rather than saving. If this new tax replaced part of the individual or corporate income tax, both of which impose a significant tax on saving, the overall burden of the tax system on saving would be reduced.

A major argument against such a tax is that it would shift more of the total tax burden to lower-income people, who spend a larger share of their incomes for consumption than do those with higher incomes. This regressive effect could be alleviated through a system of credits and rebates, but only at the cost of additional complexity. Certain types of goods, such as food, medicine, and other necessities, are often exempted from value-added or sales taxes, also adding complexity and inefficiency to the system.

A value-added or sales tax would increase the price of all goods and services to which it applied, and thus would lead to a one-time increase in the overall price level. If monetary policy permitted nominal GNP to rise by the full amount of the tax, there would be offsets elsewhere in the budget. Outlays for programs tied directly or indirectly to the rate of inflation would rise, as would income tax revenues. If monetary policy held overall nominal GNP down, however, the value-added tax would show up in the form of lower profits and incomes, which would reduce income tax collections.

Imposing a value-added or sales tax would involve substantial administrative and compliance costs, especially if it had to be collected at every stage of the production, distribution, and sales process. This suggests that a value-added tax might not be worth imposing unless it was set at a relatively high level of 5 or 10 percent. Any national value-added or sales tax, and especially a high one, would intrude on an important traditional source of state and local revenues. It would increase the financial pressure on state and local governments, which already face cutbacks in federal aid and—in many areas—new statutory or constitutional limits on property and other taxes.

#### More Fundamental Changes

A more fundamental restructuring of the tax system could also be considered. Two major possibilities are a broad-based income

tax with fewer deductions, exclusions, and exemptions, thus permitting lower tax rates, and replacement of the present income tax with a broad-based consumption or expenditure tax.

Broad-Based Income Tax with Lower Rates. Broadening the income tax base by including forms of income that are currently exempted in part or completely from tax, or taxed at lower rates, would make it possible to raise more revenue than the current tax system with lower overall tax rates. An income tax system with a top marginal rate of less than 30 percent could raise the same amount as the present system if such major forms of income as capital gains and employer contributions to employee benefit plans were fully included in income, and if deductions such as nonbusiness interest expenses and state and local taxes were reduced or eliminated. Somewhat higher tax rates, or an even more inclusive tax base, would raise more revenue than the current system. This would be, in effect, a more comprehensive version of the option discussed earlier, which involved elimination of selected tax expenditures in exchange for some reduction in tax rates. A truly comprehensive income tax would eliminate all tax expenditures, with a corresponding reduction in overall tax rates.

Consumption or Expenditure Tax. While there has been much academic discussion of substituting an expenditure or consumption tax for the present income tax, no country currently has such a tax. The major advantage of a consumption tax, in the view of its proponents, is that it would not tax income that is saved.

A consumption tax could be collected in much the same way as the current individual income tax. Each taxpayer would count up all forms of income received, and then subtract all amounts saved, including money put into savings accounts, purchases of stocks and bonds, investment in businesses, and retirements of prior debt. The tax would be levied on the remainder, representing consumption. This is quite similar to the way deposits in Individual Retirement Accounts are now treated--contributions are deductible when deposited but are taxed upon withdrawal.

While all forms of saving would be deductible without limit, the definition of taxable receipts would be much broader than it now is. All receipts of spendable cash would be subject to tax, including the entire proceeds of sales of capital assets (not just the capital gain) and all amounts borrowed. If these amounts were saved or reinvested, however, they would not be taxed. An investor

could borrow a sum of money (a taxable receipt) and save it (a deduction for saving) with no tax consequences.

A comprehensive consumption tax would need somewhat higher rates than a comprehensive income tax to raise the same amount of revenue, since the exclusion of savings reduces the potential tax base by about 5 percent. It could have lower rates than the present income tax, however, since the income tax base has been substantially eroded by exclusions, deductions, and exemptions. There is no guarantee that a consumption tax base would not also be subject to erosion.

