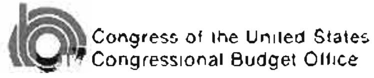
A CBO Study

The Budgetary Status of the Federal Reserve System

February 1985



THE BUDGETARY STATUS OF THE FEDERAL RESERVE SYSTEM

The Congress of the United States
Congressional Budget Office

NOTE

The report includes budget data through calendar year 1983, the most recent data available when the report was prepared.

PREFACE

This report on the budgetary status of the Federal Reserve System was undertaken at the request of the Joint Economic Committee. The study describes the structure, activities, and financing of the Federal Reserve System, and reviews the history of the budgetary independence of the System. It considers in detail two proposed alterations in the Federal Reserve's budgetary status: a complete presentation of Federal Reserve System finances in the budget, and a requirement of prior appropriations for Federal Reserve System expenditures. The study does not examine in detail the Federal Reserve's determination and conduct of monetary policy.

The study was prepared by Roy T. Meyers of the Budget Process Unit under the supervision of Richard P. Emery, Jr. David Delquadro, Mitchell Mutnick, and Marvin Phaup contributed material and valuable advice. Useful comments and suggestions were made by Valerie Amerkhail, Jacob Dreyer, Louis Fisher, Robert Hartman, Mary Maginniss, Marty Regalia, Stephen Swaim, Jean Wells, and John Woolley. Francis S. Pierce edited the manuscript. Paula Gatens prepared the manuscript for publication.

Rudolph G. Penner
Director

February 1985

CONTENTS

PREFACE iii

SUMMARY xi

CHAPTER I. INTRODUCTION ....

CHAPTER II. A HISTORY OF THE BUDGETARY INDEPENDENCE OF THE FEDERAL RESERVE SYSTEM 3

- The Federal Reserve Act 3
- The Banking Acts of the 1930s 7
- The "Accord" 8
- The Martin-Patman Years 10
- The Recent Decade 12
- Summary 14

CHAPTER III. AN OVERVIEW OF THE FEDERAL RESERVE SYSTEM 19

- Structure 19
- Activities 20
- Financing and Expenditures 26

CHAPTER IV. BUDGET PRESENTATION 39

- Limitations of the Current Budget Presentation 40
- Reasons for the Current Budget Presentation 44
- Federal Reserve Finances and Current Budget Concepts 49
- Predictability as a Factor 56
- The Federal Reserve's Independence 59
- The Mechanics of Budget Presentation 60

CONTENTS (Continued)

CHAPTER V. THE FEDERAL RESERVE SYSTEM AND THE APPROPRIATIONS PROCESS 63

Congressional Spending Control Processes 64
Alternative Methods of Evaluating the Spending Record of the Federal Reserve 71
Federal Reserve Budget Savings Approaches 86
The Appropriations Process and Congressional Policy Direction 94

APPENDIX A. BUDGET PRESENTATION COMPARISONS 97

APPENDIX B. BUDGETING IN THE FEDERAL RESERVE SYSTEM 105

TABLES

TABLE 1. INCOME, EXPENSES, AND EARNINGS OF THE FEDERAL RESERVE BANKS, 1983 28

TABLE 2. STATEMENT OF CONDITION, FEDERAL RESERVE BANKS, 1983 29

TABLE 3. FEDERAL RESERVE BANKS' CAPITAL OUTLAYS, 1983 31

TABLE 4. FEDERAL RESERVE BANKS' TOTAL OUTLAYS, 1983 32

TABLE 5. COMPOSITION OF FEDERAL RESERVE BANKS' CURRENT DIRECT AND INDIRECT EXPENSES, 1983 33

TABLE 6. COMPOSITION OF FEDERAL RESERVE BANKS' CURRENT EXPENSES, NET OF REIMBURSEMENTS AND COLLECTIONS, 1983 34

TABLE 7. INCOME AND EXPENSES OF THE BOARD OF GOVERNORS, 1983 35

TABLE 8. COMPOSITION OF BOARD OF GOVERNORS' EXPENSES, 1983 36

TABLE 9. FEDERAL RESERVE BUDGET PRESENTATION FOR FISCAL YEAR 1985: TOTAL BUDGET RECEIPTS 42

TABLE 10. FEDERAL RESERVE BUDGET PRESENTATION FOR FISCAL YEAR 1985: BUDGET APPENDIX PROGRAM AND FINANCING SCHEDULE 43

TABLE 11. THE UNIFIED BUDGET OUTCOMES OF FEDERAL RESERVE INCOME RECLASSIFICATION AND EXPENSE PRESENTATION 57

TABLES (Continued)

TABLE 12. FEDERAL RESERVE EARNINGS TRANSFERS AND NET BUDGETARY INTEREST 58

TABLE 13. TOTAL FEDERAL RESERVE SYSTEM EXPENSES, CALENDAR YEARS 1979-1983 72

TABLE 14. SELECTED ECONOMIC STATISTICS AND POLICY EXPENSES, FISCAL YEARS 1979 AND 1983 73

TABLE 15. ADMINISTRATIVE EXPENSES OF FEDERAL AGENCIES WITH FINANCIAL REGULATION DUTIES, FISCAL YEARS 1979-1983 74

TABLE 16. COMPOSITION OF FEDERAL RESERVE BANKS' CURRENT EXPENSES, 1979-1983 75

TABLE 17. COMPOSITION OF BOARD OF GOVERNORS PROGRAM OBLIGATIONS, 1979-1983 76

TABLE 18. FEDERAL RESERVE BANKS: PRICED SERVICES EXPENSES AND REVENUE, 1983 83

TABLE A-1. OFF-BUDGET FEDERAL ENTITIES AND GOVERNMENT-SPONSORED ENTERPRISES, FISCAL YEAR 1985 98

TABLE A-2. CHARACTERISTICS OF ORGANIZATIONS WITH ACTIVITIES SIMILAR TO THOSE OF THE FEDERAL RESERVE SYSTEM 100

BOXES

FEDERAL RESERVE FINANCIAL OPERATIONS 41

BUDGET TREATMENT OF THE CONTINENTAL ILLINOIS DISCOUNT LOAN 54

SUMMARY

The Federal Reserve System was established by the Federal Reserve Act of 1913 to serve as the nation's central bank. Underlying its creation was the desire for an efficient payments system and an elastic currency. To accomplish these purposes, the Federal Reserve Banks were granted the powers to transfer funds nationwide and to advance funds to member banks. The Banks were also given the duties of issuing currency and handling government deposits and debt issues. These responsibilities have since expanded, and the System currently provides many services to the financial sector and the government.

As the Federal Reserve System matured, two additional responsibilities--the determination and conduct of monetary policy and the supervision and regulation of part of the banking system--became more important. Monetary policy is considered to be its most important activity. The Federal Reserve attempts to promote price level stability and high levels of production and employment by influencing the quantity of money and the price of credit (interest rates). Its primary policy instrument is the purchase and sale of government securities in the open market. In concert with the Treasury, the Federal Reserve also trades in currencies to moderate movements in the foreign exchange value of the dollar.

The Federal Reserve shares responsibility for supervision and regulation of the commercial banking sector with the Comptroller of the Currency and the Federal Deposit Insurance Corporation. It is primarily responsible for the regulation and supervision of bank holding companies and state chartered banks that are members of the Federal Reserve System. The System also writes regulations for consumer protection and credit availability laws.

THE FEDERAL RESERVE'S STRUCTURE AND FINANCES

The structure of the Federal Reserve System has remained relatively unchanged since passage of the Federal Reserve Act. The Board of Governors in Washington sets general operating policies for the System as a whole. The Board is composed of seven members appointed by the President and confirmed by the Senate, and is assisted by a staff of about 1,600 persons.

Most of the operations of the System are carried out by 12 Federal Reserve Banks and their branches and other facilities located throughout the country. Each Bank has nine directors, six selected by member banks and three appointed by the Board of Governors, two of whom serve as chairman and deputy chairman. The directors appoint the chief operating officers of the Banks with the approval of the Board of Governors. The Federal Reserve Banks have about 23,000 employees.

The Federal Open Market Committee, which meets in Washington at frequent intervals, is responsible for determining the course of monetary policy. The Committee consists of the seven Governors of the Board and five Reserve Bank Presidents. The Federal Reserve Bank of New York carries out the Committee's directives. Nearly 6,000 commercial banks are "member banks" of the System.

The Federal Reserve Banks earn almost all of the income of the Federal Reserve System, and spend approximately 95 percent of its gross expenses. Income exceeded $16 billion in calendar year 1983, 94 percent of which was interest earnings on U.S. government securities. Operating expenses of the Federal Reserve Banks were about $1.1 billion dollars in 1983. The Board of Governors spent about $70 million with funding from assessments on the Federal Reserve Banks.

In 1983, nearly $700 million of the System's gross operating expenses were for providing services to financial institutions and the public, and nearly $500 million was received in compensation for these services. Expenses for supervision and regulation of banks were nearly $150 million, and expenses for economic policy exceeded $100 million. Gross expenses for services to government agencies exceeded $120 million, and the agencies reimbursed 60 percent of these expenses.

THE FEDERAL RESERVE'S BUDGETARY STATUS

The budget of the Board of Governors for the most recent calendar year is printed in the Budget Appendix along with those of other off-budget entities such as the Federal Financing Bank, the Postal Service, and the U.S. Synthetic Fuels Corporation. The Board's expenses are not included in the budget's tabulation of total off-budget outlays, however, and because the Board's budget is presented on a calendar year basis it does not cover most of the federal budget year.

The financial operations of the Federal Reserve Banks are not shown in the federal budget documents. They are instead reported to the Congress in the Annual Report of the Board of Governors. The report is limited to

the completed calendar year, and does not include projections of future financial operations.

While the outlays of the Federal Reserve System are not explicitly shown in the federal budget, the net earnings of the System--total income less operating expenses--are reflected in the federal budget totals. This results from the System's weekly transfer of its net earnings to the U.S. Treasury, which are recorded as "miscellaneous receipts" in the revenue side of the budget. The net earnings of the Federal Reserve System have grown substantially in recent years as its portfolio of U.S. government securities has expanded and interest rates have risen. For fiscal year 1983, total transfers of earnings by the Federal Reserve amounted to $14.5 billion, about equal to the total amount of receipts from estate and gift taxes and customs duties.

Because Federal Reserve income from portfolio earnings greatly exceeds operating expenses, financing of these expenses from other revenue sources is unnecessary. Annual appropriations approval of Federal Reserve spending plans is not required, a result of a provision of the Federal Reserve Act which stipulates that the Board's assessment "shall not be construed to be Government funds or appropriated moneys."

The History of the Federal Reserve's Budgetary Independence

The Federal Reserve System has never been subjected to the appropriations process, and aside from the recording of transfers of Federal Reserve earnings as budget receipts, its financial operations have always been excluded from the federal budget. This insulated budgetary status has enabled the Federal Reserve to make decisions with relative independence from Congressional and Presidential influence. A review of the 70-year history of the Federal Reserve (see Chapter II) indicates that the relationships between the Federal Reserve's functions and its independence have varied over time.

When the Federal Reserve Act was being considered, it was generally agreed that establishing an institution with the power to provide liquidity to the banking system would make financial crises less likely. The structure of this proposed institution, however, was highly controversial. Although some favored a strong central bank located in Washington under the control of the President, others wanted the Federal Reserve to be independent of the executive branch and controlled by private bankers. Widespread concern about the influence of New York as a financial center favored a regional structure. The Federal Reserve System as it emerged was a complex mixture of these opposing elements, and its budgetary status was repre-

sentative. The Banks, being privately capitalized, were thought to be out of the purview of the annual appropriations process (although the act did establish a franchise tax on the Banks' profits). The Board of Governors required no appropriations, having been given the right to assess the Federal Reserve Banks for coverage of expenses.

Two decades after the creation of the Federal Reserve System, the Federal Reserve Act was significantly modified in 1933 and 1935. These laws responded to the problems of monetary management in the Great Depression by formally establishing the Federal Open Market Committee. As power was centralized in the System, the Board of Governors was also given greater independence from the executive branch by elimination of the *ex officio* memberships of the Secretary of the Treasury and the Comptroller of the Currency. The franchise tax on Bank profits was repealed and the language which defined Board assessments as non-governmental funds was added. The fees received by the Comptroller of the Currency and the Federal Deposit Insurance Corporation were protected with similar language. The purpose was to partially insulate commercial bank regulation and monetary policy from the political process.

While no significant changes in the Federal Reserve's budgetary status were made legislatively from the mid-thirties until 1978, several important changes were made without legislation. In 1947, the Federal Reserve decided to transfer most of its profits to the Treasury after Members of Congress expressed interest in requiring the Federal Reserve to do so. At this time, the Federal Reserve was beginning to conduct monetary policy differently than it had in the past. Until the end of World War II, the main goal of monetary policy was to support Treasury financing by keeping interest rates low. As inflation threatened during the post-World War II and Korean War periods, the Federal Reserve made price stability an additional goal of monetary policy. The emphasis on price stability as a monetary policy goal strengthened the case for the budgetary independence of the Federal Reserve, since the interest-rate policies required to promote price stability could be unpopular with the President or the Congress.

This case for budgetary independence was accepted by the President's Commission on Budget Concepts, which recommended in 1967 that the Federal Reserve be excluded from the new "unified budget." This budget consolidated almost all government spending accounts into a single budget. The Commission gave three reasons for its exclusion of the System from the unified budget. It believed that inclusion would constitute an announcement of future monetary policy, thus jeopardizing the flexibility and independence of the monetary authorities. Second, projections of future System operations--which would be required if the Federal Reserve was included in the budget--did not appear feasible at that time. Third, the Commission be-

lieved that the nature and significance of Federal Reserve Bank receipts and expenditures were different from those of most other government programs and activities.

The case for the Federal Reserve's budgetary independence has not been universally accepted. Some believe that monetary policy goals should be determined by officials accountable to the public through elections, and therefore see no need for budgetary independence. Others maintain that the Federal Reserve has been allowed to make expenditures that would not be permitted for other agencies only because of its exemption from the annual appropriations process and its exclusion from the budget.

The Congress has responded to these accountability and spending control concerns recently, but only to a limited degree. Several laws of the mid-1970s required the Federal Reserve to report periodically on economic conditions and policy goals. The Congress also reviewed and directed Federal Reserve spending through authorizing legislation and oversight. In 1978, it gave the General Accounting Office the right to audit all Federal Reserve System activities except monetary policy and foreign account activities. In 1980, full recovery of the costs of certain payments services was required by the Monetary Control Act. The Senate Banking Committee held annual oversight hearings on the budgets of the Federal Reserve from 1977 to 1980.

BUDGETARY ACCOUNTABILITY AND INDEPENDENCE

From time to time, proposals are made to increase the budgetary accountability of the Federal Reserve. These proposals would have varying effects on the Federal Reserve's independence. This report does not attempt to determine the correct balance between the Federal Reserve's independence and its budgetary accountability. It simply presents information relevant to choices that would affect the balance.

The proposal that would reduce Federal Reserve independence the least would be complete presentation of the finances of the System in the Budget of the U.S. Government. This proposal is discussed in detail in Chapter IV. The proposal that would reduce independence the most would be a requirement that Federal Reserve expenditures be approved in advance through the Congressional appropriations process. Another budgetary accountability proposal would be the conduct of annual oversight of the Federal Reserve's budget and the stipulation of budget savings in authorizing legislation. Appropriations, authorizing legislation, and oversight are discussed in detail in Chapter V.

Complete Budget Presentation

One method of increasing budgetary accountability would be to include the complete finances of the Federal Reserve System in the Budget of the U.S. Government. The Federal Reserve would provide data on actual and projected income and expenses by program and type. This approach would make its budgetary transactions visible to the public and readily comparable to the transactions of other government agencies. It would also make the U.S. government's "unified budget" more comprehensive.

A not uncommon belief is that complete budget presentation of the Federal Reserve System finances is precluded by the private characteristics of the Federal Reserve Banks. These characteristics are member bank ownership of capital subscriptions to the Federal Reserve Banks and participation in selection of bank directors. The Board of Governors exercises significant control over the Banks' policies, budget, and personnel, however. Moreover, the Federal Reserve Banks' activities--especially in the monetary and regulatory policy areas--are governmental in character. After a review of these public characteristics, the President's Commission on Budget Concepts wrote, "The System is clearly a Federal Government Operation."

Of the three methods of increasing budgetary accountability, budget presentation of the Federal Reserve's administrative expenses would have the least effect on the Federal Reserve's independence. The Federal Reserve would remain free to determine its own administrative expenses. If the Federal Reserve's expenses were visible, however, proponents of less government spending might consider more readily the possibility of reductions in Federal Reserve spending. Almost all other independent agencies are included in the budget documents despite a similar threat to their spending flexibility. The Federal Reserve would need to expand its accounting and budgeting systems to conform with the federal system.

Budget presentation of Federal Reserve finances could be confined to its administrative expenses, or could include its future monetary policy finances as well. The potential impact on the Federal Reserve's independence would be greater if the Federal Reserve was required to provide specific projections of its earnings. Projections of Federal Reserve earnings are made from point estimates of interest rates and of the size and maturity distribution of the Federal Reserve's portfolio. Revelation of the Federal Reserve's estimates of these factors would convey significantly more information about its policy intentions than is currently contained in the Federal Reserve's wide range estimates of money growth and interest rates. If it was required to publish a specific projection of its portfolio size, this could serve as a benchmark for evaluation of its monetary policy goals and performance.

Appropriations

A second method of increasing budgetary accountability for the Federal Reserve would be to subject the administrative expenses of the Board and the Reserve Banks to annual appropriation review. The operating budgets of most federal agencies are reviewed in the same manner, including those of the judiciary and most regulatory agencies. This approach would provide closer scrutiny of the System's operations--preparation of economic studies and statistics, provision of financial services, and supervision and regulation of banks. Many of these activities are similar to those performed by other federal agencies, and it is possible that some savings might be achieved through appropriations review.

The magnitude of potential budgetary savings from this approach is uncertain. Congressional review and approval of agency spending is thought to restrain agencies from spending funds wastefully. A limited review of the Federal Reserve's recent spending record (see Chapter V) suggests, however, that its spending does not appear to be significantly greater than those of other agencies with comparable functions. In other words, the Federal Reserve may already be following a relatively self-restrained spending policy, and review for management efficiencies might not produce significant budgetary savings.

On the other hand, should the Congress wish to ensure that the Federal Reserve's spending remain within the normal range for federal agencies, the appropriations process could be used for this purpose. The Congress could even reduce the Federal Reserve's spending below current levels by limiting the funds available to it, although significant budgetary savings would mean reductions in the level of services provided.

The principal issue raised by the application of the appropriations process to the Federal Reserve is whether the Congress should be involved in the determination and conduct of monetary policy. Carrying the appropriations process to its fullest would entail establishing appropriations ceilings on open-market, foreign currency, and discount loan transactions. Such ceilings could greatly reduce the Federal Reserve's operating flexibility, which is needed in the conduct of monetary policy in order to respond to unexpected economic or financial market conditions. Operating flexibility could be preserved by limiting such ceilings to the Federal Reserve's administrative expenses.

Even if appropriations were required only for administrative expenses, the process could be used to influence monetary policy through legislative riders or reduction of funding levels. The degree to which the Congress would use this power, and the effects on policy, are very uncertain. To

42-777 0 - 85 - 2

determine monetary policy successfully, the Congress would need to set clear monetary policy goals that were achievable and consistent with other economic goals. The traditional focus of the appropriations process, however, is the control of agency expenditures, not economic goal-setting. Should the Congress decide to set monetary goals instead of delegating this responsibility to the Federal Reserve, it could do so more effectively through the use of authorizing legislation and an expanded budget and economic planning process.

Oversight and Authorizing Legislation

A third method of increasing budgetary accountability would be to conduct annual oversight of the Federal Reserve's budget and set mandatory budget savings in authorizing legislation. Annual oversight of System spending could be performed by the Banking Committees of the House and Senate, in a manner similar to that of hearings conducted by the Senate Banking Committee in the late 1970s. The GAO's audit role could be expanded by having it perform complete audits of the System's books, as it does now for other independent agencies. The GAO could also be asked to review System spending and judge its efficiency.

Authorizing legislation could be used to order savings in the Federal Reserve's budget, savings that would result from significant changes in the System's structure or programs. Recovery of the costs of supervision and regulation through the imposition of fees on banks--the general practice of the other depository institution regulatory agencies--is probably the greatest opportunity for savings in the Federal Reserve's budget. Savings could also be realized by extending the market test constraint of the Monetary Control Act to certain public and service programs that are now financed from current income. Consolidating certain activities of the three agencies that regulate commercial banks and bank holding companies--the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation--could result in long-term savings, although significant transition costs would be incurred.

Use of authorizing legislation and oversight would be generally less of a threat to the Federal Reserve's independence than use of the appropriations process, although it could significantly affect Federal Reserve policies and finances. In the oversight process, committees are limited to review of expenditures after the fact or to suggestions for future spending, whereas the Congress may order specific spending levels for particular purposes in the appropriations process. Most authorizations are for a multiyear or unlimited time period, whereas appropriations are considered annually. These considerations, and a concern for the independence of regulatory

policy, have led the Congress to use oversight and authorizing legislation in place of appropriations for three depository institution regulatory agencies--the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the National Credit Union Administration. Other financial regulatory agencies--the Federal Home Loan Bank Board, the Federal Savings and Loan Insurance Corporation, the Farm Credit Administration and the Securities and Exchange Commission--are subject to the appropriations process. None of these agencies have charges similar to the monetary policy responsibilities of the Federal Reserve. On the other hand, agencies with policy responsibilities comparable in importance to monetary policy, such as the Department of Defense, are subject to the appropriations process.

CHAPTER I. INTRODUCTION

Central banks are unusual instititutions. They make very important economic policy decisions, yet they are often formally independent from the elected officials of their governments. The central bank of the United States, the Federal Reserve System, is no exception. Its Governors are appointed by the President and confirmed by the Senate for 14-year terms, but are secure from removal except for cause. In general, its expenditures are not reported in the Budget of the U.S. Government, and no advance approval from the President and the Congress to expend funds is required. In its most important area of responsibility--the determination and conduct of monetary policy--the President and the Congress have traditionally declined to curb it formally with executive orders or legislation.

The Federal Reserve and other central banks are not wholly independent from government influence, however. 1/ Governments usually appoint central bank directors and often own 100 percent of central bank stock. The economic policies of governments and central banks are usually more closely aligned than might be expected given the central banks' formal independence, reflecting the frequent consultations that are common practice. Central banks often turn over their profits to the government treasury. Some central banks must submit their budgets to the government executive for review (in Japan the Ministry of Finance must approve the Bank of Japan's budget). No banks, however, are required to forward their budgets to parliaments for approval.

---

1. Sources addressing the varying independence of central banks include: Don Fair, "The Independence of Central Banks," The Banker, vol. 129 (October 1979), pp. 33-41; Patricia Wertman, "The Bank of England and the Federal Reserve System: A Brief Comparison," Congressional Research Service (September 18, 1981). "Central Banking Arrangements in Selected European Countries," International Currency Review, vol. 12 (1980), pp. 19-23; Commission of the European Communities, Monetary Committee, Monetary Policy in the Countries of the European Economic Community (1972); Bank for International Settlements, Eight European Central Banks (Praeger, 1963); David L. Grove, "Central Bank Independence and the Government—Central Bank Relationship," International Monetary Fund (April 2, 1952).

There are, of course, important differences between the U.S. system of government and the parliamentary systems of other countries. The Congress is the most active and powerful of the legislatures in developed countries, and its power of the purse is especially notable. 2/ One of the major activities of the Congress is the annual review of spending by government agencies and authorization of their plans for future spending. These plans are submitted to the Congress at the beginning of each calendar year in a comprehensive budget document prepared by the President. The Federal Reserve is one of the few agencies that are exempt from Congressional review.

The apparent anomaly created by these two traditions--the formal independence of central banks and the comprehensive review of agency spending by the Congress--is the subject of this report. Chapter II provides a history of the independent budgetary status of the Federal Reserve. Chapter III is an overview of the Federal Reserve's current structure, activities, and financing. Chapters IV and V consider in detail two possible changes in the budgetary status of the Federal Reserve: complete presentation of its finances in the Budget of the U.S. Government, and a requirement of prior appropriations for the Federal Reserve's administrative expenditures. Appendix A compares the budget presentation of the Federal Reserve to that of other agencies, and Appendix B describes the Federal Reserve's budgeting system. The report does not consider the advantages and disadvantages of the Federal Reserve's monetary policy independence in itself.

---

2. Michael L. Mezey, Comparative Legislatures (Duke University Press, 1979); Gerhard Loewenberg and Samuel C. Patterson, Comparative Legislatures (Little, Brown, 1979); David Coombes, ed., The Power of the Purse: The Role of European Parliaments in Budgetary Decisions (George Allen and Unwin, 1976).

