"On the Importance of the Plumber" by Douglas Elliott

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Comment by George J. Benston*

Elliott starts (quite reasonably) with accepting the prevalence and continuation of federal loan and insurance programs.

I complement his paper and start with asking the rationale for the programs – public or special interest?

> Necessary to determine if programs are efficient and effective
>
> E.g., a loan program that is supposed to correct for a market failure should carry a market rate; one that is supposed to benefit the recipients should have a subsidized rate

Law of unintended consequences – was a "bad" outcome (e.g., method of awarding of FCC spectra) really unintended?

Private-Market solution usually is best for the public interest, given five assumptions (even then, government intervention may be more costly than benefits)

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Basic Assumptions:

1. people are the best judges of what is best for them

   exceptions (e.g., children) not relevant

2. distribution of wealth is optimal

   direct transfers best, given 1

   directed use may be desired by taxpayers

      effects on behavior (no spending on drugs)

      loans rather than gifts screen out students who are not serious

3. market failure that can be effectively alleviated by government

   unlikely in US, except where government-imposed constraints

4. government cost advantage over private companies

   economies of scale

   lower interest rate (no default, no risk aversion)

5. externalities: reduce negative (e.g. pollution), enhance positive (e.g., professors' articles)

Summary:

public benefits of doubtful validity

government loan and insurance programs serve to enhance special interests

Special-interest Benefits from Government Loan and Insurance Programs

1. offset costs imposed by other government actions and "acts of God"

   unexpected hurricane (Katrina), extreme acts of terrorism

   does not include expected hurricanes and earthquakes

2. transfer of wealth from taxpayers to favored persons

   cost to taxpayers difficult to discern than direct subsidies

   often cloaked in the mantle of "the public interest"

Unintended Consequences

Legislators may have believed program would not be as expensive as it turned out to be

Laws may have been poorly drafted – did not account for peoples opportunistic incentives

PGGC example of poorly crafted legislation

Elliott's Questions

Useful to know actual cost to taxpayers – may result in repeal or improvement of programs

Interest rates on loans

- forbearance (opportunity cost of time; real rate of interest) = r
- expected change in purchasing power = n

  nominal rate r: (1+n) = (1+r)*(1+i)
- cost of default to lender: loss given default
- administrative costs
- cost of funds to lender (irrelevant for government)
- uncertainty (irrelevant for government)

If loan is not subsidized, first four factors

Discount rate on floating rate government loan

Government borrowing rate on obligation with same duration

Discount rate that reflects uncertainty of future cash flows

Risk of default – yes

Uncertainty – no

Insurance – PBGC

Should have power to enforce requirements for funding and asset choice

Will need (and probably get) taxpayer bail out (even though not justified)

Discount rate on federal government liabilities

Problem is not rate, but estimates of cash flows (biased to benefit special interests)

Conclusion

Establish loan funds and insurance as self-sustaining "tubs on their own bottom" – appropriations for shortfalls as required