# INFORMED BUDGETEER

## TAX DAY APPROACHES: COULD THE GOVERNMENT PASS AN AUDIT?

- As April 15, nears taxpayers are meticulously organizing their records, ready to prove their case if the IRS calls. Many wonder if the Federal government could live up to the same standards it imposes on the average citizen.

- The answer is a resounding no! This week the government flunked its first ever audit, failing to account for billions of dollars of assets and liabilities. Under the Government Management Reform Act of 1994, the government must produce audited financial statements starting this year.

- Only 8 of 24 departments and agencies covered could muster a clean opinion. If a private company suffered the same evaluation, it would no longer be able to borrow from banks or issue securities.

- The GAO reports: **"In summary, significant financial systems weaknesses, problems with fundamental record keeping, incomplete documentation, and weak internal controls, including computer controls, prevent the government from accurately reporting a large portion of its assets, liabilities, and costs. These deficiencies affect the government's ability to accurately measure the full cost and financial performance of programs and effectively and efficiently manage its operations."**

- Although the financial statements are unreliable, what they did reveal is disheartening. The net worth of the federal government at the end of 1997 was negative *$5 trillion dollars*. It is important to note that the government will remain solvent because it has the ability to tax and print money.

- Still, the supplemental information to the statements revealed another $9 trillion in potential liabilities not included in the balance sheet. $5.3 trillion of this amount represented the unfunded liabilities of Social Security and Medicare Part A. *The Administration excludes these programs from the balance sheet because it does not view them as firm commitments.*

✎The entire report, the 1997 Consolidated Financial Statements of the United States is available at www.gao.gov.

## ISTEA CONFERENCE: ACT I-- THE SETTING

- When Congress returns from the Easter recess, the House-Senate conference on the ISTEA bill will begin in earnest. The table below lays out for *Bulletin* readers the major differences between the two bills. For starters, there are different amounts, *and even types*, of highway, highway safety, and mass transit funds in each bill.

**HOUSE /SENATE ISTEA DIFFERENCES**
(Total BA 1998-2003, $ in Billions)

| | House | Senate | Difference |
|---|---|---|---|
| Contract Authority: | | | |
| Highways | 179.4 | 171.3 | 8.1 |
| Highway Safety | 2.4 | 1.7 | 0.7 |
| Mass Transit | 35.8 | 31.7 | 4.1 |
| General Fund: | | | |
| Highways | 0 | 2.3 | -2.3 |
| Highway Safety | 1.0 | 0.6 | 0.4 |
| Mass Transit | 0.9 | 9.7 | -8.8 |
| TOTAL | 219.5 | 217.2 | 2.3 |

- Overall, it would appear that the two bills are close in total funding. But upon closer inspection, the differences become greater. For example, the House bill provides over $8 billion more in highway contract authority than the Senate bill. Meanwhile the Senate bill provides nearly $9 billion more in general fund authorizations for mass transit than the House bill, over the next five years.

- Other issues will that have to be addressed include taking the Highway Trust Fund off-budget and finding the spending offsets to actually *pay* for this large increase in spending above the levels agreed to in the Balanced Budget Agreement.

- Another issue that must be addressed is the House action to take future funding of the Minimum Allocation program and other "specified high priority highway projects" away from the Appropriations Committee and make them direct spending, not subject to appropriations.

- And last but not least, there are the demonstration projects totaling approximately $11 billion in the House bill.

## CBO REPORT ADDS INSIGHT TO STUDENT LOAN MORASS

- Last week, CBO released an analysis of how different interest rate scenarios would affect the profitability of lenders who participate in the guaranteed student loan program. The study was requested by Chairman Domenici.

- CBO estimates show that, with either the scheduled new interest rate or the replacement rate proposed by the Administration, profits would likely be insufficient to attract most lenders' continued participation in the program.

- To summarize the background for the CBO report: the formula for determining the rate paid by students to their lenders is scheduled to change under current law on July 1, 1998 (i.e. the rate will change from the current rate of 8.3% to about 7%). A Treasury report released in February concluded that the scheduled new rate will be too low for banks to earn sufficient returns, and therefore banks would no longer make student loans.

- To address this looming problem, the Administration proposed an alternate rate (current rate less 80 basis points, or about 7.5%) that it argues would provide banks sufficient profits to remain in the program while keeping rates as low as possible for students. The Administration argues that investors require banks to earn no more than a 10-14 percent after-tax return on equity for making student loans. This implies that the Administration believes investors expect the stock market as a whole to perform no better than the average returns realized in the stock market since 1970.

- CBO observes that banks set their target range for gauging whether an investment offers satisfactory returns depending on how the banks' investors (stockholders) expect the market as a whole to perform in the future, and that investors currently expect the market to produce returns more consistent with those experienced in the 1990s. This expectation implies that lenders should earn from 16 to 20 percent return on equity. The argument is that if the sum of banks' investments do not produce average returns in that range, the stockholders could do better by investing in opportunities available in other industries in the stock market.

- CBO does posit, however, that the rate of return expected for student loans specifically (which account for, on average, only one percent of a bank's total investments) is likely to be a shade less because of the relatively low risk posed by student loans and because lenders do not fully hedge their basis risk (the difference in interest rates between the student loans and the rate on debt banks incur to issue the student loans). The *Bulletin* wonders whether this would make the target range look something like 13-17 percent?