CHAPTER II. A HISTORY OF THE BUDGETARY INDEPENDENCE OF THE FEDERAL RESERVE SYSTEM

In its early history, the United States created and subsequently abolished two central banks. Its third central bank, established in 1913, was given extensive powers. The Federal Reserve System controls the money supply, regulates and supervises certain banks and bank holding companies, serves as a source of liquidity to depository institutions, operates check clearing, payments mechanism, and currency facilities, and acts as fiscal agent for the U.S. government.

These activities are based upon broad delegations of authority from the Congress to the Federal Reserve System. Article 1, Section 8, Clause 5 of the Constitution grants to the Congress the power "to coin money, regulate the value thereof, and of foreign coin. . . ." The Congress, however, has delegated this power in the main to the Federal Reserve and in a limited way to the Treasury Department. The Congress has been more active in other areas of the Federal Reserve System's responsibilities, such as the regulation of depository institutions through regular amendments to the banking laws. 1/ Nevertheless, the Federal Reserve System's independence within the government is well-established, including its ability to finance its expenditures from its earnings. Because the Federal Reserve System does not depend on annual appropriations, it is not subject to a process by which the Congress could annually limit and direct its activities. Its off-budget status has reduced the visibility of its expenditures, thus decreasing interest in control of these expenditures. This chapter recounts the complex historical record of the Federal Reserve's budgetary independence.

THE FEDERAL RESERVE ACT

The Federal Reserve System was established by the Federal Reserve Act of 1913 (P.L. 63-43). Central to its creation was the desire for an efficient payments system—a system for the reliable transfer of funds, payments, and money among financial institutions across the country. Until then, holders of checks written on banks in far-off cities had to rely on

---

1. Congressional Research Service, A Reference Guide to Banking and Finance (March 1983); Formation and Powers of National Banking Associations (May 1983).

clearing services provided by correspondent banks. Because these services were time-consuming and costly, checks presented on out-of-town banks were often discounted from their full value. During financial panics, commercial transfers of funds were extremely difficult to carry out.

A related purpose of the Federal Reserve System was the provision of an elastic money supply—one that would be responsive to the seasonal needs of trade. At the time, for example, the assets and liabilities of the rural banks varied considerably from one time to another depending on the credit needs of the agricultural sector. When rural banks needed cash, they often drew down their sizable deposits with city banks. The resultant illiquid conditions of city banks often precipitated reductions in the money supply and financial panics. Other variable demands for currency and credit, particularly from the financial activities of the Treasury, had similar results.

The Federal Reserve Act granted major powers to the System, including the powers to:

- Receive and transfer gold;
- Distribute currency ("Federal Reserve Notes");
- Settle and pay the obligations of member banks to each other;
- Advance funds to member banks;
- Establish reserve requirements for member banks;
- Examine and supervise member banks;
- Serve as the fiscal agent for the Treasury; and
- Purchase and sell government securities and other eligible paper on the open market.

To carry out these activities, the Federal Reserve Act created the Federal Reserve Banks and the Federal Reserve Board, collectively known as the Federal Reserve System. Federal Reserve Banks were established in 12 Federal Reserve districts across the country. The Banks, chartered as federal corporations, were capitalized with subscriptions from private banks, which in return became members of their Banks and eligible for Federal Reserve System services. A Federal Reserve Board of seven Presidentially appointed members, including the Secretary of the Treasury (as *ex officio* Chairman) and the Comptroller of the Currency, was established to oversee the activities of the Banks. Directors of the Banks were selected by

both the Board and members. Most of the Federal Reserve System's activities were carried out by the Banks, but the Board had supervisory control of the Banks. The mixed private-public ownership and regional structure of the System reflected the traditional hostility in the United States toward the concentration of banking powers in a "central bank." 2/ Similarly, the Secretary of the Treasury and Comptroller of the Currency served on the Board to prevent the private "Money Trust" from controlling the System, but in an ex officio capacity in order to limit executive branch influence on a constitutionally prescribed legislative function. 3/

The expenses of the Banks were to be financed from earnings, and the Board was given the power to assess the Banks for coverage of its expenses. The Congress retained the power to set ceilings on the level of Governors' salaries. The Federal Reserve Act also established a "franchise tax," which mandated the transfer of one-half of the Banks' net income to the Treasury. The other half could be added to the surplus of the Banks, subject to a ceiling of 40 percent of the paid-in capital of member banks. Ninety percent of net income was to be due the Treasury following the attainment of the targeted surplus.

The legislative history of the Federal Reserve Act's grant of financial independence to the System is unclear. The Secretary of the Board in its early years, H. Parker Willis (who also helped write the Federal Reserve Act as a Congressional staff member), wrote in 1923:

> Even within the very first few weeks after the organization of the Board had been set up, there came to it memoranda and letters from politicians hinting at the desirability of concessions when the Board's annual appropriations came before Congress for adoption. Those who wrote in this manner had overlooked the fact that the Federal Reserve Act had carried an inconspicuous provision authorizing the Federal Reserve Board to obtain the necessary money for its expenses by assessing the federal reserve banks.... It may be doubted whether Congress or the Administration had recognized the importance of this provision and the significance of the independence that it might bestow

---

2. See the July 10, 1832, veto message of President Jackson on the bill for recharter of the Second Bank of the United States.

3. The Federal Reserve Banks were also given the responsibility of holding Treasury accounts, a reaction to previous instances of manipulation of these accounts for political purposes.

> upon the Board, but it served an excellent purpose in the early years of the system by enabling the Board to withstand much of the pressure both from Congress and the executive branch of the Government. 4/

The Congress did realize, however, that the Federal Reserve Banks were likely to be profitable. The House report on the Federal Reserve Act contained the following justification of the franchise tax:

> . . . It has frequently been asked why the Government should be allowed to share in the earnings of Federal reserve banks at all. There are two reasons of conspicuous and obvious character why it should do so: (1) It vests the Federal reserve banks with the sole and exclusive function of note lending, from which all other banks are debarred; (2) it places the public funds with the Federal reserve banks to an amount certainly vastly larger than that of any other depositor and equal to the combined deposits of large groups of banks. The distribution of earnings upon the basis of deposit balances would give to the Government a large share of the profits in any case and when the present national-bank notes shall have been replaced by Federal reserve notes it is obvious that the function of note issue will result in a large volume of earnings which the Federal reserve banks could not enjoy were they to share this power with other banking institutions. To a substantial share in this earning, leaving for the reserve banks only a fair compensation for their services in taking out the notes, the public is evidently entitled. 5/

Given that the Banks were projected to earn income, appropriations for the Federal Reserve Board were not necessary as a source of financing. 6/

---

4. H. Parker Willis, The Federal Reserve System: Legislation, Organization, and Operation, quoted in A. Jerome Clifford, The Independence of the Federal Reserve System (Oxford University Press, 1965) pp. 83-84.

5. House Banking and Currency Committee, House Report 69, 63rd Congress, pp. 38-39.

6. See also Richard H. Timberlake, The Origins of Central Banking in the United States (Harvard University Press, 1978).

THE BANKING ACTS OF THE 1930s

Contraction of the financial system in the Great Depression stimulated the passage of two landmark banking laws, the Banking Act of 1933 (P.L. 73-66) and the Banking Act of 1935 (P.L. 74-305). These acts established the Federal Deposit Insurance Corporation (FDIC) and prohibited the participation of banks in the securities, real estate, and insurance industries.

The Banking Acts also increased the power and autonomy of the Federal Reserve Board (renamed the Board of Governors of the Federal Reserve System in 1935) relative to the Federal Reserve Banks and the Treasury. The acts removed the Secretary of the Treasury and the Comptroller of the Currency from the Board, increased the size of the Board to seven voting members, and lengthened terms of office from 10 to 14 years. The Board was also given the authority to approve the chief operating officers (President and First Vice President) of each Bank.

Crucial to the restructuring of the system was the gradual discovery of the earnings and money creation powers of open-market operations. In 1913, the Congress considered the discount window to be the Federal Reserve System's most powerful tool, but the purchase of securities by Federal Reserve Banks in the 1920s proved otherwise. The purchases were primarily intended to increase Bank earnings (earnings from other sources were low), yet they also increased the supply of money and lowered interest rates. Treasury borrowing costs were thereby reduced, as were returns on the investments of Treasury trust accounts and member banks. Because purchases by individual Federal Reserve Banks were uncoordinated, the market for Treasury securities was often disorderly. Criticisms from the Treasury and member banks led to creation in 1922 of an advisory Open Market Investment Committee of the five largest Banks. Purchases and sales of securities in the mid-1920s by the Federal Reserve Bank of New York for the Committee, under the influence of the Treasury Department and other Reserve Banks, showed how money creation through open-market activities could affect the business cycle. The Committee was replaced by the Open Market Policy Conference in 1930, with an expanded membership of all twelve Federal Reserve Banks and the Chairman of the Federal Reserve Board as convenor. The 1933 Banking Act formally recognized the Conference as the Federal Open Market Committee, but in 1935 the Federal Reserve Banks were stripped of complete control of open-market operations. Seven of the Federal Reserve Bank members were replaced by the Board of Governors (who thus formed a bare majority of the 12-member Federal Open Market Committee).

Increased budgetary independence for the Federal Reserve System was another result of the Banking Acts. The franchise tax was repealed and the

General Accounting Office lost the power to audit the Board. Federal Reserve Board assessments on Federal Reserve Banks were insulated from direct control by elected officials by language that required that "funds derived from such assessments shall not be construed to be Government funds or appropriated moneys." This provision overturned a 1914 Ruling of the Attorney General which construed the assessments as "Public Moneys" subject to regular audits. In return for this freedom, the Federal Reserve System transferred half of its surplus ($139 million) to partially capitalize the FDIC. 7/

These changes in the Federal Reserve System's powers were the result of numerous and somewhat contradictory opinions of the previous performance and proper functions of the system. The "central" bank status of the System was weak because of the influence of the Federal Reserve Banks on System policy. Open-market activities of the System had been counterproductive during the early 1930s when the Reserve Bank-dominated Open Market Policy Conference pursued an insufficiently expansive monetary policy. On the other hand, the influence of the Treasury on Federal Reserve System purchases of securities was believed to foster inflation; a similar threat was posed by populist support in the Congress for easy money. 8/ The solution chosen for these problems was a government-controlled central bank "independent" of political influence. A contributing factor was the enhanced responsibility of the Federal Reserve System to ensure the safety and soundness of member banks.

THE "ACCORD"

The "independence" of the new Federal Reserve System, however, was only relative to its past, for the Treasury retained substantial influence over the System's activities. During the Depression, the Federal Reserve System regularly supported Treasury offerings. During World War II, it "pegged" interest rates at a range from three-eighths of 1 percent on Treasury bills to 2.5 percent on long-term bonds. As described by Herbert Stein,

> That meant that the Federal Reserve would buy those securities whenever necessary to keep their prices from falling

---

7. Clifford, The Independence of the Federal Reserve System, p. 355n.

8. Milton Friedman and Anna Jacobson Schwartz, A Monetary History of the United States, 1867-1960 (Princeton University Press, 1963), p. 445.

> and their yields from rising. But when the Federal Reserve bought securities it increased reserves of the banking system and so permitted an expansion of the money supply. As long as it remained committed to supporting the prices of government securities the Federal Reserve could not control the money supply in the interest of any other objective—such as to stabilize the price level. 9/

By 1943, one-half of the Federal Reserve System's employees were engaged in fiscal agency activities (war bonds and Treasury securities). 10/

Earnings from open-market operations relative to expenses grew rapidly during the war. By 1946, the Federal Reserve System earned $150.4 million, but paid only $67,054 to the Treasury. After this transfer, making accounting adjustments, covering expenses of the Board and the Banks, and paying dividends to member banks, the System added $81.5 million of remaining income to its surplus. As the Congress and the Treasury considered amending the Federal Reserve Act to require the System to turn over some of its earnings to the Treasury, the Federal Reserve System preempted any order by "voluntarily" deciding to pay "interest on Federal Reserve notes" in the amount of approximately 90 percent of its earnings, citing Section 16 of the Federal Reserve Act as authority. 11/ As a result, in 1947 only $8.4 million was transferred to surplus, and $75.2 million was paid to the Treasury as income on Federal Reserve notes. 12/ Shortly thereafter, the Federal Reserve ended support of the 3/8 percent rate on Treasury bills. 13/

---

9. Herbert Stein, Presidential Economics (Simon and Schuster, 1984), p. 82.

10. Clifford, p. 188.

11. This percentage was similar to the amount required under the repealed franchise tax.

12. Additions to surplus are now made to bring the surplus equal to the level of paid-in capital from member banks. Payments of interest on Federal Reserve notes have accelerated rapidly with rises in nominal interest rates, amounting to $14.2 billion in 1983.

13. Friedman and Schwartz, pp. 578-79n. See also Walter E. Spahr, "Federal Reserve Out of Bounds Again," Commercial and Financial Chronicle (June 19, 1947), pp. 2, 31, and Spahr, "More on Reserve Board's Illegal Distribution of Federal Reserve Banks' Earnings," Commercial and Financial Chronicle (September 18, 1947), pp. 1, 22-24.

With an increase in the rate of inflation during the Korean War, the Federal Reserve System formally ended its support of Treasury financing in 1951, having gradually reduced its support since 1947. The Federal Reserve Act's relatively unspecific delegation of authority to the Federal Reserve System did not require it to support Treasury financing, but President Truman, among others, expected it to do so. Following the example of President Franklin D. Roosevelt in 1937 (when he successfully "hoped" that the Federal Reserve System would cooperate with the Treasury Department's gold sterilization program), Truman called the Board of Governors to the White House to request support of long-term Treasury bonds at low rates. The Federal Reserve System was largely successful in resisting his request, for support in Congress for ending the pegging policy was strong. The result of the conflict became known as the "Accord," which simply stated the principle that:

> The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt.

The Federal Reserve System gradually exercised its new flexibility to limit inflationary pressures over the succeeding years, with the assent of the Eisenhower Administration. 14/

THE MARTIN-PATMAN YEARS

For two decades after the Accord, the issue of the Federal Reserve System's independence was dominated by two individuals: William McChesney Martin, the Chairman of the Board of Governors from 1951 to 1970, and Representative Wright Patman (D-TX), chairman of a Joint Committee on the Economic Report subcommittee in the 1950s and Chairman of the House Banking Committee from 1963 to 1974. Martin was a strong advocate for the System's independent exercise of monetary and credit powers. Patman was the System's foremost critic and a tireless proponent of bringing the System under direct Congressional control. During landmark hearings on the Federal Reserve System in 1964, 15/ Patman pro-

---

14. Friedman and Schwartz, p. 625.

15. Subcommittee on Domestic Finance, House Committee on Banking and Currency, The Federal Reserve System After Fifty Years (1964).

posed legislation that would retire the stock of Federal Reserve Banks, make the Secretary of the Treasury the chairman of the Board of Governors, mandate the deposit of all System earnings in the Treasury, require prior appropriations for System expenditures, and make Federal Reserve support of Treasury securities mandatory with a ceiling for short-term securities of 4.25 percent.

None of these proposals was adopted, despite the expanded role played by the Federal Reserve System in economic policy. In the Employment Act of 1946, the government had declared its willingness "to promote maximum employment, production, and purchasing power." The Eisenhower Administration believed that purchasing power could be protected only if money creation (Federal Reserve System) and debt management (Treasury) were carried out by separate institutions. In the words of Chairman Martin, the Federal Reserve was supposed to be "taking the punch bowl away just when the party is getting merry . . .," and could do so only if its day-to-day operations were free from direction by the Congress and the Treasury.

In actuality, the System paid great attention to elected officials during the 1950s and 1960s. Consultation with the Executive Branch was extensive, and Congress often held oversight hearings. 16/ Those who preferred to see the Federal Reserve System conduct policy with the single goal of preventing inflation were disappointed, for it often allowed the money supply to grow rapidly during this period. It participated heavily in Treasury financings, such as the 1952 Treasury refunding. Public statements of independence notwithstanding, many thought that by taking these actions the Federal Reserve System was responding to the desires of elected officials. 17/

The budgetary independence of the Federal Reserve System was bolstered by the recommendation of the 1967 President's Commission on Budget Concepts, which was that only the profits of the Federal Reserve Banks that were transferred to the Treasury be included in the new "unified budget." The Commission stated its belief that:

> Inclusion of the Federal Reserve Banks in the federal budget might jeopardize the vital flexibility and independence of the monetary authorities. Moreover, projections of System opera-

---

16. Major inquiries were made in 1950, 1951, 1952, 1954, 1957, 1959, 1960, 1964, and 1968.

17. G.L. Bach, Making Monetary and Fiscal Policy (Brookings, 1971), pp. 158-68.

tions for a forward period—as would be required if included in the budget—do not appear feasible at the present time. The nature and economic significance of Federal Reserve Bank "receipts" and "expenditures" are different from those of most other government programs and activities. 18/

(See Chapter IV for an analysis of the Budget Concept Commission's arguments.)

THE RECENT DECADE

For the most part, the Federal Reserve System retained its budgetary and policymaking independence during the 1970s. Several laws were adopted that affected its monetary policy responsibilities, audits of its expenditures, and the provision of services to the banking industry.

Legislation increased the monetary-policy reporting duties of the Federal Reserve System to the Congress. H. Con. Res. 133 of the 94th Congress, passed in 1975, required the Federal Open Market Committee (FOMC) to make public annual targets for growth in the money supply and also required periodic testimony by the Chairman of the Board of Governors before the Banking Committees. Subsequently, these provisions were made a statutory requirement in P.L. 95-188, the Federal Reserve Reform Act of 1977. The Full Employment and Balanced Growth Act of 1978 (P.L. 95-523, also known as the Humphrey-Hawkins Act) ordered the FOMC to determine whether its monetary targets were consistent with the economic objectives (for output, employment, and prices) of the President. Another law protected the System from similar "oversight" by the executive branch. P.L. 93-495 enjoined the Office of Management and Budget or any other agency from requiring advance approval of Federal Reserve System testimony or legislative recommendations.

Two laws affecting Federal Reserve System expenditures and revenues were enacted during this period: the Federal Banking Agency Audit Act of 1978 (P.L. 95-326) and the Monetary Control Act of 1980 (P.L. 96-221). The Audit Act gave the General Accounting Office the authority to audit the Federal Reserve System, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and the Financial Institutions Examination Council. Federal Reserve System activities excluded from audits were:

---

18. Report of the President's Commission on Budget Concepts (1967), p. 28.

1. Transactions for or with a foreign central bank, government of a foreign country, or nonprivate international financing organization.

2. Deliberations, decisions, or actions on monetary policy matters, including discount window operations, reserves of member banks, securities credit, interest on deposits, and open-market operations.

3. Transactions made under the direction of the Federal Open Market Committee; or

4. A part of a discussion or communication among or between members of the Board of Governors and officers and employees of the Federal Reserve System related to clauses (1)-(3) of this subsection.

The Monetary Control Act required the Federal Reserve System to charge depository institutions for certain of its financial services. This provision was part of a complex banking law, the Depository Institutions Deregulation and Monetary Control Act of 1980. In the past, these services were provided "free of charge," but only to members of the Federal Reserve System. As a condition of membership, banks had to reserve a portion of their assets as non-interest-earning reserves—an implicit charge for services. Non-member institutions could use Federal Reserve System services, but only through "correspondent banks" that demanded similar non-earning deposits in return.

With the rise of nominal interest rates in the 1970s, however, the cost to members of non-interest-bearing reserves grew. In the "dual banking system" of the United States, national banks can withdraw from the Federal Reserve System by converting to state charters. State members can withdraw by giving notice. A decline in the percentage of bank assets held as reserves in the Federal Reserve System that resulted from withdrawals from membership was thought to threaten monetary management. The Monetary Control Act solution to the "membership problem" was to lower levels of required reserves and to extend reserve requirements to all types of depository institutions. In return, Federal Reserve System services were made available to non-member depository institutions.

The costs of providing services were to be recovered through fees for the following services:

42-777 0 - 85 - 3

- Currency and coin;
- Check clearing and collection;
- Wire transfer;
- Automated clearinghouses;
- Settlement;
- Securities safekeeping;
- Float; and
- Any new services, including but not limited to electronic funds transfer.

Fees were to be phased in, and established on the basis of direct and indirect costs, including an imputation of the amount of taxes paid by and a return to capital earned by private business firms. Float prices were to be priced at the federal funds rate. The System was granted the latitude to price so as to provide an adequate level of services nationwide.

Finally, several committees reviewed the expenses of the Federal Reserve System. Most prominent was a series of Senate Banking Committee hearings from 1977 to 1980. These hearings were in the format of an appropriations hearing (although Federal Reserve System expenditures did not need to be approved by the Banking Committee in advance). Federal Reserve System justifications were less detailed than regular appropriations justifications, but Chairman Proxmire was able to question Governor Philip Coldwell, Chairman of the Board's Committee on Federal Reserve Bank Activities (which oversees Federal Reserve Bank budgets), on the purposes of particular items and on the Federal Reserve System's plans for future spending. Hearings on the Federal Reserve System were also held by the Senate Banking Committee in 1981. These hearings considered among other bills S. 1691, which would have required prior appropriations for System expenditures and the deposit of its gross income in the Treasury.

SUMMARY

The independence of the Federal Reserve System is not constitutionally based, as is that of the judiciary. Rather, it has been granted to the System by the Congress. The history of this independence is not a simple one, in part because the concept of "independence" is itself complicated. A

distinction between "formal" and "behavioral" independence should be made. 19/ The Federal Reserve has a great deal of formal independence, given the set tenure of its executives, its broad authorizing legislation, its limited presentation in the budget, and its statutory exemption from the appropriations process. Its behavioral independence--its freedom to follow policies counter to the preferred policies of the President and the Congress--may be more limited. The reason for this is simple--the Federal Reserve operates in a democracy where great value is placed on the accountability of government agencies to elected officials and the public. A 1965 study of the independence of the Federal Reserve provided the following description of this limitation:

> . . . the Federal Reserve System was constructed on the general principle that the government could not be trusted to exercise directly, through ordinary executive or legislative channels, the monetary power which was part of its sovereignty. Three reasons might explain the adoption of this principle. First, the government was not to be expected to pursue a monetary policy in vigorous fashion, especially when a restrictive policy was demanded. Hence, it would not oppose sufficiently a strong upsurge of inflationary forces. Second, wisdom and prudence seemed to demand that the borrowing and lending functions involved in the financing of the government should not be combined in a government organization directly responsible to the electorate. Such an arrangement would make it very difficult for the government to carry out actions which in their immediate effects would be unpopular with the electorate. The government was not likely to pay a relatively high current market rate of interest when it had authority as lender to bring the rate down to a more popular acceptable level. Accordingly, a buffer organization was needed. Third, the area of money and banking required a specialized and erudite knowledge traditionally not expected of the government.
>
> As the Federal Reserve System grew in experience and stature, it did not reject this principle of no-trust in the government. In fact, the Federal Reserve frequently was somewhat doctrinaire in upholding the principle. At the same time the System became more aware that it was not self-sufficient. It could not properly coordinate its actions with those of the government unless it recognized and accepted the power, the

---

19. John T. Woolley, Monetary Politics: The Federal Reserve and the Politics of Monetary Policy (Cambridge University Press, 1984), pp. 10-15.

interest, and the honorableness of the Treasury and the Administration in monetary affairs. Only by so doing would its independence be recognized and accepted. In addition, Congress was ever fearful lest the Federal Reserve would try to go its own way, promote the interests of special groups, and neglect the welfare of all other groups and sections of the nation. The dangers of government abuse were no greater than those of neglect of the wishes of government. Hence questions were raised whether the Federal Reserve provided an institutional arrangement which was a happy medium between the conflicting dangers. 20/

As questions were raised about the Federal Reserve's independence, legislative proposals to restrict its formal independence were introduced. By and large, these proposals failed. It seems unlikely, for example, that Representative Patman would be satisfied with the legislation of the 1970s compared to his bills of 1964. Proposals to make the System subject to Presidential direction—from the 1949 Hoover Commission, the 1961 Commission on Money and Credit, and others—were also rebuffed. One explanation of the failure of Congress to adopt these proposals is simply that the Congress accepted the case for insulation of the Federal Reserve as described above by Clifford. According to this view, the Humphrey-Hawkins reporting process is seen as an appropriate method of Congressional involvement in monetary policy--appropriate in part because the Congress's role is limited. 21/

Another possible explanation is that the Federal Reserve has forestalled reduction of its formal independence by limiting its behavioral assertion of this independence—that is, it has allowed the money supply to grow or contract more rapidly than it would prefer, consistent with the wishes of the President or the Congress. Several empirical studies have concluded that the Federal Reserve has been generally responsive to the President's

---

20. Clifford, pp. 33-35. See also Ralph C. Bryant, Money and Monetary Policy in Interdependent Nations (Brookings, 1980), pp. 318-33.

