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Report to the Chairman, Committee on the Budget, U.S. Senate

March 1994

CREDIT REFORM

Speculative Savings Used to Offset Current Spending Increase Budget Uncertainty

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United States
General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

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March 18, 1994

The Honorable Jim Sasser
Chairman, Committee on the Budget
United States Senate

Dear Mr. Chairman:

You requested that we review specific issues related to implementation of the Federal Credit Reform Act of 1990 (Public Law 101-508). The first part of our response was issued in January 1993.[1] A second report responding to your questions on modifications and the use of the financing account was issued in September 1993.[2] This letter, responding to a third issue in your request, discusses the use of present value based[3] estimated future credit savings to offset expenditures of a noncredit program. Specifically, you asked us to address whether the use of present value based savings from Federal Family Education Loan Program (commonly referred to as the guaranteed student loan—GSL—program) to offset the cost of unemployment benefits provided in the Emergency Unemployment Compensation Act of 1991 (Public Law 102-164) was prohibited and whether savings estimates were speculative. We will report separately on the other areas in your request.

The pay-as-you-go procedures of the Budget Enforcement Act of 1990 required that, in the aggregate, mandatory spending or legislation dealing with receipts enacted during a session of Congress (such as the unemployment legislation) not increase the deficit in any fiscal year through 1995. The pay-as-you-go procedures were extended through 1998 by enactment of the Omnibus Budget Reconciliation Act of 1993 (Public Law 103-66). The present value based estimated future credit savings resulting from two financing provisions of the Emergency Unemployment

[1]Federal Credit Programs: Agencies Had Serious Problems Meeting Credit Reform Accounting Requirements (GAO/AFMD-93-17, Jan. 6, 1993).

[2]Federal Credit Reform: Information on Credit Modifications and Financing Accounts (GAO/AIMD-93-26, Sept. 30, 1993).

[3]Present value means the worth of future returns or costs in terms of money paid today. A dollar available now is worth more than one available in the future because it could earn interest in the interim. The future sums are converted to present value using the prevailing interest rate which, in the case of credit reform, is defined as the average interest rate on marketable Treasury securities of similar maturity to the direct loan or guaranteed loan that is disbursed.

Compensation Act were scored,[4] by both the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO), as offsets to the cost of the unemployment legislation under the pay-as-you-go procedures.

Results in Brief

Using the present value based estimated future savings from a credit program to offset expenditures of a noncredit program is consistent with both the theory behind credit reform and the application of credit reform requirements. However, the opportunity to use such savings to offset current spending can create an incentive for overly optimistic, if not unrealistic, savings estimates.

The net present value of estimated additional future collections on guaranteed student loans resulting from provisions in the 1991 Emergency Unemployment Compensation Act was scored as anticipated under the Budget Enforcement Act, the Omnibus Budget Reconciliation Act of 1993, the Federal Credit Reform Act of 1990, and existing scorekeeping conventions governing cost estimation and the budgetary effect of legislation. Estimates of the guaranteed student loan program savings were speculative because the Department of Education had little historical data on which to base estimates for one of the collection methods. This greatly increased budgetary uncertainty.

Background

The Federal Credit Reform Act of 1990 changed the budget treatment of loans and loan guarantees made on or after October 1, 1991, to more accurately reflect the cost to the government. It requires that the budget include budget authority in the amount of the full estimated cost (calculated on a net present value basis for the entire life of the credit instrument) in the year decisionmakers authorize an initial credit commitment or make any changes to outstanding credit. Outlays are to be included in the budget in the year in which a direct loan or a guaranteed loan is disbursed. This permits appropriate cost comparisons between credit and cash-based programs.

When subsequent legislation changes an existing credit program, any revised cost is termed a modification under the Credit Reform Act. The net present value of such a modification—whether it increases or decreases the cost to the government over the life of the credit—must be included in the budget when the legislation is enacted.

[4]Scorekeeping is the process used by the Office of Management and Budget and the Congressional Budget Office to estimate the budgetary effects of pending and enacted legislation and compare them to limits set in the budget resolution or legislation.

The GSL program was modified by the Emergency Unemployment Compensation Act of 1991, enacted November 15, 1991. This legislation, authorizing a temporary program that provided extended or additional benefits to unemployed workers, included two provisions to increase collections from borrowers in default on guaranteed student loans. Lower default losses are expected to reduce the cost to the government, thereby producing future credit savings.

