

## Commentary

George J. Benston

**D**ouglas Elliott (2006) begins his discussion of some important issues concerning how federal government financing and insurance programs should be structured by assuming that these programs are here to stay. He writes (p. 260): “The federal government has a long history as a lender and insurer, and there is no sign that this is going to change. If anything, concerns about the federal budget deficit are likely to encourage an expansion of these programs.” He perceptively explains that “Lending and insurance programs allow politicians to throw out multibillion dollar figures for the volume of good their proposals will provide, without having the budget cost approach those levels. This is especially true if politicians use overly optimistic figures for the proportion of borrowers who will actually pay the loans back or the proportion of insureds who will submit claims.” Having presented both the fact of the programs and reasons why they are attractive to legislators, Elliott turns from a positive (or descriptive, albeit very brief) introduction, to the normative (or prescriptive) issues of how the programs should be structured, the budget rules that should be adopted, the human resources that should be harnessed to manage the programs efficiently, and the tools those managers should use.

Considering how much of value he has to say and the important questions he raises on how the programs should be run, it is reasonable for him to restrict his paper to normative issues. However, I suggest that the questions he raises cannot be answered successfully without first understanding

and delineating the reasons or justifications for the programs. In particular, were they established to serve a public or a special-interest benefit? The extent to which a given procedure is efficient depends on what the program is expected to achieve. For example, if a student-loan program is supposed to make it possible for poor students to attend colleges so that they can become wealthier than they otherwise would be, the interest rate charged might be a market rate. If this is the purpose of the program, an essential question is whether there is market failure—that is, why and to what extent do private sector lenders not offer such loans? Is there some legal or regulatory impediment that forecloses or restricts private sector lending? Is such lending insufficient because there is a positive (negative) externality that could effectively be achieved (alleviated) with a government program? If the purpose of the program is to benefit colleges, though, by allowing them to charge higher tuition to poor students rather than offer them scholarships and/or if the purpose is to help poor students become better educated in general because this benefits the nation, the interest rate should be below market rates for all poor students.

An understanding of the reason for specific programs also is necessary to answer Elliott’s concerns and questions of how those programs should be administered. The “law of unintended consequences” plays a particularly important role here. An example is the bidding procedure for rights to the Federal Communications Commission (FCC) spectrum that Elliott discusses.

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Federal Reserve Bank of St. Louis *Review*, July/August 2006, 88(4), pp. 273-79.

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If the objective were to benefit smaller and minority businesses, the auction rules should be structured to give these companies an advantage. The situation he describes, where smaller businesses and minority-designated firms with little equity were awarded rights to spectra, is consistent with that objective. But, why was the contract written so that, when these firms could not pay their contractual obligations, they nevertheless could still control the spectra they were awarded? This might be an unintended outcome that was not foreseen by drafters of the legislation because of inadequate analysis. In this event, a better analysis could have avoided the situation and it could be corrected with new legislation. But, it might be that the drafters of the legislation intended to benefit particular constituents. These drafters might have known people represented by favored lobbyists and other donors to their campaigns who controlled “smaller” businesses and minority-owned companies (or companies fronted by minorities). If this were the case, the procedures adopted did what was intended.

Despite what might appear to be cynicism (or reality) on my part, I agree with Elliott that understanding the extent of a subsidy or wealth transfer would be useful to many. Legislators who sponsored the program may not have realized that it would cost as much as it does and, therefore, might move to repeal or restrict it. Or, legislators and others who do not want to favor a particular group could use these numbers to defeat or reduce the cost of financial programs, in part by appealing to citizens to vote against politicians who are shown to be misusing public resources. It would be useful, therefore, to examine the extent to which government financing and insurance programs are likely to provide public or special-interest benefits.

## THE BENEFITS AND LIMITATIONS OF PRIVATE-MARKET SOLUTIONS

### *Benefits*

It is virtually a truism (that I presume I need not describe here) that private-market solutions usually are preferable to government solutions.