21. Steven M. Roberts, "Economic Policymaking in the United States: New Procedures Under Humphrey-Hawkins," Journal of Economic Dynamics and Control, vol. 1 (1979), pp. 271-82.

economic program in the post-World War II period. 22/ These studies are limited, however, by the great difficulty of accurately determining the preferred monetary goals of the President, the Congress, and the Federal Reserve. Others have suggested a "scapegoat theory." Its central assumption is that elected officials find it useful to retain the formal independence of the Federal Reserve so that they are shielded to some degree from blame for some of the costs of anti-inflation policies, while knowing that certain legal and practical restraints make the Federal Reserve responsive in a general way to the economic goals of the President and the Congress. 23/

Other studies suggest that the Federal Reserve has been able to determine and conduct monetary policy with relative freedom. These studies emphasize the highly technical nature of monetary policy and the sporadic interest of the Congress in monetary policy. 24/ They also note that the belief that the Federal Reserve Banks are wholly private entities, widely held in the early years of the System, has protected it from threats to its formal independence. 25/

The budgetary independence of the Federal Reserve has not been emphasized in analyses of its behavioral independence. Formal budgetary independence is often justified as a means of protecting the independence of the Federal Reserve in its monetary policy activities. The connection between budgetary independence and monetary policy flexibility was weaker at the Federal Reserve's creation than it is at present, however. In the early history of the System, changes in the amount of money in the economy

---

22. Robert W. Weintraub, "Congressional Supervision of Monetary Policy," Journal of Monetary Economics, vol. 4 (April 1978), pp.341-62; Nathaniel Beck, "Presidential Influence on the Federal Reserve in the 1970s," American Journal of Political Science, vol. 26 (August 1982), pp.415-45.

23. Edward J. Kane, "Politics and Fed Policymaking," Journal of Monetary Economics, vol. 6 (1980), pp. 199-211.

24. Woolley, Monetary Politics; John F. Chant and Keith Acheson, "Mythology and Central Banking," Kyklos, vol. 26 (1973), pp.362-79; James L. Pierce, "The Myth of Congressional Supervision of Monetary Policy," Journal of Monetary Economics, vol. 4 (1978), pp. 363-70.

25. Michael D. Reagan, "The Political Structure of the Federal Reserve System," American Political Science Review, vol. 55 (March 1961), pp. 64-76.

were not used as a macroeconomic policy instrument. Maintaining price stability through control of the money supply did not become a generally accepted policy goal until after World War II; by that time the Federal Reserve System's budgetary independence was established.

Other factors have contributed to the formal budgetary independence of the Federal Reserve. The Federal Reserve System has often accommodated the express desires of the Congress in regard to its programs and spending—a notable example being the 1947 deposit of earnings. Misgivings about the possibility of political interference in the regulation and supervision of banks favored a grant of budgetary independence in 1933. Similar misgivings insulated the FDIC and Comptroller of the Currency from the appropriations process. The Federal Reserve Banks were exempted from the Government Corporation Control Act of 1945 in part because of the perception of private status. (See Chapter IV for an analysis of the accuracy of this perception.) 26/ Finally, the Federal Reserve System is often perceived to be a "profitmaker," given that it earns income and transfers its earnings (less expenses) to the Treasury. Federal Reserve System earnings are an outcome of the government's money-creation powers and have grown rapidly. Although any expenses of the Federal Reserve System decrease the net income of the Treasury, the growth in net income has dwarfed the growth in expenses. Therefore, some argue that increased Federal Reserve System spending may not be apparent (especially when excluded from the unified budget and when not subject to the appropriations process), and may create support for the budgetary independence of the Federal Reserve System among the beneficiaries of this spending. 27/

---

26. Clifford, pp. 356, 390-91.

27. William F. Harrison, "The Relationship Between Federal Reserve Structure, Resource Allocation, and Political Independence," Social Science Quarterly, vol. 59 (September 1978), pp. 362-70.

CHAPTER III. AN OVERVIEW OF THE FEDERAL RESERVE SYSTEM

This chapter describes the current structure of the Federal Reserve System, its activities, and its financing methods and expenditures.

STRUCTURE

The Federal Reserve System consists of the Board of Governors, 12 Federal Reserve Banks, the Federal Open Market Committee, several other governing and advisory bodies, and member banks.

The Board of Governors. The Board of Governors has the responsibility to set System policy and support its operations. The seven Governors are appointed by the President and confirmed by the Senate. Governors serve for 14-year terms, with one term expiring every two years. The Chairman and Vice-Chairman are designated for four-year, renewable terms by the President and are confirmed by the Senate. The staff of the Board of Governors numbered 1,583 at the end of 1983.

The Federal Reserve Banks. The country is divided into 12 Federal Reserve Districts with a Reserve Bank in each District. Twenty-five branches and 11 regional check-processing centers have also been established. Each Bank has nine directors, six elected by member banks (three to represent the banking industry and three to represent business in general), and three appointed by the Board of Governors to represent the public, two of whom serve as chairman and vice chairman. Its president and first vice president are appointed by the directors, with the approval of the Board of Governors.

The Federal Reserve Banks employed 22,925 in 1983. Most Bank employees are involved in support and overhead activities (44 percent) and the provision of services to banks and the public (37 percent). Equal numbers (8 percent each) are engaged in supervision and regulation of banks and bank holding companies and in fiscal agent services for government agencies. Only 3 percent are directly involved in monetary and economic policy.

The Federal Open Market Committee. The Federal Open Market Committee (FOMC) is responsible for determining monetary policy and the course of open-market transactions. Open-market transactions are carried out by the managers for domestic operations and foreign operations of the

System Open Market Account, who are officers in the Federal Reserve Bank of New York. The FOMC consists of the seven Governors of the Board, and five Reserve Bank presidents. The president of the Federal Reserve Bank of New York is a permanent member; the other four Bank voting seats are rotated within groups of reserve districts. Non-voting presidents attend the meetings of the FOMC in Washington. The FOMC draws on the Board of Governors and Federal Reserve Banks for staff support.

Other Systemwide Bodies. The System has established three conferences of the chairmen, presidents, and vice presidents of the Banks. The latter two conferences contribute to Systemwide policymaking on operational matters. Systemwide staff level committees are used frequently to coordinate planning for the Banks.

Member Banks. All national banks are members of the Federal Reserve System. State-chartered commercial banks, trust companies, and mutual savings banks may join upon meeting the requirements of the System. At the end of June 1983, 5,758 banks were members of the Federal Reserve System. These banks were 39.7 percent of all insured banks, and held 73.4 percent of insured banking assets.

ACTIVITIES

The activities of the Federal Reserve System can be generally categorized into four areas (called "service lines" by the Federal Reserve Banks): monetary and economic policy, services to the United States Treasury and government agencies, services to financial institutions and the public, and supervision and regulation of financial institutions. 1/

Monetary and Economic Policy

Monetary and economic policy activities are the most prominent functions performed by the System. The System attempts to promote price level stability and high levels of production and employment by influencing the

---

1. Many of the activities of the Federal Reserve System are described in Board of Governors of the Federal Reserve System, The Federal Reserve System: Purposes and Functions, 6th ed. (1974). This publication (somewhat dated) emphasizes monetary policy. One chapter discusses the regulatory and supervisory functions. Coverage of services to the U.S. Treasury and other government agencies, and to financial institutions and the public, is sparse.

price of credit (interest rates) and the quantity of money (as measured by several money aggregates). The narrowest money aggregate, M1, consists of currency and demand deposits; M2 adds savings and small time deposits and general-purpose money market assets to M1; and M3 adds large time deposits and institutional money market assets to M2. 2/ The FOMC sets publicly announced target ranges of growth for these aggregates semi-annually, and may revise the targets in light of changed economic conditions.

The primary tool of monetary policy is the sale and purchase of U.S. government securities in the open market. Open-market operations, carried out by the Federal Reserve Bank of New York, allow the Federal Reserve System to control indirectly interest rates or the rate of growth of money. Two other monetary policy instruments are available to the Federal Reserve System: reserve requirements and the discount window. Reserve requirements specify the minimum quantity of reserves (vault cash and deposits with the Federal Reserve Banks) that depository institutions must hold against certain types of deposits. 3/ If, for example, a bank's required reserve ratio against demand deposits is 12 percent, it is required to hold 12 cents in reserve assets for each dollar in demand accounts. Within limits specified by law, the Federal Reserve System may define reserve assets and change reserve ratios, thus changing the maximum volume of deposits subject to requirements. Depository institutions may borrow reserves from the Federal Reserve Banks at the System's discount rate or from the excess reserves of other institutions in the federal funds market.

The open-market operations of the Federal Reserve affect the supply of money by changing the supply of bank reserves. Assume, for example, that the reserve ratio is set at 12 percent and that the banking system is just meeting the required reserve ratio. If the Federal Reserve System purchased $1 billion in government securities in the open market, it would present the sellers of these securities with checks drawn on itself. The sellers would deposit these checks in their banks, the banks would present the checks to the Federal Reserve Banks, and the Federal Reserve Banks would pay these banks by crediting the banks' accounts at the Federal

---

2. Technical definitions of money aggregates are available in the 1983 Annual Report of the Board of Governors, p. 16.

3. Until 1980, only member banks were subject to reserve requirements. Nonmember banks and thrift institutions also became subject to reserve requirements on a phased-in basis after passage of the Monetary Control Act of 1980.

Reserve System. 4/ Because deposits with the Federal Reserve count as reserves, total reserves would thereby be increased by $1 billion. With $1 billion in additional reserves, the banking system could at most increase deposits by $8.3 billion (additional reserves divided by the reserve ratio of 12 percent) by making loans or buying securities. Either would have the effect of putting downward pressure on short-term interest rates. Conversely, a sale of securities by the System reduces reserves and causes a constriction of the quantity of money, and may result in upward pressure on short-term interest rates. Most trading is meant to offset technical, temporary changes in reserves (such as unexpected Federal Reserve check collection float caused by transportation problems) or to compensate for uncertainty about the trend in reserve balances. Such factors, along with changes in bank holdings of excess reserves or the public's desire for currency, prevent the Federal Reserve from having precise control over the money supply in the very short run. In the longer run it can, if it desires, generally approximate its money supply targets. Temporary adjustments are made through repurchase agreements (which supply reserves) and matched sale-purchase transactions (also known as "reverse repurchase agreements," which subtract reserves). Daily security transactions range in size from several hundred million to several billion dollars.

A depository institution may borrow funds from its Federal Reserve Bank (with the Bank's permission) at the discount "window" by receiving an advance on acceptable assets (mostly government securities). 5/ The discount window is used by depository institutions to cover unexpected deposit or portfolio changes. It is also intended to serve as a reliable source of liquidity if financial markets are in disarray--the "lender of last resort" function. Use of the discount window increases the reserves of depository institutions. Discount rates are determined by the System and may be set in coordination with open-market policy and in light of the cost to depository institutions of funds from alternative sources. Rates may vary by the term of the extension. At the end of 1983, loans and acceptances outstanding totalled $1.3 billion.

The Federal Reserve participates in the international financial system through the Federal Reserve Bank of New York under the direction of the FOMC. The Bank may buy and sell currencies to moderate movements in

---

4. These transactions are actually carried out by wire transfers.

5. A common request from visitors at Federal Reserve Banks is to see the discount window. The term refers to a borrowing arrangement, which does not have a genuine teller station counterpart.

the foreign exchange value of the dollar. It handles transactions with foreign central banks who wish to sell or buy Treasury securities. The Federal Reserve Bank of New York also holds the international reserve assets of the Treasury Department's Exchange Stabilization Fund. The international transactions of the Federal Reserve are buttressed by special regulations on banks and holding companies engaged in foreign banking. These regulations establish special reserve requirements and limitations on foreign lending volumes.

The Federal Reserve System also has considerable regulatory power over credit flows, based on numerous banking and securities laws. These controls have had various purposes—preventing rapid growth in credit extensions, maintaining stability in financial markets, ensuring the soundness of the banking system, and allocating credit to specific purposes. For example, Regulations G, T, U, and X limit the amount of credit available for the purchase of securities. These "margin requirements" stipulate that a percentage of a stock or security purchase must be collateralized (currently 50 percent in most instances).

Services to the U.S. Treasury and Government Agencies

The Federal Reserve Act designates the Federal Reserve Banks as fiscal agents for the United States government. Under the general supervision of the Treasury, the System maintains the Treasury Tax and Loan and other transactions accounts (over 10.4 million transactions in 1983). The System issues (sells), reissues and replaces, services, and redeems savings bonds, other Treasury securities, and the securities of other government agencies. It also redeems and ultimately destroys food stamps for the Department of Agriculture, processing 2.7 billion coupons in 1983.

Services to Financial Institutions and the Public

The Federal Reserve System is a major participant in the payments system. It provides coin and currency distribution, check processing and collection, wire transfer and settlement services, automated clearinghouse services, and safekeeping, book-entry, and coupon collection for securities. The System also provides informational benefits to its members and the public.

In the currency and coin services, the Federal Reserve Banks process and wrap, distribute, and verify Federal Reserve notes and coin. In 1983, for example, the Banks processed $9.7 billion in worn notes and counterfeit currency, destroying $3.9 billion of it. They shipped 8.6 million containers

of currency and coin, using armored carriers that made over 550,000 stops. New coin and currency are purchased from the Bureau of the Mint and the Bureau of Engraving and Printing.

Check collection is the major activity in this service line. Checks are received from depositing institutions, processed through check-sorting machines at Federal Reserve Banks and regional check processing centers, transported across the country, and presented to paying institutions. Uncollected checks ("return items") are sent back to depositing institutions. The Banks directly participated in the collection of over 14.9 billion commercial and U.S. government checks in 1983. This was approximately 36 percent of the total checks written.

The Federal Reserve Banks aid collection of many of the checks they do not process directly by providing wire transfer and settlement services to banks and check clearinghouses. Institutions often present checks directly to each other and indirectly through correspondent banks and check clearinghouses. Institutions may settle their obligations from these exchanges by making adjustments in their clearing and reserve account balances at the Federal Reserve Banks. Settlement is made through the "Fedwire," an electronic communications system that is also used to transfer reserves in the federal funds market.

Rapid growth in the numbers of checks presented for collection has led to increased costs to the banking sector. In response, the Federal Reserve Banks have made an effort to replace paper checks with electronic funds transfers, especially through the development of automated clearinghouses (ACH). ACH facilities process computer tapes with bulk payments, such as payrolls and dividends. In 1983, 156.5 million commercial items and 240.3 million government items were processed using automated clearinghouse operations, servicing nearly 30,000 financial institutions.

In their security safekeeping activities, the Federal Reserve Banks hold government securities in both definitive and book-entry form. Transfers of ownership of Treasury securities are accomplished through computerized book-entry form, which reduces the need for hard copies. Non-cash items such as coupons on state government bonds are collected and presented to paying agents. Finally, Federal Reserve Banks and the Board of Governors perform a variety of informational services for banks and the public, including publications, seminars, data dissemination, and cost-accounting assistance for small banks.

Supervision and Regulation of Financial Institutions

The Federal Reserve System plays a major role in the supervision and regulation of banks. Its activities are based on powers granted in the Federal Reserve Act, the Banking Acts of 1933 and 1935, the Bank Holding Company Act of 1956 (and amendments of 1966 and 1970), the Bank Merger Act of 1960, and many other banking laws.

The general purpose of these laws is to further the safety and soundness of the banking system. The laws limit the permissible commercial activities of banks and their holding companies and the permissible banking activities of commercial corporations. Concentration in the banking industry is restricted by limitations on interstate banking and by necessary approval for bank acquisitions and mergers. 6/ Banking laws also empower the bank regulatory agencies to conduct regular examinations and require periodic reports to ensure adequate capitalization, competent management, and prudent loan portfolios.

The System shares regulatory jurisdiction over commercial banks at the federal level with the Comptroller of the Currency and the Federal Deposit Insurance Corporation (state banking agencies may also regulate banks with state charters). Operational responsibilities (for examinations, for example) are divided by law and by practice among these agencies. The Federal Reserve System is primarily responsible for examination of state-chartered member banks, whereas the Comptroller oversees national member banks and the FDIC oversees non-member insured banks. These agencies along with the Federal Home Loan Bank Board and the National Credit Union Administration comprise the Federal Financial Institutions Examination Council, a coordinating body. The Federal Reserve System also oversees bank holding companies, U.S. corporations involved in international banking and trade, and certain foreign bank operations in the United States. 7/

---

6. Commercial corporations and banks have aggressively sought and exploited loopholes in these laws in recent years. The creation of "non-bank banks" and the nearly nationwide activities of certain banks has led to active consideration of banking regulation bills by the Congress. See F. Jean Wells, "Financial Deregulation: Current Status and Legislative Issues," Congressional Research Service (1984).

7. See Andrew S. Carron, "Banking on Change: The Reorganization of Financial Regulation," The Brookings Review (Spring 1984), pp. 12-21.

Supervisory and regulatory activities are carried out by both the Board and the Federal Reserve Banks. The Board is responsible for setting policy, and the Banks conduct examinations. Major activities in this service line include examinations of state member banks (736 in 1983), inspections of bank holding companies and their non-bank subsidiaries (1,398 in 1983) and reviews of bank holding company applications (2,542 in 1983). The System also reviews mergers, bank acquisitions, and changes in bank control. Periodic reports on the condition and income of banks and holding companies are collected, processed, and made available to the public. International activities include monitoring the international debt exposure of banks and the debt service capabilities of borrowing countries.

In the consumer protection and credit availability areas, the Federal Reserve System is responsible for adopting regulations for all financial institutions and for enforcing regulations for state member banks. Laws in the System's jurisdiction include the Truth in Lending Act, the Equal Credit Opportunity Act, the Electronic Fund Transfer Act, the Home Mortgage Disclosure Act, and the Community Reinvestment Act. 8/

FINANCING AND EXPENDITURES

During calendar year 1983, the Federal Reserve contributed $14.2 billion of earnings to the revenues of the Treasury Department. Federal Reserve earnings are net of the expenses of the Federal Reserve Banks and Board, dividends to member banks, and other deductions. In 1983, deductions included $1,100.2 million in operating expenses for the Federal Reserve Banks, $70.4 million in Board expenses, and $85.2 million in dividends to member banks. 9/ These deductions reduced the amount of Federal Reserve earnings available to the Treasury to finance other government operations.

Description of the financing and expenditures of the Federal Reserve System is complicated by the decentralized structure of the System. Separate balance sheets and operating statements are prepared for the 12

---

8. The Supervision and Regulation service line also includes monitoring of reserve accounts and formulation of margin requirement and interest rate ceiling regulations mentioned above under Monetary and Economic Policy.

9. All figures are for calendar years.

Banks, the Banks as a whole, and the Board, and are presented in the Annual Report of the Board of Governors. Because the Banks and the Board budget separately and use different accounting concepts, their financing and expenditures are discussed separately in this report.

Federal Reserve Banks

The Federal Reserve Banks earn almost all of the income of the Federal Reserve System, and incur approximately 95 percent of its expenses. Table 1 shows the income, expenses, and net earnings of the Banks for calendar year 1983.

About 94 percent of Federal Reserve Banks' earnings are interest payments on U.S. government securities. The amount of interest earnings is a function of interest rates on government securities and the size and maturity distribution of the portfolio. Other earnings related to monetary policy are interest on Federal Reserve advances and discounts (0.9 percent) and on foreign currencies (1.7 percent). Service fees from depository institutions and the public (3.1 percent) constitute the remainder.

The money-creation powers of the Federal Reserve System ensure that the System will be profitable. As sole holder of the right to issue currency whose cost of production is a fraction of its value in exchange, the Federal Reserve System captures the "seigniorage" in the money creation process. Like monarchs of old, the Federal Reserve makes money by making money. It does this first by purchasing Federal Reserve Notes at the cost of production (less than 3 cents per note) and by issuing the notes at par. These non-interest bearing IOUs (Federal Reserve Notes) are then exchanged for interest bearing assets (government securities). Securities are also purchased with the funds on deposit in Reserve Banks that meet reserve requirements and serve as clearing balances (these accounts are also the means by which currency is exchanged for securities). These securities are added to the System's portfolio, and the interest income from the securities is used to fund expenses or is returned to the Treasury. Table 2, the Statement of Condition (balance sheet) of the Federal Reserve Banks, shows the Federal Reserve Note liabilities and government security assets of the Banks at the end of 1983. 10/

---

10. The potential earnings of the System from money creation are limited by the goal of price level stability. Securities purchases increase reserves and the money supply.

TABLE 1. INCOME, EXPENSES, AND EARNINGS OF THE FEDERAL RESERVE BANKS, 1983 (In millions of dollars)

Income a/		Expenses a/	
Interest on U.S. Government Securities	15,150.2	Salaries and Other Personnel Expenses	499.8
Interest on Discounts	138.9	Retirement and Other Benefits	141.2
Interest on Foreign Currencies	273.8	Postage and Shipping	97.1
Priced Services Fees	496.2	Equipment	114.7
Other	9.3	Buildings	82.4
		Earnings Credits	71.8
Current Income	16,068.3	Recoveries and Capitalized Expenses	-17.2
		Other	116.7
		Current Expenses	1,100.2 b/
		Reimbursements	-76.6
		Net Current Expenses	1,023.7

Current Net Income	15,044.7
Adjustments	-400.4
Adjusted Net Income	14,644.3

Distribution of Adjusted Net Income	
Cost of Currency Assessment	152.1
Board of Governors Expenses Assessment	71.6
Dividends	85.2
Transfer to Surplus	106.7
Payment to U.S. Treasury	14,228.6

SOURCE: Board of Governors of the Federal Reserve System, Annual Report (1983), Table 7.

a. Details may not add to totals because of rounding.

b. Total expenses are $5.9 million less than the sum of expense categories because of a deduction of Federal Reserve Communications System expenses in the Federal Reserve Bank of Richmond's account.

ADDENDUM: The display of Federal Reserve Bank income and expenses may be recast to show income and expenses on a grossed-up basis. This recasting would shift recoveries ($14.6 million) and reimbursements to the income accounts and shift the cost of currency production to the expense accounts, showing gross current income as $16,159.5 million and gross current expenses as $1,266.9 million.

TABLE 2. STATEMENT OF CONDITION, FEDERAL RESERVE BANKS, December 31, 1983 (In millions of dollars)

Assets		Liabilities	
U.S. Government and Agency Securities	160,795.0	Federal Reserve Notes	157,098.6
Loans and Acceptances	1,335.7	Deposits	26,126.1
Gold and SDR Certificates, and Coin	16,155.1	Deferred Availability Cash Items	9,958.2
Cash Items in Process of Collection	11,564.3	Other Liabilities	2,464.0
Bank Premises and Other Assets	8,724.8	Total Liabilities	195,646.9
Total Assets	198,575.1	Capital, Paid-in	1,464.1
		Surplus	1,464.1
		Total Liabilities and Capital Accounts	198,575.1

SOURCE: Board of Governors of the Federal Reserve System, _Annual Report_ (1983), Table 1.

The expenses of the Federal Reserve Banks (see Table 1) are largely for personnel, as the operations of the System are labor-intensive. In 1983, salaries and other personnel expenses cost $499.6 million, and retirement and other benefits another $141.2 million. Equipment expenses were $114.7 million and building expenses were $82.4 million. Postage and shipping costs, mostly for the transportation of checks and currency, were $97.1 million. The cost of earnings credits—interest on clearing balances of the banks that participate in the payments system—amounted to $71.8 million, and $116.7 million went to other expenses such as travel and communications. The Banks received $14.6 million in recoveries and temporarily capitalized $2.6 million of expenses. Reimbursements from government agencies for fiscal agent activities are subtracted to obtain net current expenses.

42-777 O - 85 - 4

Subtracting net current expenses from current income yields current net income in the amount of $15,044.7 million in 1983. The Federal Reserve Banks made adjustments to net income of -$400.4 million in 1983, primarily adding profits on sales of securities and subtracting unrealized losses on foreign currency holdings. The resultant adjusted net income was reduced by four amounts:

- The cost of currency production: $152.1 million. This is the amount of reimbursement for production costs paid by the Federal Reserve Banks to the Bureau of Engraving and Printing through the Board of Governors. 11/

- Payments of semiannual assessments for Board of Governors expenses—$71.6 million;

- Annual dividends to member banks at the rate of 6 percent on their capital subscriptions—$85.2 million; and

- A transfer to the Federal Reserve Banks' surplus to bring it level to the amount of paid-in capital from member banks—$106.7 million.

The remaining net income is paid to the Treasury in amounts transferred weekly.

Building and equipment expenses of the Federal Reserve Banks are unusual compared to other federal agencies. The Federal Reserve Banks paid $19.4 million in real estate taxes in 1983, as required by the Federal Reserve Act; other federal agencies do not pay real estate taxes but may make payments in lieu of taxes to certain jurisdictions. Second, the Federal Reserve Banks charge depreciation as an operating expense instead of following the practice of other federal agencies (including the Board of

---

11. The cost of currency production is also carried in the Board of Governors' budget, but in the amount of $128.2 million in 1983. This is the actual amount spent on currency by the System in 1983. The additional $23.9 million (resulting in the total of $152.1 million) is a single-year amortization of previous-year currency costs made necessary by the change in the accounting treatment of currency from an expense in 1982 to an assessment in 1983.

