

Statement of
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Mr. Chairman, I am pleased to testify before this Committee on the proposal to include a presentation of the Federal Reserve System's finances in the unified budget of the United States. The Congressional Budget Office (CBO) has prepared a report on the budgetary status of the Federal Reserve at the request of this Committee. That report has been distributed to Members, and I hope that it can be included in the record.

In my remarks today, I will describe the current budgetary treatment of the Federal Reserve System to indicate why a more complete presentation of the System's finances would be useful. I will also note some difficult issues that would be raised by including all activities of the Federal Reserve System in the unified budget.

CURRENT TREATMENT

The current budgetary presentation of the Federal Reserve's finances is incomplete compared with that of other independent government agencies. The main budget document includes an entry for Federal Reserve net earnings transferred to the Treasury. For 1985, these "miscellaneous receipts"--as they are called--from the deposit of Federal Reserve earnings are expected to total \$18 billion. Federal Reserve earnings consist of gross income minus operating expenses, dividend payments to member banks, and other adjustments. Gross income and expenses are not shown separately in the budget.

The Budget Appendix, but not the main budget document, reports operating expenses for the Board of Governors. Reserve Bank expenses-- accounting for about 95 percent of the System's expenses--are not shown. Further, the expenses of the Board of Governors are reported only for the current calendar year rather than the projected fiscal year. To the extent that the System's accounts are available to the public, they are generally not comparable with budget data. For example, purchases of capital goods are handled in Federal Reserve accounts more as they would be in a private firm rather than on the cash flow basis used in the budget.

THE CASE FOR A MORE COMPLETE
AND CONSISTENT BUDGET STATEMENT

On its face, the current budgetary treatment of the Federal Reserve violates a basic principle of budgeting: namely that the budget document should be comprehensive about government operations and should facilitate cost comparisons among agencies and activities. More particularly, the reporting of net earnings provides little information about financial performance or operating characteristics of an agency with the power to create money. Although the distinction between the expenses of the Reserve Banks and the Board of Governors may once have had some justification in the technical status of the Banks as "privately owned," it is now clear that the Federal Reserve's earnings accrue to the Treasury; thus, when a Reserve Bank spends money for a new building or check processing center, public

monies are being dispensed. Finally, the continued adherence by the Board to a calendar year budget statement confuses attempts to compare their accounts with the **fiscal** year accounts of other agencies.

This failure to explicitly show the expenses of the Federal Reserve leads to underreporting of government outlays for financial regulation, economic policy, and government financial services. The large volume of Federal Reserve business-type **activities--check** collection and the electronic transfer of funds, for **example--are** obscured from public view.

It is tempting to conclude, therefore, that the Federal Reserve System should be brought fully on-budget and afforded the same fiscal accounting treatment as the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the federal judiciary, for example. Nonetheless, an attempt to increase the comprehensiveness and content of the unified budget by including a complete statement of Federal Reserve activity would raise **difficult** policy and accounting questions that need to be addressed.

SPECIAL DIFFICULTIES RAISED BY THE BUDGETARY TREATMENT OF A CENTRAL BANK

Most of the troublesome issues involved in putting the Federal Reserve fully on-budget arise because of the System's role as the **nation's** central bank. In this section of my testimony, I will focus on several of these issues

by considering three budgetary treatment options for the Federal Reserve: first, adding only the Reserve System's operating costs to the budget; second, including the financial transactions along with operating expenses; and third, appropriating funds for Reserve System operations.

Displaying Operating Expenses

A long-standing, but not unquestioned, American political tradition suggests that in order to discharge its responsibilities for maintaining a sound currency and for avoiding financial crises, a central bank must have a degree of policy independence from both the executive and legislative branches of government. My understanding is that the proposal being considered here is not intended to modify the existing balance of authority over monetary policy. Rather than mandate prior Congressional approval of the System's budget, which might be interpreted as a means to exert detailed influence over monetary policy, the intent is simply to require the Federal Reserve to account for its operating expenditures in the same terms as other federal entities. Some conflict exists, however, between the basic purpose of the budget and its use merely as a means for promoting disclosure.