This conclusion, though, is subject to five important assumptions. Note, though, that even when these assumptions obtain, the benefits from government intervention might be more than offset by the cost of inefficiencies because of the absence of a profit and loss motive. Although government agents have incentives to increase their budgets, and often to stay within their budgets, exceptional performance (above-normal profits or lower costs) rarely increases the agents’ wealth. Further, excessive losses not only do not result in the bankruptcy of their organizations and the consequent loss of their personal wealth, but may bring forth additional budget allocations to keep the programs alive. In addition, government agents may find it difficult to determine what price to charge different recipients for the services provided by their agency. Unlike privately owned organizations, they do not face competitors who tend to pick-off overcharged clients and often do not have the political ability to increase charges on underpriced clients. An example presented by Elliott is federally provided flood insurance, which undercharges owners of older structures and overcharges owners of new structures.

## LIMITATIONS AND CAVEATS: THE FIVE ASSUMPTIONS

One basic assumption is that people are the best judges of what is best for them. This is not always the case. Generally, children and people of severely diminished intelligence are seen as not capable of making decisions that are in their own self interest. But, this caveat does not apply to the government programs in question.

A second assumption is that distribution of wealth is optimal (however that might be defined operationally). Of course, the citizens of a democracy may believe that the nation benefits when wealth is redistributed to bring the poorest citizens up to some level of well-being and keep the richest citizens from controlling too great a proportion of resources (even though both levels are difficult to define with much precision). In this event, given the assumption of the primacy of individual choice, direct redistribution is prefer-

able to subsidized loan and insurance programs. However, particularly when it comes to giving up some wealth for the benefit of others, people (through their elected representatives) often want those resources to be used in specific ways. Thus, they may not want the recipients to spend transferred wealth on alcohol or other drugs, but may want them to spend it on education or housing. People who give up some of their wealth also might believe that one form of transfer is more effective than another in achieving a desired outcome. For example, a loan rather than a grant to poor students may be more effective in getting them to take full advantage of their educational opportunities because they will have to repay the funds advanced. Loans also could be effective in screening out those who are pretending to be students in order to get a grant. If these are the reasons for giving students subsidized loans rather than grants, students should not be permitted to avoid repayments by declaring bankruptcy just after they leave school.<sup>1</sup>

Third, there should be evidence of a market failure that can be effectively alleviated with a government program. For example, presumably the Small Business Administration was established because (it was alleged) established lenders (banks, in particular) employed market power to charge small businesses higher interest rates than justified by costs.<sup>2</sup> Direct or indirect loans to minority, poor, or female home buyers have often been based on the belief that private lenders are biased, perhaps as a result of bigotry or ignorance borne of limited experience, and either charge these borrowers more onerous terms or refuse to offer loans.<sup>3</sup> But, given the situation in the United States of substantial competition among financial institutions and anti-trust laws that make cartels and agreements to fix prices illegal, there are likely

to be few market failures. Furthermore, where there are government-imposed barriers to or constraints on entry and competition, the most effective way to help consumers is to remove these restrictions rather than to establish an alternative government program.

Fourth, government programs can be justified as beneficial to the public if the government has a cost advantage over private companies. This can occur when there are economies of scale that can be achieved only by a nationwide operation. Restrictions on nationwide bank branching (which were not fully removed until 1994) exacerbated this situation. Given these constraints on the markets, mortgage financing by government-sponsored (lending) enterprises (GSEs), particularly Fannie Mae and Freddie Mac, was beneficial. Considering that this constraint is no longer present and that these GSEs are now privately owned, there is no justification for continued government support in the form of investors' expectation that the GSEs' debt is de-facto guaranteed (as shown by the interest rate the GSEs pay on that debt, even though they have low capital/asset ratios).

The interest rate that should be charged for government loans or assumed for government projects should take into account losses from defaults and poor outcomes, in the same way that private parties include these risks, assuming that government agents are as capable of assessing the risks. Considering that political considerations often play a role in determining the loans and projects that are made by government agencies and that these considerations are likely to result in higher losses, the applicable interest or discount rate should be greater than that employed in private transactions.