Governors) of charging the entire purchase price in the year of acquisition. 12/ Building depreciation was $18.9 million in 1983 and equipment depreciation was $39.7 million. Remaining expenses in the buildings and equipment categories were utilities, rent, and repairs and maintenance.

Actual capital outlays of the Federal Reserve Banks are shown in Table 3. The annual report of the Board of Governors does not include a record of these outlays. The level of total Federal Reserve Bank outlays can be found by adding the amount of capital outlays to total expenses less depreciation charges. The results, shown in Table 4, increase the reported expenditures of the Banks by 3.5 percent.

TABLE 3. FEDERAL RESERVE BANKS' CAPITAL OUTLAYS, 1983 (In millions of dollars)

Data Processing and Communications Equipment	52.1
Furniture and Furnishings	6.5
Other Equipment	14.9
Land	0.5
Buildings	18.5
Building Machinery	4.6
Leasehold Improvements	0.3
Total	97.2a/

SOURCE: Capital outlays data supplied by the Board of Governors of the Federal Reserve System.

a. Details do not add to total because of rounding.

12. The Banks use straight-line historical cost depreciation, capitalizing expenditures on most physical assets with useful lives of beyond a year. The Postal Service also capitalizes and depreciates its major capital purchases. Some federal agencies pay "Standard Level User Charges" (SLUCs). SLUCs are rent-like fees for building occupancy.

TABLE 4. FEDERAL RESERVE BANKS' TOTAL OUTLAYS, 1983
(In millions of dollars)

Current Expenses	1,100.2
Less depreciation	-58.6
Current Outlays	1,041.6
Capital Outlays	97.2
Total Outlays	1,138.8

SOURCE: Board of Governors of the Federal Reserve System, Annual Report (1983), Table 7; capital outlays data supplied by Board of Governors.

Table 5 shows the composition of Federal Reserve Bank's expenses by service line. Almost two-thirds of the expenses of the Banks are in the Services to Financial Institutions and the Public service line. Spending in the other three service lines is in roughly equal amounts. These spending data are drawn from the Planning and Control System (PACS) of the Federal Reserve System, which allocates costs among services (for example, "adminstration of laws and regulations related to banking" in the Supervision and Regulation service line) and activities ("processing holding company applications" in the same service). This system also records indirect costs for support and overhead activities that are then allocated to the four service lines. Major support services include data communications ($39.6 million), data processing ($93.5 million), data systems support ($93.9 million), and building operations ($104.9 million). Support services constitute 30.3 percent of total direct and indirect expenses (that is, before support and overhead costs are allocated to service lines). Overhead services (administration, budgeting and accounting, personnel, systemwide projects, etc.) are 33.5 percent of total direct and indirect expenses.

Table 6 shows Federal Reserve Bank expenses before and after reimbursements and collections. Most reimbursements are for fiscal agent services from the Treasury and Department of Agriculture. All collections are from priced services fees.

TABLE 5. COMPOSITION OF FEDERAL RESERVE BANKS' CURRENT DIRECT AND INDIRECT EXPENSES, 1983
(In millions of dollars)

		Total Expenses	Percent of Total Expenses After Reallocation
A.	Monetary and Economic Policy	100.4	9.8
	Services to U.S. Treasury and Government Agencies	120.3	11.7
	Services to Financial Institutions and the Public	675.9	65.7
	Supervision and Regulation	131.8	12.8
	Total expenses	1,028.5	
		Indirect Expenses	**Percent of Total Expenses Before Reallocation**
B.	Support	312.1	30.3
	Overhead	344.3	33.5

SOURCES: Board of Governors of the Federal Reserve System, Planning and Control System (PACS) Expense Report, 1983; and Board of Governors staff.

Notes: Part A shows expenses for output service lines, with support and overhead expenses allocated to the service lines. Part B shows indirect expenses before allocations as a percent of direct and indirect expenses. PACS includes all current expenses in Table 1 except for the cost of earnings credits--the cause of the difference between total expenses here and in Table 1. Because capital outlays are not allocated to service lines by the Federal Reserve Banks, all tables using PACS data report capital spending as represented by depreciation charges.

TABLE 6. COMPOSITION OF FEDERAL RESERVE BANKS' CURRENT EXPENSES, NET OF REIMBURSEMENTS AND COLLECTIONS, 1983 (In millions of dollars)

	Current Expenses				Net Expenses	
	Millions of Dollars	Percent	Reimbursements	Collections	Millions of Dollars	Percent
Monetary and Economic Policy	100.4	9.8	0.5	0.0	99.9	21.9
Services to U.S. Treasury and Government Agencies	120.3	11.7	72.9	0.0	47.4	10.4
Services to Financial Institutions and the Public	675.9	65.7	3.0	496.2	176.7	38.8
Supervision and Regulation	131.8	12.8	*	0.0	131.8	28.9
Total	1,028.5	100.0	76.4a/	496.2	455.8	100.0

SOURCES: Board of Governors of the Federal Reserve System, Planning and Control System (PACS) Expense Report, 1983; and Board of Governors staff.

* Less than $50,000.

a. The $149,658 disparity between Table 2 reimbursements and PACS-reported reimbursements is due to a currently unrectified reporting error in PACS.

NOTES: Current expenses are net of recoveries ($14.6 million). All support and overhead costs are allocated to output service lines. As Table 5 does not show $71.8 million in earnings credits costs as expenses, Table 6 does not show $84.9 million in income from clearing balances. Details do not add because of rounding.

Board of Governors

Table 7 shows the income and expenses of the Board of Governors. Ninety-eight percent of income is from assessments on the Federal Reserve Banks. Most publications revenue is from the Federal Reserve Regulatory Service, which provides information on regulatory actions. Net revenue

TABLE 7. INCOME AND EXPENSES OF THE BOARD OF GOVERNORS, 1983 (In millions of dollars)

Income	
Assessments on Federal Reserve Banks	71.6
Sale of Publications	1.1
Other	0.5
Total	73.1 a/
Expenses	
Salaries	47.1
Retirement and Insurance Contributions	7.7
Buildings and Equipment	4.7
Communications	3.7
Travel	1.9
Contractual Services	2.0
Other	3.3
Total	70.4
Net Income	2.7
Adjustment for unfunded accrued annual leave	-0.3
Net Revenue	2.4 b/

SOURCE: Board of Governors of the Federal Reserve System, Annual Report (1983), p. 208.

a. Details may not add to total because of rounding.

b. A Federal Reserve payment of $128.2 million to the Treasury for currency production was offset by reimbursement from the Federal Reserve Banks.

(after an adjustment for unfunded annual leave) was $2.4 million. The Board of Governors had a cash balance of $5.8 million and total assets of $85.8 million (including $61.2 million in buildings valued at cost) at the end of 1983.

Like the Federal Reserve Banks, expenses are largely for personnel--66.8 percent in salaries and 10.9 percent in retirement and other benefits. Building and equipment expenses include utilities, repairs and maintenance, equipment purchases, rentals, and property additions. Buildings and equipment expenses for 1983 are low relative to previous years, when the two Board of Governors buildings were undergoing construction and renovation and when computers were acquired.

TABLE 8. COMPOSITION OF BOARD OF GOVERNORS' EXPENSES, 1983
(In millions of dollars)

Expenses	
Formulation of Monetary Policy	16.1
Supervision and Regulation of Financial Institutions	15.4
Financial Services for System, Government, and Public	0.7
System Policy Direction and Support	38.5
Total	70.7
Offsetting Collections	
Federal Funds	0.1
Non-federal Funds	73.0
Total	73.1

SOURCE: Board of Governors staff.

NOTE: Expenses include $0.3 million in unfunded accrued annual leave distributed to programs.

Table 8 shows the composition of Board of Governors expenses in the Program and Financing format used in the Budget Appendix. This categorization of Board of Governors expenses is produced only for the Budget Appendix and is not based on the regular accounting procedures of the Board, which are structured by office and division. The first program category is similar to the Federal Reserve Bank service line for Monetary and Economic Policy. The Supervision and Regulation program category contains the expenses of supervision and regulation of member banks, bank holding companies, and supervision of Reserve Banks. The expenses shown in the Financial Services category are restricted to those for service pricing and systemization of automation. The fourth program activity of the Board of Governors, "system policy direction and support," represents all policymaking, overhead, and support activities. These activities are not reallocated to output activities as they are by the Federal Reserve Banks' Planning and Control System. When major capital outlays are made, these outlays are reported in a separate line in the Budget Appendix.

CHAPTER IV. BUDGET PRESENTATION OF THE FEDERAL RESERVE

Every January the President sends the Congress his proposed budget for the next fiscal year. The budget provides comprehensive information about the financial operations of government agencies. It also shows the President's recommended fiscal policy, includes the Administration's requests for budget-related legislation, and indicates the probable financing needs of the Treasury for the upcoming year.

The budget provides only limited information on the Federal Reserve System. The data are adequate for the purpose of projecting Treasury financing needs, since they include an estimate of the Federal Reserve System's transfer of earnings to the Treasury. They are inadequate, however, to the extent that the budget is to inform the Congress and the public of the proposed allocation of the government's limited financial resources. Almost all Federal Reserve System operating expenses are currently excluded from the budget.

The purpose of this chapter is to explore the feasibility of a complete presentation of Federal Reserve finances in the budget documents. The chapter begins by describing the System's current budget presentation and the reasons why it is so limited. The chapter then considers whether the Federal Reserve's finances are compatible with the budget concepts used to describe the finances of other federal agencies. It concludes by discussing whether Federal Reserve financial operations can be accurately estimated in advance, and whether the Federal Reserve's independence would be seriously weakened by requiring a complete budget presentation. 1/

---

1. The latter issue was underscored recently in the report of the Task Force on the Budget Process of the House Committee on Rules, which included the following: "To the degree that the U.S. Postal Service and the Board of Governors of the Federal Reserve System are independent establishments, the Task Force believes these entities should continue to be excluded from the unified budget." House Committee on Rules, Report of the Task Force on the Budget Process (May 1984), p. 43. The budgetary status of the Federal Reserve was also studied by the House Budget Committee in 1976, which reported, "It is the Committee's view that the expenses and budget status of the Board should be considered at a later time." Off-Budget Activities of the Federal Government, H.Rept. 94-1740 (September 30, 1976), p. 4.

LIMITATIONS OF THE CURRENT BUDGET PRESENTATION

The U.S. government's budget documents routinely include certain types of information about the financial operations of government agencies and programs. Finances are summarized in the main budget document and presented in detail in the Appendix volume. The Budget Appendix contains at least two financial schedules for all programs--for Program and Financing and for Object Classification. A Program and Financing Statement lists the major categories of program activity giving rise to a flow of obligations, and the flow of financing for the discharge of these obligations. An Object Classification Schedule describes the types of goods and services to be purchased (salaries, travel, printing, for example) regardless of the program purpose being served. Specialized schedules may also be included for certain programs. For example, a Statement of Financial Condition (or balance sheet) shows the assets, liabilities, and equity of a government corporation, and a Status of Direct Loans statement shows the volume of direct loan originations and repayments.

The complex finances of the Federal Reserve (see the box on the following page) are not included in the main budget document except for a single entry for the Federal Reserve earnings that are transferred to the Treasury. This transfer is classified as a "miscellaneous receipt" on the revenue side of the budget, as shown in Table 9. The earnings consist of gross income minus operating expenses, dividends, and other adjustments. The Appendix volume includes schedules of Program and Financing, Object Classification, and Financial Condition for the Board of Governors, but no information on Federal Reserve Bank operating expenses is presented anywhere in the budget documents. The Board of Governors is shown in the Appendix as an off-budget federal entity, but is not included in the tabulation of off-budget outlays. Its budget is presented on a calendar year basis, and covers only a quarter of the federal budget year. The fiscal year 1985 Appendix, which was published in early 1984, included estimates of Board of Governors spending through December 1984 and estimates of federal agency spending through September 1985. Table 10 shows the Program and Financing schedule of the Board of Governors for fiscal year 1985.

Current presentation thus limits the amount of public information on Federal Reserve finances that is comparable to readily available information on the finances of other government agencies. It might be argued that these data are already available in the Annual Report of the Board of Governors, but that report receives much less public attention than do the budget documents. Moreover, it does not show some information that the Appendix, other agency reports, and justification books for appropriations requests routinely provide. For example, it does not include data on current Federal Reserve Bank outlays for capital purchases. Ordinarily, users of

Federal Reserve Financial Operations

The Federal Reserve Banks buy, through the Board of Governors, Federal Reserve Notes from the Bureau of Engraving and Printing at the cost of production. The notes are sold to depository institutions by means of reserve accounts, which most depository institutions must keep with the Federal Reserve Banks.

The Federal Reserve Banks own and trade government securities and foreign currency for the purpose of conducting monetary policy. Unrealized capital gains and losses result when the market values of the securities and foreign currency fluctuate. Realized capital gains and losses result when the Banks sell securities and foreign currency.

The Federal Reserve Banks make interest-earning loans to financial institutions through the discount window. These loans return income at the discount rate, which is usually below the earnings rate on the Federal Reserve Banks' portfolios.

The Federal Reserve Banks transfer checks and securities across the country, often crediting the accounts of depositing institutions before collecting from paying institutions--resulting in a "float." The cost of float is recovered from depository institutions.

The Federal Reserve Banks and the Board of Governors spend cash for operating expenses--salaries, retirement, buildings, equipment, shipping, etc. The Banks also receive collections from the private sector in return for financial services, and reimbursements from government agencies for fiscal agent services.

The Federal Reserve Banks finance the expenses of the Board of Governors by paying assessment charges to the Board. They also pay member banks annual dividends on their capital subscriptions and transfer capital to the Banks' surplus accounts.

The Federal Reserve Banks transfer their current income net of expenses, assessments, dividends, adjustments, and additions to surplus to the Treasury. Most of the income is derived from payments by the Treasury on its securities held by the Federal Reserve.

TABLE 9. FEDERAL RESERVE BUDGET PRESENTATION FOR FISCAL YEAR 1985: TOTAL BUDGET RECEIPTS
(In millions of dollars)

Source	1983 Actual	1984 Estimate	1985 Estimate
Individual Income	288,938	293,260	328,410
Corporation Income	37,022	66,606	76,540
Social Insurance	208,994	239,494	270,683
Excise, Estate, Gift and Custom	50,008	53,181	53,458
Miscellaneous			
Deposit of earnings, Federal Reserve System	14,492	14,352	14,799
All other	1,109	3,179	1,238
Total Budget Receipts	600,562	670,071	745,127

SOURCE: Executive Office of the President, The Budget of the United States Government, Fiscal Year 1985.

capital budgets show in a supplementary statement the sources and uses of funds for capital acquisitions. The Annual Report does not include such a statement, as the Federal Reserve Banks do not need to go to the market to fund capital purchases. A capital purchase is represented only by an increase in the value of building or furniture and equipment assets included in the Statement of Condition, but this amount may be offset by depreciation charges for existing capital assets or by disposal of assets. Furthermore, the Annual Report does not display Federal Reserve Bank administrative expenses by program, nor does it project future expenses. Separate books and accounting practices for the Board of Governors and the Federal Reserve Banks also prevent easy calculation of totals for Systemwide spending by program.

Even the limited information currently included in the Budget Appendix—on the expenses of the Board of Governors--is not timely. The figure for the Federal Reserve deposit of earnings is reached by netting of

TABLE 10. FEDERAL RESERVE BUDGET PRESENTATION FOR FISCAL YEAR 1985: BUDGET APPENDIX PROGRAM AND FINANCING SCHEDULE
(In thousands of dollars)

Board of Governors	Calendar Year 1982 Actual	1983 Estimate	1984 Estimate
Program by Activities			
Operating Expenses			
Formulation of monetary policy	15,163	16,289	16,717
Supervision and regulation of financial institutions	13,728	15,751	16,145
Financial services for system, government and public	886	701	880
System policy direction and support	35,524	38,027	40,797
Total operating expenses	65,301	70,768	74,539
Capital Investment			
Computer acquisition	900	---	---
Total program costs	66,201	70,768	74,539
Changes in selected resources	17	---	---
Total obligations	66,218	70,768	74,539
Financing			
Offsetting collections from:			
Federal funds	-123	-122	-122
Non-federal sources	-61,813	-71,551	-72,600
Unobligated balance available, start of year	-582	3,700	2,795
Unobligated balance available, end of year	-3,700	-2,795	-4,612
Budget Authority	---	---	---
Relation of Obligations to Outlays:			
Obligations incurred, net	4,282	-905	1,817
Obligated balance, start of year	5,583	8,314	6,937
Obligated balance, end of year	-8,314	-6,937	-7,114
Outlays	1,551	472	1,640

SOURCE: Executive Office of the President, The Budget of the United States Government, Fiscal Year 1985.

Federal Reserve income and expenses. This failure to show Federal Reserve Bank expenses explicitly leads to underreporting of the total program obligations of the federal government; thus governmentwide administrative expenses for financial regulation, economic policy, and debt marketing are actually higher than shown in the budget documents. The large volume of Federal Reserve business-type activities (for example, check collection) are also obscured from public view.

REASONS FOR THE CURRENT BUDGET PRESENTATION

The incomplete presentation of Federal Reserve finances in the budget is not the result of any legislation explicitly directing that the Federal Reserve be excluded from the budget documents. Rather, the most important reason for the Federal Reserve's current budget presentation is the 1967 recommendation of the President's Commission on Budget Concepts. It has also been suggested that the quasi-private status of the Federal Reserve Banks bars including their finances in the budget. These causes are discussed in turn.

The President's Commission on Budget Concepts

Until fiscal year 1969, the budget documents simultaneously reported two different budgets:

- The administrative budget, which was limited to federal funds in the General Fund of the Treasury; and

- The consolidated cash budget, which included both federal and trust funds.

Federal Reserve net income was included in both the administrative and consolidated cash budgets as miscellaneous receipts. The different coverages of these budgets created problems. Although the President's budget documents usually centered on the administrative budget (the budget that was limited generally to appropriated accounts), this budget included only about 75 percent of the government's financial activities. Many budgetary experts believed that the lack of coverage of trust funds allowed trust fund programs to grow rapidly without sufficient Congressional review. Additionally, the existence of two budgets meant two different deficits, which led to a great deal of confusion among the public. Administrations occasionally publicized the consolidated cash budget more heavily if it showed a smaller deficit than did the administrative budget.

Responding to these problems, the Commission on Budget Concepts recommended that the federal government report its revenues and expenditures in a single "unified budget." Central to the unified budget concept was the comprehensiveness of its coverage:

> . . . different and competing budgets confuse public and congressional understanding and impede governmental decision-making . . .
>
> The Commission's major recommendations with respect to coverage of the budget are:
>
> o The budget should, as a general rule, be comprehensive of the full range of Federal activities. Borderline agencies and transactions should be included in the budget unless there are exceptionally persuasive reasons for exclusion. Specifically, the budget should include the transactions of the Federal trust funds which are now outside the administrative budget (although the Commission believes that the identity and integrity of trust funds should be maintained);
>
> o Most agencies and transactions now included in the consolidated cash budget should continue to be reflected in the budget. However, the Commission recommends exclusion from the budget of those Governmental-sponsored activities which are now completely privately owned, and local receipts and expenditures of the District of Columbia Government; 2/

---

2. Report of the President's Commission on Budget Concepts, Government Printing Office (1967), pp. 2, 25. Support for the concept of a unified budget has remained strong. A recent report of the Committee on Economic Development, for example, stated: "We strongly believe that continued adherence to a comprehensive, unified budget is essential to the effectiveness and credibility of the budget process. A unified budget that includes all activities by federally owned entities is necessary to allow the Executive and Congress to make informed decisions on the overall fiscal and financial impact of federally owned activities and to serve as a framework for trade-offs among competing claims on federal fiscal resources. Crosscuts of budgetary information should be complementary to the unified budget, not a substitute for it." Committee on Economic Development, Strengthening the Federal Budget Process: A Requirement for Effective Fiscal Control (June 1983), p. 27.

42-777 O - 85 - 5

The Commission found, however, some persuasive reasons for exclusion of the Federal Reserve System from the unified budget:

> The Federal Reserve System is a government instrumentality which Congress has established principally to execute its responsibilities with regard to the Nation's money supply.
>
> The Federal Reserve System is responsible to the Congress, and reports annually to the Congress on the results of its operations. Discussions about the independence of the Federal Reserve System are concerned with its position within the Federal Government—not whether it is independent of the Federal Government. The System is clearly a Federal Government Operation.
>
> Each of the three present budget concepts includes as a receipt the payment to the Treasury of excess Federal Reserve profits. Apart from this receipt, none of the three budgets includes receipts and expenditures of the Federal Reserve System arising from its lending and other activities. Inclusion of the Federal Reserve banks in the Federal budget might jeopardize the vital flexibility and independence of the monetary authorities. Moreover, projections of System operations for a forward period—as would be required if included in the budget—do not appear feasible at the present time. The nature and economic significance of Federal Reserve bank "receipts" and "expenditures" are different from those of most other government programs and activities.
>
> For the above reasons the Commission recommends:
>
> The payment of excess Federal Reserve profits to the Treasury should continue to be treated as a Federal budget receipt. But other receipts and expenditures of the Federal Reserve Banks should continue to be excluded from the budget. 3/

This presentation has been followed by Presidents Johnson, Nixon, Ford, Carter, and Reagan.

---

3. Report of the President's Commission on Budget Concepts, pp. 28-29. The third budget concept referred to is the National Income and Product Accounts, which includes Federal Reserve and other governmental transactions in its records of aggregate economic activity.

The Quasi-Private Status of the Federal Reserve Banks

The Federal Reserve Banks have retained some private characteristics that were established when the System was devised in 1913. Commercial banks that wish to be members of the System are required to purchase the capital stock of their Reserve Banks and are granted the right to select a majority of each Bank's directors. The act also requires that if the Federal Reserve is dissolved the capital subscriptions of member banks must be refunded before the remaining assets are turned over to the U.S. Treasury. A not uncommon belief is that these characteristics are cause for exclusion of the Banks from the budget.

In general, private ownership and control of an organization have been sufficient grounds for excluding the organization's finances from the budget, although the Budget and Accounting Act of 1921 does not require this. The degree of private ownership and control of the Federal Reserve Banks is limited, however. Ownership of Federal Reserve Bank stock is an obligation incident to membership in the System, and does not represent a full interest in Bank assets. 4/ Member banks participate with the Board of Governors in the selection of Bank directors, but the degree of control exercised by these directors is restricted. For example, the Board of Governors must approve the directors' nominees for the chief executive postions of the Banks and the salaries of Bank officers. The Board of Governors also reviews and approves the Banks' budgets and directs the Banks' implementation of System policies. Moreover, the role of the Federal Reserve Banks is to carry out governmental functions with governmental powers. It does not seem reasonable to consider the Federal Reserve Banks as nongovernmental, given their monetary and regulatory policy activities.

This interpretation that the Federal Reserve Banks are essentially governmental in character has been supported by the Board of Governors

---

4. The money creation powers of the Federal Reserve System make capital subscriptions and the Banks' surpluses (retained earnings) unnecessary as sources of financing. Some have proposed that the System's structure be modernized by abolishing these vestigial characteristics, and by subsequently requiring the Federal Reserve Banks to submit business-type budgets under the Government Corporation Control Act (31 U.S.C. 9101).

and the courts in a number of instances. 5/ The courts have held that the Federal Reserve Banks are "independent, privately owned and locally controlled corporations" for certain limited purposes, but only when the Congress has specifically defined the Banks to be private in character. 6/ The courts have not issued any rulings on the question of whether the Banks have been considered by the Congress to be governmental or private organizations for the purpose of presenting their financial operations in the unified budget.

The President's Commission on Budget Concepts reviewed a paper that suggested that the Banks' private characteristics were grounds for excluding the Banks from the budget, but the Commission did not accept this reasoning. 7/ On the contrary, for the Commission wrote (as quoted above), "The System is clearly a Federal Government Operation." Nor is the language that exempts the Board of Governors, and by extension the Federal Reserve Banks, from the appropriations process and government audit the cause for the System's exclusion from the budget. This language was included in the Banking Act of 1933:

> The Board shall determine and prescribe the manner in which its obligations shall be incurred and its disbursements and expenses allowed and paid, and may leave on deposit in the Federal Reserve banks the proceeds of assessments levied upon them to defray its estimated expenses and the salaries of its members and employees, whose employment, compensation, leave, and expenses shall be governed solely by the provisions of this chapter and rules and regulations of the Board not inconsistent therewith; and funds derived from such assessments shall not be construed to be Government funds or appropriated moneys. 8/

---

5. See, for example, the Board of Governors' response to a question posed by Representative Patman, in Joint Committee on the Economic Report, Monetary Policy and the Management of the Public Debt (1952), vol. 1, pp. 261-62; Raichle v. Federal Reserve Bank of New York, 34 F.2d 910 (2d Cir. 1929); Raymond Natter, "Legal Status of the Federal Reserve System," Congressional Research Service (March 3, 1983).

