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S. 1300: THE MULTI-BILLION DOLLAR RURAL ELECTRIC GIVEAWAY

INTRODUCTION

Just as the nation's lawmakers are pressing forward with a major tax increase, arguing that there is little fat that can be cut from the budget, they are about to vote on a multi-billion dollar giveaway to rural voters. Even some conservatives seem poised to back the measure. Powerful special interest groups are bent on convincing the Senate to pass a federal handout to financially viable rural electrical cooperatives (RECs) that could increase cumulative future spending by over $19 billion. Under pressure from the same interest groups, the House passed the "Rural Electrification and Telephone Revolving Fund (RETRF) Self-Sufficiency Act of 1983," H.R. 3050, by a lopsided 283-111 vote in March. Despite threats of a presidential veto, the comparable Senate bill, S. 1300, introduced by Senator Walter D. Huddleston (D-KY) has 46 co-sponsors and is scheduled to be marked up by the Senate Agriculture Committee on June 7.

The RETRF is administered by the Rural Electrification Administration (REA). The REA lends money to rural electrical cooperatives from the fund, together with money borrowed from the Federal Financing Bank, for the purpose of electrifying rural America. Its activities generally are not scrutinized by Congress and the media because its operations are largely off-budget. Under current law, the net assets of the RETRF will begin to decline in FY 1986 or FY 1987. At that time, interest payments on the money borrowed from the Federal Financing Bank will exceed interest receipts into the fund from RETRF borrowers. H.R. 3050 and S. 1300 aim to avert the prospective shortfall. The legislation would convert RETRF's obligation to repay $7.9 billion owed by the REA to the Treasury from a liability of the fund to equity capital owned by REA itself--thereby forgiving the loan. The REA currently is scheduled to begin repaying the loan in 1993.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

The measure forgives the debt, essentially appropriating $7.9 billion to the RETRF and increasing future federal borrowing. The bill also replaces the current fixed loan rate of 5 percent with a variable rate only slightly closer to the Treasury cost of money.

These and other provisions of S. 1300 would cost upwards of $19 billon over the next several years, according to the Office of Management and Budget (OMB),[1] but would only postpone insolvency a short time. Moreover, the REA itself opposes the bailout. According to REA Administrator Harold Hunter, it would continue a non-means tested subsidy to non-rural and non-needy co-ops. This would increase the incentive to rely more heavily on the federal government,[2] forego the opportunity to redefine the role of the REA in light of the achievement of its original objectives, and encourage 40 other Federal Financing Bank programs, worth over $133 billion, to request forgiveness of their loans through equity capital conversions.[3]

The REA fulfilled its original purpose of electrifying rural America many years ago. Yet in the last ten years alone, rural electrical cooperatives have received subsidies totalling over $69.9 billion, according to the Office of Management and Budget.[4] Because the REA is off-budget, S. 1300 could reduce on-budget deficits by $22.3 billion over the next 25 years. This reduction would be more than offset, however, by a $32.7 billion increase in off-budget outlays[5]--plus billions of dollars of unaccounted subsidies resulting from subsidized loans. The rural cooperatives have been able to extract these subsidies from the the American taxpayer because, as economists James Bennett and Thomas DiLorenzo note, "the activities of the FFB give federal politicians and bureaucrats a virtual blank check, with no direct budgetary consequences with which to dispense rapidly growing amounts of

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1 Estimates contained in a letter from David A. Stockman, Director of the Office of Management and Budget to Senator Paula Hawkins (R-FL), Chairman, Agriculture Subcommittee, U.S. Senate, January 17, 1984. On April 12, 1984, the Congressional Budget Office issued an analysis that estimated the total cost of the bill at $10.4 billion. CBO did not estimate losses for some provisions of the bill nor did they estimate losses occuring after the year 2010. Moreover, neither the OMB or CBO estimate is time discounted. See, "Analysis of the Budget Impact of S. 1300, The Rural Electrification and Telephone Revolving Fund Self-Sufficiency Act of 1983," Congressional Budget Office, April 12, 1984.

2 Testimony to the House Committee on Agriculture, Subcommittee on Conservation, Credit, and Rural Development, Hearings on H.R. 3050, 98th Congress, 1st Session, October 5, 1983.

3 Sylvia Morrison, "Solvency of the Rural Electric Fund: An Economic Analysis of S. 1300 and H.R. 3050, 98th Congress," Congressional Research Service, December 29, 1983.

