Legislation Eliminating the Federal Reserve's Surplus

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On November 5, 2015, the House adopted H.Amdt. 824 as a "pay for" (revenue offset) to the highway bill (H.R. 22). It would permanently eliminate the Federal Reserve's (Fed's) surplus account and transfer those funds to the Treasury. (This provision was also included in the version of H.R. 3189 that passed the House on November 19, 2015.) The amendment's sponsors described it as an alternative to the Fed dividend cut and G Fee increase "pay fors" in the Senate version of H.R. 22, which the House did not adopt. However, a scorekeeping rule adopted in 2000 prohibits the scoring of such Fed surplus transfers as an offset in the Senate.

The Fed retains some of its profits in a surplus account, which currently has a balance of $29.3 billion. Since 1964, the Fed has set its surplus equal to the amount of capital that private banks are required to pay in as members of the Federal Reserve System. Together, the paid-in capital and surplus represent the total capital of the Fed, loosely analogous to the capital that private banks hold. But unlike a private bank's capital, "if a Reserve Bank were to incur an overall loss, its capital would not fall, rather it would suspend remitting to the Treasury until such time as it had returned to positive earnings and had earned back any losses to date," according to a Fed working paper.

The Fed earns income on its holdings of Treasury and mortgage-backed securities that exceed its expenses. The Fed's net income (hereinafter referred to as profits) is used to pay dividends to banks on paid-in capital, add to its surplus, and make remittances to Treasury, where they become general revenues. In 2014, the Fed earned profits of $101.3 billion, of which $1.6 billion were used to pay dividends, $1.1 billion were added to the surplus, and $96.9 billion were remitted to the Treasury.

Since the Fed began setting its surplus equal to paid-in capital in 1964, its surplus has not fallen on an annual basis, but there were reductions in some years before that. In some of those years, the surplus was reduced to meet dividend payments to banks. Thus, eliminating the surplus makes it more likely that dividends will not be paid promptly. GAO found that the Fed has occasionally needed to draw from its surplus on a weekly basis. Annual losses are more likely in the next few years, however, because of the Fed's normalization policy. The Fed working paper forecasts no losses in the next 10 years under a baseline scenario, but losses for up to 6½ years under alternative scenarios.

Because the Fed cannot be declared insolvent and can never run out of funding (since there is no limit on how much it
can expand the monetary base), there would arguably be few practical implications of the Fed suffering losses, regardless of whether it had a surplus. The Fed could erase those losses over time using profits in future years (which means those profits would not be remitted to the Treasury). Even if eliminating the surplus posed few practical problems, it might negatively affect the Fed's credibility. The Fed could be perceived as financially weaker or less self-sufficient, and therefore less independent from Congress and the Treasury. The Fed's position on the proposal is reportedly that "[u]sing the resources of the Federal Reserve to finance fiscal spending sets a bad precedent. It infringes on the independence of the central bank and weakens fiscal discipline."

Laws requiring the Fed to transfer the surplus to Treasury, as was done in FY1997, FY1998, and FY2000, led to a one-time gain in federal revenues. Since those laws only prohibited the Fed from replenishing the surplus in the same fiscal year, those gains were cancelled out by reduced remittances in subsequent years when the Fed replenished the surplus.

By contrast, H.Amdt. 824 and H.R. 3189 would permanently eliminate the surplus, which CBO estimated would result in an initial gain in revenues of $29 billion. Because the Fed would no longer be adding to the surplus each year, CBO estimates that remittances by the Fed to Treasury in future years would also be $50 billion higher over the next 10 years. Partly offsetting that increase in remittances, CBO assumes the Fed would "sterilize," or offset the effects of the transfer to Treasury on monetary conditions, by selling an equivalent amount of assets. CBO estimates that selling securities would reduce future remittances by $20 billion because the Fed would earn less interest income on its assets in the future (because it held fewer assets).

Alternatively, if the Fed "monetizes" the transfer to Treasury by allowing the monetary base to expand, then future profits (and remittances) would be lowered because bank reserves, which the Fed pays interest on, will ultimately be higher. It could be argued that the Fed does not currently use the money supply as a main policy indicator, making it less likely the Fed would respond to the transfer by selling assets. Or the Fed might choose to offset the change in monetary conditions caused by the transfer by raising interest rates, which would reduce future remittances because it would increase the interest the Fed pays banks on reserves.

If the Fed does sell Treasury securities to private investors, the government would no longer be paying interest on those securities to a federal agency that remits them back to Treasury. For that reason, former Fed chair Ben Bernanke said the proposal "amounts to 'paying' for the spending by issuing new government debt," making it "a budgetary sleight-of-hand that would count funds that are already designated for the Treasury as 'new' revenue." Likewise, CBO stated that "the transfer of surplus funds from the Federal Reserve to the Treasury has no import for the fiscal status of the federal government ... where the funds reside has no economic significance." By contrast, a reduction in the Fed dividend represents new federal revenue in this view because those funds are currently paid to private banks.