The government discount rate should mimic the private discount rate and take into account timing as well as the amount of the net cash flows expected to be generated from the loan or project. Like the private loan rate, the government rate should include an additional "systematic risk" premium that is similar to the premium on high-beta stocks. Loans have higher payouts (less loss due to default) in good times, when returns on other assets are high, and lower payouts when times are bad, when returns on other assets are

<sup>1</sup> Indeed, this is the situation now. However, it has a possibly unintended consequence, in that it gives purveyors of worthless occupationally directed "education" programs strong incentives to oversell their programs to gullible, often poor, people seeking to better their situations.

<sup>2</sup> An earlier study, though, found that 75 percent of the difference in rates on smaller loans is explained by higher marginal operating costs per loan (Benston, 1964).

<sup>3</sup> Empirical studies, though, do not support this belief (Benston, 1999).

low. Because of this positive covariation, loans are less desirable compared with assets that covary negatively with economic conditions—hence the systematic-risk premium.<sup>4</sup>

Furthermore, it should be noted that lower observed interest rates on state and municipal obligations result from the exemption from income taxation of the interest. Hence, the lower interest rate on these obligations is not a net benefit to the public but simply a transfer of wealth among taxpayers.

The fifth basic assumption is that the government programs reduce negative externalities (such as pollution) or enhance positive externalities (such as research by professors), net of costs. Student loans might achieve a positive externality to the extent that it would be detrimental to the nation if some people would otherwise not be able to use their talents effectively. An educated public might also be seen as necessary or at least desirable for democracy and a well-functioning modern economy.

To summarize, government-sponsored or -supported finance and insurance programs might achieve some public benefits. These programs could be effective for encouraging specific behavior among recipients that voters (or their representatives) favor, such as education and homeownership. However, there are likely to be both honest and dishonest (that is, actually self-serving) disagreements as to which people or programs should be subsidized. Government could provide financing or insurance where there is a market failure. However, I believe that this rationale is of doubtful validity, particularly in the Internet age, when those who want financing or insurance can readily find and be contacted by many private suppliers. Finally, there are few negative externalities that I can think of related to finance and insurance. Nor are there many positive externalities.

If my conclusions are correct, government finance and insurance programs primarily serve to enhance special interests. As Elliott points out, these programs offer legislators the substantial

advantage of shifting public resources to favored individuals, groups, and organizations at what appears to be a smaller cost to taxpayers than direct subsidies. Furthermore, as he also points out, the cost of government-provided loans or loan guarantees and of insurance tends to be understated in the budget. As he puts it so well (pp. 260-61), “There are not a lot of other areas in the government where you can propose a program that directs \$10 billion to some sector and claim at the same time that it will directly make money for the government, at least not in areas where the budget scoring might back you up.”

## **SPECIAL-INTEREST BENEFITS FROM GOVERNMENT LOAN AND INSURANCE PROGRAMS**

Two types of special-interest benefits should be distinguished. One that I believe most people would support (other than those that give rise to net public benefits, as discussed earlier) is a program that offsets costs imposed by other government actions or inactions or “acts of God” that are seen as having a collective impact on all citizens. An example is damage from an unexpected natural disaster, such as the massive wave surge due to Hurricane Katrina that damaged properties many more miles inland than expected from previous experience. However, damage from recurrent hurricanes or likely-though-imperfectly-predicted earthquakes is expected. Private insurance could be purchased, and the cost would and should be borne by people who own properties that are at risk. Events that are extremely difficult to predict that might affect large numbers of people, though, such as extreme acts of terrorism, might justify some form of government-provided insurance.

The second type of special-interest benefit is much more common. It involves a transfer of wealth from taxpayers to favored people, groups, and organizations in the form of direct or indirect subsidies, such as lower interest rates and fees and the assumption of risks. As Elliott points out, these programs abound, in large measure because the cost to taxpayers is difficult to discern and publicize. Furthermore, when enacted they often

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<sup>4</sup> I am indebted to George Pennacchi for clarifying my thinking on these issues. See Chap. 4 in his forthcoming asset-pricing text when it comes out (as it surely will).



are cloaked in the mantle of “the public interest” and said to have no cost to taxpayers. Federally provided flood insurance is an example. The risk is no different from other risks that typically are insured, such as fire and wind damage. Why, then, should the federal government be involved except to transfer wealth to people who own structures and property in flood-prone areas?