4 Stockman letter, op. cit.

5 CBO, "Analysis of the Budget Impact of S. 1300."

loans and subsidies to their constituent interest groups. The political costs of the federal largesse are effectively reduced by the FFB."[6]

Instead of passing another bailout bill, Congress should restore the integrity of the REA and the federal budget by bringing the activities of the REA onto the federal budget. The REA should pay back its debts to the Treasury and the FFB as scheduled. To accomplish this Congress should reduce the loan activity of the RETRF and increase the interest rate charged by the fund closer to the Treasury cost of money. The REA has computed that every such percentage point increase in their lending rate would increase the average consumer's electric bill by just ½¢ per day.[7]

THE ROLE OF THE REA

The REA was created in 1935 to reduce rural unemployment and provide electricity to America's farms. At that time less than 12 percent of American farms had electricity, and established utility companies refused to bear the costs of extending transmission lines to low population density areas. In 1949 Congress amended the legislation to include the development of telephone service, then available in only 36 percent of American farms.[8]

Under the law the REA makes loans to rural electrical cooperatives, at subsidized interest rates and regardless of need, to provide rural electrical and telephone services. When first established, the RECs must not include communities with populations over 1,500, but once a cooperative is formed and registered with the REA, it does not have to retain its rural character. In addition to direct loans, the REA also can guarantee REC loans made from the Federal Financing Bank. Unlike other federal loan guarantees, such as those provided Chrysler or New York City (where the federal government guaranteed private loans from private banks), REA loan guarantees merely involve one government agency insuring loans made by another government agency.

The program has accomplished its goal. By 1982, 99 percent of all farms had electricity, and 95 percent enjoyed telephone services. The National Rural Electrification Association (NRECA) now consists of nearly 1,000 co-ops in 46 states, serving 10 million households and over 25 million individuals--or approximately 10.5 percent of Americans.[9] As Senator Alan Simpson (R-WY) notes, the program has taken on a life of its own:

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6 James Bennett and Thomas DiLorenzo, Underground Government: The Off-Budget Public Sector (Washington, D.C.: Cato Institute, 1983), p. 139.

7 House Testimony, op. cit.

8 "A Brief History of the Rural Electrification and Telephone Programs," REA, U.S. Department of Agriculture, February 1983.

9 Ibid.

> When this remarkable agency first embarked upon its mission in this country it was a stunning thing to observe. It literally changed the face of America. But after the extraordinary effort had been largely completed--when over 99 percent of rural America then received electrical energy--then some very creative financiers, accountants, lawyers and businessmen entered the fray. The complexity of the financing schemes and revolving fund capers of the REA would make an atomic scientist blanch.[10]

The REA has evolved into a massive federal subsidy to a powerful constituency. Off-budget financing and complicated financing schemes have concealed the costs of the REA program to the American taxpayer. Special interest groups have supported S. 1300 in order to further complicate and hide increased subsidies.

THE PROBLEMS OF REA

Prior to 1973, loans to RECs were made directly by the Treasury, with REA evaluation and approval. In 1973, however, Congress transferred the existing loan obligations from the Treasury to the REA, to be used as a revolving fund for future loans. The Treasury thereby foregoes to the REA some $158 million annually in interest on outstanding loans.

When loan requests began to exceed fund receipts in 1976, the REA sold Certificates of Beneficial Ownership (CBOs), representing liens on loans it had made and is servicing, to the Federal Financing Bank.[11] In effect, the REA borrowed money from the Federal Financing Bank, using its loans outstanding as collateral. The REA (but not the co-ops) pays an interest rate on this money equivalent to the long-term Treasury rate plus one-eighth of a percentage point.

Using 1983 as an example, the cash flow situation of the REA fund can be understood. The RETRF received $864 million in income from repayments of principal and interest on past loans to RETRF borrowers. Much of this income was derived from $7.9 billion in outstanding loans transferred from the Treasury to the

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[10] Dear Colleague Letter from Senator Alan K. Simpson (R-WY), May 3, 1984.

[11] Bennett and DiLorenzo explain the importance of CBOs in Underground Government, p. 138. "Agencies sometimes pool their loans and issue securities backed by the pooled loans. These securities, known as CBOs, are then turned over to the FFB for cash, placing them off-budget. The agency has cash to loan again, and can repeat the process as many times as it chooses. This procedure allows federal agencies to make loans to privileged customers with virtually no budgetary limit."

