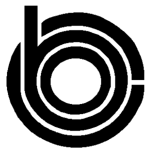

CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

September 5, 1997

H.R. 2323
The Small Business Banking Act of 1997
As introduced on July 31, 1997

SUMMARY

H.R. 2323 would direct the Federal Reserve to pay interest on required reserves held on deposit at the Federal Reserve, and would also repeal the prohibition on depository institutions paying interest on demand deposits of businesses. CBO estimates that the provisions would reduce governmental receipts by $260 million in 1998 and $660 million over the 1998-2002 period, assuming enactment on September 30, 1997. All of the budget effect occurs from the provisions affecting payment of interest on required reserves. Because enacting H.R. 2323 would affect receipts, pay-as-you-go procedures would apply to the bill.

H.R. 2323 contains no intergovernmental mandates as defined in the Unfunded Mandates Reform Act of 1995 (UMRA) and would not have a significant effect on the budgets of state, local, or tribal governments. In addition, the bill would impose no new private-sector mandates as defined in UMRA.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of H.R. 2323, all to revenues, is shown in the following table.

	By Fiscal Year, in Millions of Dollars					
	1998	1999	2000	2001	2002	2003-2007
REVENUES						
Proposed Changes	-260	-115	-90	-95	-100	-575

The source of the budget effect is the federal payment based on the profits of the Federal Reserve System. The Federal Reserve remits its profits to the Treasury, and those payments are classified as governmental receipts, or revenue, in the federal budget. Any additional income or costs to the Federal Reserve, therefore, can affect the federal budget. The Federal Reserve's largest source of income is interest from its holdings of Treasury securities. In effect, the Federal Reserve invests in Treasury securities the required reserves and issues of currency that comprise the bulk of its liabilities. Since the Federal Reserve pays no interest on required reserves or currency, and the Treasury Department pays the Federal Reserve interest on its security holdings, the Federal Reserve earns profits.

Paying Interest on Required Reserve Balances

H.R. 2323 would direct the Federal Reserve to pay interest on the required reserves that depository institutions hold on deposit at the Federal Reserve ("required reserve balances"). That payment would cause a shift in profits between the Federal Reserve and depository institutions that, on net, would reduce governmental receipts. The budgetary effect can be divided into two components. First, as a direct effect, the bill would cause the Federal Reserve to pay interest on the level of its required reserve balances expected under current law, reducing its net income and, therefore, governmental receipts. The reduced receipts would be offset only partially by increased corporate income tax receipts from the higher profits of depository institutions. Second, as an induced effect, the availability of interest on reserves would cause depository institutions to increase their level of reserve deposits at the Federal Reserve. The Federal Reserve invests required reserve balances at a greater rate than it would pay on them. The induced effect would increase governmental receipts on net, but enough to offset only partially the loss from the first effect.

Direct Effect: Because depository institutions earn no return on required reserve balances, they have an incentive to minimize such balances. Required reserve balances measured

almost $30 billion at the end of 1993, but have since fallen dramatically to about $9 billion today. The expansion of certain consumer sweep accounts, as widely reported, has caused the sharp decline. In typical sweep accounts, banks shift overnight their depositors' funds from demand deposits, against which reserves are required, into savings accounts, against which no reserves are required. The banks shift the funds back the next business day. Recent advances in computer technology have made the shifting feasible for many consumer accounts. Sweep accounts for business demand deposits have been in place for over 20 years. Under current law, we expect the expansion of consumer sweep accounts to continue for the next couple of years and required reserve balances to decline further to about $6.5 billion in 1998 and nearly $4.5 billion by 1999 and 2000. Thereafter, we project them to rise gradually at the rate of growth of GDP, reaching nearly $5 billion in 2002 and over $6 billion by 2007.

H.R. 2323 would permit the Federal Reserve to set the interest rate it would pay on required reserve balances, but the rate would be limited to no more than the return on its portfolio of Treasury securities during the previous quarter. That limit should not be constraining during the projection period, given CBO's baseline projection for interest rates. The Federal Reserve has indicated that it would choose to pay an interest rate near the federal funds rate, perhaps 10 basis points or so lower to account for the lack of risk. That rate is currently below the Federal Reserve's portfolio return, as it usually is, and CBO projects it to remain so. CBO assumes, therefore, that the Federal Reserve would pay a rate near the federal funds rate, projected to reach about 5.9 percent in 1998 and then decline to about 4.7 percent by 2000 and thereafter. As a result, CBO projects that the bill would cause the Federal Reserve to pay interest to depository institutions of about $380 million in 1998 on the $6.5 billion of required reserve balances expected under current law. Interest payments would fall in the following two years because of reductions in interest rates and reserves, reaching $230 million in 1999 and $210 million in 2000. Over the period from 1998 through 2002, interest payments would total about $1.3 billion. Those payments would reduce the profits of the Federal Reserve--and hence its payment to the Treasury--by the same amount.

