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Public and Private Institutions in the Federal Reserve

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Abstract
The mix of public and private governance in the Federal Reserve System makes it an interesting case of entangled political economy. Does the governance of the Board of Governors differ significantly from that of the district banks? I argue that it does. Besides their significantly different organizational and accountability structures, I show two distinct trajectories of growth for the district banks versus the Board of Governors using budget and employment data from 1987 through 2014. The Board of Governors seems to be purely a government agency, while the district banks are much more like private entities. If district banks face incentives and have institutional features that make them act like private entities—constraining growth in budget and employment, developing and implementing new technology, and being responsive to market feedback—then we can expect them to implement better monetary policy and financial oversight than the bureaucratic Board of Governors does.

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> *"Monetary developments during the past few decades have, I believe, been determined far more by the institutional structure of the Federal Reserve and external pressures than by the intentions, knowledge, or personal characteristics of the persons who appeared to be in charge."*
> —Milton Friedman (1985, p. 4)

I. The Federal Reserve and Its Independence

Since the 2008 financial crisis, the Federal Reserve System has had an increasingly prominent role in the financial markets. Over the past seven years, the Fed has grown significantly both in size and in its influence over the performance of various financial markets.

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Supporting the banking system during the crisis more than doubled the Fed's balance sheet as it gave liquidity to banks (and nonbanks) and bought their "toxic" mortgage-backed securities. Now, its balance sheet stands at $3.9 trillion (as of June 1, 2015), more than four and a half times larger than in June 2008. The Fed's influence has also grown significantly due to its broader regulatory role in the banking system under the 2010 Dodd-Frank financial reform bill. Bankers, investors, and pundits try to guess what the Fed will do next because billions of dollars are at stake.

Besides being one of the most influential organizations in the United States, the Federal Reserve's institutional and organizational structures give us an interesting case of entangled political economy. The Fed has also engaged in many "unconventional" monetary policies and programs since the financial crisis. Some of these policies and programs are public; others are opaque. Why has the Fed more than quadrupled its balance sheet in less than ten years? What consequences will its unprecedented expansion have? When will it raise interest rates? How will it respond to the next crisis? And most importantly, should we reform the Fed, and if so, what reforms should we make? We can only answer these questions if we understand what incentives the Board of Governors faces and how they differ from the incentives faced by the district banks. Successful reform will require changing the Fed's structure, not just setting new statutory goals.

An important question is whether or not the Federal Reserve operates independently of political considerations. The literature on Fed independence is divided between those who claim that it is indeed independent (Wallace and Warner 1985; Maier 2002; Caporale and Grier 2005; Blinder 2010) and those who claim it is not (Friedman 1985, 2009; Timberlake 1993; Chappell, MacGregor, and Vermilyea 2005; Meltzer 2009; White 2012; Selgin, Lastrapes, and White 2012; Boettke and Smith 2013a, 2013b). The conflicting results of studies about the Fed's independence should not be surprising for two reasons. First, the subject is complex and there are multiple methods of defining independence. Second, although some scholars have addressed the public-private nature of the Federal Reserve System (Rowe 1966; Woolley 1986), most of the independence studies fail to distinguish sufficiently between the Board of Governors, the district banks, and the Federal Open Market Committee (FOMC). This paper contributes to the independence literature by further clarifying the public and private aspects of the system and by introducing new evidence to support that distinction.

But what are people referring to when they talk about "the Fed"? Is it a single unified organization? How does it make decisions and carry them out? People clearly believe the chairman of the Board of Governors wields a lot of power because Janet Yellen's (and formerly Ben Bernanke's) name appears frequently in conversations about the Fed. Their belief is not without justification. Silber (2012) argues that the board chair exercises a great deal of influence over other board members. She not only leads the Board of Governors, she also chairs the FOMC, meaning she sets its agenda. But just how much does the chair influence monetary policy and what are her constraints? When people talk about the Fed, they are usually referring to decisions made by the FOMC about interest rate targets, lending, or bond-buying programs, and they often attribute those decisions to the chairman. A brief synopsis of the Federal Reserve System will answer some of these questions.

There are three major components of the Federal Reserve System. First, there is the Board of Governors, which is a government agency based in Washington, DC. The board is composed of seven governors, including the chairman, and thousands of staff. Second, there are twelve district or regional Federal Reserve banks. These are not branches of the Board of Governors. They are privately owned banks with separate financial statements and separate boards of directors. Third, there is the FOMC, which meets every six weeks to determine monetary and other general policy for the Federal Reserve System.