REA in 1973. On the expenditure side, the RETRF advanced $856 million to borrowers in new loans and was required to pay $368 million in Certificate of Beneficial Ownership interest expenses to the Federal Financing Bank. FY 1983 RETRF expenditures exceeded income by $360 million. This deficit forced the REA to borrow from (that is, sell Certificates of Beneficial Ownership to) the Federal Financing Bank every year since 1976. The 1983 deficit was covered by an additional $340 million in Certificate of Beneficial Ownership offerings to the Federal Financing Bank. In an attempt to stem this steady depletion of RETRF strength, Congress appropriated nearly $200 million to the fund in FY 1984.

Given the same loan program level, the REA would run a deficit totaling well over $600 million in FY 1985. Every year that loans advanced plus interest exceed loan repayments, the REA will be forced to borrow even more funds. And when interest on the Certificates of Beneficial Ownership exceeds loan repayments (now expected to occur in FY 1986 or FY 1987) the fund's ability to sell CBOs will begin to erode, thus accelerating the fund's slide into insolvency. Moreover, the REA will not have the funds available to begin repaying the principal $7.9 billion debt to the Treasury, scheduled to start in 1993, nor its Certificate of Beneficial Ownership principal to the Federal Financing Bank, scheduled to begin in 2006.

THE CAUSE OF THE PROBLEM

The primary cause of this huge shortfall is the increasing gap between the interest rate at which the REA borrows from the Treasury and the rate at which it lends to its co-ops. When the program began in 1935, the REA loan rate was 2 percent--25 basis points above the Treasury cost of money, but still below market rates. The REA loan rate floated with the Treasury cost of money until Congress fixed the interest rate at 2 percent in 1944. When market interest rates reached 5.1 percent in 1972, Congress adjusted the fixed REA rate to 5 percent. Between 1973 and 1983 the gap between the loan rate and the cost of money increased dramatically, peaking at 8.06 percentage points in 1981.[12] Yet, Congress did not readjust the loan rate.

THE OPTIONS FACING CONGRESS

This interest rate gap would not, of itself, drive the fund to insolvency, but Congress also requires the REA to loan more than it receives in payments. If it is to prevent the REA from running out of money, therefore, Congress has three options:

1) increase receipts to the fund by raising the interest rate it charges to REA borrowers;

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12 Morrison, op. cit.

2) cut the loan program level to match receipts; or

3) supplement the fund with further direct subsidies.

If the REA were allowed by Congress to reduce loan advances to one-half the current program level, it could maintain the current interest rate structure. Conversely, if it brought interest rates closer to the Treasury cost of money it could expand its loan program. Current loan levels could be maintained at about two percentage points below the government's cost of borrowing (about 10 percent). Instead, the legislation now before Congress resorts mainly to direct subsidies, and does nothing to rectify the financial insolvency causing the problem.

WHAT DOES S. 1300 DO?

The National Rural Electrification Association has supported Senator Huddleston's S. 1300, which would accomplish several objectives critical to its constituency. The bill is intended to finance low subsidized interest rates for RETRF borrowers and to maintain the current level of loans ($1.1 billion in FY 1984). It also purports to make the revolving fund self-sufficient. To keep rates low and loan levels high, however, S. 1300 includes direct initial support from the American taxpayer to the RETRF, plus several other creative ways of dipping into Treasury revenues.

In addition to $7.9 billion in loan forgiveness, S. 1300 proposes a new REA interest rate formula.[13] It also would allow the REA to refinance loans from the Federal Financing Bank whenever the Treasury rate drops one hundred basis points, and it would permit the Federal Financing Bank to lower its interest rates on guarantees to co-op borrowers every seven years if the new rate is lower than the existing rate.

These provisions could cost the American taxpayer $8 billion and $5 billion respectively, according to the Office of Management and Budget, because they only allow refinancing when interest rates drop.[14] Whenever interest rates do decline in the future, the REA's interest rate obligations would also decline with the cost of money, but the rate the REA pays to the Federal Financing Bank would not increase when the Federal Financing Bank cost of money increased. In a volatile interest rate market these direct subsidies to the REA could skyrocket.

Other potentially costly provisions of the bill would require the federal government to forfeit the right of first lein on any

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13 $$\frac{\text{(loans advanced + CBO interest expense - repayments to fund)}}{\text{loan approvals}} \times \text{CBO rate}$$

14 Letter from OMB, op. cit.; see also CBO, "Analysis of the Budget Impact of S. 1300."

assets of a bankrupt RETRF borrower, and the Congress to appropriate funds to make up for REA losses incurred in granting hardship loans at interest rates as low as 2 percent.

