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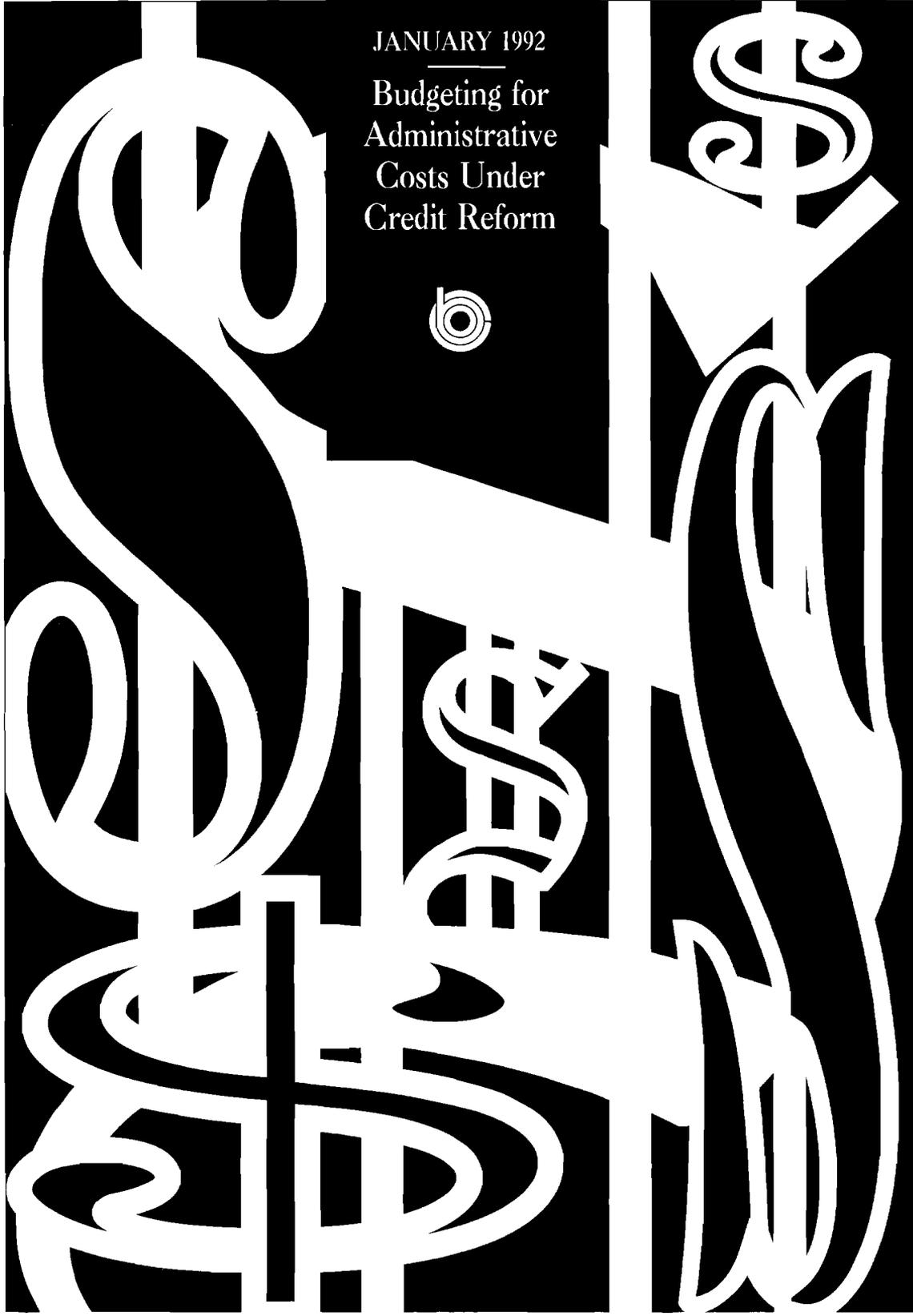
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CBO

STUDY

JANUARY 1992

Budgeting for
Administrative
Costs Under
Credit Reform



**BUDGETING FOR ADMINISTRATIVE
COSTS UNDER CREDIT REFORM**

The Congress of the United States
Congressional Budget Office

NOTES

Data in Chapter 3 that compare the administrative costs of direct loans, loan guarantees, and grants were provided by the Office of Management and Budget (OMB). OMB collected these data for use in its own report to the Congress on administrative costs, which has yet to be transmitted. OMB may modify these data before publishing its report. The data are therefore labeled "preliminary" for purposes of this CBO study.

Numbers in the tables and text of this study may not add to totals because of rounding.

Preface

This report on the administrative costs of federal credit and grant programs and their budgetary treatment satisfies the requirement of section 503 of the Federal Credit Reform Act of 1990. That statute directs the Congressional Budget Office (CBO) and the Office of Management and Budget to "each analyze and report to Congress on differences in long-term administrative costs for credit programs versus grant programs by January 31, 1992. Their reports shall recommend to Congress any changes, if necessary, in the treatment of administrative costs under credit reform accounting."

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Summary

Credit reform--enacted by the Federal Credit Reform Act of 1990--is now a reality. It requires that the expected cost of defaults and interest subsidies in credit programs be recorded in the budget on a discounted present-value basis when credit is extended. Agencies that manage credit programs also have administrative costs, however, and these costs were not included in credit reform. If administrative costs were budgeted on a present-value basis, the present and future administrative costs associated with a loan would be recognized when federal direct or guaranteed loans were disbursed.

Credit Reform and Administrative Costs

Most federal credit programs are costly to the government because they lend or guarantee funds to borrowers on terms that do not enable the government to recover its expenses. This loss may occur because the borrowers are ones who have been rejected by private lenders as poor credit risks, or because the government offers borrowers a favorable interest rate.

Before the Credit Reform Act, the federal budget accounted for all credit transactions on a cash basis, which recognized transactions only as money was paid out or received. This treatment did not recognize the costs of credit

programs in a timely fashion, since there was often a major discrepancy between first-year and long-term costs. Consequently, a credit program with high expected defaults appeared in the budget as no more expensive than one with low expected defaults.

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Furthermore, before credit reform, the budget was biased in favor of loan guarantees and against direct loans and grants. Cash budgeting overstates the short-term costs of direct loans by ignoring future repayments. It treats loan guarantees, on the other hand, as relatively costless when credit is extended, since the government's losses occur in the future.

Credit reform aims to identify the expected costs of credit transactions in the budget when credit is extended and to separate these costs from the unsubsidized cash flows inherent in credit transactions. It does so by budgeting for the subsidized and unsubsidized portions in different ways. The subsidy--the present value of the long-term cost to the government

of a loan transaction--is appropriated and treated as an outlay in the budget. The unsubsidized portions of direct loans and loan guarantees are treated as nonbudgetary financing flows.

Administrative costs of federal credit programs, while they also represent costs that would not exist without a decision to extend or guarantee credit, are not included in current subsidies. Their exclusion from the subsidies requires these costs to continue to be funded separately on a cash basis. The budget thus fails to identify the estimated long-term cost of administering current-period loan obligations and guarantee commitments.

The Credit Reform Act requires a review of the budgetary treatment of administrative costs. The mandate for this study separates the issue of administrative costs into two parts. First, how do the administrative costs of federal credit programs compare in size and duration with the administrative costs of federal grant programs? Second, what is the appropriate way to treat the administrative costs of credit programs in the budget?

Estimating the Size and Duration of Administrative Costs

If the characteristics of administrative costs were the same for all types of assistance programs, their budgetary treatment would have little impact on the choice of one type of assistance over another. However, there may be differences in both the timing and size of administrative costs. For example, if the administrative costs of grant programs occur up front and those of credit programs stretch far into the future, a cash-basis treatment would understate the long-term costs of credit programs relative to those of grants. Further, if administrative costs were negligible or at a constant level, their budgetary treatment might have little significance. If the long-term

costs of administering direct loans were relatively large, however, and the long-term costs of administering grants and guarantees were relatively small, a cash-basis budgetary treatment might understate the cost of these direct loans. This understatement could distort budgetary choices away from grants or guarantees and toward direct loans.

The research reported in this study indicates that there are substantial differences in the timing and size of administrative costs for direct loan, guarantee, and grant programs.

The timing of costs is primarily a function of program characteristics. In a representative sample of grant programs, more than 60 percent of administrative costs occurred in the first year; generally, all costs were paid in the first five years. This pattern is not surprising since grant programs concentrate on getting money to recipients and, in some programs, monitoring its use. These activities rarely extend beyond five years.

Credit programs have different cost cycles than grant programs, and direct loans have different cycles than loan guarantees. In the case of direct loans, the majority of costs (more than two-thirds) typically occur in the first five years; around 40 percent of these occur in the first year. The administrative costs of loan guarantees are concentrated in later years. This difference in the cost cycles of direct loans and loan guarantees reflects the fact that the federal government is much more involved in originating direct loans, whereas federal activity for loan guarantee programs is concentrated in the period after loans begin to default.

The long-term administrative costs to the federal government of direct loan programs are greater than those of loan guarantees or grants. The present value of the long-term costs of administering 1991 direct loans is estimated at nearly 8 percent of total 1991 lending. For loan guarantees and grants, the cost is estimated to be less than 2 percent. The larger costs for direct loans are a result of the duration of administrative costs for loans

compared with the duration for grants, and of the fact that the federal government bears a higher percentage of administrative costs for direct loans than for loan guarantees. Furthermore, long-term costs vary widely among programs within each category.

How Should Administrative Costs Be Budgeted?

Credit reform sought to treat federal subsidy costs for credit programs on a present-value basis. This approach would argue for similar budgetary treatment of administrative costs, as these costs are no different from current subsidy costs. Including them in the subsidy would make the subsidy calculation more complete and would provide policymakers with more accurate cost estimates when making budget decisions. Better cost estimates are important since the long-term costs of direct loans are estimated to be greater than those of guarantees or grants, since costs vary widely between programs in the same category, and since the timing of costs is so different between and among loans, guarantees, and grants.

There are, however, strong arguments against changing the budgetary treatment of the administrative costs of credit programs. First, such a change would invariably increase the budgeting and accounting work load of federal agencies. Although the budgeting problems might be overcome without great difficulty, the prospects for changing federal accounting systems to meet the requirements imposed by a change in budgetary treatment are much less encouraging. Agencies might find it quite expensive to move to a system that would enable them to account for costs in the necessary detail. This change would not only consume budgetary resources, but would force agencies to divert attention away from carrying out credit reform, including refining subsidy estimates.

A second concern with moving administrative costs into the subsidy has to do with its impact on the control of appropriated resources. Currently, the Congress annually appropriates the estimated full amount needed to administer all loans, regardless of when they were made. If administrative costs were moved into the subsidy, that subsidy would include an appropriation for the present value of all estimated current and future costs of administering loans to be made in the budget year. The sitting Congress would not be able to exercise contemporaneous control over the funding of the administrative activities of a credit agency--or it would need to influence these activities in some other way.

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Third, the level of budget authority and outlays required by a present-value method of budgeting for administrative costs would increase the deficit in the short run. Under the Budget Enforcement Act, this could have the effect of crowding out other programs covered under the discretionary spending limits. The President has the authority to adjust these limits to reflect changes in budget concepts, however, which would protect these other programs.

Finally, including administrative costs in the subsidy could potentially make credit programs and other programs less comparable, even though an explicit goal of credit reform was to increase comparability. The administrative costs of noncredit programs are not budgeted for on a present-value basis. Al-

though this lack of comparability could be a concern, a counterargument is that credit programs ought to be treated uniquely, since they have administrative costs that extend much farther into the future than do those of other programs.