The FOMC has twelve voting members: the seven governors, the president of the New York Fed, and four other district bank presidents who serve yearly on a rotating basis. This setup gives the board a majority of the vote. It also limits the ability of the district bank presidents to form a coalition. Table 1 and figure 2, for example, show that although there are more monetary hawks among district bank presidents than among the governors, they regularly rotate off of the committee.

With regard to a "hawkish" coalition, the transition from the 2014 FOMC to the 2015 FOMC saw Richmond bank president Jeffrey Lacker join the committee while Richard Fisher, Loretta Mester, and Charles Plosser all left it. Esther George, who would be categorized as a hawk, is also out of the picture due to the rotation of district bank presidents on the FOMC.

Table 1. Dovishness of the FOMC

2014 Members of the FOMC		**2015 Members of the FOMC**	
Janet Yellen, Board of Governors, Chair	1	Janet Yellen, Board of Governors, Chair	1
William C. Dudley, New York, Vice Chair	1	William C. Dudley, New York, Vice Chair	1
Lael Brainard, Board of Governors	2	Lael Brainard, Board of Governors	2
Stanley Fischer, Board of Governors	2	Stanley Fischer, Board of Governors	2
Richard W. Fisher, Dallas	5	Charles L. Evans, Chicago	1
Narayana Kocherlakota, Minneapolis	1	Jeffrey M. Lacker, Richmond	3
Loretta Mester, Cleveland	4	Dennis P. Lockhart, Atlanta	1
Charles I. Plosser, Philadelphia	5	John C. Williams, San Francisco	2
Jerome H. Powell, Board of Governors	3	Jerome H. Powell, Board of Governors	3
Daniel K. Tarullo, Board of Governors	2	Daniel K. Tarullo, Board of Governors	2
Average ranking >	**2.6**	**Average ranking >**	**1.8**

Source: Deustche Bank.
Note: dove = 1, hawk = 5

Part of what makes the Fed so interesting and convoluted is that the Board of Governors and the district banks are two distinct and different *types* of organizations. This observation is not unlike Salter's (2013) point that not all nominal gross domestic product (NGDP) targeting is the same. Stable NGDP emerging under a free banking system is different from a formal NGDP policy target. The twelve district banks behave more like private organizations than like government agencies. They are owned by member banks, they innovate and respond to changes in the market, and they compete with other organizations like the Clearing House Interbank Payments System. District banks have different information and pressures than the board. So although it may appear on the surface that the district banks and the board are the same, their underlying institutional structures are different.

In contrast, the board can be characterized as a political organization because of its governance structures and because it operates according to political/bureaucratic principles. Its directives come from political priorities, not feedback from market participants.

When I use the term "Fed" throughout the rest of the paper, I am either referring to the entire Federal Reserve System or to the FOMC.

In the following section, I argue that the Board of Governors is a government agency and raise several objections to treating the district banks like private organizations. Section 3 answers those objections and argues that district banks are more like private entities. In section 4, I consider and reject the centralization theory that the Fed is a single unified organization ruled by the board. I conclude in section 5 by considering recent trends in the Federal Reserve System and the implications of those trends for public policy.

II. The Board of Governors As a Government Organization

Although few economists, if pressed on the issue, would call the Board of Governors a private organization, many argue strongly that it is independent (Wallace and Warner 1985; Maier 2002; Caporale and Grier 2005; Blinder 2010). But independent from what? It is true that Congress has less control over the Federal Reserve than it has over other government agencies. But does that make the Fed an objective agency that is solely, or even primarily, interested in improving the economy? The Fed has many hallmarks of a government agency. It operates in a political environment and faces bureaucratic incentives to expand its authority, staff, and budget. In fact, the board, and really the whole Federal Reserve System, was created to influence monetary policy and the financial system according to the interests of the state (Cargill 2014).

The board qualifies as a government agency for several reasons. It was created and subsequently modified by act of Congress. It also reports directly to Congress twice a year. Although Congress does not direct the Board's activity day to day, Congress has the authority to change both the tools and the policy objectives of the Fed. The board is also a regulatory agency responsible for writing regulations, not simply carrying them out. No one owns the Board of Governors. The closest thing to a residual claimant is the Treasury, which receives all the profits from the Federal Reserve System. The support staff for the board are counted as government employees and the board has a government (.gov) website. Finally, the governors themselves are political appointees of the president and are confirmed by the Senate.