6. Lewis v. United States, 680 F.2d (9th Cir. 1982).

7. Elmer B. Staats, "Coverage of the Budget—Government-Sponsored Enterprises," in Staff Papers and Other Material Reviewed by the President's Commission (October 1967), pp. 187-95.

8. 12 U.S.C. 244.

Similar language was enacted for the Office of the Comptroller of the Currency, which also regulated banks, and for the Federal Deposit Insurance Corporation, which insured banks. Before the adoption of the unified budget, these agencies' finances were excluded from the administrative budget by virtue of their trust fund status. The revenues and expenditures of the Comptroller and FDIC are now included in the unified budget.

FEDERAL RESERVE FINANCES AND CURRENT BUDGET CONCEPTS

The President's Commission on Budget Concepts stated that "the nature and economic significance of Federal Reserve Bank 'receipts' and 'expenditures' are different from those of most other government programs and activities," and concluded that they should be excluded from the unified budget. This section examines the nature of Federal Reserve Bank finances and considers whether they could appropriately be shown in the budget given current budget concepts. 9/

Administrative Expenses and Offsetting Collections

In citing the different "nature and economic significance" of the Federal Reserve's financial operations, the President's Commission on Budget Concepts was obviously referring to the unique nature of the Federal Reserve's monetary policy activities. But the Banks' administrative expenses and offsetting collections, on the other hand, are no different from the expenses and collections of other federal agencies that are shown in the budget documents. Construction of a building, for example, whether by the Federal Reserve, General Services Administration, or Department of Defense, draws upon the supply of construction goods, employs labor in the building trades, and reduces the cash balances of the government. The Federal Reserve's payment to the Bureau of Engraving and Printing for currency, and its receipts from the Treasury and other agencies for fiscal agent services, are similar to the many intragovernmental transfers of funds made between agencies. Priced services fees are comparable to similar offsetting collections made by federal business-type enterprises like the Tennessee Valley Authority or the Federal Housing Administration. All of these expenses and receipts are included in the Federal Reserve's calculation of its payments to the Treasury, but they are not shown in the budget documents.

---

9. The budget presentation for the Federal Reserve is compared to that for other off-budget organizations and for other organizations with activities similar to those of the Federal Reserve in Appendix A.

Monetary Policy Finances: Open-Market Transactions

The Congress has given both the Federal Reserve and certain trust and revolving funds authority to purchase and sell Treasury securities. These transactions may be distinguished by their different purposes and financing sources. The main purpose of purchases by trust and revolving funds is cash management, for funds often find that they have more cash on hand (from dedicated revenues, receipts from borrowing, and offsetting collections) than is necessary for immediate disbursement. In the case of some government funds, U.S. securities are accumulated to earn interest and lessen the need for subsequent appropriations to these funds.

The funds invest their temporary excesses of cash in government securities and receive interest payments, and the Treasury uses these temporary deposits to meet the cash needs of other programs. The securities assets of the funds are shown in Program and Financing Statements as unobligated balances, and are readily convertible to cash for payment of program obligations. Conversions of government securities to cash reduce the cash balances of the Treasury.

In constrast, Federal Reserve security purchases and sales are not carried out for cash management purposes, but to expand, stabilize, or contract the money supply. The Federal Reserve's financing practices also differ from those of government trust and revolving funds. The Federal Reserve finances its purchases by "writing a check on itself" through the creation of bank reserves. The authority to create bank reserves gives the Federal Reserve an unlimited capacity to purchase securities. A Federal Reserve purchase of Treasury securities does not increase the cash balances of the Treasury, for the Federal Reserve exchanges cash for securities with the private sector in the open market. When the Federal Reserve sells or exchanges maturing securities, this cash it obtains in exchange is not available to finance other government expenses, since the goal of security sales is to reduce bank reserves.

It is conceivable that a Program and Financing Statement for the Federal Reserve could include its securities transactions. The statement would show the net amount of bank reserves and currency created during the fiscal year as financing for the program obligations of the net security purchases during the fiscal year. On the other hand, the peculiar nature of Federal Reserve financing might preclude showing security transactions in this way. Federal Reserve transactions do not draw upon "budgetary resources" as

conventionally defined--receipts from taxes, borrowing, or offsetting collections. 10/

It can be argued that monetary policy transactions should be shown in a Program and Financing Statement because the Federal Reserve's current net income is already included in the budget as a receipt. This income, which is transferred to the Treasury, is primarily derived from interest on government securities. Because the budget shows these interest earnings, it is argued, the budget should also show the financial transactions that lead to changes in the level of these payments. On the other hand, also excluded from the budget is information on the projected debt transactions of the Treasury, even though the budget includes projections of outlays for payment of interest on the debt. This limited presentation maintains the Treasury's flexibility to conduct debt financing operations.

Monetary Policy Finances: The Discount Window

Discount loans are financed by the creation of bank reserves, as are securities purchases. Yet the functions of discount loans differ from the functions of securities purchases in several respects. Over time, discount loans are a relatively unimportant factor in the growth of total reserves when compared to securities purchases. The main uses of the discount window are instead to serve the short-term credit requests of banks, to signal the direction of monetary policy through changes in the discount rate, to function as a tool of Federal Reserve regulatory power, and to supply large amounts of credit during a banking crisis. The first function, which

---

10. Of all other federal programs, only the Treasury Department also makes transactions the primary purpose of which is the conduct of monetary policy. The Exchange Stabilization Fund's holdings of foreign currency are considered to be cash assets; changes in these holdings are outlays only to the extent there is a realized loss on currency exchanges, and are offsetting collections only to the extent there is a realized profit. Deposits with the International Monetary Fund are also considered to be similar to cash assets, and movement of money between the International Monetary Fund and the Treasury is excluded from budget totals.

often involves provision of a subsidy, is similar to the provision of below-market-rate loans by other government loan programs. 11/

When the Federal Reserve makes short-term loans--known as adjustment credits--it loans funds to banks at the discount rate. The discount rate is usually lower than the market rate charged for the alternative source of overnight funds for banks, the federal funds rate. If the difference between the discount rate and the federal funds rate is taken to represent the subsidy conferred on the borrowing banks, the subsidy for short-term (adjustment and seasonal) credit averages approximately $10 million to $30 million annually. In periods of peak interest rates and borrowing, the subsidy for short-term credit may amount to $100 million on an annual basis (the subsidy for extended credit was not estimated), and in other periods it may be negligible. 12/

The discount rate is also usually below the earnings rate on the Federal Reserve's portfolio of securities. If the money supply is to be unchanged, an increase in outstanding discount loans must be offset by a decrease in securities held by the Federal Reserve. The Federal Reserve consequently suffers the opportunity cost of an earnings loss when the earnings rate on its portfolio exceeds the discount rate. 13/ The earnings loss on short-term loans was approximately $20 million to $25 million in fiscal year 1984.

If the Federal Reserve's discount loans were included in the budget, neither the value of a subsidy to banks nor the opportunity cost of an earnings loss to the Federal Reserve would be shown. The budget instead would show the net cash flow of the discount loan program--the net of

---

11. Depository institutions argue that the subsidy conferred by low-cost discount window funds is more than offset by the "reserve tax." The "reserve tax" is the earnings loss suffered by depository institutions on the non-interest-bearing funds on deposit with the Federal Reserve Banks that exceed the depository institutions' preferred level of reserves.

12. It should be noted that funds loaned at the discount rate are fully secured by collateral and that overnight federal funds are not. The risk of default on federal funds is extremely small, however.

13. The Federal Reserve minimizes its earnings loss on extended credit loans by charging discount rates that are roughly equivalent to the earnings rate on its portfolio.

current loan originations and repayments--which is the measure reported for other government loan programs. Almost all discount loans are repaid within the federal budget year, and such repaid loans are not shown--for any agency--as loan activity in the budget documents. Moreover, no cash outlays are made when a discount loan is originated, a result of using reserve creation as the source of financing. Using conventional cost concepts, as is the case with security transactions, the budget would not show any discount loan activity. (See the box on the following page on budget treatment of the discount loan to Continental Illinois.)

On the other hand, the Federal Reserve recognizes and reports a similar type of transaction that is financed through reserve creation--the advance of Federal Reserve float. Federal Reserve float results when banks are paid for deposited checks before the Federal Reserve collects on these checks. Additional reserves are created when float increases. As is the case with discount loans, an increase in Federal Reserve float must be offset by a decrease in securities held by the Federal Reserve if the money supply is to be unchanged. The Federal Reserve does not suffer an earnings loss, however, for under the Monetary Control Act of 1980 the Federal Reserve must charge interest on float at the federal funds rate. This policy, which eliminates the subsidy associated with float before 1980, is consistent with the policy contained in a recently released OMB Circular on credit programs. Circular A-70 of August 24, 1984, requires agencies to report the subsidy costs of federal loan programs. Given that the Federal Reserve already reports the levels of Federal Reserve float and charges for its subsidy value, it is plausible that the subsidy value of the discount window could also be reported by the Federal Reserve. In addition, a Status of Direct Loans schedule could show past and projected discount loan activity.

Monetary Policy Finances: Income from Securities

The deposit of Federal Reserve current income is presently included in the budget, where it is classified as a receipt. Government financial documents must show that the payment by the Federal Reserve to the Treasury reduces the need to borrow from the public in order to fund spending. Not all of the cash received by the Treasury is counted as budget receipts, however. Excluded from the budget are Treasury receipts from borrowing, profits from gold sales, and coin seigniorage, which are classified as a "means of financing" the deficit.

Most Federal Reserve current income results from currency and reserve seigniorage, made possible by the difference between the cost of producing currency and reserves and their value in exchange. The Federal Reserve's profits from money creation have been invested in securities and

Budget Treatment of the Continental Illinois Discount Loan

A Federal Reserve discount loan of $3.5 billion was recently assumed by the Federal Deposit Insurance Corporation (FDIC) as part of its assistance plan to Continental Bank of Illinois. In return for assuming Continental Illinois's debt of cash to the Federal Reserve, the FDIC acquired loans previously owned by Continental Illinois. Over the next five years, the FDIC will pay the interest and principal payments due on these loans to the Federal Reserve, and will finance any shortfalls from its collections on the loans by drawing down its fund. This financing procedure is not the normal method of providing assistance. Normally, the FDIC sells some of its securities to obtain the cash it provides to an assisted bank. In the Continental Illinois case, the Federal Reserve's discount window served as the source of financing.

The use of the discount window as a source of financing affected the budget treatment of the assistance to Continental Illinois. Normally, loans and equity assistance from the FDIC's fund are scored as contributing to outlays, and repayments of assistance are scored as offsetting collections. An FDIC sale of securities is reflected in a decrease in the fund's unobligated balances (its equity). In contrast, the Office of Management and Budget has chosen to show the assistance to Continental Illinois as outlays only if and when the FDIC's fund suffers losses.

This decision was based on the fact that the FDIC did not disburse cash to Continental Illinois nor draw down any of its equity. The cash assistance received by Continental Illinois was provided directly by the Federal Reserve. The FDIC simply acquired problem loans from Continental Illinois (which increased the FDIC's assets) in return for promising to pay off Continental Illinois's debt to the Federal Reserve (which increased the FDIC's accrued liabilities). The FDIC's exposure is similar to that from other assistance plans--the possibility that its new assets will not cover its new liabilities over the long run. Its current equity position, unlike in other assistance plans, was not affected.

The Continental Illinois loan is not recorded in the FDIC's budget because the FDIC did not provide any "budgetary resources," even though the FDIC did assume the risk of loss in the transaction. The loan is not recorded in the budget under the Federal Reserve's account because the discount operations of the Federal Reserve are excluded from the budget. The Federal Reserve is carrying the loan in its own books as an increase of $3.5 billion in its "Other Assets." The outcome of these decisions is that a government loan of $3.5 billion for a five-year term was not recorded for the 1984 budget.

foreign currencies and return a flow of income. 14/ Classifying Federal Reserve currency seigniorage in the same manner as coin seigniorage would be consistent with the economic nature of Federal Reserve current income. 15/ It would have the effect of reducing budget receipts and increasing the budget deficit, but the cash position of the Treasury would be the same. This effect is shown in the second column of Table 11.

Alternatively, since most Federal Reserve current income is from payments by the Treasury on its debt, Federal Reserve income could be seen simply as an intragovernmental transfer of funds. The Federal Reserve returns this income net of expenses to the Treasury on a weekly basis, and such intrayear transactions are not shown in the budget as program activities. Payments by the Treasury to the Federal Reserve could thus be netted from gross interest payments by the Treasury, much like the current treatment for other government funds (such as Social Security) that own Treasury securities. By classifying Federal Reserve interest income and Treasury receipts of Federal Reserve earnings as intragovernmental transfers, total budget outlays and receipts would be reduced by like amounts (assuming the Federal Reserve Bank's operating expenses were reported separately as outlays), as shown in the third column of Table 11. This net budgetary effect is currently reported in the budget as an addendum in the presentation of outlays in the net interest function. 16/ Table 12 shows the magnitude of Federal Reserve earnings transfers and of interest outlays net of these transfers from fiscal year 1970 to fiscal year 1983.

---

14. See articles by Benjamin Klein, Harry G. Johnson, and Thomas F. Wilson in Kenneth F. Boulding and Thomas Frederick Wilson, Redistribution Through the Financial System, Praeger (1978), pp. 3-56.

5. The Report of the President's Commission on Budget Concepts stated, "The Commission recommends treating seigniorage as a means of financing rather than as budget receipts. Seigniorage does not involve a transaction with the public, and grows out of the exercise of the Federal Government's sovereign powers to create money, essentially equivalent in character to the issuance of bank notes (which happens to be a function of the central bank, rather than the Treasury in the United States, but which could easily be done by the Treasury)." (pp. 57-58).

16. The addendum shows the "net budgetary effects of interest transactions with the public" by deducting from gross interest outlays the interest paid to trust funds, interest on loans to the FFB, and the Federal Reserve's deposit of earnings, and by making several other (Continued)

Summary: Budget Concepts

It is clear that Federal Reserve Bank administrative expenses and collections could be appropriately included in the budget given current budget concepts. Whether this holds for monetary policy finances, however, is less clear. Aspects of these finances--the purchase and sale of securities, the subsidy element in the discount loan program, and the transfer of funds to the Treasury--are similar to other government agency activities that are included in the budget. The Federal Reserve's unique ability to create money, on the other hand, is an ever present dissimilarity, one that has been used to justify excluding monetary policy finances from the budget. Yet, budget concepts are not immutable. It is conceivable that current budget concepts could be carefully extended to cover all of the Federal Reserve's monetary policy finances.

PREDICTABILITY AS A FACTOR

The President's Commission on Budget Concepts also cited as a reason for excluding the Federal Reserve Banks from the budget its belief that Federal Reserve Bank financial operations could not be projected with acceptable accuracy.

Treasury and OMB projections of Federal Reserve earnings are now provided in the budget documents. They are sensitive to variations in current income. The level of current income is dependent on conditions that may change unexpectedly and widely from the time of the budget projection to the end of the fiscal year. Forecasts of Federal Reserve current income combine economic assumptions for interest rates with projections of the size and maturity distribution of the Federal Reserve's portfolio. Projections of the Federal Reserve's portfolio are made from economic assumptions that include the level of nonborrowed reserves and currency, the level of real GNP, and the term structure of interest rates. In the past few years, forecasts of interest rates have been less accurate than have forecasts of other major economic variables. As a result, the fiscal year 1983 Treasury model estimating error for Federal Reserve earnings was $1.1 billion--that

---

16. (Continued)
adjustments. The Treasury currently classifies Federal Reserve-owned Treasury debt as "debt held by public." To be consistent with the presentation of Federal Reserve earnings as either seigniorage or intragovernmental transfers, the classification of Federal Reserve-owned Treasury debt would have to be changed to "debt held by government." See also Congressional Budget Office, Federal Debt and Interest Costs (September 1984).

TABLE 11. THE UNIFIED BUDGET OUTCOMES OF FEDERAL RESERVE INCOME RECLASSIFICATION AND EXPENSE PRESENTATION
(In billions of dollars, hypothetical figures)

	Current Presentation	Expenses Presented as Outlays: Income as Seigniorage	Expenses Presented as Outlays: Income as Intragovernmental Transfer
Outlays			
Net interest	90.0	90.0	74.5
Federal Reserve	0	0.5	0.5
All other	700.0	700.0	700.0
Total	790.0	790.5	775.0
Receipts			
From Federal Reserve	15.0a/	0	0
All other	585.0	585.0	585.0
Total	600.0	585.0	585.0
Deficit	190.0	205.5	190.0
Means of Financing b/	-0.5	-15.5	-0.5

SOURCE: Congressional Budget Office.

a. Federal Reserve gross receipts are assumed to be $15.5 billion and expenses are assumed to be $0.5 billion (net of collections). When receipts and outlays are netted, Federal Reserve earnings transferred to the Treasury are $15.0 billion.

b. Recorded as "transactions not applied to current year's surplus or deficit" in Treasury financial statements.

TABLE 12. FEDERAL RESERVE EARNINGS TRANSFERS AND NET BUDGETARY INTEREST (By federal fiscal year, in millions of dollars)

Year	Deposit of Earnings by the Federal Reserve System	Net Interest Outlays	Net Effect of Interest on Budget Deficit
1970	3,266	14,379	11,113
1971	3,533	14,840	11,307
1972	3,252	15,478	12,226
1973	3,495	17,349	13,854
1974	4,845	21,449	16,604
1975	5,777	23,245	17,468
1976	5,451	26,711	21,260
TQ	1,500	6,946	5,446
1977	5,908	29,878	23,970
1978	6,641	35,441	28,800
1979	8,327	42,615	34,288
1980	11,767	52,511	40,744
1981	12,834	68,734	55,900
1982	15,186	84,995	69,809
1983	14,492	89,774	75,282

SOURCE: Office of Management and Budget, "Federal Government Finances."

is, actual receipts were $14.5 billion and the estimate was $13.4 billion. The CBO estimating error was $-0.5 billion. Most of the error resulted from different economic conditions than expected, and the rest was caused by technical factors. The estimating error was relatively small in comparison to the estimating errors in other categories, in dollar terms, but relatively large in percentage terms.

Expenses and priced services fees are affected by changing economic conditions, but are relatively stable and may be forecast very accurately. From 1979 to 1983, actual expenses in service lines from 1979 to 1983 differed from Board-approved budgets by an average (the mean of absolute differences) of 6.1 percent. (These estimates were made just prior to the budget years.) Federal Reserve System projections of capital outlays consistently overestimated actual spending by an average of 28.7 percent in

1979-1983, reflecting the difficulty of projecting the timing of capital outlays and the low priority placed by the System on annual outlay estimates for capital purchases.

Were the budget documents to include projections of discount loans, the problem of predictability might be more serious. While the average level of Federal Reserve discount loans is relatively stable over time, its loan activity often varies by billions of dollars from day to day. Therefore, the level of loans on September 30th could be quite different from the average level for the period at the end of the fiscal year, "distorting" the figures shown in the budget. On the other hand, end-of-year financial transactions by some on-budget loans and insurance funds--such as the Farmers Home Administration and the FDIC--are also quite variable.

The potential error in predictions of net open-market transactions at year-end is also large. The Federal Reserve often trades several billion dollars of securities a day in response to technical market factors. This trading activity is unpredictable beyond a short-term period. The most reliable annual projections are based on growth trends and seasonal cycles, the method used in budget projections for other programs with highly variable rates of activity. If future activities are thought to be too unpredictable for projection, budget schedules could show only the actual discount loan and open-market transactions from previous years.

THE FEDERAL RESERVE'S INDEPENDENCE

The Commission's most important argument was that the independence of the Federal Reserve would be jeopardized by the inclusion of its finances in the budget. In particular, it felt that any requirement that the Federal Reserve Banks project their finances would amount to an announcement of future monetary policy. Projections by the Federal Reserve of its earnings could give an indication of its goals and expectations for money supply growth and interest rates. At present, this information is not revealed by the estimates in the budget documents, which are prepared by Treasury and OMB without assistance from the Federal Reserve. The CBO makes similar independent estimates for the budget baselines used in the Congressional budget process.

Ten years after release of the Commission's Report, the Congress enacted the Federal Reserve Reform Act of 1977 (P.L. 95-188). This law required the Federal Reserve to make public annual targets for growth in the money supply. Under this law and the "Humphrey-Hawkins" Act of 1978, the Federal Reserve provides the Congress with estimates for ranges of the money supply, interest rates, and other economic variables. It does not

provide point estimates, with the assent of the Congress. Range estimates have been preferred to point estimates because of uncertainty about the course of the nation's economy and the variable relationship between monetary aggregates and economic activity.

As stated above, projections of Federal Reserve earnings are made from point estimates of interest rates and of the size and maturity distribution of the Federal Reserve's portfolio. Revelation of the Federal Reserve's point estimates of these factors would convey significantly more information about its plans than is currently contained in its wide range estimates of money growth and interest rates. For example, the Federal Reserve can affect money growth only to a degree, and the relationship between money growth and the Federal Reserve's policy instruments is complex. The Federal Reserve's portfolio, on the other hand, is its major policy instrument. If it was required to publish a specific projection of its portfolio size, this could serve as a benchmark for evaluation of its monetary policy performance. Whether or not the System's monetary policy performance should be made easier to evaluate is a subject beyond the scope of this paper.

A Federal Reserve projection of earnings might come to be seen as an operating target, creating pressure on the Federal Reserve to transfer the projected amount to the Treasury. Nearly all observers believe, however, that open-market transactions should be carried out only for monetary purposes, without concern for their effects on the fiscal condition of the government. To do otherwise--maintaining a portfolio large enough to return the projected earnings--could result in supplying an inflationary level of bank reserves to the economy.

Finally, the Federal Reserve's freedom to determine its operating expenditures could conceivably be threatened by including these expenditures in the budget documents. Making Federal Reserve Bank operating expenditures visible might lead proponents of reducing government spending to press for reductions in Federal Reserve operating expenditures in authorizing and/or appropriations acts. It should be observed, however, that almost all other independent agencies are included in the budget documents despite a similar threat to their spending flexibility.

THE MECHANICS OF BUDGET PRESENTATION

The actual form that budget presentation of Federal Reserve finances might take would depend on choices made by the Office of Management and Budget and the Congress. Most technical decisions on budget presentation are made by OMB, often after consultation with the Congress. These deci-

sions are strongly influenced by interpretations of the statutes that govern agency finances.

Six major choices of budget presentation form exist for the Federal Reserve. They are:

- o Whether to have a unified set of accounts for the System as a whole or separate accounts for the Board of Governors and the Federal Reserve Banks.

- o Whether to have separate funds for the different programs of the System or a single fund. The number of funds and their types (federal or trust, for example) would be affected by the degree of Congressional and Presidential control over Federal Reserve expenses. Separate funds of different types could be established for monetary policy, supervision and regulation, market-oriented financial services, and government fiscal and financial services, for example. This choice would affect the allocation of outlays to budget subfunctions (likely candidates are in functions 370--Commerce and Housing Credit, and 800--General Government).

- o Whether or not to include monetary policy finances as program obligations and financing sources.

- o Whether or not to include Federal Reserve projections of monetary policy finances.

- o Whether or not to report Federal Reserve discount loans as a loan operation in a Status of Direct Loans schedule.

- o Whether to classify Federal Reserve income as budget receipts, as a means of financing the deficit, or as intragovernmental transfers in the net interest function.

Budget presentation of Federal Reserve finances would require it to provide budget submissions that are consistent with federal budget documents. At a minimum, this would mean changing from the calendar-year fiscal year to the federal fiscal year, expensing capital purchases, and recording obligations of Federal Reserve Banks. In addition, the System would need to estimate its operating expenditures beyond a single budget year. Current Federal Reserve Bank accounting, which converts its expenses to a private-sector basis, would have to be maintained for Monetary Control Act pricing purposes. Changes in budget preparation activities of this magnitude have been carried out by other government agencies in the past.

42-777 O - 85 - 6

CHAPTER V. THE FEDERAL RESERVE SYSTEM AND THE APPROPRIATIONS PROCESS

The Congress has developed three basic processes by which it reviews government agency spending. The Federal Reserve System is subject to two of these processes--authorizing legislation and oversight--but not to the third, the appropriations process.

The freedom of the Federal Reserve to make important decisions without prior appropriations approval from the Congress has implied to some that the Federal Reserve spends more than is necessary. Some also contend that the Federal Reserve's freedom violates the principle that government should be accountable for the money it spends. Accordingly, repeal of the Federal Reserve System's exemption from the appropriations process has been proposed. 1/ Against this it can be argued that the Federal Reserve System's appropriations independence is justified by the unique nature of the functions it performs. In addition, existing oversight and authorization controls on the Federal Reserve System's spending and policy decisions are thought to foster accountability to the public.