In short, neither the current cash basis nor the present-value basis is without drawbacks. The cash basis of accounting for administrative costs runs counter to credit reform's goal of recognizing all costs at the time that decisions are made to incur those costs. Alternatively, there are real disadvantages associated with moving these costs into the subsidy, including the potentially large expense of making the necessary accounting changes and the loss by the Congress of contemporaneous control over appropriations.

For the above reasons, the Congressional Budget Office does not recommend changing the budgetary treatment of the administrative costs of credit programs at this time. The apparent disadvantages associated with moving administrative costs into the subsidy outweigh the apparent advantages.

Taking Intermediate Steps to Increase Information

Other actions could be taken. One alternative is to stop short of moving administrative costs into the subsidy, but to begin to collect

and report more information on long-term administrative costs for budgeting. The President's budget could report such cost information and the Congress could use it for preparing the budget resolution, for the authorization process, and for appropriation action. Since costs would not be appropriated on a present-value basis, concerns about accounting and about Congressional control would be lessened.

In particular, long-term cost information is crucial to informed decisions in two situations: when considering a new credit program or a significant program expansion, and when considering substituting one type of program for another--for example, replacing a loan guarantee with a direct loan program. In planning for the expansion of the government's capability for knowing, measuring, and recognizing administrative costs, the Congress should give first priority to supporting these two types of decisions.

In the end, the only way to integrate fully the long-term costs of credit programs into the budget is to recognize them on a present-value basis. Present-value treatment might be justified if a low-cost method of accounting for costs could be found (such as using random surveys or time and motion studies to allocate costs), coupled with a method of maintaining Congressional control. Changing the budgetary treatment of the administrative costs of credit programs does not, however, seem warranted at this time.

Introduction

The Federal Credit Reform Act of 1990 requires a new treatment in the federal budget of direct loans and loan guarantees. Beginning in fiscal year 1992, the discounted present value of the expected future costs of interest subsidies and defaults in credit programs are charged to budget authority and outlays when credit is extended rather than when the costs are incurred.¹ In turn, the unsubsidized portions of direct loans and loan guarantees are treated as non-budgetary financing flows.

Besides the above costs, agencies that manage credit programs also incur administrative costs. These include the costs of developing credit policy, originating loans, servicing loans, and collecting debts owed to the federal government. These costs, which total more than \$1 billion a year on a cash basis, were explicitly excluded from credit reform, pending further study. However, administrative costs could be recorded in present-value terms and included in a more comprehensive cost measure. This study will consider the issues surrounding the budgetary treatment of administrative costs for federal credit activities.

The current cash-basis method of budgeting used for administrative costs and the present-value method lead to differences in when administrative costs are recognized. Using the

cash basis, expenditures for the administrative costs of credit programs are recognized in the budget when they occur, rather than when the commitment to those costs is implicitly made. In a given fiscal year, the budget records only those administrative costs that are actually paid in that year. Future costs associated with current-year loans are recognized in future fiscal years.

Alternatively, using present-value treatment, the budget would recognize all of the present and estimated future administrative costs associated with a loan when the commitments to those costs were made. For example, if costs were to extend for 10 years into the future, the costs would be discounted to a single present value and this value would be recorded in budget authority and outlays when the loan was made.

Table 1 compares the budgetary treatment under both methods of the total administrative costs of a hypothetical loan program. In each case, administrative costs total \$1 million in the first year and \$100,000 annually in years two through 10. Using cash budgeting, budget authority and outlays for these activities would be spread over the 10-year period. Alternatively, using the present-value method, the present value of the long-term costs would be estimated and charged to both budget authority and outlays in year one. A subsidy payment that included these administrative costs would be made to a nonbudgetary financing account, where the money would earn interest until needed to pay the annual administrative costs.

1. Present value is the current value of an amount or series of amounts of cash to be paid in the future. More precisely, it is the capital sum today that, when invested at the going interest rate, could meet the future series of cash payments.

In this example, the current and future stream of administrative costs would result in budget authority and outlays of \$1.504 million in year one. In subsequent years, the balance of the administrative cost appropriation would earn interest to enable the \$1.504 million to increase to the total amount that would ultimately be required, \$1.9 million. However,

these interest payments, which represent the time value of money, would be treated as outlays of net interest rather than as a program cost.

This study assesses the potential for treating administrative costs in the budget as a part of subsidy costs on a present-value basis compared with current policy. It does so by reviewing the nature and budgetary consequences of credit reform, comparing the long-term administrative costs of various types of programs in the budget, and assessing the advantages and disadvantages of a change in budgetary treatment for the administrative costs of credit programs.

The Federal Credit Reform Act of 1990 (Title V of the Congressional Budget Act, amended by the Budget Enforcement Act of 1990), which mandates this study, separates the issue into two parts:

- o How do the administrative costs of various federal credit programs compare in size and duration with the administrative costs of various federal grant programs?² and
- o What is the appropriate way to treat the administrative costs of credit programs in the budget, particularly given the goals of credit reform?

These questions are addressed in detail in the following chapters.

2. This study employs a broader definition of grants than is typically used. Specifically, it includes direct payments to individuals as well as grants provided to state and local governments.

Table 1.
Administrative Costs of a Hypothetical Loan Program Using Cash and Present-Value Budgeting Methods (In thousands of dollars)

Year	Budget Authority and Outlays	
	Cash Basis	Present-Value Basis
1	1,000	1,504 ^a
2	100	b
3	100	b
4	100	b
5	100	b
6	100	b
7	100	b
8	100	b
9	100	b
10	100	b

SOURCE: Congressional Budget Office.

NOTE: The program is assumed to have lending costs of \$1 million in the first year, and costs for servicing and debt collection of \$100,000 in each of the next nine years. Costs are assumed to occur at the beginning of each fiscal year.

- a. This figure represents the present value of the 10-year stream of costs, using an 8 percent discount rate. The \$1.504 million flows to a nonbudgetary account where it is invested until needed.
- b. Funds are located in a nonbudgetary account where they earn interest that is used to pay future administrative costs.

Changes Created by Credit Reform

Most federal credit programs are costly to the government because they provide loans to targeted borrowers on terms that do not enable the government to recover fully its expenses. For policy reasons, the government often lends to borrowers who have been rejected by private lenders as poor credit risks, and it does so on more lenient terms than a private lender would. In addition, the government sometimes lends at interest rates that are less than its own cost of borrowing. Hence, most loan programs experience losses from net interest costs, delinquencies, and defaults. Similarly, the federal government also guarantees private loans to high-risk borrowers in exchange for fees that are below the expected loss to the government.

The federal cost of credit programs, however, is not limited to financial losses resulting from the provision of funds at favorable interest rates or from loan defaults by borrowers. Costs are also incurred by the government in identifying borrowers who meet eligibility requirements, servicing loans and monitoring guarantees, collecting delinquent loans and defaulted guarantees, and seizing, managing, and selling collateral. Such administrative costs are sizable for many programs, even though they are usually less than other explicit costs. In all, the federal government spends more than \$1 billion a year (on a cash basis) administering new and existing credit contracts. By comparison, present-

value subsidies for new activity total about \$4 billion a year.¹

Beginning with fiscal year 1992, the federal budget measures new federal credit activity in terms of the discounted present value of expected long-term financial losses on loan obligations and guarantee commitments issued in the budget year. This cost measure excludes expenses that the government incurs in administering loans and guarantees. The result is that administrative costs, which would not be incurred without a decision to lend or guarantee lending, are not recognized in the same way as other costs of credit programs. In considering the budgetary treatment of administrative costs, it is useful to review the conceptual framework of credit reform, the mechanics of the new system, and the current means of funding administrative costs.

The Conceptual Framework of Credit Reform

Before the Credit Reform Act, the federal budget did not recognize the costs of credit programs with sufficient timeliness to permit

1. Congressional Budget Office, "An Explanation of the Budgetary Changes Under Credit Reform," Staff Memorandum (April 1991).

their effective control.² In addition, the treatment of credit programs created a bias in favor of loan guarantees and against direct loans and grants.

The prereform budgetary basis of accounting for credit was cash, which recognized transactions only as money was paid out or received. For credit programs, this treatment created a major discrepancy between the budgetary consequences of a transaction in the current budget period and its long-term cost to the government. The difficulty was that budget decisions were made on the basis of effects on the current budget rather than on long-term costs. Further, this method of accounting diminished the usefulness of the budget in reporting the substance of federal transactions.

An example is the timing of the budgetary effects of direct loans and guarantees. Before credit reform, the budgetary effect of a direct loan was to increase outlays by the amount of the disbursement. The first-year outlay cost of a direct loan, therefore, was equal to a grant of the same size, even though the loan's long-term cost was less because of expected repayments of principal and interest. On a cash basis, repayments of direct loans are recorded in the budget as offsetting collections when received. Thus, depending on the pattern of disbursements and repayments, a loan program's net outlays could be zero or negative in a year in which substantial amounts of costly lending occurred.

Under the cash basis of budgeting for loan guarantees, most costs appeared in the budget only when defaults occurred, which could be long after the government had committed itself to bear this loss. In fact, because fees were sometimes collected, guarantee programs could reduce the recorded deficit in the year of commitment. Only in later years, when

payments were required to honor federal guarantees, were the costs of loan guarantees recognized and recorded with cash-basis budgetary accounting. Under cash-basis accounting, the costly effects on outlays and the deficit occurred long after the commitment had been made.

In the year a loan was disbursed, therefore, cash accounting for credit generally overstated the long-term financial costs to the government of new direct loans and understated the costs of new loan guarantees. This misstated the cost of new activity and created a budgetary bias in favor of guarantees and against direct loans. Further, cash-basis accounting made it possible to reduce the current-year budget deficit by substituting loan guarantees for direct loans, even where federal losses from the two types of assistance were the same.

Credit-reform accounting was adopted to remove the discrepancy between the financial loss to the government and the cash-basis budgetary consequences of federal credit activity. It does so by providing a more accurate and timely measure of long-term costs in the budget. This change also permits more effective control of program costs through the budget and more meaningful comparisons of costs between credit and noncredit programs.

How Credit Reform Operates

As a special form of accrual accounting, credit reform aims to identify most of the expected costs of credit transactions in the budget when credit is extended and to separate these costs from the unsubsidized cash flows that are inherent in credit transactions. This separation enables the budget to control and report most of the cost of an assisted credit transaction when the assistance is extended. Using estimates of cost, credit reform switches the budgetary focus from total current-period cash flows to the expected financial loss on this period's new credit activity.

2. For a more detailed discussion of this situation, see Congressional Budget Office, *Credit Reform: Comparable Costs for Cash and Credit* (December 1989).

Elements of a Loan Transaction

A federal loan transaction can usefully be divided into three parts: the financial subsidy, which is the value of the cash disbursement that is not expected to be recovered by the federal government from borrower payments; the unsubsidized component, which is the present value of amounts that the government expects borrowers to repay over the life of the loan; and the stream of administrative costs that the government incurs in monitoring, servicing, and collecting the loan under the various economic conditions that the borrower is likely to encounter over the life of the loan.

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Before credit reform, the full costs of new loan or guarantee transactions were not identified. Neither long-term income nor expenses were attributed to the assistance extended in any specified year. A single budget account was used to report loan disbursements, repayments, interest received and paid, fee collections, debt transactions with the Treasury, and appropriations of general funds. Frequently, the transactions of several programs, including both direct loans and guarantees, were recorded in a single budget account. Within such a budgetary accounting system, determining the costliness of individual credit programs or transactions was im-

possible, even after a loan or guarantee or a group of such credits had matured.

Replacing the Account Structure

Credit reform replaced the single account with three accounts: liquidating, program, and financing accounts.³ These new accounts are used to change the basis of accounting and to separate cash flows for new and old activity. (The three accounts do not correspond, however, to the three-part division of a loan into financial costs, administrative costs, and unsubsidized cash flows.)