Would Fundamental Changes Increase Revenues? While fundamental changes of the kinds just outlined could in theory raise large amounts of additional revenue, even with lower tax rates, the difficulties involved should not be underestimated. Any fundamental change would inevitably increase taxes for those who are taxed relatively lightly by the current system. One way of cushioning the transition to a new system would be to exempt or "hold harmless" for a period of time those who would experience relatively large tax increases. This could reduce or eliminate any potential revenue gain from the new system for a considerable period of time.

#### CONCLUDING COMMENTS

The Economic Recovery Tax Act of 1981, which is already in place, will reduce total revenues to less than 18 percent of GNP over the next five years, while outlays will remain at around 23 percent of GNP unless further cuts in spending are made. This five percent gap--the largest since World War II--could be narrowed with three kinds of tax changes: postponement or elimination of some portions of the 1981 tax cut, elimination of some of the special preferences in existing tax law, or enactment of new or increased taxes.



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## CHAPTER XIII. THE CREDIT BUDGET--LOANS AND LOAN GUARANTEES

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The federal government conducts a variety of loan and loan guarantee programs in which it plays the role of a bank or other financial institution: it chooses who can borrow funds and under what terms. These programs are intended to reallocate credit resources toward selected uses, often with the inducement of below-market interest rates. The reallocation of credit by the government can be costly both to taxpayers and the efficiency of U.S. credit markets. Furthermore, federal credit has been expanding faster than direct federal spending, partly because its costs are not easily identified.

This chapter is concerned with the effects of federal lending on the economy, even if no unified budget costs are incurred. Although reduced federal credit activities would, in some instances, result in lower outlays, the long-term government costs associated with federal credit programs are small because most loans are eventually repaid. The full costs, however, are felt throughout the economy in those cases where reallocated capital causes a reduction in growth and productivity.

Federal credit activities use a large and increasing share of total available credit, often without adding to its supply. If the supply of credit for private uses is diminished, some private borrowers are "crowded out" and interest rates are bid up. As the government frequently selects borrowers according to criteria other than maximum return on investment, the substitution of federally for privately chosen borrowers may also lead to a reduction in the efficient use of capital.

Federal credit activities are understated in the budget totals. In 1982 about 30 percent of total direct loans are expected to be financed by off-budget federal entities, such as the Federal Financing Bank. Off-budget loans constitute an unrecognized government deficit, adding dollar-for-dollar to federal borrowing needs. Since off-budget loans were first used in 1974, they have added almost \$94 billion to outstanding federal debt. They are expected to add an additional \$16 billion in 1982. The amount of new on-budget direct loans is also understated in the budget, which records only the net of new loans less repayments. In

addition, government-guaranteed loans made by private lenders are also excluded from the budget, unless the borrowers default.

This chapter suggests three mutually compatible means to reduce the growth in federal credit. It employs the credit budget framework, developed in 1980 explicitly to deal with the off-budget treatment of federal credit programs. The credit budget presents the total amount of credit channeled through the government: new direct loan obligations and new loan guarantee commitments. Since 1980, aggregate figures for new direct loans and loan guarantees have been proposed in the President's budget and enacted in the concurrent budget resolutions by the Congress. Limitations have been included in appropriations bills, setting maximum figures for many lending programs. This chapter addresses the impact of credit on the economy by focusing on lending levels rather than the traditional budgetary impact.

#### BUDGET HISTORY AND PROJECTIONS

During the last decade, and particularly during its last half, federal loan and loan guarantee programs have expanded rapidly. Throughout the decade the housing sector has been the most important recipient of federal credit assistance, accounting for about a third of all direct loans and two-thirds of loan guarantees (see Appendix A-370-a). During the past few years new varieties of federal credit programs have been developed--including loans for energy development and aid to large failing businesses--at the same time programs in traditional areas have continued to expand and diversify. There are now major credit programs in 12 of the 16 programmatic budget functions.