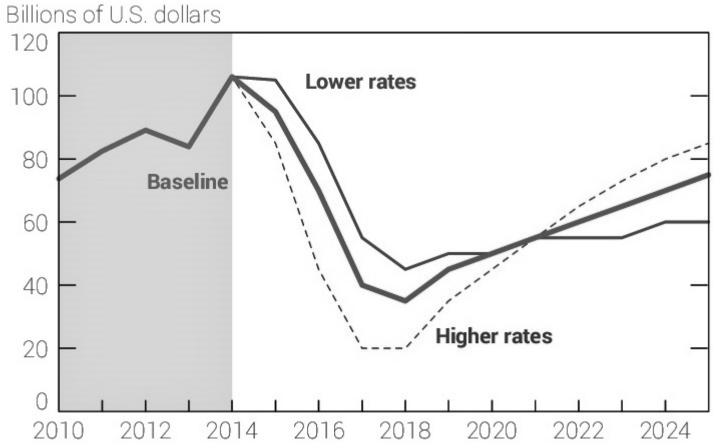
The Federal Reserve Act of 1913 created the Federal Reserve Board (the precursor to the Board of Governors) to advise the district banks. Both the treasury secretary and the comptroller of the currency were members. The Board had few regulations to administer and acted more like an advisory than a supervisory body. There was no monetary policy to speak of. The goal of the Federal Reserve System was to promote an "elastic currency" by rediscounting bills. It was later modified under the Banking Act of 1935 to become the Board of Governors of the Federal Reserve System. That act also created the FOMC. Now the board oversees the entire system through the FOMC and regulates not only the district banks, but the entire commercial banking industry.

Another governmental aspect of the board is its regulatory authority. The Dodd-Frank financial reform bill gave the Federal Reserve more extensive power over the financial system by creating the Consumer Financial Protection Bureau (CFPB), which operates within the Federal Reserve System. In conjunction with the CFPB, the board not only has the power to enforce existing financial regulations, but also the power to create new ones. Being able to decree new regulations generally falls under the purview of governments, not markets. As a government regulator, the board is tasked with seeing banks as objects to be regulated or corrected, not as customers.

A third important reason that the Board of Governors should be considered part of the federal government is its ownership structure. No one really "owns" the board. The residual claimant of the board's revenues is technically the US Treasury, though it exercises no direct authority over the board. By law, the board must report to Congress, rather than to shareholders, twice a year about its monetary policies and its outlook on the economy. But even Congress has little knowledge or authority to direct the board's day to day activities. And since remittances from the Fed have been at record highs (see figure 1), many in Congress have been unwilling to confront the board.

Fed policy has supported the government by strengthening Fannie Mae and Freddie Mac's financial positions after they entered government conservatorship by buying their agency mortgage-backed securities. And like most of the federal government, the Board of Governors is located in Washington, DC, where it interacts with other government agencies—not only the Treasury, but also the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Comptroller of the Currency, and others.

Figure 1. Projections for Fed Remittances to the Treasury



Source: Federal Reserve Bank of New York.
Notes: Figures for 2010–2014 (shaded area) are realized returns. Projected figures are rounded. Higher- and lower-rate scenarios use baseline interest rates plus or minus 100 basis points.

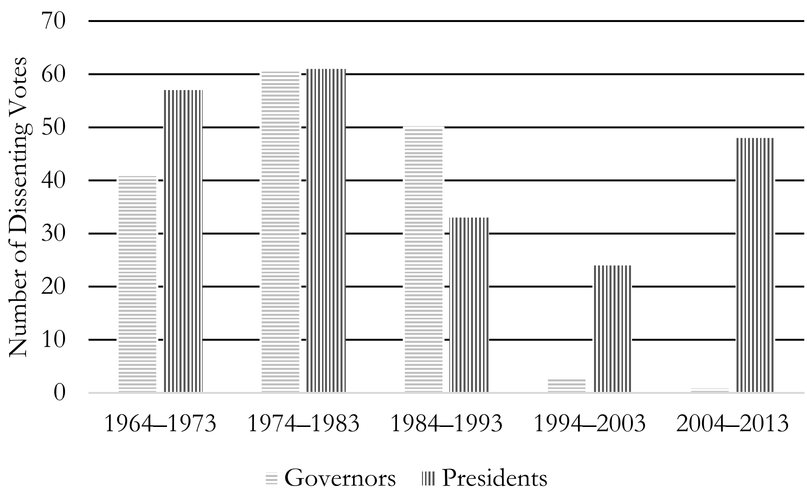
Fourth, and perhaps most important, the governors are political appointees chosen by the president and confirmed by the Senate. Technically, they have fourteen-year terms, a system intended to limit the number of governors any single president could appoint. But a strong tradition of Fed governors stepping down before their terms are finished has developed. Conti-Brown (2015, pp. 30–33) points out that every president since the Great Depression except Kennedy has been able to appoint Fed governors at a greater rate than two per term.[1] Gerald Ford appointed five Fed governors during his less than two and a half year term. And that was after Nixon had appointed five governors during his five and a half years in office.