The first, the liquidating accounts, are for loans and guarantees committed to before fiscal year 1992. Credit reform made no attempt to modify the budgetary treatment of existing credit assistance, the cost of which is fixed in existing contracts. Rather--unless the terms of these contracts are modified in such a way as to affect their cost to the government--these contracts are to be treated until maturity on the same cash basis that was used when they were originated. (Contract modifications that change the subsidy cost will require recording the new subsidy amounts and restating the loans and guarantees at credit-reform values.) With the passage of time, these accounts will diminish in size and activity until they eventually disappear.

The other two types of accounts, program and financing, deal with new activity. Program accounts are used primarily for recording the estimated present-value cost of credit assistance extended in the budget year. Financing accounts are used for recording the unsubsidized cash flows and as a temporary

3. For pre-credit-reform accounts that contained both direct loan and guarantee programs, two new financing accounts--one for direct loans and one for guarantees--were established. In addition, new accounts were created to treat the noncredit programs formerly financed from mixed credit and noncredit accounts. See Congressional Budget Office, "An Explanation of the Budgetary Changes Under Credit Reform."

haven for funds that will be needed later in program accounts.

The financial cost of a loan is calculated by comparing the amount that is advanced with the present value of expected repayments. If, for example, the government lends \$100 now and expects to receive \$95 back in one year, the subsidy is \$100 minus the present value of \$95 in one year. If the one-year Treasury bill rate is 5 percent, the present value of \$95 in one year is \$90.48. The subsidy component of the transaction, therefore, is \$100-\$90.48, or \$9.52.

Distribution of a Transaction Between Accounts. Under credit reform, the \$9.52 cost of the transaction is appropriated to the relevant program account. When the agency obligates the \$100 loan to the borrower, the program account recognizes an obligation to pay \$9.52 to the financing account. Simultaneously with the disbursement of the loan to the borrower, the program account pays \$9.52 to the financing account. The financing account uses the subsidy payment of \$9.52 and \$90.48 that it borrows from the Treasury to advance the \$100 loan to the borrower (see the top panel of Figure 1).

One year after disbursement, if all goes as expected, the agency will collect \$95 from the borrower and deposit this amount in the financing account. The financing account will repay its \$90.48 debt to the Treasury plus 5 percent interest (\$4.52), for a total of \$95 (see the bottom panel of Figure 1). Thus, if the subsidy estimate was correct, the financing account will have assets and liabilities of zero after the loan matures.

In cases where the subsidy estimate is too low and the financing account receives less than expected, the Credit Reform Act provides permanent and indefinite budget authority for use in retiring the excess debt to the Treasury. The shortfall is made up by an additional payment from the program account to the financing account. If the subsidy estimate is too high, the excess funds are paid into a receipt account at the Treasury.

Identifying the subsidy, which is one of the key elements of the transaction for budgeting, permits this cost to be recognized in the budget when the loan is made. It also insulates the budget from the equal-value cash exchanges that constitute the nonsubsidy element of the transaction. This insulating is accomplished by classifying the program account as a budgetary account and the financing account as a nonbudgetary account. The nonbudgetary financing account, therefore, serves simply as a means of financing, similar to other cash flows from federal borrowing that are not included in budget totals.

Borrowing and debt repayment between the financing account and the Treasury are also classified as nonexpenditure transactions, meaning that neither is recorded as a budgetary outlay. As a consequence, the costs of credit assistance paid out by the program account are included in budget authority, outlays, and the deficit, but the costless transactions of the financing account are excluded from these measures. (The cash flows of the financing account are reported in the "other means of financing" portion of the budget.)

Effects on the Budget Deficit. Under credit reform, the loan shown in Figure 1, for example, would increase budget outlays and the deficit by \$9.52 when the loan is disbursed, because only outlays for credit from the program account are counted in budget outlays. Under pre-credit-reform accounting, outlays and the deficit would have been initially increased by \$100. Likewise, under credit reform, budget outlays and the deficit are unaffected when the \$95 payment is received as expected.⁴ Under the old system, budget outlays and the deficit would have been reduced by \$95 when the payment was received.

Similarly, through use of such accounts, the estimated cost of loan guarantees is included in budget outlays and the deficit when the

4. In fact, the interest paid by the financing account to the Treasury (\$4.52 in the illustration) is an offsetting collection of the Treasury. However, the Treasury must pay \$4.52 in interest to the public on its own borrowing of \$90.48, so the net budgetary effect is zero.

guaranteed loan is disbursed to the borrower. The deficit is unaffected by expected federal payments to honor the guarantee, by expected collections from defaulting borrowers, or by expected recoveries from the sale of seized collateral.

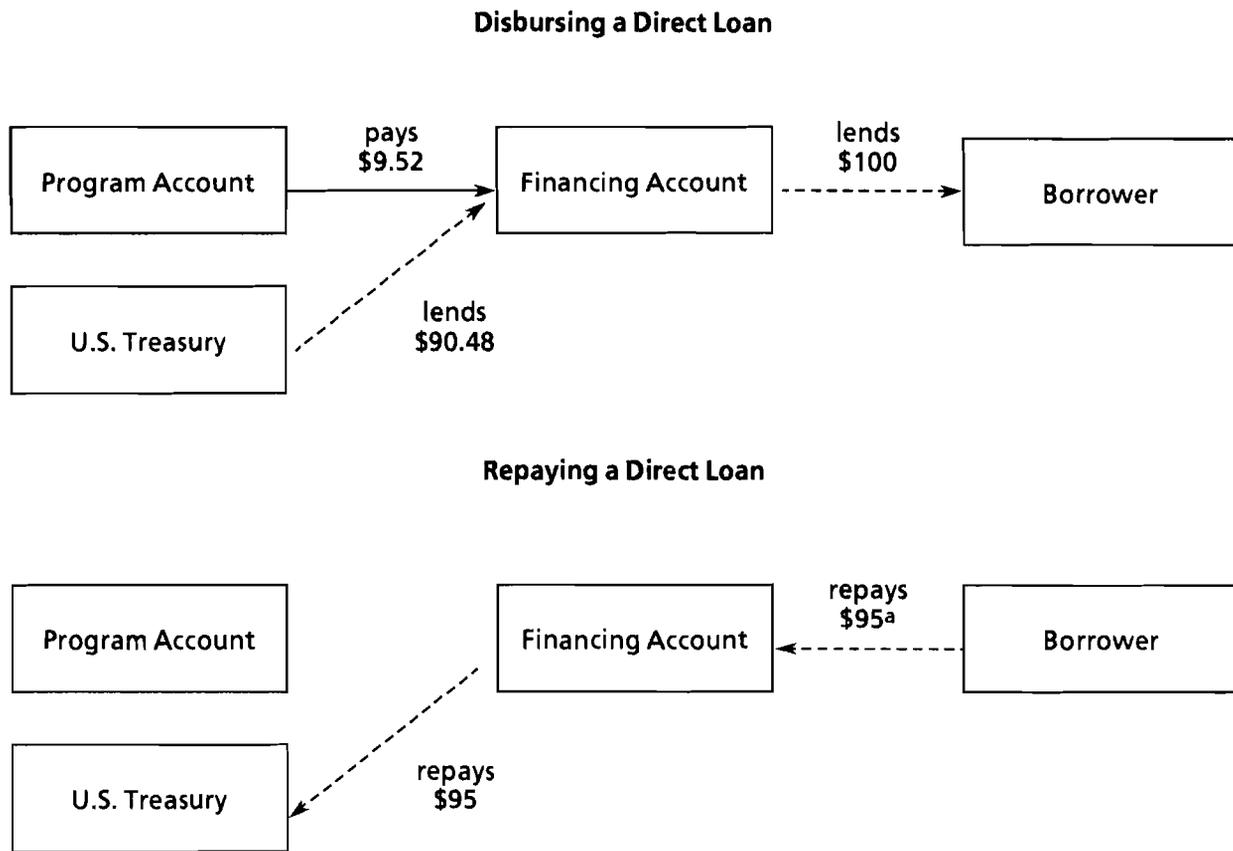
Under credit reform, however, the deficit is affected by discrepancies between the estimated loss on a loan and the actual loss. If, for example, the borrower in Figure 1 had repaid only \$90 at maturity, the \$5 shortfall would have appeared in outlays and the

deficit as a payment for unanticipated losses from the program account to the financing account.

How Administrative Costs Are Currently Funded

Excluding administrative costs from the subsidy calculation requires these costs to be funded separately. Currently, an appropria-

Figure 1.
Cash Flows for Loan Disbursement and Repayment Under Credit Reform



SOURCE:

NOTE: Dashed line indicates nonbudgetary flow. Solid line indicates budgetary flow.

a. The example assumes that, because of a borrower default, the government is able to recover only \$95 of the \$100 owed. Of the \$95 payment from the financing account to the Treasury, \$4.52 represents interest, which is a budgetary flow. This payment offsets the equal \$4.52 payment of interest that the Treasury owes its bondholders.

tion is made for the administrative costs to be incurred by an account in a given year for both old and new credit activity. An exception occurs where no new activity is planned, so the only activity is in the liquidating accounts. In this case, administrative costs are appropriated to and paid from the liquidating accounts. In most cases, however, these appropriations are transferred to and merged into the agency's larger salary and expense account.

This recognition of administrative costs is largely pro forma, inasmuch as no provision has been made for separate accounting for these costs. No information, therefore, is available to assess the accuracy of the provision for administrative costs under current policy. Further, these costs--to the extent that they are identified--are recorded in budget outlays on a cash basis when paid. No distinction is made in the account for expenses related to pre-credit-reform activity and post-credit-reform loans and guarantees. Under credit reform, the budget fails to identify the estimated long-term cost of administering current-period loan obligations and guarantee commitments.

Thus, Figure 1 could be made more complete by adding a series of annual appropria-

tions and payments from the program account for labor services and supplies used in the origination, oversight, servicing, and collection of direct and guaranteed loans.⁵

Convincing arguments can be made both for including administrative costs in subsidy calculations and for retaining their current treatment. These arguments are explored in detail in Chapter 4. Any discussion of appropriate budgetary treatment of administrative costs, however, must take into account the magnitude and timing of these costs. Program decisions may be unaffected by the treatment of these costs in the budget if, for example, administrative costs for credit programs are of negligible size; if the majority of these costs are incurred in the first year, so that cash costs and long-term costs are largely coincident; or if the size and timing of administrative costs for credit and grant programs are the same. These points are examined in detail in the following chapter.

5. Under the Office of Management and Budget's Circular No. A-11, certain administrative costs incurred by those under contract to manage and sell acquired collateral, which are routinely deducted from sales proceeds, are indirectly included in the subsidy estimates because these costs reduce the estimated recovery from liquidated collateral.

The Administrative Costs of Federal Credit and Grant Programs

Administrative costs of federal credit and grant programs are a potentially important, yet incomplete, element in budgeting. Since the enactment of credit reform, decisionmakers have had more complete estimates of the other costs of the various methods of providing assistance, but little information has been available to them on long-term administrative costs.

If administrative costs are not considered, however, when considering trade-offs between programs, the Congress and the President run the risk of making decisions without complete information. This could result in the substitution of one type of program for another (a loan program instead of a loan guarantee program, for example) based solely on non-administrative cost comparisons, when the inclusion of administrative costs would have yielded a different outcome. The same potential for cost distortions exists, although perhaps to a lesser extent, between credit and grant programs.

Common sense suggests that administrative costs will vary widely between and among credit and grant programs, given the substantial differences in the level and timing of administrative effort required to carry out these programs. For example, in a grant program, where recipients have no obligation to repay, the major costs involve identifying eligible recipients, disbursing funds, and monitoring spending in line with any grant conditions that are imposed. Loan programs, on the other hand, have major additional costs

associated with collecting repayments from borrowers and collecting delinquent debts (including acquiring, protecting, and disposing of collateral). These costs would be expected to occur throughout the life of the loan, rather than just in the first year or two.

