

**Hutchins Center**  
**Roundtable discussion, presentation by Richard Kogan,**  
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**1. Default Risk vs. Market Risk: This debate is *not* about loan defaults**

FCRA (existing law) is the **Federal Credit Reform Act**. It tells OMB and CBO to take into account all expected losses from defaults. “Fair-Value Accounting” or FVA = “Loss Aversion Penalty.” Advocates of a loss-aversion penalty want to add a further amount to the FCRA spending estimate, *on top* of the loss government suffers from loan defaults.

Advocates of FVA agree that loss-aversion penalties are *not* default risks and in fact are not government payments or lost collections at all.

- a) **“FCRA and market-based cost estimates alike take into account expected losses from defaults by borrowers.”** *CBO issue brief, March 2012.*
- b) **“Accounting for the cost of risk is further complicated by the fact that it is an opportunity cost that involves no actual cash flows.”** *Lucas & Phaup, 2008 Reforming Credit Reform. Journal of Public Budgeting and Finance, Winter 2008*

**2. “Risk” and additional market costs:**

In addition to loss aversion, loan assets are more valuable to the government than to private investors for other reasons:

- a) Markets cannot usually garnish wages or income tax refunds, but the government can and does.
- b) Markets cannot usually override bankruptcy courts, but the government can, by law.
- c) Markets cannot usually put themselves first in line in a bankruptcy proceeding, but the government can.

**3. Cash accounting (pre 1992) and FCRA accounting (1992 on)  
 produce identical totals over time:**

Ultimately, the costs of loans and guarantees is the same under cash or FCRA accounting – only the *timing* is different. That is, over the life of a portfolio of loans, the pure cash flows and Treasury debt service on them sum to the increase (or decrease) in debt caused by the loans. Likewise, the up-front FCRA cost and the imputed debt service on that cost sum to the same total over the life of the portfolio, correctly adding to the amount by which debt has increased (or decreased). Ramifications of this fact include:

- a) FCRA merely puts direct loans and guarantees on equal footing: each is scored up front as the FCRA cost, equal to the net transaction over time. Congress isn’t swayed by exaggerated first-year costs (direct loans) or apparent first year savings (guarantees).

- b) If it is justifiable to add a loss-aversion penalty to *FCRA* accounting, it is equally justifiable to add the same penalty to *cash* accounting of loans.
- c) The government’s long-term fiscal gap, as calculated by Gale-Auerbach, CBO, GAO, OMB, and others, is the present value, *using Treasury interest rates*, of all programmatic cash disbursements and receipts. Because *FCRA* accounting is *precisely* the same as fiscal gap accounting, *FCRA* shows the amount that a loan or guarantee adds to the long-term fiscal gap. *FCRA* thus focuses policymakers on exactly the right question: will loan/guarantee programs add to or subtract from the fiscal gap, and if so, by how much?
- d) *All* other federal spending and all federal revenues are scored on a cash (or cash equivalent) basis [except TARP and the 2009 IMF quota increase]: the amount that flows from the government to the public and vice versa. Thus, *FCRA* accounting — which only changes timing, not amount — means that loans and guarantees ***are*** scored on the same basis as all other programs; they do ***not*** receive favorable treatment.
- e) But adding a loss aversion penalty to credit scorekeeping would disadvantage loans and guarantees relative to *all* other spending and tax transactions, which suffer no such penalty.

#### 4. Loss Aversion and Utility: #1

- a) “Never bet more than you can afford to lose.” *Anon*
- b) “Because everyone does poorly in recessions, these risks are not diversifiable.” *Hutchins Center, Credit Scoring (p. 4)*
- c) “[A]lthough the *FCRA* methodology accounts for expected losses from defaults, it does not account for the fact that losses from defaults tend to be highest when economic and financial conditions are poor, which is when resources are scarcer and hence more valuable.” *CBO answer for the record to Bernie Sanders, Ranking Member of the Senate Budget Committee, February 27, 2015.*

Thus: credit losses impose disutility; equally likely and equally sized credit gains provide utility; but the disutility is larger because losses hurt more (a) and the timing is worse (b and c). Hence loss aversion and CBO’s rationale for adding it to the expected value of a credit transaction.

CBPP doesn’t buy conflating utility and budgetary costs (see section 8, below). But even if *you* do, note that —

- By spreading the costs (pooling risk) over all taxpayers, the government can reduce disutility below the “can’t afford to lose” threshold. The utility function is a smooth curve only in econ class, not in real life.
- By borrowing during recessions — at *very* low rates — the government can spread the costs (pool risk) across even more people and impose it when times are good, not bad.
- By having a progressive tax structure, the government can ultimately shift risk up the income ladder, from beneficiaries to (on average, wealthier) taxpayers, thus decreasing disutility.

In short, the government can greatly diversify risk and decrease disutility even when markets cannot. So FVA, to the extent it uses market interest rates, exaggerates disutility and overstates the loss aversion.

## 5. Loss Aversion and Non-Credit Programs

If you do believe that loss aversion (caused by variability in expected cash flows) should be added to actual government costs for credit programs, you really need to apply it to *all* programs with undiversifiable uncertainty and variability, e.g.:

- Unemployment insurance; deposit insurance; and PBGC pension insurance
- Veterans' compensation and pensions, SSI, SNAP; the EITC and CTC
- Medicare, Medicaid, ACA tax credits, and Social Security
- Certain "discretionary" programs such as Pell, section 8 housing, and cost-plus defense contracts.