A more comprehensive discussion of the history and principles of credit reform appears in appendix I.

Scope and Methodology

We (1) reviewed relevant sections of the Federal Credit Reform Act of 1990, the Emergency Unemployment Compensation Act of 1991, the Deficit Reduction Act of 1984, the Omnibus Budget Reconciliation Act of 1993, 26 U.S.C. (Internal Revenue Code), and OMB guidance and scoring reports for the Emergency Unemployment Compensation Act, (2) reviewed the accuracy of the estimates of future GSL program savings, (3) interviewed Department of Education officials responsible for budget execution and revenue collection, and (4) discussed and confirmed the above information with OMB and CBO staff, obtaining and analyzing their rationales for the scoring and revenue decisions.

We performed our work in Washington, D.C., between October 1992 and October 1993, in accordance with generally accepted government auditing standards. OMB provided written comments on a draft of this report. We have addressed these comments in the Agency Comments and Our Evaluation section and they are reprinted in appendix II.

Estimated GSL Savings Scored as Offset to Unemployment Legislation Costs

The Emergency Unemployment Compensation Act authorized a temporary program to provide additional weeks of federal assistance to unemployed workers who had exhausted current benefits, as well as additional unemployment benefits for former members of the armed forces, railroad workers, and school employees. These outlays were to be paid over more than 1 fiscal year and were scored on a cash basis like most programs in the budget. The act also contained several provisions to finance the extended benefits, including two that applied to borrowers who had defaulted on guaranteed student loans. The first provision permanently extended the authority of federal agencies to enter into agreements with the Internal Revenue Service (IRS) to collect overdue non-tax debts by

withholding income tax refunds. The second authorized the garnishment of an individual's disposable pay.[5]

OMB and CBO scored these two provisions of the Emergency Unemployment Compensation Act (authorizing seizure of income tax refunds and garnishment of the pay of GSL borrowers in default) as modifications that decreased the costs of pre-fiscal-year 1992 guaranteed student loans, thereby creating an estimated future savings to the government. The anticipated future collections from GSL defaulters resulting from the two provisions together are estimated to total $2.7 billion.[6] The estimated collections from the seizure of income tax refunds (so-called IRS offsets) are expected by OMB and the Department of Education to total $1.9 billion over a 12-year period beginning in 1994. The additional collections resulting from the pay garnishments are estimated to total $0.7 billion over a 14-year period beginning in 1992. In accordance with credit reform requirements, the total estimated collections ($2.7 billion) were discounted to present value at the time the Congress enacted the legislation. The $1.9 billion in present value based savings then was scored as an offsetting receipt in fiscal year 1992 and used with other financing provisions of the Emergency Unemployment Compensation Act to offset expenditures for the additional unemployment benefits.

GSL Savings Estimates Were Speculative

Although use of the net present value of estimated future credit collections to offset current expenditures is consistent with credit reform requirements,[7] it creates an incentive to be optimistic in estimating the future savings. While that incentive exists for all savings estimates, it is a particular problem for present value based savings because such savings occur in future years and the spending that it offsets occurs in the present. In this case, by the time estimates may be proven incorrect, the spending already would have occurred.

Any estimate carries a risk of inaccuracy, but this risk is increased markedly when little relevant historical data exist. According to credit reform requirements, both costs and savings are estimated over the entire life of the credit instrument and discounted to present value. This

[5]Disposable pay is defined in the act as that part of the compensation of any individual from an employer remaining after the deduction of any amounts required by law to be withheld.

[6]Estimated collections from pay garnishment ($0.7 billion) and the IRS offset ($1.9 billion) do not add to this total due to rounding.

[7]Credit reform requirements are embodied in the Federal Credit Reform Act of 1990 and in related OMB and Treasury implementation guidance.

estimation period can range from as little as 6 months for the Export-Import Bank's loan guarantee program to 50 years for some rural housing loans. In the case of the GSL program, a lack of reliable historical data imparts a high degree of risk to the savings estimates.

The additional GSL collections, estimated to be $2.7 billion[8] over 14 years, would result from two collections actions. More than one-quarter of the estimated collections ($0.7 billion) was to come from additional collections from individual pay garnishments. This 1991 estimate was especially speculative because the Department of Education had little implementation experience and no historical collection data. Although several of the 46 guaranty agencies did use pay garnishment under state-granted authority, they did not report the resulting collections separately to the Department of Education. In July 1993, the Department of Education first required guaranty agencies to report separately the receipts from pay garnishment.