Similarly, the timing and degree of administrative effort varies widely among grant programs and among loan programs, based on the obligations of recipients and the responsibilities of the federal government. For instance, administrative costs to the federal government should be lower for loan guarantees, in which a third-party lender services the loans, than for direct loans, which the government services. Administrative costs can also be expected to vary directly with the default rate because more administrative effort will be required in attempting to recover payments from borrowers in default.

Estimating Long-Term Administrative Costs

Unfortunately, agencies do not routinely produce information on the long-term administrative costs of credit programs to back up such commonsense assertions. This lack of data is not surprising, since the information has not been required for budgeting or policy choice in the past. In addition, traditional accounting systems have been designed to record past transactions rather than antici-

pated ones. Because administrative costs are treated on a cash basis, agencies typically record information on the salaries and expenses that are used to administer a credit program during a specific year rather than the long-term costs associated with this year's additions to the portfolio. This problem is most acute in those programs--such as direct loans and loan guarantees--that have administrative costs extending farthest into the future.

Since agencies sometimes produce information on annual costs for administration by budget account, however, these data provide a useful starting point for calculating the long-term administrative costs of credit programs. The primary limitation is that they do not match cost information with cohorts, or obligations made in a given year. Rather, they present information on current-year administrative costs for all new and old cohorts.

For example, the President's 1992 budget included a separate estimate of administrative costs for each account covered by credit reform, as required by the Federal Credit Reform Act. The 1992 budget for administrative costs, however, includes not only those amounts needed for 1992 loans (that is, loans covered by credit reform), but also those costs associated with managing the pre-1992 loan portfolio. For this reason, these are not the long-term costs associated with the loans made in 1992; rather they are the costs in 1992 associated with all loans in an agency's loan portfolio regardless of when the loans were made.

The method that the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) used to determine long-term administrative costs involved converting annual administrative costs of loans and grants into long-term administrative costs. For loan programs, administrative activities were first divided into four types: policy and oversight, credit extension, account servicing, and delinquent debt collection. Then, estimates were made of the proportion of total funds dedicated to each of these activities in fiscal year 1991. Next, these categories were

used to calculate annual costs per loan and to distribute total costs over the life cycle of the loans based on certain other variables, including the size of the loan portfolio, the default rate, and the timing of expected defaults. Finally, the current and future costs were discounted to a single present value. This resulting figure represents an estimate of the present value of the long-term administrative costs associated with credit that was extended in fiscal year 1991.

The approach was much the same for grant programs, although the categories of administrative activity were different: policy and oversight, grant award, grant monitoring, and review and closeout. (The appendix to this study presents more details about the estimating method, as well as an example of its application.¹)

*CBO estimates reveal
substantial differences
in the long-term
administrative costs
of direct loans,
guarantees, and
grants.*

Resource constraints prevented the application of this method to all federal credit and grant programs. Most of the credit programs affected by credit reform were studied, along with a sample of 14 grant programs listed in the 1991 *Catalog of Federal Domestic Assistance*. These were selected to assure a broad

1. CBO assisted the Office of Management and Budget in designing the data collection effort. Agencies were requested to provide information to their OMB examiners, which OMB staff then used to derive estimates using the conversion model described in the appendix.

range of program types from a diverse set of agencies.

How Costs Differ Between and Among Credit and Grant Programs

Estimates derived with the above method reveal substantial differences in the long-term administrative costs of direct loans, guarantees, and grants. In particular, differences occur in the length of time that administrative costs continue after the assistance (grant or loan) is provided, the distribution of this total across the life of the credit or grant, and the total administrative costs over the life of the credit or grant.

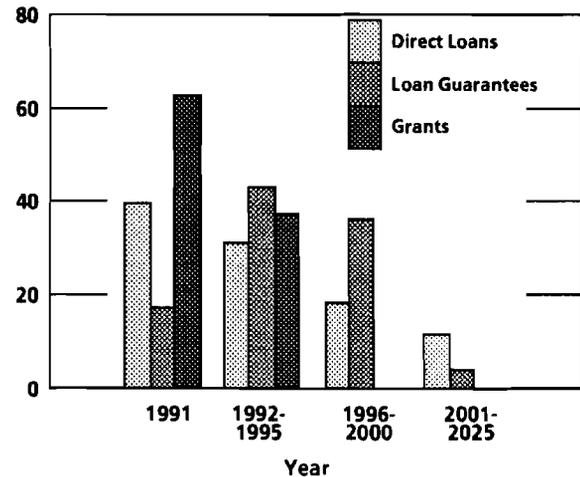
The Temporal Distribution of Long-Term Costs

Direct loans, guaranteed loans, and grants vary according to the duration of administrative effort and the timing of that effort (see Figure 2). Direct loans involve a relatively higher percentage of administrative costs in the first year than do loan guarantees, primarily because of the costs associated with extending credit. In addition, more than two-thirds of the administrative costs of direct loans occur in the first five years. (It is important to note that these life-cycle cost percentages are expressed in present-value terms. That is, two-thirds of the present value of the administrative costs of direct loans, for example, are incurred in the first five years. In undiscounted values, the costs in later years would represent a higher percentage of total costs.)

For loan guarantees, however, the administrative costs are concentrated in later years, as loans begin to default. Thus, for the typical loan guarantee, a higher percentage of the administrative cost commitment extends into

Figure 2.
Estimated Cost Cycles for the 1991 Cohort of Direct Loans, Loan Guarantees, and Grants

Percentage of Total Administrative Costs



SOURCE: Congressional Budget Office based on preliminary information from the Office of Management and Budget.

the future (nearly 40 percent of the costs occur after the fifth year). In contrast, virtually all of the costs associated with grant programs occur in the first five years; more than 60 percent are incurred in the year that the grant is made.

These overall data mask a considerable amount of variation among programs. Tables 2 through 4 present estimates of the distribution of administrative costs associated with loans made in 1991 over the first, second to fifth, sixth to tenth, and remaining years. Separate estimates are presented for direct loan programs, loan guarantee programs, and grant programs.

For direct loan programs, around 40 percent of costs occur in the first year, but there is wide variation among programs (see Table 2).² For example, the direct loan programs of the Rural Development Insurance Fund have administrative costs that are relatively front-loaded (48 percent in the first year), whereas

2. This average represents the total first-year administrative costs as a percentage of total administrative costs for all years, all expressed in present-value terms.

college housing loans from the Department of Education and pollution abatement loans from the Environmental Protection Agency are heavily back-loaded (only 15.5 and 11.2 percent of costs in the first year, respectively). These large differences are consistent with the expectation that differences in the structure and characteristics of loan programs affect the timing of costs.

There is also substantial variation among loan guarantee programs. Although overall only about 17 percent of administrative costs for loan guarantees occur in the first year, individual programs deviate substantially from

this figure (see Table 3). The export assistance program of the Department of Agriculture's Commodity Credit Corporation and the loans guarantees of the Overseas Private Investment Corporation are normally short-term guarantees. Thus, they incur the majority of their administrative costs in the first five years. At the other end of the spectrum, the Health Professions Graduate Student Loans program incurs most of its costs in years 11 through 35.

Only one grant program included in the study has costs that extend beyond the fifth

Table 2.
Distribution of Administrative Costs for Selected 1991 Direct Loans, 1991-2025 (In percent)

Department/Agency and Loan Program	1991	1992- 1995	1996- 2000	2001- 2025	1991- 2025
Funds Appropriated to the President--Overseas Private Investment Corporation	48.0	38.0	14.0	0	100
Agriculture					
Agricultural Credit Insurance Fund					
Emergency	61.9	34.8	3.3	0	100
Farm ownership	42.3	34.7	20.4	2.6	100
Farm operating	83.5	16.5	0	0	100
Rural Development Insurance Fund--Water and waste	48.3	18.6	8.5	24.6	100
Rural Housing Insurance Fund					
Single family	37.6	35.2	19.7	7.5	100
Rental housing	41.6	20.4	14.7	23.2	100
Rural Telephone Bank	37.3	19.3	12.2	31.2	100
Education--College Housing and Academic Facilities	15.5	20.2	19.2	45.2	100
Interior--Bureau of Indian Affairs	22.8	19.9	18.6	38.7	100
State--Repatriation Loans	100	0	0	0	100
Transportation--AMTRAK Corridor Improvement Loans	26.9	25.3	26.0	21.7	100
Environmental Protection Agency--Abatement, Control, and Compliance	11.2	25.1	25.4	38.4	100
Federal Emergency Management Agency-- Disaster Assistance (State Share)	30.0	70.0	0	0	100
Small Business Administration					
Disaster loans	35.6	29.2	22.5	12.7	100
Business loans	13.1	52.8	34.1	0	100
Total	39.5	30.7	18.2	11.6	100

SOURCE: Congressional Budget Office based on preliminary information from the Office of Management and Budget.

Table 3.
Distribution of Administrative Costs for Selected 1991 Loan Guarantees, 1991-2025 (In percent)

Department/Agency and Loan Guarantee Program	1991	1992- 1995	1996- 2000	2001- 2025	1991- 2025
Funds Appropriated to the President--Overseas Private Investment Corporation	63.3	27.5	9.2	0	100
Agriculture					
Agricultural Credit Insurance Fund	31.5	61.9	6.5	0	100
Commodity Credit Corporation	81.0	19.0	0	0	100
Rural Development Insurance Fund	67.7	22.1	7.6	2.5	100
Commerce--NOAA Federal Ship Financing Fund	44.2	26.5	28.6	0.7	100
Education--Guaranteed Student Loans	1.0	32.8	66.1	0	100
Health and Human Services--Health Professions Graduate Student Loans	1.5	5.6	31.6	61.3	100
Housing and Urban Development					
FHA mutual mortgage	27.0	68.7	2.0	2.3	100
FHA general and special risk	18.3	36.7	43.4	1.7	100
Community development loan guarantees	36.7	52.6	10.7	0	100
Interior--Indian Loan Guaranty and Insurance Fund	67.6	20.3	6.7	5.5	100
Veterans Affairs--Housing Programs	16.1	40.0	32.3	11.6	100
Small Business Administration--Business Loans	31.8	26.1	38.7	3.4	100
Total	17.3	42.8	36.0	3.9	100

SOURCE: Congressional Budget Office based on preliminary information from the Office of Management and Budget.

NOTES: NOAA = National Oceanic and Atmospheric Administration; FHA = Federal Housing Administration.

year--the Title III endowment program in the Department of Education (see Table 4). Other programs do vary, however, according to the portion of costs that occurs in the first year. The Department of Agriculture's Cooperative Forestry Research program incurs almost all of its costs in year one, whereas the research programs of the Department of Health and Human Services incur just over one-third of theirs.³

3. The average loan maturity is used to derive estimates of long-term administrative costs for this study. In the case of guaranteed student loans, for example, the average maturity is nine years, even though some loans may still be outstanding for 12 or 15 years. Thus, actual costs will have a longer duration than reported here. Any bias in net present values from this method is likely to be very small.

The Size and Variability of Long-Term Costs

The size of administrative costs also varies among programs. Although the duration of costs can influence their magnitude, other factors make some programs especially costly to administer. These include the initial cost of processing applications, the need for follow-up and monitoring, and, in the case of loans or defaulted guarantees, the cost of debt collection efforts. Tables 5 through 7 present estimates of the size of costs for each of the three types of assistance.