Outline of the Chapter

This chapter considers the important question of whether the Federal Reserve's exemption from the appropriations process should be repealed. The first section describes the three basic spending control processes. It provides examples of how the Congress could use the appropriations process to direct the Federal Reserve, and reviews the recent authorizing and oversight activities of the Congress relating to the Federal Reserve. This section concludes by describing some of the criteria that the Congress has considered to be important when deciding whether to apply the appropriations process to particular agencies. Three of the most important criteria are the potential effects of the process on spending efficiency, on budget

---

1. In the 98th Congress, bills that would subject the Federal Reserve System to the appropriations process included: H.R. 3530, Conyers (D-MI); H.R. 4569, Vento (D-MN); and S. 10, Cranston (D-CA). Bills in the 97th Congress were: H.R. 5066, Conyers (D-MI); S. 1691, Hawkins (R-FL); and H.R. 6639, Patterson (D-CA).

savings, and on policy direction. These considerations form the basis for the remaining three sections of the chapter.

The second section reviews three methods of evaluating the spending record of the Federal Reserve: comparing the growth rates of Federal Reserve and other agency spending, comparing Federal Reserve and other agency objects of expense costs, and judging the Federal Reserve's success in complying with the market test constraint of the Monetary Control Act. A detailed comparison of personnel compensation policies is included to emphasize the complexity of such evaluations.

The third section of the chapter provides illustrations of budget savings approaches for the Federal Reserve. These include spending ceilings and also spending reductions for specific purposes, approaches that are commonly used in the appropriations process. Other savings approaches are more commonly used in authorizing legislation, including cost recovery, privatization, and administrative restructuring. The chapter closes with an analysis of the potential use of the appropriations process to direct Federal Reserve regulatory and monetary policy.

CONGRESSIONAL SPENDING CONTROL PROCESSES

The Congress uses three basic processes to authorize and control spending by individual agencies--the appropriations, authorization, and oversight processes. 2/ This section describes the characteristics of these processes. It also provides examples of how the Congress could potentially direct the Federal Reserve through the appropriations process, and describes how the Congress has reviewed and directed the Federal Reserve through recent authorizing and oversight actions.

The Appropriations Process

In the appropriations process the Congress passes acts that provide authority for agencies to incur obligations and make payments out of the Treasury for specified purposes. Thirteen regular acts of this type are prepared and reported each year by the House and Senate Appropriations Com-

---

2. Supplementing these basic processes is the budget process established by the Congressional Budget Act of 1974 (P.L. 93-344), through which the Congress sets aggregate spending goals to guide the authorization and appropriations processes.

mittees. Supplemental and continuing appropriations acts are also routinely considered by the Congress.

The appropriations process is the procedure used to control the administrative expenses of most federal agencies. Appropriations acts generally set limits on the yearly expenditures of agencies for certain broad categories, such as "salaries and expenses." Spending within these categories is often directed by statements in Appropriations Committee reports (or on the floors of the House and Senate) that describe the expected distribution of funds to activities. Activities may be specified to the level of individual projects. Agencies generally follow these directions, but occasionally request permission from the Committees to reprogram funds to other activities.

Appropriations acts may also contain provisions that restrict spending for certain purposes or objects of expense. These provisions (called "riders") may, for example, limit the number of personnel hired by an agency or prohibit spending to enforce a specific regulation. Riders that do not merely restrict spending, but also make policy, are called "legislative" riders. Legislative riders must generally receive waivers from the House and Senate rules to remain in an appropriations bill. If waivers are not received, points of order may be raised (and frequently are) to strike the legislative provisions from the bill. Finally, in recent years limits on direct loan obligations and loan guarantee commitments have been included in appropriations bills.

Making the Federal Reserve System subject to the appropriations process would allow the Congress to set the level of Federal Reserve System spending annually and to allocate funds to specific purposes. For example, the System could be prohibited from spending more than $695.6 million on salaries and expenses (the actual level of personnel and retirement spending in calendar year 1983), or it could be directed to spend a certain amount in the Kansas City district. The Congress could conceivably also set specific limits on discount loan activities and securities and foreign currency transactions. Use of the appropriations process could also force the Federal Reserve to provide the Congress with more detailed information about its spending plans, and would give the Congress a convenient, annual opportunity to direct Federal Reserve policy. For example, the System could be directed by a rider to take actions to ensure that growth of the money aggregate M1 fall within the range of 6 to 9 percent or that the prime rate not exceed 10 percent in an upcoming fiscal year. Or it could be ordered not to process applications for bank holding companies to operate new "nonbank banks" in the upcoming fiscal year, or to end its subsidization of automated clearinghouses. These specific examples are merely illustrations of the potential uses of the appropriations process. The merits and drawbacks of selected appropriations limitations are discussed below.

Authorizing Legislation

Authorizing legislation sets up or continues the legal operation of an agency or program, or sanctions a particular type of obligation or expenditure within a program. Legislative jurisdiction for the Federal Reserve System is currently held by the House Banking, Finance and Urban Affairs Committee and the Senate Banking, Housing and Urban Affairs Committee. Authorizations may expire periodically (in some cases annually) or may be permanent. They may instruct an agency in great detail how to carry out specific activities, or may charge an agency with the duty to achieve broad goals with a program of its own design. Most authorizations for Federal Reserve activities are permanent and unspecific. Open-market operations, for example, are to

> . . . be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country. 3/

Authorizing legislation may also structure the financial operation of an agency or program. Some authorizations set a ceiling on budget authority to be included in appropriations acts, whereas others authorize "such sums as may be necessary," leaving the spending maximum to the discretion of the appropriations process. Other authorizations grant agencies the right to spend funds without being subject to the annual appropriations process. This spending is known commonly as "direct spending" and takes several forms. Some agencies have the right to borrow, to contract, or to pay funds to legally-eligible beneficiaries ("entitlement" payments), before receipt of appropriated funds. Treasury funds are available automatically to selected agencies through a "permanent appropriation." Some agencies possess authority to make expenditures out of a revolving fund financed with collections from a business-type operation, tax revenues that have been earmarked for that fund, or appropriations made in prior years.

Numerous legislative authorizations have affected the Federal Reserve System's financial operations. Changes in banking laws directly affect Federal Reserve System spending by, for example, increasing the workload for review of bank holding company applications. The most important authorizing legislation spending limit is the requirement of the Monetary Control Act of 1980 that the Federal Reserve Banks recover the costs (adjusted to a private-sector cost basis) of their services to financial institutions. The Federal Reserve Act requires that cumulative expenditures by the Federal Reserve Banks on branch buildings cannot exceed a $140 million

---

3. 12 U.S.C. 263(c)

ceiling (with cost valued at book and depreciated over a 50-year period). 4/ Certain governmentwide personnel policies also must be followed by the System. Contractors with the Federal Reserve Banks, for example, are required by the Service Contract Act to pay minimum wages and fringe benefits for service workers. The Federal Reserve Banks became subject to this act following a ruling of the U.S. District Court of the District of Columbia in 1979. The applicability of other personnel and procurement policies to the Federal Reserve System depends on the construction of the statute establishing the policy (some statutes have explicitly or implicitly exempted the Federal Reserve System) or on the decision of the System to conform with the policy voluntarily.

Oversight

Oversight is review by the Congress of actions of the executive branch, and particularly of the interpretation and implementation of policy by federal agencies. It can take many forms, including hearings, studies, GAO audits, formal investigations, and letters to the agency with comments or questions from Members. Oversight of the Federal Reserve is generally carried out by the Joint Economic Committee, the Banking Committees, and the Government Operations Committee in the House and the Governmental Affairs Committee in the Senate. Oversight activities are generally not required, but are carried out at the initiative of a committee.

Congressional oversight of the Federal Reserve in recent years has been concentrated in four areas: economic policy, banking regulation, implementation of the Monetary Control Act, and the Federal Reserve System's budgets. The Federal Reserve is required to report semiannually on its targets for growth in the money supply and to comment on the consistency of its monetary targets with the economic objectives (for output, employment, and prices) of the President. The Chairman of the Board of Governors, other Governors, and Presidents of Reserve Banks regularly appear before the Banking Committees, the Joint Economic Committee, the Budget Committees, and other committees to discuss economic conditions, monetary policy, and fiscal policy. Domestic and international economic policy was the focus of over half of the 33 appearances made by Governors in

---

4. H.R. 4009, reported on April 24, 1984, by the House Banking Committee, would have increased this ceiling to $200 million. See Federal Reserve System Modernization Act, House Report 98-694.

1983. 5/ Oversight of Federal Reserve monetary policy is limited by the traditional practice of permitting the Federal Reserve to decline to discuss in detail recent policy decisions or the reasons for them. Members objecting to the vague character of Federal Reserve reporting have proposed that it eliminate the month-long delay in revealing FOMC decisions and end the use of wide target ranges. 6/ The Federal Reserve has resisted these requests, claiming that these changes would encourage speculation in the securities markets. It also argues that the case for full disclosure presumes less uncertainty about the course of the economy than is actually present.

In recent years, the Banking Committees have annually reviewed the regulatory policies of the Federal Reserve System, responding to the rapid deregulation in the banking sector. 7/ The Congress has also reviewed the Federal Reserve's implementation of the Monetary Control Act in oversight hearings held by the Banking Committees and the House Government Operations Committee's Subcommittee on Commerce, Consumer and Monetary Affairs. These committees have also sent written comments to the Federal Reserve's docket on pricing decisions and have requested two GAO studies. 8/ Reviews of Federal Reserve System budgets were performed

---

5. See Senate Banking, Housing and Urban Affairs Committee, First Monetary Policy Report for 1984 (March 28, 1984), and House Banking, Finance and Urban Affairs Committee, Monetary Policy Report (December 6, 1983).

6. See Legislation for Alternative Targets for Monetary Policy, Hearings before the Subcommittee on Domestic Policy, House Committee on Banking, Finance and Urban Affairs (April 26, May 11, and August 3, 1983) and remarks of Representative Jack Kemp (R-NY), "Federal Reserve Reform Legislation Open and Predictable Monetary Policy," Congressional Record, H2930-2 (April 12, 1984).

7. See Financial Services Industry Oversight, Hearings before the Senate Banking, Housing and Urban Affairs Committee (April 6-June 29, 1983).

8. General Accounting Office, "An Examination of Concerns Expressed About the Federal Reserve's Pricing of Check Clearing Activities" (January 14, 1985); General Accounting Office, "The Federal Reserve Should Move Faster to Eliminate Subsidy of Check Clearing Operations" (May 7, 1982); The Role of the Federal Reserve in Check (Continued)

from 1977 to 1980 by the Senate Banking Committee. The GAO has also prepared several studies on selected Federal Reserve expenditures. 9/

Arguments For and Against Appropriations

The Congress has made the administrative expenses of almost all federal agencies subject to control through its annual appropriations process. The appropriations process has proved attractive primarily because it allows the Congress to make very specific decisions about agency spending. Appropriations reviews are based on detailed justifications of spending plans by the agencies. Regular review of spending justifications permits the Congress to become knowledgeable about programs and encourages agencies to describe accurately their plans and carry them out in good faith.

Unlike the oversight process, in which committees are limited to review of expenditures after the fact or to suggestions for future spending directions, the appropriations process requires the Congress to act before an agency can obligate funds. If the necessary regular, supplemental, or continuing appropriations are not enacted, the agency must shut down nonessential operations or be in violation of the Anti-Deficiency Act. Unlike most authorizations, appropriations bills are considered annually, according

---

8. (Continued)
Clearing and the Nation's Payment System, Joint Hearings before the Subcommittee on Domestic Monetary Policy, House Committee on Banking, Finance and Urban Affairs, and the Subcommittee on Commerce, Consumer and Monetary Affairs (June 15-16, 1983); Report of the House Committee on Government Operations, Federal Reserve Competition with the Private Sector in Check Clearing and Other Services (April 11, 1984); Federal Reserve Pricing Policy on Check Clearing Services, Hearings before the Senate Banking Committee (April 11, 1984); The Role and Activities of the Federal Reserve System in the Nation's Check Clearing and Payments System, Report of the Subcommittee on Domestic Monetary Policy, House Committee on Banking, Finance and Urban Affairs (November 1984).

9. 1980 Budgets of the Federal Reserve Bank Regulatory Agencies, Hearings before the Senate Committee on Banking, Housing and Urban Affairs (January 25, 1980); General Accounting Office, "Response to Questions Bearing on the Feasibility of Closing the Federal Reserve Banks" (May 21, 1981), and "Information on Selected Aspects of Federal Reserve System Expenditures" (February 12, 1982).

the opportunity for yearly adjustments in spending levels or policy direction through riders.

Finally, the appropriations process offers the Congress an opportunity to compare the relative merits of the different spending proposals of many agencies and to choose among them. This opportunity is constrained by the fact that less than half of the budget authority (43 percent in 1985) is subject to control by the annual appropriations process, because so-called "direct spending" programs have been excluded from appropriations control. Some direct spending programs could easily be converted to appropriated programs should the Congress wish to increase the comprehensiveness of the appropriations process.

Despite its advantages, the appropriations process is neither equally nor universally applied by the Congress to programs that are subject to it. A major limitation is the time required to review a specific agency or program. The Congress attempts to cope with this problem by concentrating its attention where it can have the greatest impact. Certain agencies with records of good management and budgeting often receive less scrutiny in the appropriations process than those with ineffective spending records.

Another limit on the efficacy of the appropriations process is the effect of prior decisions made during the authorizations process. Although the appropriations process is formally the point of discretion for the legal obligation of funds for many programs, authorizing legislation may greatly affect the amount of spending by setting the goals of programs and by structuring agency operations. Consequently, spending reductions in certain objects of expense (travel, for example) made in the appropriations process may be less effective as controls on spending than are changes in agency goals and operations made in authorizing legislation. Furthermore, spending limits set through the appropriations process may be inappropriate for programs designed to react on a day-to-day basis to changing markets. Only half of the government's business-type enterprises are subject to the appropriations process, with the Congress relying instead on oversight and authorizing legislation to review and control their finances. 10/

Finally, it is clear that certain agencies have been exempted from the appropriations process because the Congress has decided to insulate them from direct Congressional influence. The Comptroller of the Currency and

---

10. Ronald C. Moe, "Administering Public Functions at the Margin of Government: The Case of Federal Corporations," Congressional Research Service (December 1983).

the Federal Deposit Insurance Corporation, two agencies with activities similar to the Federal Reserve's regulatory activities, are exempt. 11/

ALTERNATIVE METHODS OF EVALUATING THE SPENDING RECORD OF THE FEDERAL RESERVE

The ability of the Federal Reserve to draw on its open-market income to fund expenses without annual Congressional approval has implied to some that the Federal Reserve spends more than is necessary. By "more than necessary," critics have meant that they believe that the Federal Reserve has purchased higher quantities of goods and services than was needed, at higher prices than paid by other government agencies.

CBO cannot pass judgment on this charge. To do so would require inherently political, value-laden choices of the preferred quantity of activities to be carried out by the Federal Reserve, and the preferred tradeoff between the quality and price of Federal Reserve-purchased goods and services. It would also require an exhaustive audit review of the Federal Reserve.

Instead, this section illustrates three basic methods of evaluating the Federal Reserve's spending record: by comparing Federal Reserve and other agency spending growth rates; by comparing Federal Reserve and other agencies' objects of expense costs, with an emphasis on personnel compensation; and by reviewing the Federal Reserve's record in complying with the market test constraint of the Monetary Control Act. The latter method has been used in reviews of Federal Reserve spending by the House Government Operations and Banking Committees, the General Accounting Office, and the competitors of the Federal Reserve in the financial services markets.

Program Spending Growth

Comparisons of Federal Reserve spending growth with that of similar government agencies run up against two obstacles. One is the lack of com-

---

11. For fuller descriptions of the factors that the Congress has considered to be important to the choice for or against appropriations, see Allen Schick, Legislation, Appropriations, and Budgets: the Development of Spending Decision-Making in Congress, Congressional Research Service (May 1984); and Louis Fisher, "The Authorization-Appropriations Process in Congress: Formal Rules and Informal Practices," Catholic University Law Review, vol. 29 (Fall 1979), pp. 51-105.

parable accounting practices. The Federal Reserve Banks capitalize capital purchases while other agencies do not. The Federal Reserve Banks do not record obligations--the focus of federal agency accounting. In Table 13, Federal Reserve Bank expenses were adjusted to approximate regular federal budget accounting practice, which expenses rather than capitalizes capital purchases. The other accounting disparities may be moderated by comparing rates of growth of spending over time. (The standard period used for comparison is 1979-1983, in calendar years for the Federal Reserve and in fiscal years for other agencies.)

TABLE 13. TOTAL FEDERAL RESERVE SYSTEM EXPENSES, CALENDAR YEARS 1979-1983 (In millions of dollars)

	1979	1980	1981	1982	1983	Average Annual Rate of Growth (Percent)
Board of Governors a/	52.7	61.5	59.7	66.2	70.7	7.6
Federal Reserve Banks b/	727.1	851.7	974.2	1,064.5	1,067.0	10.1
Net of Collections and Reimbursements	658.3	776.9	748.2	602.0	494.2	-6.9

SOURCE: Board of Governors of the Federal Reserve System, Annual Reports (1979-1983).

a. Board of Governors expenses are obligations as reported in the Budget Appendix.

b. Federal Reserve Banks expenses are adjusted, excluding the cost of currency and earnings credits, and replacing buildings and equipment depreciation with actual capital outlays.

A further complication is the choice of federal government spending activities to which the Federal Reserve's can appropriately be compared. Two areas of Federal Reserve activity--services to the financial sector and to government agencies--lack clear parallels in federal agency activities. In the areas of economic policy and financial regulation, however, the oper-

ating expenses of the Federal Reserve are quite similar in character to those of other agencies. The obligations of these agencies are shown in Tables 14 and 15. Tables 16 and 17 show the composition of Federal Reserve Bank current expenses and Board of Governors program obligations. 12/

TABLE 14. SELECTED ECONOMIC STATISTICS AND POLICY EXPENSES, FISCAL YEARS 1979 AND 1983 (In millions of dollars)

	1979	1983	Average Annual Rate of Growth (Percent)
Bureau of Economic Analysis	14.6	19.1	7.0
Bureau of Labor Statistics	93.0	130.0	8.7
Council of Economic Advisers	2.0	2.2	2.4
Office of Management and Budget	27.5	35.0	6.2
Office of the Secretary of the Treasury	63.0	80.2	6.2

SOURCE: Executive Office of the President, The Budget of the United States Government (fiscal years 1979-1983).

NOTE: Figures are program costs for economic analysis in the Bureau of Economic Analysis and total obligations for other agencies. Fiscal year 1979 expense categories adjusted to fiscal year 1983 expense categories.

12. Expenses unadjusted to federal accounting treatment of capital are shown for the Federal Reserve Banks because capital outlays are not distributed to service lines by the Planning and Control System reports. The largest difference between adjusted and unadjusted total expenses in the period was 9.9 percent of total unadjusted expenses.

TABLE 15. ADMINISTRATIVE EXPENSES OF FEDERAL AGENCIES WITH FINANCIAL REGULATION DUTIES, FISCAL YEARS 1979-1983 (In millions of dollars)

	1979	1983	Average Annual Rate of Growth (Percent)
Comptroller of the Currency	96.6	144.2	10.5
Federal Deposit Insurance Corporation	107.7	138.2	6.4
Federal Home Loan Bank Board Total	49.2	67.0	8.0
Examinations and supervision only	28.9	32.3	2.8
National Credit Union Administration Total	20.3	27.6	8.0
Examinations and supervision only	15.7	18.8	4.6
Securities and Exchange Commission	66.5	87.8	7.2
Federal Trade Commission	65.0	67.3	0.9

SOURCE: Executive Office of the President, The Budget of the United States Government (fiscal years 1979-1983).

NOTE: Total obligations are shown for all agencies, with the exception of the Federal Deposit Insurance Corporation (FDIC). The administrative and operating obligations of the FDIC are reported, excluding the costs of closed bank activities. Examination and supervision expenses only are also reported for the Federal Home Loan Bank Board and the National Credit Union Administration. Board of Governors expenses for the Divisions of Supervision and Regulation and Consumer and Community Affairs grew at a rate of 8.7 percent from 1979-1983.

TABLE 16. COMPOSITION OF FEDERAL RESERVE BANKS' CURRENT EXPENSES, 1979-1983
(In millions of dollars)

	1979	1980	1981	1982	1983	Average Annual Rate of Growth (Percent)
Monetary and Economic Policy	38.2	59.6	81.2	93.0	100.4	27.3
Services to U.S. Treasury and Government Agencies	83.5	92.5	93.4	115.1	120.3	9.6
Services to Financial Institutions and the Public	500.3	554.7	611.6	646.2	675.9	7.8
Supervision and Regulation	71.7	86.1	99.9	119.3	131.8	16.4
Total	693.7	792.9	886.1	973.6	1,028.5	10.4

SOURCE: Planning and Control System (PACS) expense reports. The costs of Federal Reserve Note issue, which are included in PACS reports from 1979 to 1982, are not shown. The costs of monitoring reserve accounts are included in the supervision and regulation service line.

TABLE 17. COMPOSITION OF BOARD OF GOVERNORS PROGRAM OBLIGATIONS, 1979–1983 (In millions of dollars)

	1979	1980	1981	1982	1983	Average Annual Rate of Growth (Percent)
Formulation of Monetary Policy	11.8	13.1	14.2	15.2	16.1	8.1
Supervision and Regulation of Financial Institutions a/	10.7	11.9	12.7	13.7	15.4	9.5
Financial Services for System, Government and Public	0.6	0.8	0.8	0.9	0.7	3.9
System Policy Direction and Support, and Capital Investments	29.5	35.8	31.9	36.4	38.5	6.9
Total b/	52.7	61.5	59.7	66.2	70.7	7.6

SOURCE: Executive Office of the President, The Budget of the United States Government (fiscal years 1979–1983).

a. These obligations include not only those for bank supervision and regulation, but also those of Reserve Bank supervision. Board of Governors expenses for the Divisions of Supervision and Regulation and Consumer and Community Affairs grew at a rate of 10.3 percent from 1979 to 1983.

b. Details do not add because of rounding.

These tables show that the rate of growth of Federal Reserve Bank spending for economic policy (Table 16) was far greater than that of the economic policy agencies in Table 14 (all of which are subject to the appropriations process). Spending by the Board of Governors (Table 17) grew at a rate lower than that of the Banks, somewhat higher than the rate for the Office of Management and Budget, the Council of Economic Advisers, and the Office of the Secretary of the Treasury, but similar to the rates for the Bureau of Economic Analysis and the Bureau of Labor Statistics. Federal Reserve Bank spending in the regulatory area also grew faster than spending by comparable regulatory agencies shown in Table 15 (only the FHLBB, SEC, and FTC are subject to the appropriations process). 13/

Simple comparisons of growth rates can be misleading, for differences between the growth rates of spending by these agencies may reflect different legislative requirements and program factors. Recent spending by the Federal Reserve has increased in part because of legislative requirements, particularly the Monetary Control Act's establishment of universal reserve requirements and service pricing. Other significant factors in spending growth of the System--such as the adoption of contemporaneous reserve accounting--appear to have been regarded in the Congress as being justified, although the Congress did not give specific prior approval for the costs of such actions. In the regulatory area, the Federal Reserve is responsible for regulating the rapidly growing number of bank holding companies. Its spending on bank examination has risen in response to the financial problems of many large banks. CBO did not attempt to compare the spending productivity of the Federal Reserve and the other agencies because of the substantial technical difficulties this task would present. 14/

---

13. If the costs of monitoring reserve accounts are excluded from the supervision and regulation service line (the main purpose of reserves being to enhance the Federal Reserve's ability to control the money supply, not to ensure safety and soundness), Federal Reserve Bank spending grew by nearly 16 percent during the period.

14. For example, spending on supervision and regulation is partially a function of the different methods and frequencies of examination used by the agencies and of the relative risks presented by the groups of banks they supervise. Relatively arbitrary assumptions must be made about these factors to evaluate the benefits associated with the agencies' different spending levels. See Leonard Lapidus and others, State and Federal Regulation of Commercial Banks, (Federal Deposit Insurance Corporation, 1980); General Accounting Office, "Comparing Policies and Procedures of the Three Bank Regulatory Agencies" (March 29, 1979).

42-777 O - 85 - 7

Objects of Expense: Personnel

A second approach to reviewing the spending record of the Federal Reserve is to compare spending on particular objects of expense. Critics have sometimes focused on examples of spending that would not be permitted for other government agencies—the classic example being Representative Wright Patman's censure of the Federal Reserve Bank of Dallas for its purchase of ping pong balls.