The $1.9 billion in additional estimated collections from the seizure of income tax refunds is likely to be a more reliable figure, primarily because the IRS offset program has been in place for a number of years and because the Department of Education maintains an historical database of information used to make current estimates.

Conclusions

The use of present value based estimated future savings from a credit program to offset expenditures of a noncredit program is consistent with both the theory behind credit reform and the application of credit reform requirements. However, the opportunity to use such savings to offset current spending can create an incentive for overly optimistic, if not unrealistic, savings estimates.

While the net present value of the estimated future collections from guaranteed student loans resulting from provisions in the 1991 unemployment law was scored as anticipated under credit reform requirements, the estimates were speculative. Maintaining revenue data by collection method would permit more accurate estimates in the future and facilitate review and oversight.

[8]See footnote 6.

Agency Comments and Our Evaluation

In commenting on a draft of this report, OMB agreed that the report is factually accurate, aside from some suggested technical changes which have been incorporated where appropriate. OMB also raised several concerns and one question relating to legal and estimating issues.

OMB was concerned that our report, which said that the use of present value based estimated credit savings to offset current expenditures is not inconsistent with credit reform requirements, implied that OMB and CBO did not follow the law when calculating costs and savings from modifications. We do not think that the draft report's wording implied this but we revised the report to eliminate OMB's concern. As our report states elsewhere, the cost of the GSL modification was discounted to present value in accordance with credit reform requirements and the scoring of the unemployment legislation was as anticipated under credit reform requirements.

OMB said that the draft did not distinguish between the legal requirement to measure costs on a present value basis and the quality of the estimates. We disagree. Like OMB, we viewed these as separate issues and structured our report to address each separately. The first section of the report discusses the legal requirement to discount estimated collections to present value, and the second section presents our view that these estimates were speculative. These issues also are addressed separately in the conclusion.

Regarding the statement in our Results in Brief that using present value estimates greatly increases budget uncertainty, OMB commented that while present value estimates are based on cash flows over a longer period of years, it is not clear whether they are more speculative than cash-based estimates. We clarified this section by noting that the GSL savings estimates were speculative because they were calculated on the basis of little historical data for one of the collection methods.

OMB also commented that the report does not distinguish between the calculation of the savings from credit modifications and the use of such savings to offset spending in a non-credit program. We disagree. The first section of our report addresses the legal requirements to measure costs of modifications on a present value basis. It separately discusses the use of the present value based savings from a modification of the GSL program to offset unemployment spending, a non-credit program. The Conclusions section also presents these issues separately.

Finally, OMB asked whether GAO advocates an alternative method to measuring savings on a present value basis to produce better estimates. We continue to support measuring the costs of and savings from credit programs on a present value basis. It is the speculative nature of the GSL savings that concerns us. As noted in our Conclusions section, maintaining revenue data by collection method would permit more accurate estimates and facilitate review and oversight.

We are sending copies of this report to the Director, Office of Management and Budget; the Director, Congressional Budget Office; the Secretaries of Education and Labor; interested congressional committees; and other interested parties. Copies also will be made available to others upon request.

Please contact me at (202) 512-9142 if you or your staff have any questions concerning the report. Other major contributors to this report are listed in appendix III.

Sincerely yours,

Susan J. Irving
Associate Director, Budget Issues

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Abbreviations

CBO	Congressional Budget Office
GAO	General Accounting Office
GSL	guaranteed student loan
IRS	Internal Revenue Service
OMB	Office of Management and Budget

Background: Credit Reform

This background appendix also will be a part of two other forthcoming reports on credit reform implementation: an evaluation of decisions to include certain programs under the Federal Credit Reform Act and an evaluation of the use of negative subsidy credit receipts.

The federal government uses direct loans and loan guarantees as tools to achieve numerous program objectives such as assistance to housing, agriculture, education, small businesses, and foreign governments. At the end of fiscal year 1991, the government's direct loan and loan guarantee portfolio totaled $855 billion, of which $202 billion was in direct loans and $653 billion was in loan guarantees.