Direct Loans. In direct loan programs, a federal agency loans funds to a borrower. The agency has full responsibility for processing the loan application, making the loan, servicing the loan, and collecting delinquent debt. For this reason, direct loan programs can be expected to be more costly for the fed-

Table 4.
Distribution of Administrative Costs for Selected 1991 Grants, 1991-2025 (In percent)

Department/Agency and Grant Program	1991	1992- 1995	1996- 2000	2001- 2025	1991- 2025
Agriculture--Cooperative Forestry Research	99.5	0.5	0	0	100
Education					
Pell grants	75.8	24.2	0	0	100
Title III endowment	36.2	19.0	19.7	25.1	100
Health and Human Services					
Research on aging	35.6	64.4	0	0	100
Research on lung disease	37.6	62.4	0	0	100
Clinical research on neurological disorders	38.5	61.5	0	0	100
Interior--Regulation of Surface Coal Mining	97.3	2.7	0	0	100
Justice--Regional Information Sharing	43.7	56.3	0	0	100
Transportation--Airport Improvement	35.4	64.6	0	0	100
Veterans Affairs--State Cemeteries	66.8	33.2	0	0	100
Environmental Protection Agency-- Hazardous Substances	45.9	54.1	0	0	100
National Science Foundation					
Geosciences	68.6	31.4	0	0	100
Biological, behavioral, and social sciences	69.2	30.8	0	0	100
Small Business Administration--Small Business Development Centers	89.8	10.2	0	0	100
Total	62.9	36.9	0.1	0.1	100

SOURCE: Congressional Budget Office based on preliminary information from the Office of Management and Budget.

eral government to administer than loan guarantees or grants.

Table 5 provides estimates of long-term administrative costs as a percentage of total direct loan obligations made in fiscal year 1991. The long-term costs represent the present value of the costs to administer the 1991 cohort of loans over its life. The costs to the agency of administering the loan programs were estimated for each year, as described in the appendix. Annual costs were discounted by an assumed Treasury borrowing rate of 8 percent and added to arrive at a single present value. Sixteen direct lending programs covered by credit reform are included in the analysis.⁴ The largest and most numerous are in two agencies--the Department of Agriculture and the Small Business Administration.

The ratio of the total present value of long-term administrative costs to total direct loan obligations for the 16 direct loan programs is 7.7 percent. Within this overall figure, two programs--the Rural Telephone Bank and the AMTRAK Corridor Improvement Loans--have long-term administrative costs of less than 3 percent. At the other extreme, the Small Business Administration loan programs and the pollution abatement loan program of the Environmental Protection Agency have costs that range from 15.4 percent to 22.8 percent of amounts loaned.

4. Several programs were excluded from the analysis, either because very low lending levels in fiscal year 1991 would have resulted in misleading percentages of administrative costs, or because data were not reported to OMB.

Loan Guarantees. In the case of loan guarantees, long-term costs to the federal government are expected to be lower than for direct loan programs, mainly because a large portion of administrative effort is borne directly by the private lender and indirectly by the borrower. Federal agencies have fewer responsibilities in originating and servicing the loans than is true in direct loan programs. Most of the federal cost with loan guarantees is for collecting delinquent debt.

The estimates presented in Table 6 bear out these expectations. The present value of administrative costs associated with loan guar-

antees are only 1 percent of the value of the loans guaranteed, compared with nearly 8 percent for direct loans.

As was the case with direct loans, however, the administrative costs of loan guarantees vary among programs. Some programs, such as the Commodity Credit Corporation export guarantees of the Department of Agriculture and the community development guarantees of the Department of Housing and Urban Development, report almost no administrative costs. Others have administrative costs that exceed the percentages for some direct loan programs.

Table 5.
Administrative Costs for Direct Loan Programs (In thousands of dollars)

Department/Agency and Loan Program	Fiscal Year 1991 Loans	Long-Term Administrative Costs	
		Net Present Value	As a Percentage of 1991 Loans
Funds Appropriated to the President--Overseas Private Investment Corporation	40,000	2,615	6.54
Agriculture			
Agricultural Credit Insurance Fund			
Emergency	166,320	8,247	4.96
Farm ownership	211,680	14,690	6.94
Farm operating	294,840	11,832	4.01
Rural Development Insurance Fund--Water and waste	468,000	20,780	4.44
Rural Housing Insurance Fund			
Single family	1,352,921	105,330	7.79
Rental housing	316,641	26,737	8.44
Rural Telephone Bank	177,045	5,283	2.98
Education--College Housing and Academic Facilities	29,277	1,514	5.17
Interior--Bureau of Indian Affairs	11,690	834	7.13
State--Repatriation Loans	1,320	178	13.48
Transportation--AMTRAK Corridor Improvement Loans	3,500	100	2.86
Environmental Protection Agency--Abatement, Control, and Compliance	34,736	6,314	18.18
Federal Emergency Management Agency-- Disaster Assistance	6,000	386	6.43
Small Business Administration			
Disaster loans	350,000	53,800	15.37
Business loans	57,900	13,174	22.75
Total	3,521,870	271,814	7.72

SOURCE: Congressional Budget Office based on preliminary information from the Office of Management and Budget.

On the whole, however, loan guarantees are clearly less costly for the federal government to administer than direct loans. Virtually no loan guarantee program costs as much to administer as the average direct loan program. The three largest loan guarantee programs have relatively low administrative costs: the mortgage insurance program administered by the Federal Housing Administration (0.43 percent), the housing programs of the Department of Veterans Affairs (1.21 percent), and the guaranteed student loan programs in the Department of Education (2.06 percent).

It is important to reiterate that only direct federal administrative costs are being measured. For guaranteed student loans, for example, substantial administrative costs are incurred by banks. In fact, the federal government initially pays many of these costs by

paying an allowance to the lenders. These allowances are part of the subsidy cost under credit reform.

Grant Programs. Table 7 estimates long-term administrative costs for a sample of federal grant programs. This sample represents both direct payment and more traditional grant programs, such as grants to states and local governments.

For grant programs, administrative costs vary according to the intensity or duration of administrative scrutiny required. In some programs, such as many cash income transfers, the timing of administrative costs is coincident with those of benefit costs, since the structure of the program dictates that little follow-up effort is necessary. Other programs may involve substantial follow-up to ensure

Table 6.
Administrative Costs for Loan Guarantee Programs (In thousands of dollars)

Department/Agency and Loan Guarantee Program	Fiscal Year 1991 Loan Guarantees	Long-Term Administrative Costs	
		Net Present Value	As a Per- centage of 1991 Loan Guarantees
Funds Appropriated to the President--Overseas Private Investment Corporation	250,000	1,888	0.76
Agriculture			
Agricultural Credit Insurance Fund	2,329,280	16,299	0.70
Commodity Credit Corporation	4,152,000	2,304	0.06
Rural Development Insurance Fund	13,566	4,118	30.36
Commerce--NOAA Federal Ship Financing Fund	40,100	450	1.12
Education--Guaranteed Student Loans	11,471,680	235,955	2.06
Health and Human Services--Health Professions Graduate Student Loans	260,000	4,500	1.73
Housing and Urban Development			
FHA mutual mortgage	49,034,434	209,374	0.43
FHA general and special risk	6,060,300	172,621	2.85
Community development loan guarantees	103,315	314	0.30
Interior--Indian Loan Guaranty and Insurance Fund	54,591	829	1.52
Veterans Affairs--Housing Programs	16,542,268	199,572	1.21
Small Business Administration--Business Loans	4,862,600	85,660	1.76
Total	95,174,134	933,884	0.98

SOURCE: Congressional Budget Office based on preliminary information from the Office of Management and Budget.

NOTE: NOAA = National Oceanic and Atmospheric Administration; FHA = Federal Housing Administration.

Table 7.
Administrative Costs for Grant Programs (In thousands of dollars)

Department/Agency and Grant Programs	Fiscal Year 1991 Grants	Long-Term Administrative Costs	
		Net Present Value	As a Percentage of 1991 Grants
Agriculture--Cooperative Forestry Research	17,069	494	2.89
Education			
Pell grants	2,766,971	40,926	1.48
Title III endowment	15,965	358	2.24
Health and Human Services			
Research on aging	65,029	15,957	24.54
Research on lung disease	12,405	3,366	27.13
Clinical research on neurological disorders	21,444	2,731	12.74
Interior--Regulation of Surface Coal Mining	47,659	374	0.78
Justice--Regional Information Sharing	14,000	159	1.14
Transportation--Airport Improvement	1,594,000	4,834	0.30
Veterans Affairs--State Cemeteries	12,860	115	0.89
Environmental Protection Agency--Hazardous Substances	159,783	1,727	1.08
National Science Foundation			
Geosciences	327,100	13,092	4.00
Biological, behavioral, and social sciences	313,090	14,628	4.67
Small Business Administration-- Small Business Development Centers	55,400	1,568	2.83
Total	5,422,775	100,329	1.85

SOURCE: Congressional Budget Office based on preliminary information from the Office of Management and Budget.

that funds are used in keeping with grant conditions.

The estimates for grant programs range from an almost negligible administrative cost (0.3 percent) for the Department of Transportation's Airport Improvement Program, which is essentially a check-writing operation, to a substantial cost (in excess of 20 percent) associated with two health research programs of the Department of Health and Human Services, which carry substantial review components. Overall, for these 14 programs, long-term administrative costs represent less than 2 percent of total grants. They are thus much closer in size to loan guarantee costs than to direct loan costs.⁵

Limits of the Estimates

When interpreting all of these results, it is important to keep two limitations of the data in mind. First, estimates are derived using a method by which single-year costs are converted to flows of future-year costs. Although this approach may yield the most reliable data available, the estimates are crude approximations that are sensitive to the assumptions used. The data are probably sufficiently ac-

5. For direct loans, loan guarantees, and grants, the percentages reported are weighted averages, which give larger programs more influence. The results are very similar, however, when unweighted averages are used and extreme values at either end of the distribution are excluded.

curate to support the conclusions that the administrative costs of direct loans are greater than those of grants or loan guarantees, and that costs vary widely among programs. Such inferences probably constitute the limits of the power of these data, however. In particular, little significance should be attributed to relatively small differences among individual programs.

Second, readers should not draw conclusions about the relationship between cost differences and the efficiency or effectiveness of programs. Lower-cost programs are not inherently "better" than higher-cost ones. For example, greater administrative effort may more than pay for itself by reducing default losses. It is not possible to determine from these data whether programs are being administered in least-cost fashion. The differences in costs presented here may be a function of such factors as borrower characteristics, the mix of capital and labor, and Congressional and Presidential willingness to make administrative funds available.

The purpose of these estimates is to assess the extent to which major differences exist in costs of administering different types of programs as they are currently administered. No

conclusions should be drawn about the appropriateness of these current methods. In fact, an important reason for better accounting for administrative costs of credit programs is to foster the development of information about the relationship among administrative effort, default losses, and other operating characteristics.

Comparing the Public and Private Sectors

Private financial institutions engage in many of the same activities as federal credit agencies. Some information about the administrative costs of these institutions is publicly available from the Federal Reserve. The Federal Reserve data include three categories of commercial bank loans: real estate loans, consumer installment loans, and commercial loans. Comparing the administrative costs of these loans with the federal government's costs in 1991 of managing its direct loan and loan guarantee portfolios suggests little difference in cost between federal direct loans and private-sector loans (see Table 8). (Both

Table 8.
Comparison of Administrative Costs for Private-Sector and Federal Credit Programs (In billions of dollars)

Type of Program	Total Loans Outstanding	Operating Expenses	Expenses as a Percentage of Loans
Private Sector			
Real Estate Loans	187.3	2.0	1.1
Installment Loans	101.7	2.3	2.3
Commercial Loans	164.3	2.8	1.7
Federal Government			
Direct Loans	51.6	0.7	1.4
Loan Guarantees	638.3	0.7	0.1

SOURCE: Congressional Budget Office based on private-sector data for 1990 from the Federal Reserve Board, *National Average Report, 1990*; and federal government preliminary data for 1991 from the Office of Management and Budget.

sets of estimates are on a cash basis. They thus represent the single-year cost of administering an existing portfolio, rather than the long-term costs of administering loans made in a single year.)