## 6. Loss Aversion and Utility: #2

If you believe that "market risk" should be added to actual government costs because it *exposes loss-averse stakeholders to variability*, then you must also admit that credit and other government programs reduce variability for other loss-averse stakeholders — the beneficiaries.

Simple example: UI exposes taxpayers (stakeholders) to variable outcomes but *protects* workers and their families (also stakeholders) against variable outcomes. If the theory justifies a loss-aversion penalty ("cost") for UI, it also justifies a loss-aversion bonus ("savings") for UI. To focus on the cost but ignore the savings, as FVA does, is completely one-sided.

Moreover, all of the programs listed in section 5 above provide more utility to beneficiaries than disutility to taxpayers, especially when the ability of to diversify is taken into account.

## 7. Further ramifications of adding loss aversion penalties: oh, what a tangled web we weave

- a) Under FVA, total outlays and deficits will be scored higher than the cash actually disbursed by the government over the life of the loan/guarantee, because the loss aversion penalty is *in addition* to the actual cash flows including Treasury interest.

**"[I]ncluding a risk premium in subsidy cost produces a cost estimate that, on average, exceeds outlays for realized losses."** Because overscoring the deficit is not desirable, **"That discrepancy between cash flows and subsidy costs must be reconciled in the budget, so that over the life of a credit cohort, actual cash flows match budget costs in expectations."** *Lucas & Phaup, 2008 Reforming Credit Reform. Journal of Public Budgeting and Finance, Winter 2008*

- b) In 2008, Lucas and Phaup suggested that the loss aversion penalty for credit programs should be offset by scoring higher tax revenues than are actually collected.
- c) In 2009, OMB was required by statute to include a loss aversion penalty to TARP estimates. It could not countenance scoring outlays and deficits higher than they would be over time, and so created an artificial offset; the upward loss aversion penalty for TARP (and for an assumed TARP-2) was fully offset by a downward adjustment to net interest over time. This produced the incoherent result that TARP and the assumed TARP-2, with total “costs” of \$700 billion, *reduced* government interest payments in all years.

The bill passed by the House in 2012 and 2014 includes neither type of offsets to spending or deficits, and so permanently overstates them. It doesn’t overstate debt held by the public, but only because it requires inserting into the non-budgetary “financing” schedule an artificial offset to the overstated deficit.

## 8. Loss Aversion and Budgeting

Questions policymakers should ask about any policy proposal: A) How much does it cost the government? B) How much good or harm does it do? These questions are separate, and policymakers must evaluate both.

FVA advocates note that A) individual investors are, *for good reason*, loss averse and so assert government should also be loss averse on behalf of taxpayers, and B) therefore, loss aversion should be added as a penalty to increase the scored cost of government policies that have undiversifiable, variable, and uncertain rather than guaranteed costs, e.g., loans and guarantees. **“The cost of market risk should be a budget cost because it is a cost to government stakeholders...”** {emphasis added} *Marvin Phaup, Comment on CBPP’s Release of H.R. 3581, February 2012.*

**CBPP thinks over-scoring loan costs by adding a loss aversion penalty is wrong because —**

- a) it doesn’t represent an amount the government ever pays anyone;**
- b) it produces the wrong spending, deficit, and debt totals unless offset by some other artificial bookkeeping entry;**
- c) it means budget scoring will no longer be addressing the fundamental question of whether a program is affordable (by measuring how much it adds to the long-term fiscal gap);**
- d) it is based on concepts of utility, but overstates the disutility that credit programs impose on taxpayers and entirely ignores the utility that credit programs provide beneficiaries; and**
- e) it puts credit programs at a disadvantage relative to *all* other programs and to tax policies, all of which are scored on the basis of flows of real cash (or cash-like instruments) without extra penalties.**

**In addition, “fair market valuation” goes even beyond loss aversion, adding other market costs that are not government costs, such as the market’s inability to recoup losses by withholding income tax refunds.**

## **Appendix:**

### **Red herring: What would the markets charge?**

The fact that markets would value the government's portfolio of direct loans at less than FCRA values them is a red herring.

- The government isn't a business or individual, but a sovereign (it can borrow on its sovereignty, can tax, can print money, does not have a short lifespan) and so borrows at lower rates *for valid reasons*.
- It is simply false that all other government spending is done at standard market prices: most is not.
  - Medicaid and especially the VA buy prescription drugs more cheaply than anyone else.
  - Medicare and Medicaid provide health care more cheaply than the private sector, and recently the gap has been growing. (c.f. "Medicare Advantage")
  - Governments provide police and firefighting services more cheaply than the private sector.
  - The government provides military security more cheaply than the private sector (c.f. contract security forces in Iraq).
  - The private sector barely made student loans available at any price until the government guaranteed them.
  - If private-sector companies were paid to provide food stamps, unemployment insurance, Social Security, SSI, or veterans disability (not just administer them, but also pay the benefits), they would charge the government noticeably more than these programs cost the government.
  - They would charge more even if the government promised to reimburse them for all benefits after the fact, because the markets would insist on running a profit while the government does not.
  - The government does not buy special-use infrastructure at market prices (e.g., long-distance highways, NASA launch pads) even though it may pay market prices for the components and labor, because the market value of this infrastructure is less than its cost.
  - The market value of nuclear weapons is probably far above their cost to government (though there is no legal market).

**SUMMARY:** Loss-aversion penalties would not make credit costs equivalent to other government market-based (private sector) costs because other costs are *not* market based. But it would make credit costs *unlike* other government costs because all others are recorded as the amount the government actually spends, with no penalties or bonuses.