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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-171630

MAY 25 1976

The Honorable John J. Sparkman, Chairman
Subcommittee on Housing and Urban Affairs
Committee on Banking, Housing, and
Urban Affairs
United States Senate

Dear Mr. Chairman:

In your October 20, 1975, letter, you asked us to analyze a report by the Departments of Housing and Urban Development and the Treasury on the feasibility of financing certain housing programs through various methods. As agreed with your office, we confined our inquiry to obtaining the views of financial experts on the main theme presented in the report by the two Departments--direct borrowing by the Federal Government may have the effect of increasing the interest cost on the entire public debt. We discussed this matter with financial experts at the two Departments, the Federal Reserve System, and the Congressional Research Service, in Washington, D.C.

On April 15, 1976, we informally advised your office of the results of our inquiry into this matter. This letter confirms that information.

BACKGROUND

In a January 1973 report to the Congress entitled "Opportunities to Improve Effectiveness and Reduce Costs of Rental Assistance Housing Program" (B-171630, Jan. 10, 1973), we concluded that the Department of Housing and Urban Development could achieve considerable savings in section 236 program costs if mortgage loans were financed through direct Government borrowings rather than through private lenders. We reported that these savings were possible because of the lower annual interest rate at which the Government could borrow compared with the interest rates available in the private mortgage money market. We said that the Congress should consider legislation which would permit the Government, rather than private lenders, to finance the rental assistance housing program.

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Section 822, Public Law 93-383, dated August 22, 1974, directed the Secretary of Housing and Urban Development and the Secretary of the Treasury to study the feasibility of financing the programs authorized under section 236 of the National Housing Act and section 802 of the Housing and Urban Development Act of 1974 through various financing methods, to determine whether, considering the direct and indirect effects of such methods, any method would result in net savings to the Federal Government.

DEPARTMENTS' ANALYSIS OF DIRECT FINANCING OF CERTAIN PROGRAMS

The report by the two Departments, which was sent to the Congress on October 2, 1975, stated that the various methods to be considered in financing the HUD section 236 and 802 programs were: (1) direct financing through the Treasury, (2) direct financing through the Federal Financing Bank, (3) privately financed guaranteed loans, and (4) privately financed nonguaranteed loans. The report indicated that, if direct Federal financing were to be provided for either program, the appropriate mechanism would be the Federal Financing Bank which was established by the Congress to consolidate agency financing and to finance guaranteed obligations that would otherwise be sold in the securities market. Also the report said that, since the Federal Financing Bank was financed through the Treasury, there was no reason to believe that different estimates would be appropriate for direct Treasury financing than for Federal Financing Bank financing.

For their analysis the two Departments divided the costs of each of the above alternatives into two categories--direct costs and indirect costs. Direct costs included those costs which were directly associated with financing program activities, such as borrowing costs and mortgage-servicing fees.

In the analysis direct costs were based on the net interest expense to the Federal Government of direct and guarantee financing. Indirect costs included those expenses which were incurred as a result of, but not in connection with, financing a given level of program activity. The primary indirect cost that was considered in the analysis by the two Departments was the possible increase in interest on the public debt brought about by increased Treasury borrowing.

In analyzing indirect costs, the report by the two Departments stated that a dynamic economic model must be used. This type of model gives the overall effect on the entire system, given a change in any part. The analysis by the two Departments attempted to answer the question: How does an increase in Treasury borrowing affect the interest rate the Treasury must pay to finance the public debt? The analysis substituted the Treasury borrowing for federally guaranteed private borrowing to produce an increase in the total Treasury borrowing costs. The two Departments used several economic models (Bosworth-Duesenberry and Hendershott) to make their forecasts.

Although the report did not contain conclusions and recommendations, it implied that interest costs on the public debt would be increased through the direct-financing method but that the amount of any such costs would be difficult to quantify. The report suggested that the subject merited additional study. The report stated that with regard to the economic models used to analyze the indirect costs:

> "By their nature, these indirect costs are difficult to specify and quantify, since they result from complex interactions in financial markets. An ideal model would take account of these interactions and be sufficiently detailed to allow a simulation of the precise financing options considered in this report. However, no such model presently exists. Views on the significance of these indirect costs vary considerably; some believe they are negligible while others believe they could be significant. The question of indirect costs has been investigated by performing simulations with two recently developed financial models of the United States economy. * * * Unanswered questions remain concerning this indirect cost, and we believe that the subject is sufficiently important to merit continuing research and model development."

The report stated that further research and analysis are needed to develop techniques for assessing the impact of indirect costs of direct financing of agency programs.

Regarding the methodology we used to determine whether the Federal Government could reduce its costs for the section 236 program through direct lending by the Treasury rather than through Federal guarantees of private loans to the project sponsors, we limited our analysis to those costs that could reasonably be measured on the basis of the accepted practices at the time. We made no attempt to measure indirect costs since there were no techniques available to quantify such costs.

We discussed with financial experts at several Federal agencies the matter of indirect costs that the two Departments used in the simulation tests in their analysis. Generally they told us that there were no techniques or models that could measure the indirect costs to the Federal Government as a result of direct borrowing. They said that opinions varied as to the amount of increase in Federal borrowing costs as a result of direct borrowing. They said also that much more study and research remained to be done on the development of economic analytical techniques concerning indirect costs. They indicated that it probably would be many years before such techniques were developed and widely accepted, because of the complex economic issues that need to be resolved.

We believe that direct financing of certain Department of Housing and Urban Development programs is an important consideration and that further research should be done to try to provide some means of quantifying indirect costs.

Because the direct-financing matter could involve many agencies and many Federal programs, the Subcommittee should consider assigning to one agency the responsibility of spearheading the Government's efforts to resolve this matter.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States