Only limited inferences can be drawn from the data in Table 8, and no significance should be attached to individual differences in costs. There are no assurances, for example, that the private-sector and public-sector programs are directly comparable (they may face substantially different borrowers) or that costs are defined in any consistent manner between federal programs and private lending institutions.

Comparing Administrative Costs with Total Credit Costs

A danger inherent in the current budgetary treatment of administrative costs is that policymakers may be misled about total costs by the exclusion of long-term administrative costs from the definition of credit subsidies. The importance of this depends on the portion of total costs that are included in the current subsidy. If most costs are being included,

then it is reasonable to assume that excluding administrative costs from the subsidy does not substantially distort cost estimates.

Table 9 shows the long-term administrative costs and the 1992 subsidy amounts for various loan and loan guarantee programs as percentages of direct loan or loan guarantee obligations or commitments. The two cost components are added to measure total costs.

The extent to which total costs of individual programs are understated is displayed in the last column, which shows currently recorded subsidy costs as a percentage of total costs. For virtually all of the programs, the administrative costs make up 20 percent or more of the total costs.

The problem is less acute with loan guarantee programs, owing in large part to the lower administrative costs of these programs. Although a higher percentage of these programs include the majority of costs in their subsidies, nonetheless in some of them--such as the Rural Development Insurance Fund and the Federal Housing Administration's general and special risk program--the omission of administrative costs excludes a substantial percentage of costs from the subsidy. The implications of this finding are discussed in Chapter 4.

Table 9.
Long-Term Administrative Costs for Credit Programs, Compared with Existing Subsidy Costs (In percent)

Department/Agency and Credit Program	Long-Term Administrative Costs as a Percentage of 1991 Obl- gations and Commitments	Subsidies as a Percentage of 1992 Obl- gations and Commitments	Total Revised Subsidy	Current Subsidy as a Percentage of Total
Direct Loans				
Funds Appropriated to the President--Overseas Private Investment Corporation	6.5	9.6	16.1	59.5
Agriculture				
Agricultural Credit Insurance Fund				
Emergency	5.0	42.0	47.0	89.4
Farm ownership	6.9	39.0	45.9	84.9
Farm operating	4.0	21.0	25.0	84.0
Rural Development Insurance Fund	4.4	14.3	18.7	76.5
Rural Housing Insurance Fund				
Single family	7.8	19.4	27.2	71.3
Rental housing	8.4	44.6	53.0	84.1
Rural Telephone Bank	3.0	4.3	7.3	59.1
Education--College Housing and Academic Facilities	5.2	20.9	26.1	80.2
Interior--Bureau of Indian Affairs	7.1	21.8	28.9	75.4
State--Repatriation Loans	13.5	33.2	46.7	71.1
Transportation--AMTRAK Corridor Improvement Loans	2.9	24.9	27.8	89.7
Environmental Protection Agency--Abatement, Control, and Compliance	18.2	48.0	66.2	72.5
Federal Emergency Management Agency--Disaster Assistance (State Share)	6.4	9.0	15.4	58.3
Small Business Administration				
Disaster loans	15.4	30.8	46.2	66.7
Business loans	22.8	37.7	60.5	62.4

SOURCE: Congressional Budget Office based on information from the Office of Management and Budget.

(Continued)

Table 9.
Continued

Department/Agency and Credit Program	Long-Term Administrative Costs as a Percentage of 1991 Obliga- tions and Commitments	Subsidies as a Percentage of 1992 Obliga- tions and Commitments	Total Revised Subsidy	Current Subsidy as a Percentage of Total
Loan Guarantees				
Funds Appropriated to the President--Overseas Private Investment Corporation	0.8	0	0.8	a
Agriculture				
Agricultural Credit Insurance Fund	0.7	1.0	1.7	58.8
Commodity Credit Corporation	0.1	19.6	19.7	99.7
Rural Development Insurance Fund	30.4	5.7	36.1	15.8
Commerce--NOAA Federal Ship Financing Fund	1.1	3.4	4.5	75.3
Education--Guaranteed Student Loans	2.1	20.8	22.9	91.0
Health and Human Services--Health Professions Graduate Student Loans	1.7	10.2	11.9	85.5
Housing and Urban Development				
FHA mutual mortgage	0.4	-2.8	-2.4	b
FHA general and special risk	2.9	0.6	3.5	17.4
Community development loan guarantees	0.3	0	0.3	a
Interior--Indian Loan Guaranty and Insurance Fund	1.5	13.7	15.2	90.0
Veterans Affairs--Housing Programs	1.2	0.4	1.6	22.4
Small Business Administration--Business Loans	1.8	5.5	7.3	75.8

NOTE: NOAA = National Oceanic and Atmospheric Administration; FHA = Federal Housing Administration.

a. Represents a subsidy estimate of zero for fiscal year 1992.

b. Value greater than 100 percent because of negative subsidy estimate.

Pros and Cons of Changing the Budgetary Treatment of Administrative Costs

Many different factors have a bearing on the appropriate budgetary treatment of administrative costs. These include the objectives of credit reform, the size and variability of administrative costs, the cost of changing accounting methods, the control of administrative costs in the appropriation process, the consequences for the recorded deficit, and the effects on the comparability of administrative costs for credit programs with other costs in the budget.

The Objectives of Credit Reform

The federal subsidy for credit programs has four main components: the interest rate subsidy, the default subsidy, any fee charged (known as a cost offset), and administrative costs. Currently, the first three are included in the subsidy calculation; the fourth is not. A more complete estimate of the total long-term costs associated with a given credit cohort might be achieved if administrative costs were included in the subsidy.

An important goal of credit reform is to recognize costs for budgeting when commitments are made, rather than when they are actually paid. One reason that cash-based budgeting was discontinued for other types of credit costs was that it avoided recognizing the long-term subsidy implicit in the provision of credit, in favor of short-term cash flows. In-

cluding administrative costs in the subsidy means that they would be computed as the net present value of the administrative costs that would occur over the life of a loan. These would include not only costs occurring at the point of origination, but also future costs such as those of processing loan repayments and recovering loans in default.

*Including administrative
costs in the subsidy
would guard against
making policy changes
based on misleading
information.*

There is one conceptual difference between current credit-reform subsidies and present-value administrative costs. The existing subsidies are structured such that, when the Congress is appropriating funds associated with future costs, these costs are mandatory, in the sense that they flow out of the legal obligations (specified in credit contracts) of the federal government to incur these costs. Administrative costs differ because the present-value appropriation would reflect not only contractual commitments, but also assumptions about the choices that will be made by

future Congresses concerning the manner in which the programs will be managed.

The primary advantage to the present-value approach may be that accounting for administrative costs in the same way as other subsidy costs is consistent with the goal of providing accurate cost signals when budget decisions are made. This has two implications. First, more comprehensive cost information would be available to the President and the Congress when funding decisions are made, which could facilitate budgetary trade-offs. Second, the budget would record the complete subsidy (the total cost to the federal government) at the point when an implicit commitment to incur that cost was made.

Consider that some of the current subsidy cost estimates, as reflected in Table 9, are either very low or negative. This low or negative cost may be a consequence of omitting administrative costs. An ability to estimate the total cost of these programs may thus be compromised by excluding administrative costs from the subsidy calculation, in the same way that it would be compromised if recorded subsidy costs were low or negative because the cost of defaults was omitted. Therefore, including administrative costs in the subsidy would guard against making policy changes based on misleading information.

Including administrative costs in the subsidy could conceivably lessen the government's default losses as well. If administrative costs are underfunded, as might be more likely to occur with annual discretionary funding, fewer resources might be provided to minimize future defaults. As a result, default losses could be higher than those assumed in the initial subsidy estimate. In short, the validity of the subsidy estimates depends on the availability of sufficient resources to administer the contracts effectively. If the actual level of future administrative funding is significantly different from that assumed, the estimate of default losses will be biased.

Size and Variability of Administrative Costs

The assumption that including administrative costs in the subsidy calculation would significantly benefit decisionmaking and budgetary incentives depends in large part on two questions. First, are the long-term administrative costs of credit programs large enough that failing to include them could bias the budget in favor of credit assistance and away from other kinds of aid? To the extent that administrative costs of credit programs are substantially greater than those of grants, including them in the total cost of making a loan could provide a more accurate comparison with grants. Further, including administrative costs in the subsidy could provide for a more complete cost comparison of direct loan programs and loan guarantees, if there are cost differences between the two (see Box 1).

Second, are there significant differences in administrative costs among programs in the same category? If there are not (that is, if administrative costs represent a relatively fixed percentage of loan obligations), excluding them from the subsidy will not create biases in choosing among credit programs. To the extent that significant differences exist among programs, however, this information is an important element in evaluating the costs of different methods of providing assistance to beneficiaries.

The estimates presented in Chapter 3 show that, for both direct loan and loan guarantee programs, administrative costs are sizable in many cases and do vary substantially among programs. For direct loans, long-term administrative costs are estimated to equal nearly 8 percent of total loan obligations; for loan guarantees, they equal 1 percent. Further, the range of administrative costs for the direct loan programs studied was between 2.9 percent and 22.8 percent of total 1991 loan

Box 1.
**Administrative Costs and Cost Comparisons of
 Guaranteed Student Loans and Direct Loans**

One proposal that has surfaced since the enactment of credit reform would replace guaranteed student loans with direct loans. This case, while somewhat unique, illustrates the importance of accurately measuring administrative costs in making cost comparisons between programs.

The current credit-reform subsidy for guaranteed student loans consists primarily of loan default losses, interest paid on behalf of students to lenders while students are in school, and a special allowance paid to lenders. This special allowance is intended to encourage lender participation in the program by assuring that interest income is sufficient to offset the lender's costs of funding and administering these loans. The special allowance ensures that lenders receive a gross rate of return of no less than 3.25 percent above the rate of interest on 91-day Treasury bills. Because the special allowance is used in part to pay administrative costs, some of these costs are included on a present-value basis in the current credit-reform subsidy.

Advocates of replacing loan guarantees with direct loans claim that such a change would save the government money because the special allowance would be eliminated.

This claim overstates the savings from a direct loan program, since a direct loan program would also have administrative costs. Even if the administrative costs of a direct loan program were taken into account, current accounting and

budget scorekeeping would understate total costs of direct loans relative to the existing loan guarantee program. This bias would occur because a portion of the lender's long-term administrative costs are included in the current subsidy (on a present-value basis), but the administrative costs of a direct loan alternative would be treated on an annual cash basis.

Switching to a direct loan might entail the same administrative costs as the special allowance, but because administrative costs are recognized on an annual basis rather than on a present-value basis, only the first-year administrative costs could be shown in the budget in the first year. Further, the savings from such a change would be credited to the mandatory category of expenditures, whereas the administrative costs would be charged against the discretionary caps established in the Budget Enforcement Act.

Chapter 3 presents data suggesting that only a small portion of the administrative costs of direct loans occur in the first year. In addition, for guaranteed student loans, Table 3 indicates that only 1 percent of administrative costs occur in the first year, with fully two-thirds occurring after year five. The timing of costs is likely to be similar for direct student loans. For this reason, it is analytically incorrect to predict savings from converting to a direct loan program if administrative costs are treated on a present-value basis for loan guarantees but on a cash basis for direct loans.

obligations, and for loan guarantees the range was 0.1 percent to 30.4 percent. Even if the percentages at either extreme are ignored because of the crudeness of the measures used, the range is substantial.

These results indicate that, particularly for direct loan programs, including administrative costs in the subsidy has potential benefits. However, as the next section explains, it has large potential costs as well.