### ***Unintended Consequences***

It is likely that many government lending and insurance programs were enacted to help a particular group or sector of the economy that people in general want to help. For example, given the past history of racial and gender discrimination in the United States, I believe that most people are in favor of, or at least not strongly opposed to, helping minorities and women get financing to start new businesses. A perhaps romantic sympathy for small farmers probably has motivated people to support farm-loan programs. (The initial questions, though, should be whether, why, and to what extent loans are not available from private lenders.) Concern for workers losing their pensions when their companies declared bankruptcy (dramatized by the bankruptcy of Studebaker in 1974, which did not fund its retirement fund adequately) led to the creation of the Pension Benefit Guaranty Corporation (PBGC) in 1974 as part of the Employee Retirement Income Security Act of 1974.

Legislators and citizens generally, though, often do not adequately take into account the incentives for and ability of “undeserving” individuals to benefit themselves at the expense of others. For example, minorities may indeed be deserving of help in starting businesses. But others may set up companies that appear to be controlled by minorities in order to garner the subsidies. In fact, such people are likely to be more skilled than real minorities in drafting successful applications for subsidized loans. Although some small farmers have benefited from subsidized loans and insurance, most of the subsidies have gone to large corporate farms. The PBGC has benefited many employees, but its costs have increased sufficiently for it to be economically bankrupt: Financially distressed corporations covered by the PBGC had

incentives to promise their employees higher guaranteed pensions in exchange for current wage concessions. Furthermore, the PBGC was not given the authority or resources (or it did not use the powers it had) to impose high costs on corporations that did not adequately fund their pensions and require that the corporations invest pension funds in close-to-riskless assets. Of course, as noted earlier, it may be that drafters of the legislation realized that the programs would benefit favored people and companies and would be much more costly than they admitted at the time. If this were the case, the outcome was not unintended.

## **THE RELEVANCE OF ELLIOTT'S QUESTIONS**

Elliott raises several intellectually interesting and challenging questions, most of which are related to the “proper” interest rate that should be charged. As noted earlier, he assumes that the goal is to use rates that correctly measure the cost of the programs. Given his focus, I accept this assumption, for two reasons. First, legislators may not be aware of the cost of some programs that they supported based on the belief that the programs were almost costless to taxpayers. A second related reason is that public knowledge of the actual cost to taxpayers of programs might result in a demand for their cancellation or restriction or, where the programs are cost effective, expansion. Considering that the Congress and presidency are now controlled by Republicans, who presumably are opposed to government waste and taxation (deficits, of course, are just the present value of future taxation), such calculations might not be disregarded.

## **MY ANSWERS TO SOME OF ELLIOTT'S QUESTIONS**

### ***Interest Rates on Loans***

With respect to Elliott's concerns about interest rates, it should be useful to consider initially the factors that determine interest rates generally. Six such factors may be distinguished:

1. Forbearance, or the opportunity cost of time. This is measured best as the risk-free real rate (which excludes the effects of changes in purchasing power).
2. Expected change in purchasing power. The nominal rate on risk-free obligations of a given duration provides an effective measure of the first two factors. It often is termed the “cost of funds.”
3. The cost of default to the lender. This is the amount of loss given default by the borrower at a particular time because of the borrower’s inability or unwillingness to repay a loan as contracted. The interest rate is increased such that the higher present value (discounted at the nominal rate of interest) of the higher interest payments and the loss given default is zero.
4. Administrative costs. These include the cost of determining default risk, recording the loan and payment thereon, monitoring the loan, and collecting the payments. As with the cost of default, the interest rate should provide the funds required for these costs.
5. Systematic risk. Such risk increases the discount rate if the returns on the loan or project covary positively with the economy’s discount rate (as is likely for loans, because both rates are higher [lower] in good [bad] times).
6. Uncertainty (e.g., variance of expected cash flows). This affects the interest rate if the lender is risk averse or cannot construct a sufficiently diversified portfolio of loans to reduce uncertainty to a very small number. Although, as Modigliani and Miller established, the effect of risk aversion is eliminated when there is cost-effective arbitrage, such arbitrage of government loans may not be possible.