Comprehensiveness is desired in a budget precisely to ensure that all resources are subject to the allocative decision process. No agency or use is

presumed to have a first claim on fiscal resources. But in the case being considered here, the intent is to include expenditures in the budget without exercising any control over their use. Although this is at odds with the basic concept of allocative budgeting, it would not be the only example of this phenomenon found in the budget. Trust funds and revolving funds, for example, are now on-budget, even though the monies they receive are not routinely considered for reallocation to other uses.

The urgency of the case for **including** operating expenses in the budget is dampened somewhat by the legislated requirement that the Federal Reserve compete fairly in the market for financial services by charging full-cost prices for many of its services and by the reimbursement it receives for costs incurred on behalf of other government agencies. Over 55 percent of Federal Reserve expenses for **services** to agencies and private **financial** institutions is now recovered from beneficiaries. Putting these accounts on-budget, therefore, would largely consist of adding both outlays and their offsetting receipts.

Including Financial Transactions

Most of the Federal **Reserve's** disbursements are to acquire financial assets, specifically to purchase U.S. government securities and to make loans to financial institutions. In fact, these disbursements dwarf operating

costs. Completeness of budgetary coverage would require that these transactions be included in the budget even though they are usually offset within days by the sales of assets and by the repayment of Reserve Bank advances.

Under current budget practice, these financial transactions would be reported on an annual, net assets acquired basis. This netting process will mask an enormous volume of activity and, simultaneously, fail to capture the value of subsidies that may be conveyed through discount window loans.

The Federal Reserve is not unique among government agencies as a dealer in financial assets and provider of credit assistance. The Export-Import Bank of the United States and the Federal Deposit Insurance Corporation, for example, are engaged in acquiring and managing substantial quantities of financial assets. Both institutions are on-budget even though federal budget accounting is not well suited to their operations. For example, net lending during the fiscal year, which is what is shown in the budget, tells little about the value of the subsidy inherent in the lending.^{1/} The imperfections of the current budget system, however, have not been regarded as a sufficient reason for omitting an activity or agency from the budget.

1. For a detailed discussion of the failings of the budget treatment of federal credit, see Congressional Budget Office, New Approaches to the Budgetary Treatment of Federal Credit Assistance (March 1984).

Another aspect of the issue of policy independence is raised by the need to project future data for budget accounts. In the case of the Federal Reserve, projections of asset holdings might be interpreted as an announcement of or a target for future monetary policy. One way to avoid such an interpretation would be to adopt as a budget convention the practice of extrapolating Federal Reserve accounts solely on the basis of current policy. Such a projection would provide the budget with "order of magnitude" numbers, but would not commit the Reserve System to a particular policy course.

Appropriating Federal Reserve Expenditures

Alternatively, as noted in the CBO report, Federal Reserve operating expenses could be explicitly subject to Congressional **appropriation**. While this approach may suggest an increase of Congressional influence over monetary policy, that suggestion **might** be minimized by restricting coverage of budget and appropriations to functional expenses other than those incurred in the design and execution of monetary policy. The separation of monetary policy expenses from all other expenses, however, will not be easily accomplished because of shared support and overhead cost. A danger exists also, that legislative riders would be attached to such appropriations and used to influence monetary policy.

SUMMING UP

The current budget presentation for the Federal Reserve System is incomplete, inconsistent with many other accounts, and less useful than the budget statements for many independent agencies. These deficiencies go beyond what can be justified by a desire for an independence of monetary policy or the special nature of central banks. But it is not completely clear that the best solution would be to bring the Federal Reserve immediately and fully on-budget. The limitations of the current budget accounting system are a concern. Moreover, it must be noted that accounting and budgetary changes of this magnitude **increase** accounting costs by nontrivial amounts. But the major unresolved issue is the extent to which a budgetary change would reduce, to an undesired extent, the Federal Reserve's policy of independence. The risk is greatest if Federal Reserve expenses are appropriated and if the Reserve System is required to project its financial operations. The risk is smaller if the budgetary coverage is primarily informational and limited to operating expenses. The expected gain from taking these risks would be to provide better information for Congressional oversight. This is not an easy choice, nor is it one that CBO is equipped to make. It is, I think, a matter for Congressional judgement.