That trend of high turnover can be seen in the vacancies on the Board of Governors. From March to June of 2014, there were three vacancies. As of May 2016, there are still two empty positions. In fact, the board has not had a full seven members since 2007, and even that was for a brief time. In the last decade, there has been a trend of governors serving for shorter terms. Part of the reason for the decline in term length may be the increasing power of the chairman—dissent from governors has all but disappeared in the past

[1] The seven governors are supposed to be staggered in their terms by two years—meaning that every two years, a governor will need to be replaced. So theoretically, a president should only have the opportunity to appoint two governors during a four-year term.

decade (Thornton and Wheelock 2014). In contrast, dissent from district bank presidents has grown substantially (see figure 2).

Figure 2. Dissenting Votes in the FOMC



Source: Author's chart based on data from Thornton and Wheelock (2014).

The high turnover rate means that the Board of Governors is more likely to be oriented toward politics and Washington than toward economic efficiency or the interests of the whole country (Cargill 2014). Kettl (1986, p. 75) and Meltzer (2009, p. 135), for example, show that US presidents can pressure governors to resign before their term ends. Boettke and Smith (2013b) point out that every chairman of the Board of Governors has caved to political pressure from Congress at some point during their tenure. The selection process for board governors has a critical political element.

Rather than being selected solely on merit, governors often need political connections, too. Self-selection may be an even more important factor than political connections. Those who are optimistic about the Fed's ability to manage the economy are far more willing to join the board than skeptics are. Both parties have a history of nominating moderate governors who generally support more expansive monetary policy over contractionary monetary policy. This has contributed to the inflationary drift over the past 100 years documented by Selgin, Lastrapes, and White (2012).

Not surprisingly, governors are appointed for political reasons. President Obama, for example, has flagrantly disregarded the geographic requirements of section 10 of the Federal Reserve Act and has appointed two governors who are technically not eligible to be governors (Calabria 2012). Section 10 of the Federal Reserve Act states:

> In selecting the members of the Board, *not more than one of whom shall be selected from any one Federal Reserve district*, the President shall have due regard to a fair representation of the financial, agricultural, industrial, and commercial interests, and geographical divisions of the country. (National Bank Act 1935, emphasis added)[2]

Arguing that the district banks act like private organizations may seem like a losing proposition. The whole system, including the district banks, was created by Congress and it has a unique relationship with the federal government. Even some of the district banks emphasize how they serve the "public interest." As the Dallas Fed's website puts it, "The Fed has a unique public/private structure that operates independently within government but not independent of it" (Dallas Federal Reserve Bank 2013). Furthermore, the Board of Governors, which supervises and regulates the district banks, is clearly a government agency.

One would be tempted, therefore, to think that the district banks are part of the government as well since they share many characteristics of the board and are regulated by the board. Their similarities with the board include: being created by an act of Congress, implementing banking regulations (although they cannot create new regulations like the board can), remitting their profits to the Treasury, and having the unique government privilege of creating bank reserves. But the story is complicated by the mix of public and private functions in their governance, goals, and operations. They are examples of entangled political economy (Wagner 2009, 2010).

Besides their similarities with the Board of Governors, the district banks are also regulated by the board and the FOMC, which is usually controlled by the board, in the following ways: which bank regulations to enforce; what penalty and discount rates to charge; whether to purchase or sell certain securities; appointment of three of the bank's nine directors, including the chairman and vice chairman; approval of the bank president; approval of the budget; and, often,

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[2] This passage comes from section 10 of the Federal Reserve Act. Jeremy Stein and Jerome Powell were both appointed to be governors by President Obama in 2012. Stein was the second governor from the Boston Fed district and Powell was the second governor from the Richmond Fed district.

approval of new programs or new technology. The district banks also remit all of their profits to the Treasury after paying their shareholders. They are also unlike private banks in that they can issue government liabilities in exchange for goods, services, and assets.

Because of their similarities and the amount of control exerted by the Board of Governors, it is easy to attribute a minor and passive role to the district banks and to treat them as extensions of the Board. According to that treatment, the trends I highlight in the next section could be explained by the board taking power and resources from the district banks in order to improve its own status. I give several reasons for rejecting this theory, however, including its incentive incompatibility and its lack of evidence. I will explain why district banks should be modeled as highly regulated private firms—an example of entangled political economy—and how the character of their organization has important ramifications for monetary policy and banking regulation.