After over 20 years of discussion about the shortcomings of using cash accounting for credit programs and activities, the Federal Credit Reform Act of 1990 was enacted on November 5, 1990, as Title 13B of the Omnibus Budget Reconciliation Act of 1990, Public Law 101-508. The Credit Reform Act changed the budget treatment of credit programs so that their costs can be compared more accurately with each other and with the costs of other federal spending. It also was intended to ensure that the full cost of credit programs over their entire lives would be reflected in the budget so that the executive branch and the Congress might consider them when making budget decisions.

In addition, it was recognized that credit programs had different economic effects than most budget outlays, such as purchases of goods and services, income transfers, and grants. In the case of direct loans, for example, the fact that the loan recipient was obligated to repay the government over time meant that the economic impact of a direct loan disbursement could be much less than other budget transactions of the same dollar amount.

Credit Reform Was Designed to Remove Difficulties Caused by Cash Treatment

Before credit reform, it was difficult to make appropriate cost comparisons between direct loan and loan guarantee programs and between credit and noncredit programs. Credit reform requirements were formulated to address the factors that caused this problem. Two key principles of credit reform are (1) the definition of cost in terms of the present value of cash flow over the life of a credit instrument and (2) the inclusion in the budget of the costs of credit programs in the year in which the budget authority is enacted and the direct or guaranteed loans are disbursed.

Credit Reform Was Designed to Allow Appropriate Cost Comparisons

Before credit reform, credit programs—like other programs—were reported in the budget on a cash basis. This cash basis distorted costs and, thus, the comparison of credit program costs with other programs intended to achieve similar purposes, such as grants. It also created a bias in favor of loan guarantees over direct loans. Loan guarantees appeared to be free while direct loans appeared to be very expensive because the budget did not recognize that at least some of the loan guarantees would default and that some of the direct loans were to be repaid.

For direct loans, the budget showed budget authority and outlays in the amount that loan disbursements exceeded repayments received in that budget year. This cash approach overstated direct loan costs in the initial years of a program when loan disbursements were likely to be greater than repayments. Conversely, this treatment understated costs in later years when loan repayments were more likely to be greater than disbursements. Cash-based budgeting did not recognize that at least a portion of the loan outlays would be repaid in the future. In contrast, for loan guarantees, the budget did not record any budget authority or outlays when the guarantees were made (except the negative outlay resulting from any origination fees), even though they were likely to entail future losses. It showed budget authority and outlays only when, and if, defaults occurred.

Credit reform changed this treatment for direct loans and loan guarantees made on or after October 1, 1991. It required that budget authority to cover the cost to the government of new loans and loan guarantees (or modifications to existing credit instruments) be provided before the loans, guarantees, or modifications are made. Credit reform requirements specified a net cost approach using estimates for future loan repayments and defaults as elements of the cost to be recorded in the budget. This puts direct loans and loan guarantees on an equal footing; it permits the costs of credit programs to be compared with each other and with the costs of noncredit programs when making budget decisions.

Credit Reform Identifies the Government's Cost of Credit Activities

Credit reform requirements separate the government's cost of extending or guaranteeing credit, called the subsidy cost, from administrative and unsubsidized program costs. Administrative expenses receive separate appropriations. They are treated on a cash basis and reported separately in the budget. The unsubsidized portion of a direct loan is expected to be recovered from the borrower.

The Credit Reform Act defines the subsidy cost of direct loans as the present value—over the loan's life—of disbursements by the government (loan disbursements and other payments) minus estimated payments to the government (repayments of principal, payments of interest, and other payments) after adjusting for projected defaults, prepayments, fees, penalties, and other recoveries. It defines the subsidy cost of loan guarantees as the present value of cash flows from estimated payments by the government (for defaults and delinquencies, interest rate subsidies, and other payments) minus estimated payments to the government (for loan origination and other fees, penalties, and recoveries).

According to OMB guidance, credit programs have a positive subsidy, that is, they lose money, when the present value of estimated payments by the government exceeds the present value of estimated receipts. Conversely, negative subsidy programs are those in which the present value of estimated collections is expected to exceed the present value of estimated payments; in other words, the programs make money (aside from administrative expenses).