#### Historical Trends, 1970-1980

During the 1970s, net direct loans extended per year (new loans minus repayments) rose from \$3 billion in 1970 to \$24 billion in 1980. During the same period, annual net loan guarantees increased from \$8 billion to \$32 billion. This brought the total of outstanding loans and loan guarantees to \$462 billion in 1980. Since 1976 federal credit has grown 27 percent per year, more than doubling every three years. By contrast, direct spending rose at a rate of about 12 percent annually during these years. By 1980, one of every eight dollars in federal aid (excluding tax expenditures) was extended in the form of a direct loan or loan guarantee.

Federal credit has also increased faster than total domestic credit. In 1976, 9 percent of all funds advanced in credit markets were direct or guaranteed federal loans. By 1980 that proportion had risen to 16 percent. At the end of 1980, one-quarter of all outstanding debt in national markets was federally backed securities--Treasury or federal agency securities or guaranteed loans.

The reasons for the surge in federal credit during the 1970s are not fully understood, but several contributing factors deserve notice. First, increasing market interest rates in recent years have driven a large wedge between the interest rates offered by fixed-rate federal loan programs and the rates available to borrowers through private institutions. This has increased demand for the low-interest federal loans, which are now heavily subsidized, and has probably contributed to higher program levels. This is one factor in the increase in the Guaranteed Student Loan program, which provides postsecondary students with 7 and 9 percent loans (see Appendix-500-d).

A second factor contributing to the overall growth in federal credit activity during the late 1970s was the surge in Federal Housing Administration (FHA) mortgage insurance--now the largest single federal credit program. After changing little during the first part of the decade, the dollar volume of outstanding FHA-insured single-family mortgages increased from \$50 billion in 1976 to nearly \$78 billion in 1980. This increase occurred during a period of rapidly rising housing prices and steeply increasing mortgage-interest rates.

The third and fourth factors relate to changes in the budgetary treatment of federal credit. In 1974 the Federal Financing Bank began operations, allowing some budget agencies to transform their on-budget direct loans into off-budget loans and others to transform guaranteed loans into off-budget direct loans. Access to federal funds at near Treasury interest rates, with no impact on the unified budget, may have contributed to higher lending levels for those programs.

Also in 1974, the Congressional Budget Act was passed. This act established a process allowing the Congress to control federal spending, but loan guarantees were specifically excluded from its coverage. The change in control over direct spending relative to loan guarantees may have encouraged an increasing use of the guarantee mechanism.

## The 1982 Budget Decisions

The reconciliation process did not directly affect the credit budget, as the budget resolutions contained no instructions to Congressional committees for reducing gross lending levels of credit programs. The 1981 reconciliation act did, however, modify several credit programs (including loans by the Farmers Home Administration (FmHA), Small Business Administration (SBA), and Guaranteed Student Loan program) in ways that lowered program subsidies. Interest rates for FmHA disaster loans were increased to market rates for comparable loans, a change expected to decrease the demand for these loans. Several SBA lending programs were consolidated and direct loan levels were lowered (see Appendix A-370-c). The reconciliation act also imposed a needs test for higher-income borrowers under the reduced-interest Guaranteed Student Loan program and imposed a 5 percent origination fee for all new loans.

In September 1981, the Administration announced a series of proposed reductions in loan guarantees for 1982 to be effected largely through administrative action. The proposals included a \$16 billion decrease in secondary guarantees of the Government National Mortgage Association (GNMA) mortgage-backed securities program and \$4.3 billion in reductions under other credit programs, the largest being the Export-Import Bank, the SBA, and the Rural Electrification Administration (REA). (The REA reduction requires legislation first.) To the extent that these changes are adopted administratively, program levels established as ceilings in appropriation acts are being modified without opportunity for Congressional review, since the Impoundment Control Act of 1974 does not apply to federally guaranteed loan programs.

CBO estimates that the credit budget total for 1982 will reach \$147 billion. This total will include \$87 billion in new loan guarantee commitments and \$60 billion in new direct loan obligations. In addition, \$68 billion in secondary guarantees, largely by GNMA, are expected, although these are not included in the credit budget total.