If a loan is not subsidized, the interest rate charged should include the effects of the first four factors. Assuming that both government and private lenders are risk (uncertainty) neutral and

the government agency is as efficient as a private lender in assessing the risk of default and in monitoring and administering the loans, the “correct” rate is the same rate a private lender would charge for a similar loan.

In responding to Elliott’s questions, I assume that the goal is not to subsidize borrowers or insurees. If the goal is to subsidize them, the rate charged should be lower.

His first question (p. 264) is, “What discount rate should we use for a floating-rate loan made by the [federal] government?” My answer is, the rate charged by commercial lenders for a loan with similar terms (duration, etc.). The rate should not be the government’s borrowing rate on similar obligations with the same duration, as this rate does not include default and administrative costs and systematic risk. It might seem that the cost of defaults should not be included in the relevant rate because the federal government cannot default on its obligations (not as long as Federal Reserve notes are accepted for the payment of debts). However, some people who borrow from the government do not repay these debts and some government-sponsored projects fail. Those costs necessarily must be borne by taxpayers. Hence, although the holders of government debt do not incur losses, they must be borne by someone. The expected returns from government-financed programs should cover those expected losses (assuming, still, that a subsidy is not intended). Further, losses from default are difficult to estimate and may be biased to serve special interests. Hence, reference to the commercial rate is a desirable check and is likely to underestimate the relevant discount rate.

His second question (p. 266) is, “Should the federal government use a discount rate that reflects the uncertainty of future cash flows from a lending program?” I assume that here Elliott means what I call the “cost of default.” Assuming no bias in estimating cash flows, my answer is “yes.” It also should include administrative and monitoring costs and systematic risk. However, he later brings in risk aversion, which I call “uncertainty.” As noted above, this aspect of the interest rate should not be included in the interest rate.

## Insurance

Elliott poses an overall question with respect to insurance (p. 268): “How can we improve federal budgeting for insurance programs?” He then shows that the present cash budgeting system is “a disaster,” particularly with respect to the PBGC and flood insurance. I assume for this question that repeal of these programs and their transfer to private insurance companies is not politically feasible.

With respect to the PBGC, I cannot imagine any public benefit of a taxpayer subsidy to corporate pension grantors or pension recipients (who certainly are not among the poorest of our citizens). Consequently, the PBGC should be restructured and be required to operate as a self-contained unit that will get no taxpayer funds, directly or indirectly by being allowed to borrow from the Treasury Department if it falls short of funds. It should have the independent authority to increase premiums, adequately penalize corporations that do not make payments sufficient to fully fund their plans, and regulate and monitor fund assets. I expect that as premiums are increased, corporations with well-funded plans will drop out by converting to defined-contribution plans (e.g., 401(k) plans) and the PBGC will become even more insolvent. The Congress and president will then have to decide whether to bail out present and prospective pension holders (which Elliott and I expect them to do).

Elliott does not ask any questions about flood insurance, but presents data showing that the National Flood Insurance Program charges premiums that do not reflect the actuarial risks and that it reports on a cash basis. Both procedures distort the costs of the program to taxpayers. As he makes clear, this should be changed if the goal is to achieve public benefits. However, it may be that the goal is to benefit some people at the expense of others and to deceive voters and perhaps legislators of the real economic costs of the program.

## People and Tools

Finally, Elliott questions whether government agencies can employ the people and tools that

would improve the performance of federal credit and insurance agencies. I suggest that appointing inexperienced political supporters and cronies to head such agencies is not desirable.

## CONCLUSION

To summarize, I believe that there are few public but many private-interest benefits from government loan and insurance programs. I agree, though, with Elliott, that these programs are unlikely to be disbanded and more such programs are likely to be established. Consequently, from the viewpoint of taxpayers generally, it would be preferable to have them organized as self-sustaining agencies. If they make direct loans, the Congress can appropriate the funds necessary to get them started. Loan repayments and fees collected by the agencies would not be recorded as federal budgetary inflows, and loans and operating expenses would not be recorded as budgetary outflows. To the extent that legislators determine that their activities should be subsidized, the necessary amounts would be provided through appropriations that would be recorded as budget outflows. The agencies, then, would have an incentive to operate efficiently so as to maintain and possibly expand their programs and reduce the amount of additional funding that the Congress would have to appropriate.

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