The Costs of Changing Accounting Methods

Switching to a different method of accounting for administrative costs would make it substantially more difficult to budget for administrative costs, and careful future monitoring of actual experience would be necessary to determine deviations from predicted levels. A

major obstacle to budgeting for administrative expenses on a present-value basis is that the information and accounting requirements may be so onerous that the costs of meeting these requirements outweigh the expected gain from improved budgetary decisions.

A change in methods would affect both budget development and budget execution. The importance of accurately projecting administrative costs before the fact (budget development) lies in its contribution to improving the information available for allocating resources and to recognizing full costs when commitments are made. The importance of being able to track actual administrative effort (budget execution) lies in the ability to tell whether estimates of administrative costs are accurate. Such tracking is key to improving data for developing the budget.

Budget Development

Budget development--the preparation of the budget by the President and its approval by the Congress--requires projections of events and budget transactions that have not yet occurred but that can be expected to occur under current and alternative federal policies. Under existing budgetary accounting, administrative costs for both pre-credit-reform loans and guarantees and those made since credit reform are projected for each future budget year on a cash basis. Total budget authority and outlays for all credit programs financed from a budget account are estimated for each year in the projection period. Although expenditures for administration are projected by dollar amount, account, and year, they are not further identified by annual cohort.

With a present-value treatment of administrative costs, the measurement focus of budget projections would change from the amounts expected to be spent annually to administer all loans and guarantees held by the account in that year, to the amounts expected to be spent in all years to administer the loans and guarantees obligated or committed by the

account in each year. In other words, under current practice, annual administrative costs are the sum of such costs over all loans without regard to the year of origination. Under the present-value approach, annual administrative costs would be the sum of such costs over all years that a single year's cohort of loans is expected to be outstanding.

Changing to present-value accounting could not be done without cost. Either the government would "pay" in less accurate budget projections, or it would have to spend more money to maintain the existing level of accuracy.

As an illustration, consider two loans, each with a five-year maturity, originated in year one and year two, respectively. Under current policy, the administrative cost estimate for year two represents the cost associated with the portion of administrative effort occurring in year two for both of these loans. Under the present-value approach, costs for year two would be the estimated costs of administering the loan made in year two over the following five years.

Clearly, this change in measurement would require a change in method for projecting these amounts. One method of doing so is described in Chapter 3 and in the appendix.

but many other possible methods exist or could be devised.

All of these methods suffer from a shortcoming compared with cash-basis projections. Namely, for a given level of resources for preparing the budget, the present-value estimate of long-term administrative costs for any year will be less accurate than the cash-basis estimate for the same year. This conclusion follows from the obvious fact that it is harder to predict events in the distant future than those in the near future. There is a related tendency for the accuracy of budget projections to decrease with the length of the projection. Since estimating present-value costs would require projecting year-by-year costs many years in advance, these estimates will be less accurate than current, cash-based estimates. In addition, these estimates depend on uncertain, sometimes inaccurate, assumptions about future interest rates.

Changing to present-value accounting for administrative expenses, then, could not be done without cost. Either the government would "pay" in a deterioration in the accuracy of budget projections, or it would have to spend additional resources to maintain the existing level of accuracy.

Budget Execution

In carrying out the budget, information is required to assure consistency between agency actions and the budget enacted into law. These requirements extend both to the Office of Management and Budget, which is responsible for overseeing the budget execution process, and to the agencies, which are subject to severe penalties for issuing obligations in excess of those authorized by law.

Currently, the budget for administrative costs of credit programs is executed as follows. Agencies receive an appropriation for administrative expenses for each credit program account. These amounts are usually transferred to and merged within one salary and expense account for the agency, which pays

the expenses of administering all loans in the agency's current loan portfolio, regardless of when the loans were made.

If administrative costs were included in credit-reform subsidies, agencies would need to account for the use of these funds in much greater detail. Because it would be necessary to adjust past subsidies for misestimations, a given agency would need to keep track of expenses by program and by loan cohort. That is, it would not be enough simply to know that the agency projects a shortfall in the salary and expense budget; it would be important to determine in which cohort the estimating error had occurred in order to make adjustments to past and current subsidies.

A present-value budgetary treatment thus imposes burdensome accounting requirements on agencies. They must be able to monitor their compliance with the appropriation laws by attributing their administrative obligations to loans and guarantees by year of origination. Such an allocation of costs could be enormously expensive to carry out, especially if each dollar of resource use had to be accounted for by loan cohort. For many programs, agency staff routinely divide their time between several programs, and such a detailed cost allocation effort might consume agency resources without providing much meaningful data.

Currently, few federal agencies have the accounting capacity to allocate administrative costs to particular programs. Even federal credit agencies that are required by the Federal Credit Reform Act of 1990 to request appropriations for administrative expenses do not track the use of these monies by credit account. Only in those cases where the budget account corresponds to a structural entity (the Rural Telephone Bank, for example) are agencies able to account for credit administrative costs by fund.

Simply to acquire the capacity to account for actual obligations by budget account would require a significant investment in accounting systems. To achieve such accounting

by credit cohort appears to be impossible in the immediate future. Agencies that are contemplating changes in accounting systems, however, should factor in the potential need to account for administrative costs by credit cohort.

CBO is unable to estimate the financial cost of converting immediately to a system capable of tracking actual long-term administrative costs. It is clear, however, that there are costs. Further, it is reasonable to assume that the costs increase as the reliability of the estimates improves.

Congressional Control and the Appropriation Process

Including administrative costs in the subsidy would be likely to change the methods by which the Congress reviews and controls these expenses. Currently, the Congress appropriates the administrative costs for a given program on an annual basis for the fiscal year in which they are to be obligated and, for the most part, disbursed. For example, the fiscal year 1992 appropriation would include funds for all salaries and expenses that would occur in 1992, regardless of when the credit was extended.

A present-value system would not change the method of appropriating funds for administering pre-credit-reform loans and guarantees. These would continue to be appropriated on a cash basis. For new loans and guarantees, however, the appropriation would be made for the present value of all future costs associated with loans made in a given year. These appropriations would be made to the program accounts and paid to the financing accounts. Funds would earn interest in the financing accounts until administrative expenses associated with this loan cohort were incurred, and agencies would draw on these

accounts when they actually paid the costs associated with this cohort.

Without some alternate change in procedure, the Congress would not exercise contemporaneous control over administrative expenses under a present-value system. Funds that were expended for salaries and expenses in a given year would result from appropriations provided by many Congresses, not just the sitting Congress. Agencies would not be limited, as they are by contemporaneous appropriations, in their ability to spend salary and expense money in a given year.

The Congress could respond to this situation by substituting some other form of control for the ability to control the following year's expenditures directly through limiting appropriated funds. For example, the Congress might set annual limits on administrative expenses or on the number of personnel that an agency could employ in a given fiscal year. In like fashion, the Congress might focus on the correspondence between cost estimates and cost outcomes, or on the relationship between administrative costs and default costs. Such oversight might lead to improved incentives for agencies that administer credit programs. These alternatives suggest that the overall accountability of the executive branch to the Congress could be maintained under a present-value system, although the method used to ensure accountability would need to change.

The Effects on the Budget Deficit

Including administrative costs in the subsidy through present-value budgeting would affect the level of budget authority and outlays. In the short run, the deficit would increase, since the present value of future administrative costs would be transferred to the financing

accounts and thus would be counted in outlays. Under the Budget Enforcement Act, this increase could have the effect of crowding out other programs under the discretionary spending limits (or "caps") that exist under current law until fiscal year 1995.

The President has the authority, however, to adjust the discretionary spending caps under section 251(b) of the Balanced Budget Act. The caps could be raised by OMB to reflect this change in budgetary treatment, which would protect other programs. Such an adjustment would seem appropriate if administrative costs were included in subsidy costs.

In either case, the reported budget deficit would increase in the short run. A rough estimate of the increase can be obtained from the sum of the estimated administrative costs for credit programs found in Chapter 3. Specifically, including administrative costs in the fiscal year 1992 subsidies would have increased direct loan subsidies by approximately \$270 million and guarantee subsidies by approximately \$930 million.¹

Making Budgetary Treatment Consistent

A major goal of credit reform is to make the costs of credit programs more comparable with those of other programs in the budget. In the case of the credit subsidy, the goal is to recognize the costs of all programs at a point when decisions are made that affect those costs. In the context of this movement toward comparability, one could reasonably ask whether including administrative costs in the subsidy is a further improvement.

1. This estimate is sensitive to at least two factors. First, it would include the cost associated with the 1992 cohort that would also be included in cash-basis estimates, which leads to some double counting. Second, not all credit programs are analyzed in Chapter 3, although virtually all large programs are included.

On the one hand, as noted above, including these costs in the subsidy has the advantage of recognizing all estimated costs to the government when decisions are made. Decision-makers would be required to finance the total cost of new credit extended in any year at the point when such credit is extended, and to compare such costs with the budgetary costs of other programs in allocating limited budgetary resources.

On the other hand, treating the administrative costs of credit programs on a present-value basis would make their budgetary treatment unique. No other administrative costs are treated on anything other than a cash basis. Thus, one could argue that moving administrative costs into the subsidy would run counter to the overall goal of credit reform, which is greater comparability.

Moreover, not all other administrative expenses are allocated on a program-by-program basis. Even on the grounds of making accurate comparisons among different kinds of programs, administrative costs might continue to be treated on a cash basis. When grant programs are evaluated, administrative costs are often determined separately, and these costs become part of a larger salary and expense budget. A parallel treatment of the administrative costs of credit programs might consider them separately from subsidy costs.

A counterargument, however, may be that loan programs *are* unique. To a far greater extent than most other programs, credit activities have administrative costs that extend far into the future, so that more costs are "hidden" by cash treatment than for other programs in the budget. Not much useful information is lost by treating the administrative costs of grant programs on a cash basis, for instance. In the main, the administrative expenses of grant programs occur at about the same time as the rest of program costs. For a credit program, however, administrative costs might extend 30 or more years into the future.

Other (noncredit) programs might have similar cost characteristics that merit present-

value treatment as well. If it should turn out that some of these administrative expenses warrant being financed on a present-value basis, each case could be addressed on its own merits.

CBO's Recommendation

Two options for the budgetary treatment of administrative costs have been described so far in this study: budgeting for administrative costs on a cash basis (the current practice) and including administrative cost on a net present-value basis in the credit subsidy. Each of these options has serious disadvantages.

The cash treatment of administrative costs is inconsistent with credit reform's goal of recognizing all costs associated with credit programs in the budget when decisions are made to incur those costs. As a result, policymakers receive incomplete information about

the cost of budget decisions. Understating the cost of some credit programs relative to others in the budget may bias policymakers toward those programs.

Including administrative costs in the subsidy could go a long way toward remedying these problems. However, it has two potentially significant disadvantages. First, modifying agency accounting systems so they can monitor long-term administrative expenses could itself cost a great deal. Further, the effort necessary to estimate and account for long-term costs might cause resources to be diverted from the current task of implementing credit reform for nonadministrative costs. Second, the present-value method of budgeting could change the manner in which the Congress would control the costs of administering loans and guarantees.

Because the disadvantages of doing so appear to outweigh the advantages, the Congressional Budget Office does not recommend that administrative costs be moved into credit-reform subsidies at this time.

An Intermediate Option for Reform

The choice before policymakers is not simply between the status quo and immediately moving administrative costs into the subsidy. An intermediate option could provide the Congress with more information in the short run, while improving the budgetary recognition of administrative costs in the long run.

A third option would entail collecting and reporting more information on administrative costs for budgeting, but not moving these costs into the subsidy.

Assuming it is desirable to establish a broader, more complete measure of cost, this third alternative would entail collecting and reporting more information on administrative costs for budgeting, but not moving these costs into the subsidy. Administrative costs would continue to be budgeted for on a cash basis, but additional information on long-term costs

would be made available in the budget process. The subsidy might be broadened to include administrative costs in the future, but only after the significant cost and control issues had been adequately addressed.