## BUDGET STRATEGIES

Federal credit programs change the way the private sector allocates credit to meet two general objectives: correct market failures or provide subsidies to preferred borrowers. Many federal credit programs are intended to achieve both objectives to some extent.

Federal intervention in credit markets is efficient from an economic standpoint if it corrects an inability of credit markets to perform one of their primary tasks, such as reducing risk through spreading it among a multitude of investors or accurately judging the riskiness of a potential loan. It is frequently argued, for example, that FHA mortgage insurance corrected a market misjudgment of the riskiness of long-term, low-downpayment mortgages.

If a credit program is operating in an area in which there is no market failure, the federal assistance is best understood as a reallocation of credit, often at subsidized interest rates, to specific activities or borrowers. This reallocation may sacrifice some economic efficiency. It draws credit away from private uses that must meet strict risk/return criteria and delivers it to federally selected borrowers who may not meet these criteria. In effect, it substitutes a political judgment about prospective borrowers for the market's judgment.

If the government wishes to provide a subsidy, it might be preferable in some instances to provide it directly through a grant rather than through a low-interest loan. This is because the total cost of a credit subsidy may be difficult to determine and is not always apparent in federal budget documents. Also, part of the cost may not appear until later years. The cost of a direct grant of comparable value, by contrast, would be clear, and would be acknowledged in government accounts as soon as it was made.

Reducing federal credit programs would entail two primary strategies: elimination of credit programs in areas in which there is no market failure and reductions in credit subsidies. Programs whose aims are being met by the private sector could be eliminated on the grounds that market failures no longer exist. Credit subsidies could be ended entirely either by raising interest rates to market levels or by halting the programs (and substituting direct grants, if needed). In cases in which market imperfections warrant subsidized credit, a third approach could be taken: reform of eligibility criteria to ensure that the subsidies are used cost-effectively.

#### Terminating Federal Programs That Duplicate Private Sector Lending

If the government is providing services that overlap or override private sector activities, the government might wish to

discontinue these services. The question to be addressed in these cases is whether the private provision of the service would differ significantly enough from the federal program to warrant the program's continuation, at least in part.

For instance, FHA mortgage insurance was originally designed to correct flaws in private credit markets by supplying funds in a form not supplied by private lenders. Today, however, the housing market has accepted the long-term, low-downpayment mortgage that FHA pioneered. The program, therefore, may no longer be needed to serve that purpose. Private mortgage insurers already sell similar insurance, and might be able to take over a large part of FHA's business. The private sector, however, would not provide the same benefits to low- to moderate-income homebuyers who now receive a cross-subsidy from higher-income FHA borrowers. Although curtailing FHA mortgage insurance would not reduce unified budget outlays, it could reduce government intervention in credit markets by as much as \$30 billion in 1983.

Government National Mortgage Association (GNMA) guarantees of securities backed by FHA insured or Veterans Administration (VA) guaranteed mortgages constitute a similar example. The securities were developed to bring new investors into mortgage markets, thereby increasing the availability of funds. Mortgage-backed securities are now available for conventional mortgages, as well as FHA or VA mortgages. If these new instruments gain the acceptance that GNMA securities now enjoy, the mortgage market might be able to function efficiently without GNMA. Under current law, GNMA will be permitted to make up to \$68 billion in guarantee commitments in 1982.

The Rural Electrification Administration was also designed to meet an earlier credit market gap that may no longer exist--the inability of rural utilities to raise capital to extend electric service to remote areas. Now that almost all homes and businesses have access to electricity, the capital needs of rural utilities may be more similar to those of other utilities. Since REA lending is heavily subsidized, however, these utilities would face higher interest costs. Eliminating REA lending programs would reduce federal intervention in credit markets by \$5.5 billion in guaranteed lending in 1983. (Appendix A-270-f presents a proposal to reduce, not eliminate, REA lending.)

The U.S. Synthetic Fuels Corporation is an example of a fairly new program designed to override market conditions. Under current