The Federal Reserve's spending on decorative art can be compared with that of other agencies. The General Services Administration's "Art-in-Architecture" program for the buildings used by most federal agencies allows a set-aside of 0.5 percent of a building's construction or major renovation cost to be used for commissioning and installing permanent works of art. Only $7 million was spent under this program from 1962 to 1983, amounting to 0.2 percent of total cost. The Board of Governors allows, for the purchase of fixed and portable art, one dollar per square foot of building area (excluding parking structures) up to a maximum of 500,000 gross square feet, and 50 cents per square foot above this size. The art purchase allowance for the recently constructed Miami branch building was $256,000, of which $140,000 was spent, including a sculpture with a book value of $87,000. This was 1.1 percent of the total construction cost (excluding the special safekeeping costs of the Federal Reserve) of $12.6 million. The Board of Governors also has an extensive art program.

More significant comparisons can be made of spending for personnel, buildings, equipment, and major administrative overhead. Aspects of the Federal Reserve System spending on these major objects—salaries that in some cases exceed the maximum pay for other federal workers, the imposing, monumental design of Federal Reserve Bank buildings, the System's rapid acquisition of currency counters, check reader/sorters, and computers, and the large number of employees in overhead activities--suggest that savings could be made if certain expenses were limited.

To focus on expenses that would be prohibited for other federal agencies could be misleading, however. For example, in 1984, 125 Bank officers were paid above the Senior Executive Service pay ceiling of $70,000, for a total of $2.1 million, with the New York Federal Reserve Bank president receiving the System's highest salary of $176,100. But these higher expenses are at least partially offset by personnel compensation policies that allow the System to spend less than a federal agency would in other instances. For the other major objects of expense, simple comparisons of agency and Federal Reserve costs could also be misleading. In the building area, where account must be taken of the need of the Federal Reserve to construct and secure expensive vaults, one would expect square footage costs to be higher

than those for a regular federal office building. Higher outlays for equipment may be wholly or partially offset by reductions in costs from the use of new technology, particularly reductions in labor costs.

Quantitative analyses of objects of expense are beyond the scope of this study. In the remainder of this section, however, the System's personnel policies are compared to those of federal civilian agencies. Personnel costs account for approximately 60 percent of the System's annual budget. The Federal Reserve's personnel policies reflect its decentralized structure, its tradition of directly comparing itself to the private financial industry, and its exemption from standard federal government personnel policy controls.

Federal Reserve Banks. Generally, the Federal Reserve Banks' policy is to base personnel compensation practices on those followed by the private sector, which are often quite different from those followed by federal agencies. 15/ Salary determination for employees is made on the basis of annual surveys in each branch; salaries for officers are based on a biennial national survey. The use of local wage rates for professional and support employees allows the Federal Reserve to pay salaries that reflect local conditions; this is not an option for federal agencies, which generally must pay the same salary for equally graded workers in high- and low-cost areas. Annual cost-of-living adjustments to salaries are not mandatory--the Banks use performance-based evaluations to determine promotions and raises. The Board of Governors has the authority to approve the compensation of Bank officers and to review the compensation of Bank employees.

Bank employees participate in Social Security and the System's Retirement Plan. The Banks pay the full cost of the retirement plan. Benefit adjustments for retired Bank employees (projected to equal about 60 percent of the annual change in the Consumer Price Index) are more than half again as high as those of average private-sector pension plans, but less liberal than those of the federal Civil Service Retirement program. Bank employees are also eligible to participate in a System-provided savings plan. The Thrift Plan's options include a traditional savings option, an IRA option, and a 401(k) deferred compensation option. The Federal Reserve matches employee contributions at a rate of 40 percent up to 6 percent of an employee's

---

15. For an overview of federal personnel policies, see Robert W. Hartman, Pay and Pensions for Federal Workers (Brookings, 1983) and Jane Pernice Lundy, The Federal Employees Health Benefits Program: Issues and Problems, Congressional Research Service (February 6, 1984); basic Federal Reserve System salaries and benefits practices are described in a GAO report, "Information on Selected Aspects of Federal Reserve System Expenditures" (February 12, 1984), pp. 6-11.

income, a rate that is low compared to those typically sponsored by financial institutions. The deferred compensation option is an especially attractive method of sheltering income for many employees because contributions are in pre-tax dollars and distributions after age 59 and 1/2 or in case of hardship are eligible for 10-year averaging. In 1983, 19,929 Federal Reserve Bank employees participated in the Thrift Plan, contributing an average of $1,957. System contributions totalled $8,422,394, an average of $423 per participating employee.

The Banks pay the full costs of life and disability insurance for employees. They also pay all or nearly all of health insurance premiums for employees and from 50 percent to 66.7 percent of employee family premiums. Employer-paid health insurance is common for private employees, while in the Federal Employees Health Benefits Plan the government's maximum contribution is 75 percent of the total premium. On the other hand, Bank employees have many fewer plans from which to select a provider compared to federal employees, and certain high-cost services (mental health and drug abuse services) are not covered to the degree they are in the Federal Employees Health Benefits program. The Banks also provide dental insurance, deeply subsidized cafeterias, exercise facilities, and wellness programs.

Board of Governors. Personnel compensation practices of the Board of Governors are patterned after those of civilian federal agencies, but they are not identical. The Chairman of the Board of Governors is paid $72,600, the salary for deputy secretaries of major federal departments and for Members of Congress; other Board Members are paid $71,100. Merit pay is discretionary, the Board being exempt from the Civil Service Reform Act of 1978. The pay schedules for employees corresponds to the General Schedule used for Executive Branch employees. The Board has its own retirement plan, which is separate from but nearly identical in benefits to the Civil Service Retirement plan; its military service credit is less liberal. Board of Governors employees may participate in the Thrift Plan, while no employees of on-budget federal agencies have this opportunity at present. The Board contracts for life insurance benefits with the Federal Employees Group Life Insurance program and with a separate plan cosponsored by the FDIC and the Comptroller of the Currency. The Board covers one-third of the cost of life insurance premiums (the same percentage paid by federal agencies), but costs to the Board of Governors and employees for contributions are lower than the costs for federal agencies, because of the expectation that the largely professional Board of Governors work force will be longer-lived than the federal work force. Most Board employees participate in a Board-negotiated Blue Cross-Blue Shield health plan. Dental insurance and deeply subsidized cafeterias are also made available to Board of Governors employees.

Effects. It is clear that exemption from standard personnel compensation policies allows the Federal Reserve to offer its employees certain benefits that exceed in value those received by other federal civilian employees. Direct costs associated with these benefits--whether from dental premiums, salary amounts above the pay ceiling, or Thrift Plan contributions--have no counterpart in the operating expense accounts of on-budget agencies. The exemption may also enable the Federal Reserve to attract and retain high-quality personnel.

The Federal Reserve also bears the costs of separate contract negotiations, record-keeping, and information distribution. For most on-budget agencies these costs are borne by the Office of Personnel Management. Yet the greater flexibility enjoyed by Federal Reserve personnel management may also lead to more cost-effective spending, as is the case with the Banks' Retirement Plan. Federal Reserve salary costs are below those that would be paid by civilian agencies in certain regions of the country. Had the Federal Reserve Banks not been exempt from reduction-in-force guidelines, the substantial personnel reductions made in 1974-1983 (a decrease of about 4,700 workers, or 17 percent of the 1974 work force) could have been impeded. 16/ The Federal Reserve Banks are also not subject to appropriations limitations on permanent positions (slot ceilings), which are widely believed to encourage wasteful end-of-year spending and upward grade creep. 17/

The Market Test: Priced Services

A third approach to evaluating the Federal Reserve's spending record is to review its recovery of the costs of payments services through explicit pricing. As described above, prior to the Monetary Control Act, Federal Reserve payments services were available only to member banks at the implicit charge of having their reserve balances earn no income. When the act made all types of depository institutions subject to reserve requirements, it necessitated that Federal Reserve payments services also be made available to them. Instead of maintaining the implicit fee system, the Congress determined that explicit charges should be made. The act thereby increased

---

16. During this period, Board of Governors employment increased by almost 200. Total civilian employment in the executive branch decreased from 2,847,000 to 2,819,000. See Congressional Budget Office, Contracting Out for Federal Support Services: Potential Savings and Budgetary Impacts (October 1982).

17. Robert W. Hartman, Pay and Pensions, pp. 108-111.

the efficiency of the payments sytems by informing depository institutions of the resource cost of their activities and assessing them for these costs. 18/ The act also required that fees reflect actual Federal Reserve Bank expenses plus a return on capital that would be earned by and taxes paid by private business firms (the Private Sector Adjustment Factor, or PSAF). This markup prevents the Federal Reserve Banks from having an unfair pricing advantage over competing providers of payments services, the correspondent banks. The Federal Reserve was given the latitude to disregard the cost-plus markup rule if necessary to "give due regard to competitive factors and provision of an adequate level of such services nationwide." 19/

An additional benefit of the Monetary Control Act is that it may serve as a constraint on Federal Reserve Bank spending. If the costs of designated activities cannot be covered by revenue from customers, then the activities are to be reduced to bring costs into line with revenues or be discontinued. This market test is to be applied to any new payments services introduced by the Banks. This constraint on expenses could potentially also limit expenses in other service lines where costs are shared with payments services (buildings, for example).

Table 18 shows the 1983 expenses and revenue of the Federal Reserve Banks in the priced services area. Without taking the PSAF into account, the Federal Reserve Banks earned $47.5 million in profit, primarily in the check collection and wire transfer and net settlement services. With the PSAF taken into account, the Federal Reserve Banks took a loss of $11.6 million in the areas of check collection, definitive safekeeping and noncash collections (from a sharp volume reduction in safekeeping), commercial automated clearinghouse services, and cash transportation. The Board of Governors decided to provide subsidies in the latter two services. 1983 prices for commercial automated clearinghouse services were set to recover 40 percent of expenses plus the PSAF (resulting in a subsidy of $8.1 million);

---

18. Total reserve balances were to decline under the act; in 1980, income from fees was projected to be approximately equal to the revenues forgone because of reduced earnings on reserves. See General Accounting Office, "The Federal Reserve Should Move Faster to Eliminate Subsidy of Check Clearing Operations" (May 7, 1982), pp. 53-57.

19. For an interpretation of the meaning of this clause, see Raymond Natter, Legislative Intent Regarding the Pricing of Services by the Federal Reserve Board, Congressional Research Service (January 25, 1984), p. 10.

TABLE 18. FEDERAL RESERVE BANKS: PRICED SERVICES EXPENSES AND REVENUE, 1983
(In millions of dollars)

	Commercial Check Collection	Wire Transfer and Net Settlement	Commercial Automated Clearinghouses	Definitive Safekeeping and Non-cash Collection	Book-entry Securities	Cash Transportation	Coin Wrapping	Total
Expenses	393.6	57.1	14.5	20.8	18.0	28.3	1.4	533.6
Private Sector Adjustment Factor (PSAF)	44.5	8.2	0.7	2.7	2.5	0.2	0.2	59.1
Expense Recovery Target	438.1	65.3	15.2	23.5	20.5	28.5	1.6	592.7
Revenue	436.7	67.2	7.7	19.1	21.8	27.1	1.6	581.1
Profit or Loss	-1.4	1.9	-7.5	-4.4	1.3	-1.4	0.	-11.6
Profit or Loss Excluding PSAF	43.1	10.1	-6.8	-1.7	3.8	-1.2	0.2	47.5

SOURCE: Board of Governors of the Federal Reserve System, Annual Report (1983), Table 9.

NOTE: Expenses reflect operating expenses, the cost of earnings credits, and--in the check collection service only--imputed float costs. Revenue reflects fees and income on clearing balances.

cash transportation subsidies ($1.6 million) were provided to remotely located depository institutions.

In 1982, priced services revenues were $90.9 million below expenses and the PSAF. The 1983 results show that the Federal Reserve has nearly met the revenue-cost matching requirement of the Monetary Control Act in the relatively short time period of three years. Spending on services for financial institutions and the public has risen by an average annual rate of 8.8 percent per year from 1979 to 1983, and has declined from 75.1 percent of total PACS-reported expenses to 65.7 percent (see Table 16).

Competitors of the System maintain that it has not fully complied with the act. 20/ They assert that the Federal Reserve has used its rule-making powers and guaranteed income to give itself a competitive advantage. Testimony of the American Bankers Association shows private-sector concerns about the market powers of the Federal Reserve.

> Any private sector competitor which operates on a nationwide basis, accounted for 40 percent of the market for its services, was twenty times the size of its next largest competitor, and engaged in the kind of "flexibility in pricing" described by the GAO report would be charged with price discrimination

---

20. Lawrence C. Russell, "Testimony of the National Payments Coalition," in The Role of the Federal Reserve in Check Clearing and the Nation's Payment System, Joint Hearings before the Subcommittee on Domestic Monetary Policy of the House Committee on Banking, Finance and Urban Affairs and the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations (June 15 and 16, 1983) and Barry F. Sullivan, "Statement on Behalf of the National Payments System Coalition," in Federal Reserve Pricing Policy on Check Clearing Services, Hearings before the Senate Committee on Banking, Housing and Urban Affairs (April 11, 1984). See also George C. White, "The Conflicting Roles of the Fed as a Regulator and as a Competitor," Journal of Bank Research, vol. 14 (Spring 1983), pp. 75-95. For a vigorous defense of the Federal Reserve's Monetary Control Act record, see the statement of Gerald E. Corrigan, President, Federal Reserve Bank of Minneapolis, in Federal Reserve Pricing Policy on Check Clearing Services," Hearings before the Senate Committee on Banking, Housing and Urban Affairs (April 11, 1984).

and almost certainly find itself in constant litigation with damaged competitors. 21/

These claims have been reviewed by GAO and by Committees of the House and Senate. A GAO study published in May 1982 found that the Federal Reserve needed to eliminate subsidies resulting from a decline in check-clearing volume, from a delay in pricing float, and from an intentional subsidy for commercial automated clearinghouse services. The decline in check-clearing volume, primarily the result of the establishment of explicit pricing, together with unexpected cost increases, caused commercial check collection to be subsidized at an annual rate of $40 million to $50 million in 1982. Price increases and service improvements have ended the subsidy of check-clearing services, according to a recent GAO report. 22/

In 1980, the Federal Reserve decided to reduce the level of float before pricing it at cost, arguing that the efficiency of the payments system could be improved by gradually changing its availability schedules and transportation system. The Government Operations Committee found in April 1984 that:

> ...the Fed practice of giving better availability than it achieved, without including an appropriate charge in its fees, represented unfair competition. During this period the Fed should instead have increased its fees, in anticipation of completion of the operational improvements, by an estimated amount designed to prevent any unfair competitive advantage from its failure to charge fully for float, or, alternatively, the Fed should have adjusted its availability schedules to reflect more accurately the availability actually achieved. 23/

---

21. Testimony of the American Bankers Association, "Federal Reserve System Pricing of Check Clearing Activities," in Federal Reserve Pricing Policy on Check Clearing Services, Hearings before the Senate Committee on Banking, Housing and Urban Affairs (April 11, 1984).

22. Government Accounting Office, "An Examination of Concerns Expressed About the Federal Reserve's Pricing of Check Clearing Activities" (January 14, 1985).

23. Federal Reserve Competition with the Private Sector in Check Clearing and Other Services, Report of the House Committee on Government Operations (April 11, 1984).

The Subcommittee on Domestic Monetary Policy of the House Banking Committee, on the other hand, has approved the Federal Reserve's policies. 24/ GAO estimates the revenue lost to the Federal Reserve to be $511.8 million for the period August 1981-August 1983 (inclusive). The subsidy for check collection float (the source of almost all float), was ended by the beginning of 1984, according to GAO.

The subsidy for the commercial activities of automated clearinghouses was also criticized by GAO in its 1982 report. The Federal Reserve maintained that the operations of these clearinghouses (by which transfers of funds may be made electronically in batch rather than by individual paper checks) were likely to show large economies of scale if they grew. In fact, the rates of growth of volume and cost have been similar through 1983. The GAO recommended that these automated clearinghouse subsidies be discontinued, or alternatively be capitalized and recovered through amortized interest payments by users after the end of incentive pricing. The Federal Reserve has not followed either of these recommendations; full recovery of costs is currently scheduled to occur in 1986. The April 1984 report of the House Committee on Government Operations criticized the System for continuing this subsidy.

FEDERAL RESERVE BUDGET SAVINGS APPROACHES

One purpose of subjecting the Federal Reserve to the appropriations process would be to realize savings in the Federal Reserve's budget. Savings are generally ordered through the appropriations process in two different ways. The first is the establishment of a ceiling on an agency's spending. Spending ceilings leave agency managers with the task of allocating spending reductions to different programs and objects of expense. The second way is the requirement of a reduction in spending for a particular purpose. These requirements may be explicit orders in appropriations riders or simply informal committee recommendations.

Both of these savings approaches may also be contained in authorizing legislation. It is more common, however, for authorizing legislation to order budgetary savings through major changes in the programs or structure of an agency. Authorizing legislation may require cost recovery for agency services, for example, or may reduce the size or responsibilities of an agency.

---

24. The Role of the Federal Reserve System in the Nation's Check Clearing and Payments System (November 1984).

This section provides illustrations of how these savings approaches could be applied to the Federal Reserve, and discusses briefly the possible merits and drawbacks of the approaches.

Spending Ceilings

Banking Supervision and Regulation. An appropriations ceiling on supervision and regulation expenses is currently used for the Federal Home Loan Bank Board, but not for the National Credit Union Administration, the Comptroller of the Currency, Federal Deposit Insurance Corporation (FDIC), or the Federal Reserve. An argument against appropriations ceilings for these agencies is that they could be left without sufficient funds to promote the efficiency, equity, and safety of the banking system. If funds were limited to the degree that substantial delays in processing applications resulted, new financial services would not be available as early as possible, potentially reducing efficiency. A decline in spending on enforcement of consumer protection regulations could reduce access to credit for the disadvantaged. An inadequate level of supervision could lead to more problem banks and bank failures, with attendant public confidence, discount window, and financial insurance costs. On the other hand, the possibility of comparable mishaps has not deterred the Congress in appropriating funds for most of the other activities of the federal government. Other regulatory agencies are subject to the appropriations process, as is national defense. The FDIC insurance program and the Federal Reserve discount window loans offer some protection against short-term supervision problems.

Economic Policy. Most economic policy spending by the Federal Reserve is for preparation of statistics (such as monetary aggregates and flow of funds data) and policy analysis by the Board of Governors and the Federal Open Market Committee. An appropriations ceiling that constrained the Federal Reserve's flexibility to collect statistics and prepare analyses could leave it less well-informed. The Federal Reserve's research and statistics activities are extensive, a response in part to the uncertainty within the field of economics. As new policy problems confront the System, new or expanded surveys, statistical series, and analyses are commissioned. Over time, these studies may become less useful but be retained in the interest of preserving time-series data (that may once again become useful) or advancing basic research. Elimination of some of the less useful research and statistics activities could reduce spending while limiting the knowledge losses to System policymakers and other users. Potential savings in the statistical area may be bounded, however, by the Federal Reserve's record of reviewing and reducing its reporting requirements. This program began in 1975 and continued under the Paperwork Reduction Act of 1980. Because of its record of reducing paperwork burdens for the Information Collection

Budget, the Office of Management and Budget has delegated its authority for review of individual reports to the Board of Governors. It is the only agency to have received this delegation of authority.

Fiscal Agency and Financial Services. The Federal Reserve Act states that the Federal Reserve Banks, at the order of the Secretary of the Treasury, shall act as fiscal agents for the United States. 25/ The act does not require, however, that the Federal Reserve Banks receive full reimbursement for their costs. In 1983, the Federal Reserve received $72.9 million from the Treasury, the Department of Agriculture, and other government agencies in partial payment of total expenses of $120.3 million--a 60.6 percent reimbursement rate. Reimbursements came from the appropriated funds of these agencies, but Appropriations Committee review of the funds traditionally does not examine Federal Reserve Bank costs. The remaining $47.4 million was funded out of the Federal Reserve's income, decreasing the amount it would have returned to the Treasury. The Federal Reserve also bore the costs for certain services to financial institutions and the public to which the cost recovery requirement does not apply. These expenses totalled $176.7 million in 1983, 38.8 percent of net current expenses. Most of these expenses were for services with distinct governmental purposes—coin and currency processing and government and postal orders check processing.

Savings opportunities in the fiscal and financial services area are limited, for these expenses are largely mandatory in character—the government must distribute currency, pay its bills, collect taxes, and borrow money when necessary. The appropriations process could be used, however, to determine if the Federal Reserve's performance of these functions is cost-effective. Long-term cost reduction opportunities would largely depend on the feasibility of further automation of operations and subsequent reductions in personnel costs. Because most computer acquisitions do not reach their pay-back points for several years, a focus on limiting single-year expense growth (including the expense of computer purchases) could be myopic.

A possible problem with the use of the appropriations process in this area is the tendency of the Congress not to pass appropriations bills by the beginning of the fiscal year. It failed to pass 69 percent of the regular appropriations bills on time for fiscal years 1977-1983, relying on continuing resolutions to provide appropriations in their place. Such delays may force

---

25. 12 U.S.C. 391.

agencies to follow inefficient spending practices. 26/ Basic Federal Reserve System operations would not be affected by this if the Federal Reserve was exempted from the provisions of the Anti-Deficiency Act (which prohibits spending until funds are provided by appropriations bills). The scope of the Anti-Deficiency Act is an unsettled legal issue, but some spending in the absence of appropriations is permitted under policy established by Office of Management and Budget memoranda. The policy allows agencies to continue only activities "that protect life and property and those necessary to begin phasedown of other activities." Defined to fall within this category are activities "essential to the preservation of essential elements of the money and banking system of the United States, including borrowing and tax collection activities of the Treasury." 27/

Specific Spending Reductions

In place of granting the Federal Reserve the choice of which programs or objects of expense to reduce in order to comply with a spending ceiling, the Congress could order specific spending reductions. For example, it could require that the Federal Reserve reduce its spending on regional economics. Many of the Banks have developed expertise in the economies and important industries of their districts, with staff economists serving as unpaid consultants to public and private task forces and as organizers of conferences. Such regional development and business analysis might be more appropriately performed by consortia funded by state governments and the private sector. On the other hand, if one accepts a federal interest in encouraging local economic development, regional research is a fit subject for the Federal Reserve Banks.

Another possible use of this approach would be to order the Federal Reserve to end immediately its subsidies for automated clearinghouses. These subsidies have been characterized as departures from the intent of the Monetary Control Act. So long as they are not prohibited, "Ready access to funds from the yield on Treasury securities the Federal Reserve owns makes a policy of subsidy easy to accomplish." 28/ On the other hand,

---

26. General Accounting Office, "Funding Gaps Jeopardize Federal Government Operations" (March 3, 1981).

27. Office of Management and Budget, "Agency Operations in the Absence of Appropriations" (December 1982), pp. 1-2.

28. General Accounting Office, "The Federal Reserve Should Move Faster to Eliminate Subsidy of Check Clearing Operations" (May 7, 1982), p.34.

the Federal Reserve has stated that it will gradually terminate incentive pricing by 1986.

Cost Recovery and Privatization

Cost Recovery. Cost recovery for financial services has proved a significant source of budget savings for the Federal Reserve. The policy of cost recovery could be expanded by creating new user fees for certain of the System's public and service programs that are still financed from current income. These programs provide, for example, that the public can buy Treasury securities from the Federal Reserve Banks without paying sales commissions, free accounting assistance to banks, and free publications. Beneficiaries of these expenditures can be identified and may be willing to pay for them.

Another method of increasing cost recoveries would be to charge holding companies and state member banks for the costs of applications, examinations, and general supervision. This is the general practice of other financial regulatory agencies. The Comptroller of the Currency fully covers its costs through a general assessment on national banks and specific fees for charters, mergers, and branching. The FDIC draws funds from its assessment of 0.083 of 1 percent on the deposit liabilities of insured institutions. The Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation charge fees to partially cover examination and supervision costs, funding the remainder from assessments on funds raised in the securities markets by the Federal Home Loan Banks. State banking authorities also charge assessments and fees. 29/

Adoption of cost recovery for supervision and regulation expenses could produce significant savings in the Federal Reserve's budget. The notion that an industry should be charged for being regulated by the government is not novel, but it is unusual. Some of the regulatory activities of the Federal Reserve do not provide direct benefits to member banks, such as

---

29. In 25 states, charges are added to general revenues and are appropriated to state banking departments. Charges are occasionally higher than the expenses of state banking departments, providing funding for other state programs. In 22 other states, charges are deposited into a fund for use only for the expenses of the banking department, but are still subject to appropriations review. Three state banking departments are independent. Conference of State Bank Supervisors, A Profile of State-Chartered Banking (January 1984).

examinations to determine compliance with consumer protection regulations. Supervisory activities may, however, alert management to problems with the bank's financial condition. On the whole, current policy protects banks to an extraordinary degree from economic loss, by providing access to discount window funds, restricting entry by potential competitors, and supervising risk-taking by banks that hold other banks' funds. A policy of cost recovery for regulatory costs may be justified by these benefits.