OBJECTIONS TO THE BAILOUT

Heavy Subsidies to Consumers

The National Rural Electrification Association resists any action, such as raising the cost of REA borrowing or lowering program levels, that could possibly increase utility rates to Rural Electrical Cooperative customers. This leaves direct subsidies as the only option the NRECA is prepared to contemplate. The rationale for this position is an assertion that federal subsidies to RECs are less than those provided to Investor-Owned Utilities (IOUs). According to an NRECA study, the average federal subsidy received by an REC amounts to only $9.46 per year per customer, while the federal subsidy to municipal and investor-owned utilities is $40.45 and $42.48 per customer per year, respectively.[15]

Studies by several non-partisan private and public organizations, however, demonstrate that federal subsidies to RECs substantially exceed those to investor-owned utilities, and that RECs, on the average, charge lower rates to consumers. Economist Joe D. Pace, of National Economic Research Associates, points out three substantial errors in the NRECA analysis: 1) a failure to account for implicit subsidies of guaranteed loans; 2) an incorrect calculation of the cost of capital; and 3) a fundamentally flawed methodology. Adjusting these errors, Pace calculates the subsidies as follows:

	REA	Investor-Owned Utilities
subsidy (millions of dollars)	362	511
subsidy per customer	40.29	7.24

He concludes that this subsidy results in underpricing of REA electricity by 8.3 percent--which in turn results in excessive consumption amounting to 4.2 percent.

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15 Rural Electrical Financing for the Future (Washington, D.C.: NRECA, 1983.

Artificially Low Utility Rates

A November 1982 Congressional Research Service study by Donald Kiefer measures directly the reduction in rates as a result of subsidies.[16] The Kiefer estimates focus on the capital costs only, which represent 25 percent of utility costs. According to Kiefer, federal subsidies reduce utility capital costs by 34 percent in RECs, but by only 18 percent in investor-owned utilities.[17]

According to the General Accounting Office, average residential bills of RECs are lower than bills of non-REC utilities in cities with population greater than 2,000.[18] Moreover, the Office of Management and Budget contends that REA utility rates average 12 percent less than other utilities. In the past ten years the direct taxpayer cost of these subsidies has been $31.8 billion, but the additional indirect social costs on the economy have exceeded $38 billion.[19]

Opponents of the bailout contend that the bill would keep REA interest rates artificially low, perpetuating the negative cash flow of the RETRF and thus the need for federal borrowing (i.e., Certificate of Beneficial Ownership sales) to prop up the RETRF. Moreover, growing Certificate of Beneficial Ownership principal amounts will become attractive targets for future requests for forgiveness and "equity transfers." Critics also argue that the bill sets a dangerous precedent for 40 other agencies with $133 billion in Federal Financing Bank borrowings, encouraging them to seek similar "loan forgiveness."

Impact on the Budget

Most important, critics reject the claim of proponents that the bailout will have no meaningful effect on the federal budget because the revolving fund represents money previously appropriated by Congress. Public and private research organizations have attacked the notion that loan forgiveness is merely a "transfer of equity" within the government, pointing out that it is a transfer of equity from the American taxpayer to RETRF borrowers. As Senator Simpson suggests, "you might wish to ask your banker for this kind of an equity transfer on your home mortgage."[20]

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16 Donald W. Kiefer, "Investor-Owned Utilities Versus Rural Electric Cooperatives: A Comparison of Tax and Financial Subsidies," Congressional Research Service, November 29, 1982.

17 Ibid.

18 General Accounting Office, "Legislation Needed to Improve Administration of Tax Exemption Provision for Electrical Cooperatives," 1983.

19 See letter from David Stockman, op. cit.

20 Simpson letter, op. cit.

Continued Fund Imbalance

Opponents of the bill also assert the proposed formula for REA rates is too low to maintain the balance in the fund. According to this formula the current REA rate would rise to only 5.9 percent,[21] thus failing to make the fund self-sustaining.

REA's Goals Already Achieved

The original goals of the REA programs have been met. Ninety-nine percent of all farms now have electricity. And though all co-ops must cover fewer than 1,500 residents to qualify for their first loan, future loans do not depend on the size of the community. As a result, many subsidized RECs are now suburban communities, not rural villages. Between 1971 and 1981, REA consumers increased 46 percent while the number of co-ops increased only 0.6 percent.[22] Senator Simpson has noted that many REA loans go to co-ops that serve mostly industrial users. "One co-op in my own home state," says Simpson, "had 1982 power sales of 386,000 megawatt hours--and 354,000 of those hours (91.7 percent) were sold to large industrial and commercial users, and yet the co-op still qualifies for 2 percent REA loans."[23]

Many eligible co-ops clearly no longer require subsidized loans--they are financially able to turn to the private sector for loanable funds at normal interest rates. Indeed, Congressmen and other observers believe that the REA could fully achieve its objectives with a major reduction in loan levels, if it simply applied a means or priority test to loan requests.