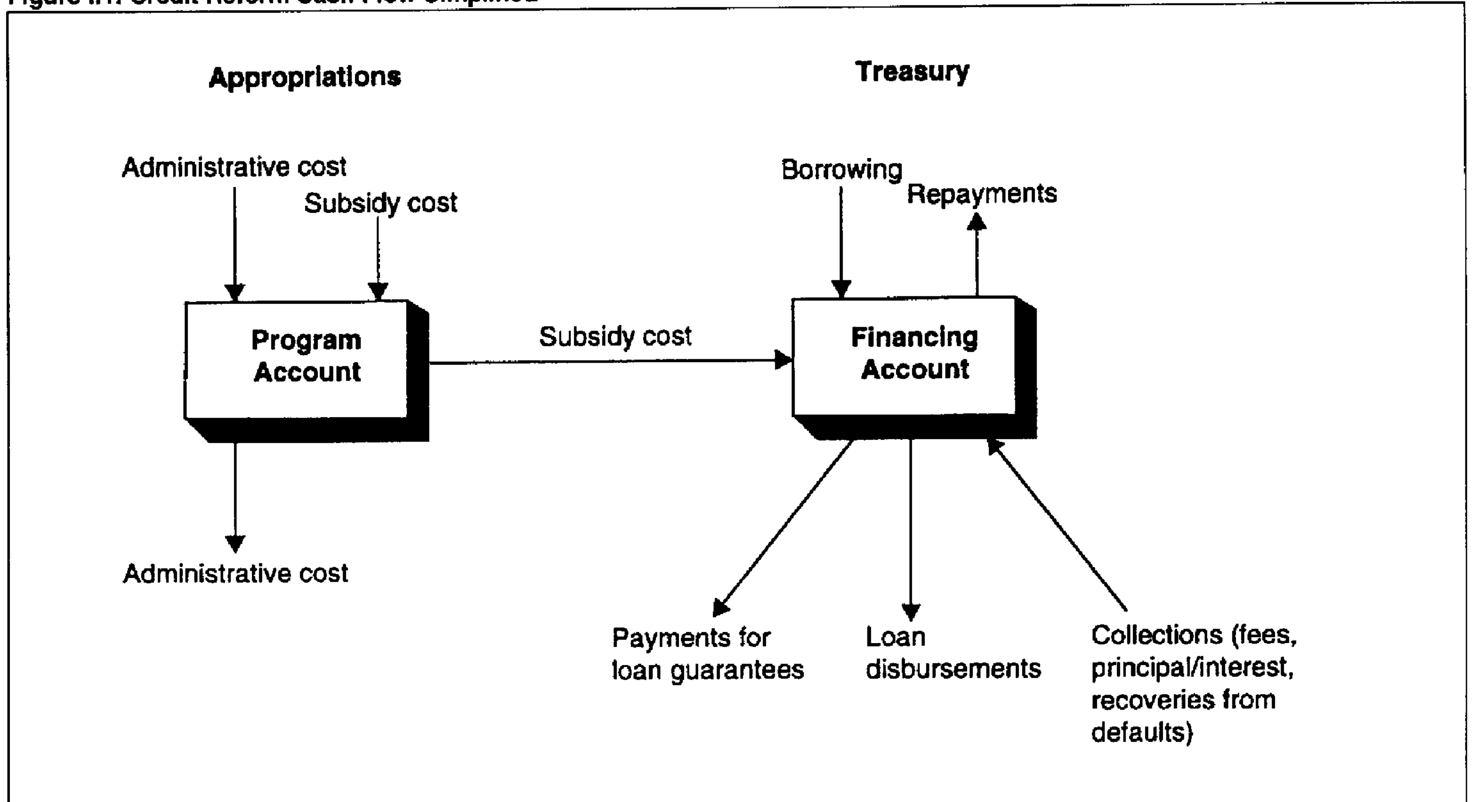
Credit Programs Now Use Three Budgetary Accounts

The Credit Reform Act set up a special budget accounting system to record the budget information necessary to implement credit reform. It provides for three types of accounts—program, financing, and liquidating—to handle credit transactions.

Credit obligations and commitments made on or after October 1, 1991—the effective date of credit reform—use only the program and financing accounts. The program account receives separate appropriations for administrative and subsidy costs of a credit activity and is included in budget totals. When a direct or guaranteed loan is disbursed, the program account pays the associated subsidy cost for that loan to the financing account. The financing account, which is nonbudgetary,[1] is used to record the cash flow associated with direct loans or loan guarantees over their lives. It finances loan disbursements and the payments for loan guarantee defaults with (1) the subsidy cost payment from the program account, (2) borrowing from the Treasury, and (3) collections received by the government. Figure I.1 diagrams this cash flow.