An efficient assessment and fee schedule would reflect the marginal costs of supervision and regulation activities. The Comptroller of the Currency charges banks assessments on a declining percentage scale of total assets, reflecting the significant economies of scale in labor costs from examining large banks. The FDIC, on the other hand, covers its supervision and examination costs by drawing on its insurance premiums from all insured banks. This creates a cross-subsidy from national and state member banks to state nonmember banks. An incentive to state member banks to withdraw from System membership would thereby exist if the Federal Reserve were to recover its supervision and regulation costs. With the adoption of universal reserve requirements, such withdrawals no longer create a problem for monetary policy control. Nevertheless, they could be retarded by separating FDIC insurance and examination costs and charging explicit fees for examination of state nonmember banks.

State member banks often are examined by the Federal Reserve and by their state supervisors in the same year, and could be charged twice if the Federal Reserve adopted cost recovery charges. In some states, state assessments and fees match or exceed those of the Comptroller, particularly for the larger banks. The desire to avoid dual charges could induce state-chartered banks to convert to national charters, which are already attractive because of the enhanced banking powers they provide in many states. They would also benefit from reduced compliance costs. It might be argued that the Federal Reserve should not charge fees for its supervisory activities in order to prevent mass conversions and preserve the traditional "dual banking system." This implies that the federal purpose in supervision and regulation of state-chartered banks is not clear. If a clear federal purpose is accepted, fees could be charged and consideration given to methods of reducing regulatory burdens from independent supervision. Substantial cost savings could be gained by having state and federal supervisors conduct annual exams on an alternating basis, or together. 30/

---

30. Randall J. Miller, "Examination Man-Hour Cost for Independent, Joint, and Divided Examination Programs," Journal of Bank Research (Spring 1980), pp. 28-35. In 1983, 19 states participated in cooperative examination programs with the Federal Reserve.

Privatization. The Federal Reserve occupies a unique position in the payments system as the largest provider of services and as a regulator of its competitors. The potential conflict between these roles is a matter of concern, especially to its competitors. Also of concern is the provision and marketing by a government agency of services that may not be essential public services. One method of allaying these concerns would be to spin off the payments services of the Federal Reserve into a privatized enterprise. Although this approach would reduce government competition with the private sector, it would also result in the loss of the substantial joint economies from combining payments services and monetary policy activities in the same facilities, particularly from settlement and reserve account uses of the electronic communications system and account balances. It should be noted that the Federal Reserve has to an extent separated its priced services activities from its other activities.

Restructuring the Federal Reserve

The decentralized structure of the Federal Reserve System has remained relatively unchanged throughout its 70-year history. This has required the maintenance by each Federal Reserve Bank of separate overhead and support operations that would likely be centralized in a federal agency. Certain overhead and support costs--personnel services, for example--could obviously be reduced if Federal Reserve Bank operations were consolidated.

In the economic policy sphere, a recurrent recommendation has been that the Federal Reserve Bank presidents be dropped from the Federal Open Market Committee, on the ground that their voting status constitutes improper private-sector involvement in government policymaking. 31/ Their participation is also held to be unnecessary since the research staffs that support the Bank presidents independently prepare information that is often similar in content to that prepared by the Board of Governors staff. 32/

---

31. Members of Congress have taken to court, unsuccessfully, to contest the absence of a requirement that Federal Reserve Bank presidents who are members of the Federal Open Market Committee be confirmed by the Senate. The courts held that the Members of Congress lacked standing. See Riegle v. Federal Open Market Committee, 656 F.2d 873 (D.C. Cir. 1981), cert. denied, 102 S.Ct. 636 (1981) and Reuss v. Balles, 584 F.2d 461 (D.C. Cir. 1978), cert. denied, 439 U.S. 997 (1978).

32. Henry S. Reuss, "The Once and Future Fed," Challenge, vol. 26 (March-April 1983), pp. 26-32.

Against this it is argued that the Bank presidents and their staffs provide regional perspectives and analytical diversity. At present the Board of Governors has several methods of controlling and coordinating Bank research, notably through its prepublication review of articles and through the System Research Advisory Committee composed of Board of Governors staff and Bank research directors.

Savings could also be made by consolidating the regulatory activities of the Federal Reserve, the Comptroller of the Currency, and the FDIC. The fragmentation among these agencies of responsibilities for federal regulation of commercial banks and bank holding companies has often been criticized. In the current system, one agency may have jurisdiction over a holding company while others have jurisdiction over the holding company's banks. The agencies have sometimes failed to share information and have duplicated each other's efforts. Separate annual surveys by the Federal Reserve System and the Comptroller of the Currency to determine pay levels for bank examiners provide an example of unnecessary overhead spending. Attempts by the agencies to coordinate activities and adopt uniform policies have had mixed success. 33/

Proposals to consolidate agencies have been made many times, most recently by the Grace Commission and the Bush Task Group. 34/ The Bush Task Group would create a Federal Banking Agency to regulate national banks and most holding companies. The Federal Reserve would have authority only for the largest holding companies and international banks, and initially be responsible for supervision of all state-chartered banks, leaving the FDIC free to concentrate on troubled banks. Over time, the Federal Reserve would divest its authority as primary supervisor of state-chartered banks to state supervisors when they were certified by the federal government. The Administration has not prepared estimates of the savings from

---

33. General Accounting Office, "Federal Reserve Could Improve the Efficiency of Bank Holding Company Inspections" (August 18, 1981), and "Federal Financial Institutions Examination Council Has Made Limited Progress Toward Accomplishing Its Mission" (February 3, 1984).

34. President's Private Sector Survey on Cost Control, "Recommendations for Consolidation and Structural Changes in the Financial Service Regulatory Agencies," Report on Boards/Commissions—Banking and Investments (1983). Office of the Vice President, Blueprint for Reform: the Report of the Task Group on Regulation of Financial Services (1984). See also F. Jean Wells, Depository Financial Institutions: Regulatory Restructuring?, Congressional Research Service (August 14, 1984).

42-777 O - 85 - 8

this plan. Any savings from consolidation would occur only over the long term, because of the significant transition costs of combining the agencies' personnel and operations. Whether states would bear the costs of supervision of state-chartered banks necessary for federal certification is uncertain.

THE APPROPRIATIONS PROCESS AND CONGRESSIONAL POLICY DIRECTION

Subjecting the Federal Reserve to the appropriations process would make possible increased Congressional direction of Federal Reserve policy. Control over the expenditures of the System could obviously give the Congress more influence on regulatory and monetary policies, because funding levels could be reduced if the Federal Reserve's goals or performance were deemed unsatisfactory. In addition, the annual regularity of the process would provide more opportunities to direct policy through riders than would use of authorizing legislation, which tends to be more sporadic.

The degree to which the Congress would use this additional power is unpredictable, as are the effects on policy. The Congress could use it to recapture the regulatory authority it has traditionally delegated to the Federal Reserve—for example, by attaching a rider to an appropriations bill that would direct the Federal Reserve, in the case of a certain set of banks, to classify loans as performing that it would otherwise classify as nonperforming. While similar limitations on the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation have not been used for this purpose, other regulatory agencies' policies have been affected by appropriations limitations. Whether the Congress should be making such decisions through the appropriations process is a highly controversial issue. Some see this as leading to political involvement in a technical area, while others see it as a legitimate exercise of Congressional policymaking authority. 35/

In the field of economic policy, the Congress could set appropriations ceilings on open-market, foreign currency, and discount loan transactions. This would be a significant change from current practice, in which the Federal Reserve has the authority to conduct its monetary transactions as it sees fit, and the ability to react to unexpected economic and financial

---

35. Frederick M. Kaiser, Congressional Control of Executive Actions: Alternatives to the Legislative Veto, Congressional Research Service (December 12, 1983).

market conditions. If the Congress wishes the Federal Reserve to retain its operating flexibility yet still make it subject to the appropriations process, it could apply the process only to the System's administrative expenses, as it has done with the Treasury's Exchange Stabilization Fund transactions.

Even if the appropriations process was limited to administrative expenses, the Congress could still attempt to direct monetary policy through the use of riders or the withdrawal of funds. The Congress has attached monetary policy riders before. For example, Public Law 97-377, "Further Continuing Appropriations for Fiscal Year 1982," included the following:

> SEC. 161. . . . (I)t is the Sense of the Congress that: In recent months, the Board of Governors of the Federal Reserve and the Federal Open Market Committee have made a significant contribution to the lower interest rates without rekindling inflation, and that, with due regard for controlling inflation so as not to have an opposite effect of driving interest rates upward, they should continue to take such actions as are necessary to achieve and maintain a level of interest rates low enough to generate significant economic growth and thereby reduce the current intolerable level of unemployment.

This particular rider was a "sense of the Congress" rider that merely expressed the opinion of Congress. The usual appropriations rider, on the other hand, would have the force of law.

It is conceivable that Congressional control over the Federal Reserve's administrative expenses would not make a great deal of difference in the System's responsiveness to Congressional desires. Several empirical studies have found that the Federal Reserve has been generally responsive to the policy goals of the Congress and the President during the post-World War II period. It is possible, therefore, that the use of appropriations limitations would not substantially affect the direction of monetary policy.

Were the Congress to use riders to direct monetary policy, it would be explicitly determining monetary policy goals (targets for interest rates and/or money growth). To successfully discharge this enhanced responsibility, the Congress would need to set clear monetary policy goals that were achievable and consistent with other economic goals. It would also need to be able to interpret the very technical and often uncertain relationships between monetary policy instruments and economic conditions in order to monitor the Federal Reserve's conduct of monetary policy. These tasks would add significantly to the Congressional workload.

Use of the appropriations process might not be the most effective way of controlling monetary policy. The focus of the appropriations process is, after all, control of expenditures. Moreover, waivers of rules prohibiting legislation on appropriations would be necessary. If the Congress decided to reduce the traditional independence of the Federal Reserve and play a more active role in the formulation of monetary policy, a more effective means than the appropriations process would be the regular authorizing process of holding hearings and marking up, debating, and voting on substantive legislation. Conceivably, this could be integrated into the planning process established by the Congressional Budget Act of 1974 and the Full Employment and Balanced Growth Act of 1978. But it must again be emphasized that such a change would be a significant departure from current practice, requiring that the Congress develop a greatly expanded capacity for setting economic goals and for analyzing the relationship between the instruments of monetary policy and economic variables.

APPENDIX A. BUDGET PRESENTATION COMPARISONS

This appendix provides some comparative information about other organizations that share the Federal Reserve's off-budget status, and about the budget treatment of organizations that have activities similar to those of the Federal Reserve.

Other Off-Budget Organizations

Federal Reserve System spending is not the only spending excluded from on-budget outlays. Off-budget federal entities and government-sponsored enterprises are also excluded (see Table A-1). The former are agencies wholly or partially owned by the federal government, the receipts and expenditures of which have been excluded from the budget by statute or Presidential direction. The latter are enterprises not owned by the government although they were chartered by it and are sponsored by a federal agency; they are generally privately financed. The finances of all off-budget entities and government-sponsored enterprises are summarized in "annexed" budget schedules in the Budget Appendix.

The principal justification given by the 1967 President's Commission on Budget Concepts for excluding government-sponsored enterprises from the budget is their private ownership. All of the government-sponsored enterprises were privatized before the adoption of the unified budget, with the exception of the Student Loan Marketing Association. 1/

Off-budget federal entities have been excluded from the budget for a variety of reasons. In most instances, off-budget status was granted by statute to protect agencies or programs from budget reductions. This was the purpose of a provision of Public Law 98-21, which removes the Old Age and Survivors, Disability, and Hospital Insurance Funds of the Social Security Program from the budget beginning in fiscal year 1993. The Federal Financing Bank was excluded from the budget originally because it was intended to serve as a passthrough financing mechanism for agency debt. At present, however, the Federal Financing Bank also provides off-budget

---

1. A Congressional Budget Office study of the budgetary status of government-sponsored enterprises is forthcoming.

TABLE A-1. OFF-BUDGET FEDERAL ENTITIES AND GOVERNMENT-SPONSORED ENTERPRISES, FISCAL YEAR 1985

Organization	Authority for Exclusion from the Budget
Federal Entities	
Rural Electrification and Telephone Revolving Fund; Rural Telephone Bank	Public Law 93-32
Board of Governors, Federal Reserve System	Presidential direction
Strategic Petroleum Reserve	Public Law 97-35
Federal Financing Bank	Public Law 93-224
Postal Service	Presidential direction
United States Railway Association	Public Law 93-236; Public Law 94-210
United States Synthetic Fuels Corporation	Public Law 96-294
Government-Sponsored Enterprises	
Student Loan Marketing Association	Presidential direction
Federal National Mortgage Association	Presidential direction
Banks for Cooperatives	Presidential direction
Federal Intermediate Credit Banks	Presidential direction
Federal Land Banks	Presidential direction
Federal Home Loan Banks	Presidential direction
Federal Home Loan Mortgage Corporation	Presidential direction
Federal Reserve Banks a/	Presidential direction

a. Federal Reserve Banks are not included in the Budget Appendix as either off-budget federal entities or as government-sponsored enterprises.

financing with the effect of reducing reported on-budget activities. 2/ Other agencies and programs--the Export-Import Bank, the Housing for the Elderly and Handicapped Fund, the Exchange Stabilization Fund, and the Pension Benefit Guaranty Corporation--have been at different times excluded from and included in the unified budget. 3/

Budget Presentation for Organizations with Similar Activities

Although many of the activities of the Federal Reserve System are similar to those performed by other federal agencies, the power and scope of Federal Reserve monetary policy activities is unique. Only the Exchange Stabilization Fund makes similar monetary policy transactions. Most of the organizations with activities similar to the other activities of the Federal Reserve System are included in the budget, as shown in the first column of Table A-2. This table also shows the means of financing for these organizations and records variances from executive agency status. The typical executive agency is headed by a single executive nominated by the President and confirmed by the Senate, is government-owned, and receives policy direction from the President. Variances from this status are multimember executives (commissions), executive members selected by private shareholders, and legal independence from Presidential policy direction.

All of the agencies having responsibilities in the fields of economic policy or economic statistics and research are dependent upon annual appropriations for financing. Depository institution regulatory agencies, on the other hand, are financed from nonfederal sources, and only the Federal Home Loan Bank Board and the Farm Credit Administration have their operating expenses limited by appropriations bills. Two other financial regulatory agencies, the Securities and Exchange Commission and the Federal Trade Commission, are subject to the appropriations process, as are three of

---

Congressional Budget Office, The Federal Financing Bank and the Budgetary Treatment of Federal Credit Activities (January 1982); New Approaches to the Budgetary Treatment of Federal Credit Assistance (March 1984); James T. Bennett and Thomas J. DiLorenzo, "The Limitation of Spending Limitations: Off-Budget Activities and the Federal Government," Federal Reserve Bank of Atlanta Economic Review (April 1983), pp. 23-34.

3. Congressional Budget Office, An Analysis of Congressional Budget Estimates for Fiscal Years 1980-1982 (June 1984), pp. 59, 62.

TABLE A-2. CHARACTERISTICS OF ORGANIZATIONS WITH ACTIVITIES SIMILAR TO THOSE OF THE FEDERAL RESERVE SYSTEM

Activity and Organization	Budget Status (Fund Type)	Financing		Variances from Executive Agency Status
		Appropriations	Other	
Federal Reserve				
Board of Governors	Off-budget	No	Assessments on Federal Reserve Banks	7 members; independent a/
Federal Reserve Banks	Off-budget	No	Interest, fees and reimbursement for services	9 members each bank, selected by private shareholders and Board of Governors; independent
Monetary Transactions				
Exchange Stabilization Fund	On-budget b/ (Public Enterprise Fund)	Administrative expenses only	Interest/foreign exchange gains	None
Economic Policy				
Council of Economic Advisers	On-budget (Federal Fund)	Annual	None	None
Office of Management and Budget	On-budget (Federal Fund)	Annual	None	None
Office of the Secretary of the Treasury	On-budget (Federal Fund)	Annual	None	None

(Continued)

a. An agency is classified as "independent" if its executives cannot be removed from office by the President.

b. Administrative expenses, interest on Treasury securities, and foreign exchange gains and losses only.

TABLE A-2. (Continued)

Activity and Organization	Budget Status (Fund Type)	Financing		Variances from Executive Agency Status
		Appropriations	Other	
Economic Statistics and Research				
Department of Commerce Economic and Statistical Analysis	On-budget (Federal Fund)	Annual	None	None
Department of Labor Bureau of Labor Statistics	On-budget (Federal Fund)	Annual	None	None
Financial Regulation, Insurance, and Intermediation				
Comptroller of the Currency	On-budget (Trust Revolving Fund)	No	Assessments; fees from examinations	None c/
Federal Deposit Insurance Corporation	On-budget (Trust Revolving Fund)	No	Insurance fees; $3 billion in Treasury borrowing authority	3 members; d/ independent
Federal Home Loan Bank Board	On-budget (Public Enterprise Fund)	Limitation	Fees from; examinations; assessments on FSLIC & FHLBs. e/	5 members; independent

(Continued)

c. Five-year term, can be removed by President with notification to Senate.

d. One member must be the Comptroller of the Currency.

e. Federal Savings and Loan Insurance Corporation and Federal Home Loan Banks.

TABLE A-2. (Continued)

Activity and Organization	Budget Status (Fund Type)	Financing		Variances from Executive Agency Status
		Appropriations	Other	
Federal Home Loan Banks	Off-budget (Government-sponsored enterprise)	No	Debt issues; $4 billion in Treasury borrowing authority	14 members selected by private shareholders and by FHLBB; f/ independent
Federal Savings and Loan Insurance Corporation	On-budget (Public Enterprise Fund)	No	$750 million in Treasury borrowing authority	Under supervision of FHLBB; independent
National Credit Union Administration	On-budget (Public Enterprise Fund)	No	$100 million in Treasury borrowing authority	3 members; independent
Farm Credit Administration	On-budget (Federal Fund)	Limitation	Assessments	13 members; independent
Securities and Exchange Commission	On-budget (Federal Fund)	Annual	$1 billion in Treasury borrowing authority	5 members
Federal Trade Commission	On-budget (Federal Fund)	Annual	None	5 members; independent

(Continued)

f. The Banks were owned by the government until their capitalization was repaid by member institutions.

TABLE A-2. (Continued)

Activity and Organization	Budget Status (Fund Type)	Financing		Variances from Executive Agency Status
		Appropriations	Other	
Financial Services				
Bureau of Engraving and Printing	On-budget (Revolving Fund)	No	Reimbursements from Federal Reserve Banks and Postal Service	None
Bureau of Government Financial Operations	On-budget (Federal Fund)	Annual	None	None
Bureau of Public Debt	On-budget (Federal Fund)	Annual	None	None
Bureau of the Mint	On-budget (Federal Fund)	Annual	None	None
Postal Service	Off-budget g/ (Public Enterprise Fund)	Annual for 2 subsidies only g/	Collections; $10 billion in public and Treasury borrowing authority	11 members; independent

g. Payments to the Postal Service Fund (Federal Fund) are on-budget. These payments are for unfunded liabilities of the Post Office Department and for free and reduced-rate mail.

four Treasury Department bureaus with financial services functions. The fourth, the Bureau of Engraving and Printing, receives its financing from Federal Reserve and Postal Service reimbursements. All of these agencies are on-budget.

Three other organizations shown in Table A-2 are wholly or partially off-budget. The Federal Home Loan Banks are privately owned financial intermediaries for savings and loans. The Federal Home Loan Banks are supervised by the Federal Home Loan Bank Board, but do not carry out activities similar to the economic policymaking and regulatory activities of the Federal Reserve Banks. The Exchange Stabilization Fund budget statement includes interest earnings as offsetting collections and administrative expenses as obligations. The Fund's assets (securities, cash, and Special Drawing Rights) available for currency exchanges are shown as unobligated balances. Changes in foreign currency holdings are counted as outlays only when there is a realized loss on currency exchanges and as offsetting collections only when there is a realized profit. The Postal Service is excluded from the budget except for two subsidy payments to it funded by appropriations.

APPENDIX B. BUDGETING IN THE FEDERAL RESERVE SYSTEM

The System prepares separate budgets for the Board of Governors (under the direction of the Controller) and the Federal Reserve Banks (under the direction of the Division of Federal Reserve Bank Operations). Budget preparation proceeds on parallel tracks, however, with final approval by the Board of Governors in December. The Federal Reserve System's budget year is the calendar year, not the October 1-September 30 fiscal year of the federal government. Operating budgets are not prepared for discount loan activities and for securities and foreign currency transactions, which are conducted with regard to monetary policy goals only.

The Federal Reserve Banks. In the Federal Reserve Banks, budget preparation begins with the establishment in mid-spring of a target for spending growth for the budget year. The budget objective is prepared initially by the Conferences of First Vice Presidents and of Presidents in conjunction with the staff of the Division of Federal Reserve Bank Operations. After approval of the objective by the Board of Governors, the individual banks prepare draft budgets in the summer. During the fall, these budgets are reviewed by the Committee on Federal Reserve Activities, a three-member committee of the Board of Governors. Final budget submission and approval occurs in November and December.

In comparison to the control of obligations that is the focus of federal agency budgeting, the emphasis in the Federal Reserve Banks' budget process is on targeting percentage rates of growth (or decline) in major operating expense categories and employment. The System relies upon data collected by the Planning and Control System (PACS), which allocates direct and support costs by object of expense to the numerous activities of the Banks. These costs are then matched with selected environmental and productivity statistics, allowing the Banks and the Division of Federal Reserve Bank Operations to evaluate the comparative efficiencies of the Banks. The operating expense budget is prepared for only the upcoming year, unlike the standard federal practice of using a three-year planning horizon.

A separate budget is prepared for major capital outlays. Complementing the capital budget are processes to plan for and acquire automation and communications equipment and buildings. Each construction project, for example, must be approved by the Division of Federal Reserve Bank Operations in six major stages of acquisition, and approval by the Board of Governors may be necessary in up to four stages, should certain dollar limits

of authority to make capital outlays (delegated by the Board of Governors to the Federal Reserve Banks) be exceeded.

In addition, a "System Project" budget process considers projects carried out by "host" Banks for the benefit of all Banks (an example is the standardization of computer software). Although System projects are controlled by the Board of Governors, the costs of these projects are shared by all Banks, and must be approved unanimously by the Banks every year. Banks also adopt "Business Plans" for their priced services activities. A Business Plan sets a course for matching the costs of priced services with revenues, and contains analyses of conditions in the payments markets, evaluations of the Federal Reserve Bank's capabilities to compete in these markets, and descriptions of planned marketing and operating strategies. Because the support and overhead activities of the Banks are shared by priced services and central bank and Treasury services, the results of the Business Plan processes are integrated into the operating and capital budgets. Business plans are approved by the Pricing Policy Committee of the Board of Governors, and are not made available to the public or to competitors. Operating and capital budgets are also affected by projected reimbursements for fiscal agent services from the Bureau of the Public Debt and Bureau of Government Financial Operations in the Department of the Treasury and the Food and Nutrition Service in the Department of Agriculture. These agencies consult with the Division of Federal Reserve Bank Operations and the Banks to determine the level of fiscal agent services to be provided.

Budget execution is monitored through monthly and quarterly reviews of PACS expense reports and a formal midsession review. In the priced services area, the stated policy of the Federal Reserve System is to respond to revenue changes with matched volume adjustments during the budget year, thereby changing the operating expense budget.

The Board of Governors. Preparation of the budget of the Board of Governors follows a similar, but compressed, timetable. Capital and operating expenses are integrated. Board expenses are budgeted for percentage rates of growth and personnel slots by division and by object of expense, and are not complicated by the reimbursement and priced services considerations faced by the Banks. The Board also prepares a currency budget, determining the amount of new currency to be produced by the Bureau of Engraving and Printing and reimbursed for by the Federal Reserve Banks. Monthly estimates of projected spending and the actual net financial condition of the Board are used to determine the semiannual assessments on Federal Reserve Bank earnings to cover Board of Governors expenses. The Federal Reserve Banks make quarterly payments to an account in the

Federal Reserve Bank of Richmond; these amounts are invested until drawn down by the Board of Governors.

Summary. Substantial differences exist between the budget processes used by the Federal Reserve and most federal agencies, especially the former's use of cost-based budgeting, decentralization, and capital planning. It is not uncommon for federal agencies to be criticized for overemphasis on control of obligations, disregard of field managers, and failure to analyze costs fully over the long term. Use of a budget process similar to that practiced by the Federal Reserve could reduce these problems. On the other hand, a drawback of decentralization is that the System may tolerate duplicative Bank overhead costs, or cause the Banks to bear high costs for coordination. The Federal Reserve's cost-based budgeting and decentralized spending authority could also complicate efforts by the Congress and agency executives to set binding limits on operating expenditures.