THE SIMPSON BILL

Senator Simpson has offered S. 2624 as an alternative to S. 1300. A similar bill (H.R. 4943), offered in the House by Representative Ed Bethune (R-AR) was defeated. The Simpson bill would raise the REA interest rate gradually to a few points below the Treasury cost of money, cap the amount of loans the REA may grant, and, according to calculations by the Congressional Research Service, make the revolving fund enduringly solvent without Treasury forgiveness.[24] The legislation would also stabilize interest rates essential for long-term capital planning.[25] The Simpson-Bethune approach thus meets Congress' original intent for the REA to fluctuate with the cost of Treasury money. It also

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21 Morrison, op. cit., p. 37.

22 Morrison, op. cit.

23 Simpson letter, op. cit.

24 Letter from Sylvia Morrison, Congressional Research Service, to Congressman Ed Bethune, February 17, 1984.

25 The Simpson standard rate is calculated by:

$$\frac{\text{(interest and principal expense on CBOs)}}{\text{interest income from borrowers}} \times \text{CBO rate}$$

abides by the intent of the 1973 law, intended to foster greater reliance on the private sector, by giving more discretion to the Administrator to set private loan ratios and hardship rates.

THE ADMINISTRATION PROPOSAL

The Simpson bill is a major improvement upon S. 1300 because it avoids an increase in subsidies to the REA over current law. Nevertheless, RETRF borrowers still would continue to secure multi-million dollar transfers from the American taxpayer under the legislation, through subsidized loans. These would generally remain unscrutinized by Congress or an unsuspecting public, because the REA would remain off-budget.

The Administration has a proposal, not yet introduced in the Senate, that would restore the integrity of the RETRF while improving on the Simpson approach. The Administration alternative would set the REA lending rate at the Treasury cost of money plus several basis points--assessed as a user fee to cover the cost of administration. It would also cap loan levels and bring the REA on-budget, where future subsidies could be carefully scrutinized and accounted for in the normal budget process.[26]

CONCLUSION

The REA's original purpose has been attained. Ninety-nine percent of all rural households now have electricity. The program should now focus on the remaining one percent of rural areas that can demonstrate financial need. This does not require massive federal subsidies or giveaways to the rest of rural America, or to favored suburbs and industrial users.

The REA and its beneficiaries should not be forgiven their debt to the American taxpayer, and the RETRF should be made fully self-sustaining. Nor should the REA loan fund be hidden from public scrutiny by being off-budget. It should be brought on-budget so that the subsidies involved can be fully accounted for in the unified budget.

Potential REA deficits could be avoided by slowly reducing loan payments and increasing loan interest--without significantly burdening RETRF borrowers or their consumers. The REA would only have to raise its lending rate to about 10 percent, or two points below Treasury cost, to make the fund self-sustaining at current loan levels and pay its debt to the Treasury and the Federal

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[26] Letter from John R. Block, Secretary of Agriculture to George P. Bush, President of the Senate, April 11, 1984.

Financing Bank. The REA itself has calculated that every percentage point increase in its loan rate would increase the average cost per day per customer by only ½ cent.[27]

Congress never intended to create permanent and heavy subsidies for rural cooperatives. The REA was founded in order to assure that rural utilities would have access to the capital markets, so that electricity could reach the nation's farms. That objective has been achieved. It is clear that the REA is now providing subsidies for many people who do not need them.[28] It is time for RETRF borrowers to turn to the private market for their finance.

John M. Palffy
Walker Fellow in Economics

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27 House Testimony, op. cit.

28 See Jeffrey H. Birnbaum, "U.S. Charges Small Electric Utilities with Improper Use of Low Interest Loans," Wall Street Journal, September 1, 1983. During the Carter Administration, REA loans were used to finance cable television. The American Enterprise Institute compared REA loans with insured student loans: "Because loan money is available under such favorable terms and conditions, many middle-income and upper-income families that did not need assistance took out the loans and reinvested the money at higher interest rates." See "Financing Rural Electrification," American Enterprise Institute, Legislative Analyses, January 1984.