Because receipts of interest by depository institutions would increase their profits by the same amount that the Federal Reserve's profits declined, overall corporate profits in the economy would remain unchanged. Assuming that the depository institutions face a marginal tax rate on corporate income of 25 percent, we estimate that corporate income tax receipts would increase by about $95 million in 1998 and $315 million through 2002 as a result of the additional interest income. That increase in receipts would offset one-quarter of the reduction in governmental receipts from reduced Federal Reserve profits. Thus, the net revenue loss to the federal government would be about $285 million in fiscal year 1998 and $950 million over the period from 1998 through 2002.

It is possible that, instead of retaining the additional interest income, depository institutions might pass some of the increased profits through to their business and consumer customers by raising interest rates on deposits or lowering rates on loans. If a complete passthrough did occur, then the customers--not the depository institutions--would accrue the income and pay the additional taxes. The increase in income tax revenues would be roughly similar to that estimated without such a passthrough assumption.

Induced Effect: If the Federal Reserve paid interest on required reserve balances, a response by depository institutions would produce a second budgetary effect that would reduce--but not eliminate--the net revenue loss from the direct effect. In particular, based on information provided by the Board of Governors of the Federal Reserve System, we would expect required reserves to increase because institutions would close down a significant share of their recent consumer sweep accounts and maintain a higher level of required reserves. By doing so, the institutions could eliminate the costs of maintaining the sweep accounts and receive a return on the required reserves. However, the return--approximately the federal funds rate--would likely be lower than they could receive with free use of the funds from the sweep accounts. CBO assumes that by 2000 depository institutions would eliminate half of all sweep accounts currently in existence, and three-quarters of those that would otherwise be undertaken. As a result, depository institutions would increase their deposits on which required reserves are calculated. We project that required reserve balances would increase by over $14 billion in 2000 and by nearly $16 billion by 2002, above the level expected under current law.

Although the Federal Reserve would pay interest on the induced reserves at approximately the federal funds rate, it would invest the reserves in Treasury securities, earning a rate of return in excess of the rate it paid by an amount estimated at between 0.6 and 0.7 percentage point. As a result of the rate differential, the Federal Reserve would generate additional profits of about $400 million through 2002 and return them to the Treasury as governmental receipts. Other corporate profits, including those of the firms that generate the computerized sweep account software and the depository institutions, would decline on net, however, by the same amount as the increase in the Federal Reserve's profits. (Again, overall corporate profits in the economy would be unchanged.) The reduced profits of other corporations would cause corporate income tax receipts to fall, assuming the same marginal tax rate of 25 percent as before, by about $100 million through 2002. The overall net effect of this induced effect would be to increase governmental receipts by $30 million in 1998 and nearly $300 million over the 1998-2002 period. The induced revenue effect, therefore, offsets about 30 percent of the five-year revenue loss estimated for the direct effect. The offset percentage increases over time to about 40 percent by 2002, because it takes time for the sweep accounts to be dismantled. The overall estimated budgetary effect of the bill--including both direct and induced effects--is a reduction in revenues of $260 million in 1998 and $660 million over the

1998-2002 period. Over the period from 2003 through 2007, the overall revenue loss would total about $575 million, making the 10-year revenue loss total over $1.2 billion.

Paying Interest on Business Demand Deposits

H.R. 2323 would also repeal the prohibition on depository institutions paying interest on demand deposits of businesses. That policy could potentially affect the level of required reserve balances by prompting depository institutions to end some of the sweep account programs put in place many years ago for business demand deposits. Because those sweep accounts have been in place so long, compared to the more recent consumer sweep accounts, the response by depository institutions is extremely uncertain. CBO has no basis for providing an estimate of that response. Any response, furthermore, would likely be small relative to that incorporated into the budget effects described above.

PAY-AS-YOU-GO CONSIDERATIONS

The Balanced Budget and Emergency Deficit Control Act of 1985 sets up pay-as-you-go procedures for legislation affecting direct spending or receipts. CBO estimates that H.R. 2323 would reduce receipts by $1.235 billion over the period from 1998 through 2007.

INTERGOVERNMENTAL AND PRIVATE-SECTOR IMPACT

H.R. 2323 contains no intergovernmental mandates as defined in UMRA and would not have a significant effect on the budgets of state, local, or tribal governments.

Regarding private-sector mandates, the bill would authorize the Board of Governors of the Federal Reserve System to prescribe regulations concerning the responsibilities of correspondent banks that maintain balances at the Federal Reserve on behalf of other institutions. Such private institutions as commercial banks, Federal Home Loan Banks and Corporate Credit Unions serve as correspondent banks for many depository institutions that are not members of the Federal Reserve. Based on information provided by the Board of Governors of the Federal Reserve System, CBO expects the Federal Reserve would not use its authority to issue regulations unless problems arose in the crediting and distribution of interest earnings. Thus, this bill would impose no new private-sector mandates as defined by UMRA. If after a period of time the Federal Reserve determined a rule was necessary, the Federal Reserve indicates that the form a rule would most likely take is to require that correspondent banks pass the interest earnings back to the institutions for which they

maintain required balances at the Federal Reserve. The cost to the correspondent banks of complying with such a rule would be negligible.

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