Federal Reserve dividends: Wrong road for a highway funding fix

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Even seasoned watchers of the Federal Reserve were shocked when the Senate attempted to change an obscure dividend rate paid by the Fed to the banks, which are technically the owners of the Federal Reserve System. This interest rate had been set more than a century ago and never altered, even as the rest of the Federal Reserve System, leadership, mission, and responsibilities have undergone significant changes. One of the many problems with this proposal is that it did not receive consideration from any committee of jurisdiction in Congress. There have been no hearings focused on the issue. Perhaps worst of all, such would set a dangerous precedent in which changes to the Federal Reserve, including ways in which it conducts monetary policy could be used to fund anything, as in this case it is being used to fund a surface transportation bill.

As former Senate Banking Committee staff, from different sides of the aisle, we have both spent considerable time examining the Federal Reserve. While we have strong differences of opinion on a number of Federal Reserve issues, both of us believe that the Federal Reserve Act could be improved. But we also believe changes to the Fed should result from careful deliberation and be not used as a random piggy bank for the topic de jour.

To be clear, we are not endorsing the current dividend rate of 6 percent as the proper figure for eternity. Perhaps the current 6 percent is not the right number – although we note that it has existed for more than a century-- untouched. We simply think it is hard to make such conclusions in the absence of analysis, which up to this point have been solely lacking. What will the effects be of such a change on regulated banks that choose to switch their regulator as a result of this change? What are the precedents for additional legislative changes to how the Fed conducts monetary policy? Is this the start of Congress going down a road to change Federal Reserve tools to come up with money for unrelated purposes?

A GAO study could well be the appropriate place to start this analysis. We applaud Financial Services Chairman Hensarling (R-Texas) for requesting one and believe that Congress should wait to see the results before acting. Congressional hearings would be another avenue to unearth the potential ramifications from such a move. Bipartisan support for such a path has emerged in the form a letter by Reps. Huizenga (R-Mich) and Foster (D-Ill) urging Congress to wait and think before they act. We agree with this.

Even if both parties concluded that the current dividend policy should change, is it right to use it as funding for any random program? The current proposal is to use it to fund the highway bill (which covers highways, public transit, and other parts of surface transportation). Traditionally, surface transportation investment has received protected budgetary treatment because it uses revenue derived from user fees such as the gas tax. This precedent has been eroded in recent years as Congress has not made the tough choices necessary to equalize spending and revenue. But Members are elected to make hard decisions. Senators such as Bob Corker (R-Tenn.) and Chris Murphy (D-Conn.) have proposed raising the gas tax to equal investment. Others might propose cutting spending to match current revenues. We may differ on which proposal we'd prefer, but we applaud these members of Congress for making tough choices and not trying one-time gimmicks that set dangerous precedents.

Tying Federal Reserve dividend reductions to transportation creates a path for other unrelated demands to tap the Fed. If transportation, why not farm subsidies? Or healthcare? Perhaps of greater concern is that once dividends are exhausted, what other Fed levers could Congress divert? A central part of the Fed's current exit strategy is paying interest on excess reserves. This tool, granted to Congress only recently at the Fed's request, creates a floor under market rates and can, in theory, help constrain future inflation. Yet such could also offer an attractive funding stream for Congress. Do we really want Congress making decisions on what tools the Federal Reserve should have as a basis to conduct monetary policy with an incentive of 'scorable savings'? We think not.

It's also worth noting that the dividends are paid on stock that member banks were required to pay into the Federal Reserve System as a condition of membership. As a general rule government should honor its promises. Written clearly into statute is that when a bank pays into the system, it gets a 6 percent dividend on its stock. Changing that deal with no debate is not equitable nor does it set a good precedent for incentives by banks, some of which can still choose whether to be a member of the Federal Reserve System. And nor has this always been a good deal for banks. For much of the Fed's history, its member banks would have earned more holding 10-year treasuries than they did holding system stock. Yet at no time did Congress raise the rate it had set, even though much of the root cause of inflation had to do with choices made by Congress and the Federal Reserve.

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