[1]Nonbudgetary accounts may appear in the budget document for information purposes but are not included in the budget totals for budget authority or outlays. They do not belong in the budget because they show only how something is financed, and do not represent the use of resources.

Figure I.1: Credit Reform Cash Flow Simplified



If subsidy cost calculations are accurate, the financing account will break even over time as it uses its collections to repay its Treasury borrowing.

Direct loans and loan guarantees made before October 1, 1991, are reported on a cash basis in the liquidating account. This account continues the cash budgetary treatment used before credit reform. It has permanent, indefinite budget authority[2] to cover any losses. Excess balances are transferred periodically—at least annually—to the Treasury.

In addition to the three accounts specified in the Credit Reform Act, OMB has directed that credit programs or activities with negative subsidies must have special fund receipt accounts to hold receipts generated when

[2]Permanent budgetary authority is available as a result of permanent legislation and does not require annual appropriation. Indefinite budget authority is budget authority of an unspecified amount of money.

the program or activity shows a profit. OMB guidance provides that these funds cannot be used unless appropriated.

OMB and Treasury Provide Implementation Guidance

OMB and the Department of the Treasury provide guidance on implementing credit reform. OMB's written guidance is contained primarily in OMB Circulars A-11, A-34, and A-129.[3] OMB also has issued memoranda to provide additional implementation guidance addressing specific situations. The Treasury's guidance is provided in materials such as Basic Transactions Relating to Guaranteed Loans and Subsidies (Apr. 30, 1992) which contains a number of illustrative cases developed by its Financial Management Service and distributed to agencies as examples of how to account for credit reform transactions.

Individual Program Characteristics Raise Credit Implementation Questions

Fiscal year 1994 is the third year that credit programs have been required to comply with credit reform. Both agencies that operate credit programs and those that provide implementation guidance—OMB and Treasury—have had to address a variety of situations for which the Credit Reform Act does not provide explicit direction. Questions have arisen and continue to arise as the agencies implement credit reform. Several groups have been created, such as the Federal Credit Policy Working Group and the Credit Reform Steering Committee, to address these implementation issues and questions.

[3]OMB Circular No. A-11 is entitled Preparation and Submission of Budget Estimates; Circular No. A-34 is entitled Instructions on Budget Execution; Circular No. A-129 is entitled Managing Federal Credit Programs.

Comments From the Office of Management and Budget

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

December 15, 1993

Donald H. Chapin
Assistant Comptroller General
Accounting and Information Management Division
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Chapin:

Thank you for the opportunity to comment on the draft GAO report entitled, "Use of future savings from credit programs to offset current spending." In accordance with Section 236 of the Legislative Reorganization Act of 1970, this letter provides our comments on the draft report.

Although the report is factually accurate, aside from some technical comments that we have informally transmitted, OMB staff would like to point out the following concerns and question:

Legal issues:

- Section (502)(5)(D) of the Federal Credit Reform Act requires that the cost of modifications be based on present value. OMB and CBO were following the law when calculating the costs/savings from modifications on a present value basis. Hence, OMB believes that the double negatives on pages 7 and 9 of the draft should be changed to read "...the use of the present value of estimated future credit savings to offset current expenditures is consistent with credit reform requirements,..."

- The report does not distinguish between the legal requirement to measure costs on a present value basis from the quality of the estimates.

Estimating issues and question:

- The report makes the statement that present value estimates "greatly" increase budget uncertainty (page 3). While present value estimates are based on cash flows over a longer period of years, it is not clear whether they are more "speculative" than cash-based estimates.

- The report does not distinguish between the calculation of the savings (costs) from credit modifications from the use of the savings generated from modifications to pay for spending in a non-credit program.

- Prior to credit reform GAO issued several reports calling for credit reform (present value) scoring, and GAO has continued to support credit reform in this and other reports. Would GAO now advocate an alternative method to measuring savings on a present value basis that would produce better estimates?

OMB staff would be interested in reviewing future drafts of this report and would be glad to continue working with your staff in this and future efforts.

Sincerely,

Richard P. Emery, Jr.
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Related GAO Products

Federal Credit Reform: Information on Credit Modifications and Financing Accounts (GAO/AIMD-93-26, Sept. 30, 1993).

Federal Credit Programs: Agencies Had Serious Problems Meeting Credit Reform Accounting Requirements (GAO/AFMD-93-17, Jan. 6, 1993).

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