- The CBO study agrees with the Treasury's conclusion that the new rate scheduled to take effect in three months would prompt most lenders to exit the program (see table, rates of return **not profitable** in all categories). However, CBO also estimated what the returns to lenders would be under the Administration's proposed solution. Such returns would **still be insufficient** to attract continued lender participation (rates of return no more than 11 percent in any category, falling short of the likely target range).

**Expected After-tax Rates of Return on Equity from Federal Family Education Loans to Students Entering School in the Fall of 1998**
(In percent)

| Interest Rate Formula | | 2-year low blnce | 2-year high blnce | 4-year school | Grad. School |
|---|---|---|---|---|---|
| Current | PL | 16 | 19 | 18 | 23 |
| | Sec. | 22 | 30 | 26 | 35 |
| Scheduled New | PL | np | np | np | 5 |
| | Sec. | np | np | np | np |
| Admin | PL | 2 | 6 | 6 | 11 |
| Proposed | Sec. | np | np | 1[A] | 9[A] |
| | PL | 10 | 14 | 13 | 18 |
| House/Senate | Sec. | 11 | 19 | 17 | 25 |
| Cmte proposed | | | | | |

SOURCE: CBO NOTES: np= not profitable, PL=portfolio lending, Sec.=securitization. [A]The returns are lower under securitization because the cost of higher interest expenses offsets the benefits of a lower capital investment.

- CBO also examined another interest rate option (current rate less 30 basis points, or 8%) included in both the House and Senate Higher Education bills marked up after the Treasury report was issued. CBO's estimates of the rates of return to lenders under this option appear to be either within or greater than the target rate of return for all categories of loans except the least profitable type (low balance loans to students in two year schools, although the majority of these schools are already in the direct loan program and would be unaffected by lenders opting out). The estimates further show that, if concerned, lenders certainly have options for increasing profits.

- One observation on the House and Senate option not included in the CBO paper, but that *Bulletin* readers should be aware of -- even though the committees set a new rate that appears to provide a necessary level of profit for lenders, the committee is not asking students to pay that rate. The bills set a lower rate for students and expects that taxpayers will subsidize the difference, at least $1 billion over the next five years (CBO estimates are not yet complete on these bills). The **committees have not attempted to offset that cost**, and the bills, therefore, would be subject to a Budget Act point of order in the Senate.

✎The CBO study is available at: www.cbo.gov. The *Bulletin* suggests a look to be an especially well informed budgeteer.

## EDUCATION TASK FORCE REPORT SPEAKS VOLUMES

- The Senate Budget Committee's Education Task Force, chaired by Senator Frist, submitted its interim report on the Prospects for Reform: The State of American Education and the Federal Role on March 27, 1998. The Task Force, established at the Chairman's request last September, was asked to begin a review of the state of American Education, to assess the current Federal role and to make any appropriate recommendations.

- The Task Force held six hearings during the past six months focusing on K-12 education. Topics addressed included: student achievement trends; current federal education programs; State and local reform efforts; State and local perception of the federal presence in education; research and evaluation; and ideas for reform.

- The Task Force reported that data from the National Center for Education Statistics demonstrate that student achievement in all grades and in subjects such as mathematics, reading, writing, and science, has remained relatively stagnant or has declined slightly from peak years. This has occurred during a twenty-year period of substantial growth in per-pupil spending and a dramatic decrease in the pupil-teacher ratio.

- In analyzing the current federal role in elementary and secondary education, the Task Force found what they determined to be "a sprawling, unfocused effort that suffered from a programmatic reluctance to ask itself the fundamental question: What works?"

- The Task Force relied heavily on the work of the GAO which found that the Department of Education administers some 244 education programs with total funding of $31 billion. GAO identified significant programmatic overlap in a number of areas relating to education. For example, GAO identified 86 teacher training programs in 9 federal agencies and offices.

- The Task Force expressed criticism of the President's budget in light of this proliferation of education programs, noting that the President proposed an additional 14 education programs in his fiscal year 1999 budget.

- The Task Force found there is no systematic effort to evaluate Federal education programs and that in fact we know very little about whether or not these programs work. The Task Force further found that investments in basic education research and program evaluation are woefully inadequate (less than one-third of one percent of education funding,) that the value of the research itself is questionable, and that the level of independence from political influence should be enhanced.

- The Task Force concluded with three recommendations:

1. Federal Education programs should be consolidated and this consolidation could take a number of forms. The Task Force recommends that some programs should be block granted. However, in addition, the Task Force strongly recommends allowing states to enter into what it calls a "strategic plans" whereby states receive increased flexibility in the use of categorical funding in exchange for fiscal accountability and improved performance.

2. Increase funding for educational research with funds targeted toward what the Task Force calls "design competitions" and "large-scale demonstration projects." The Task Force also urges greater oversight and involvement in setting the Federal research agenda by an increasingly more independent and non-partisan board.

3. The Federal government should provide strong support in terms of resources and flexibility for state and locally-designed education reform efforts. The Task Force does not recommend federally funded or mandated voucher programs. However, states and localities should have the flexibility to use federal funds for school choice options in both public and private

schools.

✎The full text of the Task Force report is available on the Senator Frist's website at www.senate.gov/~frist.

**GOODBYE** to one of the *Bulletin's* favorite budgeteers and friend: Chairman Domenici and all of the SBC staff thank Barry Andersen, Assistant Director of OMB for his dedication and service to the federal budget. May he now have a good rest and best wishes for continued success in his new endeavors.