The additional collection effort could begin immediately, so that more information on long-term costs could be incorporated into the budget process for fiscal year 1994. Agencies could be required to begin estimating the long-term costs associated with administering credit programs, and these long-term costs could be presented on a present-value basis. The budget would then report this cost information for budget-year loans in supplementary schedules. That is, information on administrative costs would be reported to the Congress with budget justifications, for use in preparing the budget resolution and for authorizing or reauthorizing programs, as well as for appropriation action. Budget authority and outlays would not be affected by this change in supplementary information.

Estimates of long-term costs could be developed using a method such as the one presented in Chapter 3 (and described in detail in the appendix), which converts costs from a cash to a present-value basis. Regardless of the budgetary treatment of administrative costs, this would provide more information to the Congress to use in budgeting and making program choices.

This approach would be more advantageous than immediately moving administrative costs

into the subsidy because it would not require agencies to account for long-term costs separately, only to report the information separately for budgeting purposes. It thus focuses on the less costly activity (budgeting) rather than the more costly one (accounting).

It would also recognize the difficulties that agencies are having in carrying out credit reform, by not piling on another layer of complexity at this time. As demonstrated in Chapter 3, the majority of costs are captured by the current subsidy, even excluding administrative costs. To significantly increase the proportion of administrative costs recognized in the first year could divert resources away from what is arguably a more important pursuit--improving the estimates of the currently defined subsidies.

This third option would not, however, recognize long-term costs in budget authority and outlays. Choices might continue to be skewed by the failure to consider administrative costs, especially in policy changes that would increase the use of direct loans. Furthermore, incentives would continue to exist to underfund administrative costs compared with other uses of budgetary resources. Fully overcoming these disadvantages would require moving administrative costs into the subsidy. But as Chapter 4 pointed out, this would be likely to increase costs to agencies and to change the method of Congressional control of agency salary and expense budgets.

It may be possible, however, to minimize the disadvantages and thus make the cost of achieving these benefits more acceptable. In the case of Congressional control, agencies could be required to seek a supplemental appropriation whenever unexpected administrative cost increases occurred--rather than being permitted to draw on a permanent and indefinite appropriation. This requirement would enable the Congress to substitute oversight on the back end for detailed contemporaneous control of salary and expense accounts.

The financial costs of carrying out this change could be minimized by using less exhaustive methods of accounting for costs. For example, instead of accounting for each hour of administrative effort by loan cohort, agencies could use random surveys of employee activity to determine the allocation of labor and other costs by loan cohort. In other words, periodic surveys would be used to determine the instantaneous use of administrative resources. These survey results would be used to attribute the agency's total budget authority and outlays for salaries and expenses to specific cohorts.

If a low-cost accounting system can be developed that maintains Congressional control, the advantages would warrant including administrative costs in the subsidy.

Similarly, time and motion studies of the loan origination, collection, and foreclosure processes could be used to determine the costs of typical credit activities. These standard costs could then be applied to the universe of administrative costs to track compliance with appropriations. (Such standard costs would need to be reviewed frequently to adjust for changes in input prices and technology.) Both time and motion studies and random surveys are used by private lending institutions for allocating costs. In addition,

agencies might conduct pilot tests to determine the costs of various methods of accounting for the administrative costs of credit programs.

The various groups that are working to improve federal accounting systems--the Federal Accounting Standards Advisory Board, the Joint Financial Management Improvement Project, the Chief Financial Officers, and the General Accounting Office--are likely to emphasize the desirability of systematically measuring costs. The marginal cost of meeting the special information needs of budgeting might be significantly reduced if these needs are recognized when an accounting system is being designed. Retrofitting old systems, by contrast, can be extremely costly. If the needs of users of financial information are factored into the planning of these systems, those needs might be met at a lower marginal cost.¹

1. Two recent private-sector accounting standards address issues closely related to budgeting and accounting for long-term administrative costs. Financial Accounting Statement (FAS) 35 requires pension plans to recognize the future costs, as well as the present costs, of administering pension systems. FAS 91 requires financial institutions to be able to account for the fees from and the costs of loan origination over the life of the credit contract. In the public sector, the Joint Financial Management Improvement Project is currently updating its core financial system requirements, and the capability to allocate labor costs could be required in the future.

A final recommendation to move administrative costs into the subsidy will depend on achieving two conditions: first, that a low-cost, reliable method of accounting for administrative costs, by year and program, has been developed; second, that the subsidy treatment of administrative costs does not cause an undesirable change in the means of Congressional control of these costs. If a low-cost accounting system can be developed that maintains Congressional control, the advantages would warrant including administrative costs in the subsidy.

Even without these prerequisites, however, data on long-term administrative costs are clearly needed to aid Congressional program and budgeting decisions. This need is especially pronounced when the Congress is considering options for new programs (including grants, direct loans, or loan guarantees) and when it is considering program changes that involve substituting one type of program for another. For example, when considering replacing a loan guarantee program with a direct loan program, accurate information on the long-term administrative costs accompanying each option would be crucial to a valid comparison of costs. In assigning priorities for increasing the federal government's capability to identify administrative costs, the main area of concern should be improving the measurement and recognition of long-term administrative costs to support these two types of decisions.

A Method for Converting Annual Cash Administrative Costs to Long-Term Administrative Costs

The estimates of long-term administrative costs used in this study are based on a method developed by the Office of Management and Budget in consultation with the Congressional Budget Office. Through a series of accounting allocations and cost projections, estimates of the present and future administrative costs of new activity are obtained from the one-year cash costs of administering existing and new credit.

The analysis begins with the administrative costs recorded in the budget accounts for credit programs in 1991. Where the 1991 level of administrative cost is not identified in the budget at the account level, agencies developed estimates of these costs. For this study, agency officials, in response to a request by OMB, allocated these single-year administrative costs for the account--first, to the individual programs financed from that account and, second, to four categories of administrative effort for each program: policy and oversight; credit extension; loan servicing, including all routine collection efforts; and delinquent debt collection, including the seizure and liquidation of collateral.

Direct Loans

As an example, consider the direct loan program of the Overseas Private Investment Corporation (OPIC), a federal agency that en-

courages U.S. investment in developing countries. Administrative costs for credit programs were not separately identified in the budget, but OPIC officials estimate that about \$3.4 million was required for administering the existing loan portfolio and for new direct lending in 1991. They allocated this cost to the four administrative activities as follows:

Policy and oversight	\$ 344,000
Credit extension	1,547,000
Loan servicing	859,000
Delinquent debt collection	<u>688,000</u>
Total	\$3,438,000

The next step was to calculate the following annual per-unit costs: policy and oversight costs per loan, loan service costs per loan, and collection costs per delinquency. For the OPIC direct loan program, these calculations are:

Annual policy and oversight costs per loan = total annual policy and oversight cost ÷ average number of loans outstanding during the year = \$344,000 ÷ 92.5 = \$3,719 per year per loan.

Annual servicing costs per loan = total annual servicing costs ÷ average number of loans outstanding during the year = \$859,000 ÷ 92.5 = \$9,287 per year per loan.

Annual collection costs per delinquent loan = total annual delinquency costs ÷ number of delinquencies at the beginning of the year = \$688,000 ÷ 14 = \$49,143 per year per delinquency.

All costs of extending credit in a year are attributed to that year's cohort. For loans that are disbursed during more than one year, the costs of extending credit are spread over the years of disbursement (up to a maximum of five years) except that at least 80 percent of extension costs are assigned to the first year. This weighted allocation recognizes that only a small proportion of origination costs consist of pure disbursement costs.

Three more pieces of information are needed to estimate the future administrative costs of defaults: the average expected number of years from origination to default (all cohort defaults are assumed to occur in that year), the expected number of defaults, and the average number of years that the active collection effort continues after a default. Armed with this information and the assumption that per-unit costs are unchanged over the life of the loan, except for an assumed 4 percent annual rate of inflation, the year-by-year costs of administering a cohort of loans can be estimated for the average life of the cohort.

The administrative costs for a cohort of loans in any single year will consist of the sum of four figures:

- o The annual per-unit cost for policy and oversight, adjusted for inflation, times the number of loans in the cohort (less the number of loans prepaid or liquidated through foreclosure and write-off);
- o The annual per-loan servicing cost, adjusted for inflation, times the number of loans in the cohort (less the number of loans prepaid or liquidated);
- o The total costs of loan extension, which are allocated in large part to the year obligated;
- o The cost of default collection, which is the product of the expected number of loan defaults and the annual per-unit cost of servicing defaulted loans, adjusted for inflation, for each year from the average year of default to the average year that collection efforts cease.

Estimated annual administrative costs for the 1991 cohort of OPIC direct loans are shown in Table A-1 by type of administrative activity. The loans have an average maturity of nine years, so no costs are projected for the 1991 cohort after 1999. The average default

Table A-1.
Estimated Long-Term Administrative Costs of 1991 OPIC
Direct Loans, by Administrative Category (In thousands of dollars)

Administrative Category	1991	1992	1993	1994	1995	1996	1997	1998	1999
Policy and Oversight	33	35	36	38	39	41	30	31	32
Credit Extension	1,238	161	167	0	0	0	0	0	0
Loan Servicing	84	87	90	94	98	102	74	77	80
Delinquent Debt Collection	<u>0</u>	<u>0</u>	<u>144</u>	<u>149</u>	<u>155</u>	<u>161</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total	1,355	283	437	281	292	304	104	108	112

SOURCE: Congressional Budget Office based on data supplied by the Office of Management and Budget.

NOTE: OPIC = Overseas Private Investment Corporation.

occurs in year three, when 30 percent of the loans in the cohort are assumed to default. Collection efforts begin in the year of default and continue through year six, when all write-offs occur.

Discounting these annual cash flows to their present value (using a discount rate of 8 percent) yields a present value for administrative costs of \$2.6 million, or 6.5 percent of the loan amount. The 8 percent discount rate and 4 percent inflation rate are used throughout the estimation process.

Loan Guarantees

The method for turning total cash-basis administrative costs of loan guarantees into long-term costs is similar to that used for direct loans. The only significant differences involve credit extension and servicing costs. Specifically:

- o Policy and oversight costs are calculated precisely as they are for direct loans: every year for the average maturity of the loan, calculated as the product of the average per-loan cost times the number of outstanding loans in the cohort;
- o Loan extension costs are calculated by the same method, but only in those cases in which the government has some

role in approving or reviewing origination of the loan;

- o Loan servicing costs are calculated using the same method, but are incurred only for loans held by the government as a result of default, from the average year of default until the average year of maturity;
- o Costs of collecting delinquent debt are calculated in the same manner as for direct loans and for the average number of years that collection efforts continue.

Grants

The method for calculating the long-term cost of grants differs from that for credit programs only in that the cost categories consist of grant extension, grant monitoring, review and closeout, and policy and oversight; and the year of closeout replaces that of average maturity as the termination point.

Clearly, these estimates could be refined. For example, more complex methods could be used for allocating the costs of default than simply assuming that all defaults occur in the same (average) year of default. It would be surprising, however, if such refinements fundamentally altered the conclusions: that administrative costs are large, variable among programs, and long-lived in credit programs compared with those in grant programs.

RELATED CBO STUDIES

Budgetary Treatment of Deposit Insurance: A Framework for Reform, May 1991.

Budgeting for Eximbank: A Case Study of Credit Reform, January 1990.

Credit Reform: Comparable Budget Costs for Cash and Credit, December 1989.

New Approaches to the Budgetary Treatment of Federal Credit Assistance, March 1984.

Questions about these studies should be directed to CBO's Budget Process Unit at (202) 226-2835. The Office of Intergovernmental Relations is CBO's Congressional liaison office and can be reached at 226-2600. Copies of the studies may be obtained by calling CBO's Publications Office at 226-2809.



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