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When Uncle Sam plays banker

By Charles Lane, Published: April 9, 2012

Today's lesson on How America Really Works begins with a question: What is the largest and most influential financial institution in the world? It's not J.P. Morgan, or even Goldman Sachs. It's the U.S. government.

That's the verdict of Brookings Institution banking expert Douglas J. Elliott, and the numbers back him up. By the end of 2011, the federal government's housing, farm, business and educational credit programs had $2.7 trillion in loans and guarantees outstanding. That's not counting the $5 trillion-plus, mostly related to housing giants Fannie Mae and Freddie Mac, that Washington took on its books amid the financial crisis that began in 2008.

We'll find out soon enough whether these "emergency" programs gradually become permanent, as did Great Depression emergency programs such as the Export-Import Bank and the Federal Housing Administration (FHA).

The federal government's massive intervention in the credit markets, necessary as it might be in a crisis, shows that our nation often honors its commitment to free markets in the breach.

It is also cause for concern — if, like me, you believe that one of the Great Recession's lessons is that financial commitments can be a lot riskier than they appear. To make matters worse, current law obscures, rather than clarifies, the risks to taxpayers in the government's portfolio.

Federal lending is always done in the name of some socially beneficial objective that the private banking system would insufficiently support, if left to its own devices.

Take, for example, student loans. A well-educated populace produces a more civilized, more productive society. Banks are not generally in the habit of making long-term, uncollateralized individual loans; ergo, it makes sense for the government to advance tuition money to would-be college students. Economists call this correcting "market failure."

Nevertheless, when government decides how to allocate scarce resources, it sometimes strikes the wrong balance. Some categories of federal credit — rural utilities, railroad upkeep, small business — benefit interest groups with no clear payoff for the overall economy.

The social benefits of government-backed student loans may indeed outweigh their costs. But even this program distorts the markets it's meant to repair. A guaranteed flow of tuition dollars weakens colleges' incentive to restrain costs. Tuition rises and students must borrow more.

Over the past generation, federal credit support for housing boosted homeownership rates — but not sustainably. The national investment in home mortgages was a lot more vulnerable to the ups and downs of the business cycle than a series of Congresses and presidents of both parties had supposed. The resulting excess supply may burden the economy for years.

Some experts believe that the government's $706 billion student loan portfoliosignifies a similar bubble in higher ed.

Federal credit programs are here to stay. Even if there were a consensus to unwind them all, doing so would be impractical in the short run. Meanwhile, in select cases, federal lending or loan guarantees may correct true market failures.

But Congress needs to be much more transparent about the costs and benefits.

There is general agreement that federal budgets should include a dollar figure for the estimated lifetime cost of each year's new lending. Congress adds up all the expected cash flow associated with a particular credit program — interest and principal payments, fees, expected defaults — and calculates its "present value," based on a notional interest rate known as the discount rate.

Under current law, however, Congress bases these estimates on the government's ultra-cheap cost of borrowing. That means the calculations are done as though everyone were as default-proof as Uncle Sam, which understates the costs and risks to taxpayers.

The Congressional Budget Office believes "fair value" accounting, which adjusts the discount rate to reflect the risk of widespread defaults during downswings in the business cycle, would be more accurate.

Under fair-value accounting, the student loan program's projected 9 percent profit for 2010 to 2020 would be a 12 percent loss, according to a 2010 CBO study. Last month, the CBO estimated that FHA single-family mortgage insurance will cost $3.5 billion this fiscal year, as opposed to the $4.4 billion savings reported under current accounting rules. And that, in turn, would increase the estimated budget deficit. Congress would have to cut other programs or raise taxes accordingly.

In February, the House passed a bill, sponsored by Rep. Scott Garrett (R-N.J.), to require fair-value accounting. So far, it has gone nowhere in the Senate. The bill would make it harder for Congress to put taxpayer resources at risk except when clearly justified. This is undoubtedly why some on the Hill don't like the legislation — and why it is so necessary.