Milking Banks For Highways, Part II

Norbert Michel

September 8, 2015

Its August recess over, Congress must get down to business. And one key piece of unfinished business is the highway-funding bill.

Congress has mishandled the Highway Trust Fund for decades. And since 2008, it has spent more money than it takes in for highway projects. Unfortunately, they've consistently handled the problem by employing their favorite solution: find more revenue elsewhere.

At the Cato Institute's 2014 monetary conference, former Cleveland Fed President Jerry Jordan made light of the federal government's propensity to tax everything.

> "In economics, we talk about stocks and flows; politicians see two sources of tax revenue. In business and finance, we talk about balance sheets and income statements; politicians see two sources of tax revenue. In households, we talk about wealth and income; politicians see two sources of tax revenue. In New York, California, and no doubt other places, people like to have dogs and cats as pets; politicians see two sources of tax revenue."

Back then, of course, Jerry didn't know that Congress would soon try to exploit the Federal Reserve System as a source of tax revenue to pay for highway spending.

As little sense as it makes economically, Congress is poised to take most of the dividends the Fed pays to its member banks to help finance the new highway bill.

When I first wrote about this in July, I was holding out a tiny bit of hope that Congress would scrap the idea of using this dividend as an offset. (The original proposal does nothing to address the long-term highway-spending problem, and, as my colleague Michael Sargent points out, it actually exacerbates the situation because it adds spending for new programs).

It's all but a given now, though, that Congress will commandeer the dividend to pay for something—if not for highways, then for something else.

It's unclear who came up with the idea to go after the dividend, but a new American Banker article quotes an anonymous Democratic staffer on the rather dubious rationale:

> "Large financial institutions have an incentive to participate in the Fed system, and we saw the dividend as an unnecessary and wasteful subsidy."

A subsidy?

To join the Federal Reserve System, banks have to buy stock in the system equivalent to 6% of their total paid-up capital stock and surplus. Half is paid in up front, with the other 3% to be held as a cash reserve.

Because this amount can no longer be used for any other purpose, the Fed pays the banks a 6 percent dividend every year. (Shareholders in a public company can trade or sell their stock, but that's not the case here.) That's not a subsidy: that's compensation.

The details are still being developed, but it appears Congress wants to cut the dividend from 6% to 1.5% for "large" banks, however those get defined.

Regardless, the dividend reduction amounts to a tax, just as any other source of federal revenue. So it's reasonable to expect banks to eventually change their behavior in some way.

Perhaps they'll be able to pass on most of the cost to their customers. Or maybe they'll exit the Federal Reserve System.

While banks may have good reasons to remain in the system, leaving would not change the requirement to maintain a reserve account at the same District Fed Bank. And many large banks (all bank holding companies with assets of more than $50 billion) will remain regulated by the Fed either way.

Besides, if the 2008 crisis is any indication, the Fed won't offer emergency loans *only* to its member banks.

At the very least this sort of change should take place after careful consideration in either the House or Senate's committee of jurisdiction. As Rep. Bill Huizenga (R-Mich.) recently argued:

> "From a process standpoint, this is extremely troubling to me and many others. I'm not aware of any fulsome debate or discussion in recent history regarding the ownership structure of the Federal Reserve Banks, and further we should always be wary of changing a 100-year-old structure in an effort to simply pay for something else."

Huizenga's cautious approach seems more than reasonable.

And there's no lack of irony in the fact that some of the very same people dead-set against auditing the Fed's monetary policy decisions under the guise of protecting the central bank's independence are perfectly willing to use the Fed as a piggy bank.

On a positive note, this entire episode exposes the Federal Reserve System for what it actually is: an arm of the federal government.

The Federal Reserve Act stipulates that all annual profits from the Fed's operations have to be turned over to the Treasury. Typically, this amounts to billions of dollars each year. Over the last decade,the Fed's annual remittances have ranged from approximately $19 billion (in 2004) to $88 billion (in 2012).

Now, Congress wants to syphon even more money out of the Federal Reserve. Hijacking the dividend would set a dangerous precedent for future raids on bank funds, particularly regarding interest on reserves (IOR).

Currently, the Fed pays banks 0.25 percent interest on more than $2.5 trillion in excess reserves. In 2013 and 2014, these payments totaled $5.2 billion and $6.7, respectively.

But what happens when interest rates rise? (It's worth repeating that the Fed does not simply make market interest rates whatever it wants them to be.)

Suppose that in a few years the economy takes off, and interest rates get closer to historic norms, with the fed funds rate near 3.5 percent. (The long-term average fed funds rate is more than 5 percent.)

If this scenario plays out, we can expect a similar IOR rate. This rate translates into an IOR payment to financial firms of almost $100 billion, more than 10 times the current amount.

In other words, Treasury would start losing out on a major source of revenue. If lawmakers are willing to divert roughly $16 billion from the Federal Reserve System to pay for highway spending, how far will they go to stop a $100 billion revenue loss to the Treasury?

Central bank independence will be an afterthought.

But the Fed will be further exposed for what it really is: a government agency that provides revenue to the Treasury. And that revenue is our money, even if Congress wants to pretend that banks pay taxes instead of people.

This whole episode also underscores the fact that the Highway Trust Fund isn't actually a fund, by any normal understanding of the term. Tapping banks for highways makes a complete mockery of the "user pays" principle that is supposed to guide highway spending.

In many ways this bill is the same old tax-and-spend policy we're used to in Washington, regardless of which political party is in the majority.