III. District Banks As Private Enterprises

How do the district banks differ from the Board of Governors? Can we really consider them to be distinct organizations? Although they are certainly not the epitome of private competitive firms, the way they are governed and the way they behave suggest that they are, in fact, private entities. Despite the similarities, the district banks differ from the board in critical ways. They compete for customers in some of the services that they provide; they are primarily accountable to their member banks and districts, not to a legislative body, through their board of directors; they implement regulations differently than the board does; and they have incentives to introduce new technology and to improve processes due to formal and informal competition.

After the 1980 Monetary Control Act (MCA), the district banks had to begin charging for many of their banking services. Although all depository institutions are required to hold reserves at the Fed, they can choose to use different payment clearing services. Many of these services, particularly payment-clearing services, are available from private, non-Fed alternatives. One competing service is the Clearing House Interbank Payments System. Competition gives the district banks incentives to keep costs low, improve the services they offer, and cultivate relationships with their customers. Member banks also have the option of moving from one district to another if they are dissatisfied with their treatment.[3] District banks must provide useful services and less onerous regulatory enforcement in order to keep their customers.

The regulatory role of the district banks differs, too, even though it is handed down from the board. Regulations can be enforced in two ways: coercion and cooperation. When governments enforce regulations, there is little room for appeal or cooperation. The governing entity forces exact compliance under threat of fines or imprisonment. Cooperative regulation, on the other hand, does not mean businesses can choose whether or not to comply with a particular regulation. Instead, it means that they have flexibility in how to comply. Private entities prefer market regulation to government regulation because market regulators, such as auditing firms or professional associations, have strong incentives to work with the entities that they are regulating and to provide value to them. If they do not, their customers can go to other market regulators. Because of their private governance and the availability of alternatives, district banks act more like market regulators than the board does.

An example of market versus government enforcement of regulation is how the district Fed banks switched to external auditing. The Board of Governors used to send its own auditors to district Fed banks. This experience was often not a profitable or pleasant one for the district banks. Eventually, one or two district banks pushed for using outside auditing firms instead of the Board of Governors. Once those districts experimented with using an outside auditing firm, their experience improved so much that the rest of the district banks quickly followed suit. Although they were still fulfilling a regulatory requirement, the flexibility of having multiple auditing firms to choose from outside of the board made complying with that regulation more flexible and cooperative.

District Fed banks are also privately owned by their member banks. Although members' shares in the district bank cannot be transferred and yield a fixed return, having shareholders that it must pay dividends to makes district banks accountable to private

[3] Dissatisfaction with the district Fed bank is not likely to be the sole, or even the primary, reason a bank would move. I am arguing, however, that its dissatisfaction is not entirely trivial and that its treatment by the district bank may be enough to tip the scales toward moving. Therefore, there is some competition, even if only along a relatively small margin.

organizations. Control of the board of directors, therefore, does not come from legislatures or from populist elections, but from the industries the district banks are serving, which are also its owners. District banks are primarily governed by businessmen, bankers, and other community leaders rather than by political appointees or longtime board staff with political connections. The board only appoints three of the nine directors for each bank. Furthermore, there are geographic restrictions on whom the board can appoint. The member banks of each district elect the other six: three representing banking and financial interests, and three representing broader community interests. The board of directors then elects the bank's president.

If the district banks were government agencies instead of private organizations, how would we expect them to behave? They would have no significant incentive to reduce employment, improve efficiency, or keep their customers happy. We would expect something akin to the post office (without the perpetual deficit problems). Although there are some similarities, the district banks have had employment *decline* over the last twenty-five years. How could that be when they do not have budget deficits to consider like the post office does? The most plausible explanation is that they are privately governed, compete with private organizations and with each other, and have incentives to innovate.

The district banks are less centralized than the board. They are each responsible for a different region of the country. They have independent staff and different customers; therefore, they provide different types of education, outreach, and services to best meet the needs of their local communities. We would expect a great deal of unanimity on the FOMC if the district banks were entirely dominated by the board. Yet, it is well established that district bank presidents dissent from FOMC decisions far more frequently than governors do and have a much stronger tendency to dissent in favor of tighter monetary policy (Wooley 1984, pp. 63–64; Havrilesky and Schweitzer 1990; Havrilesky and Gildea 1991; Chappell, MacGregor, and Vermilyea 2005).[4] Figure 3 shows how much more likely district bank presidents have been to dissent from FOMC decisions in recent years than governors have been.

[4] Esther George, the current president of the Kansas City Fed, demonstrates this finding. She dissented from the FOMC's monetary policy decisions at all but one meeting in 2013.

I have made several theoretical arguments about why the district banks have different incentives than the Board of Governors. But what other evidence do we have that the district banks act more like regulated private firms in contrast to the board acting like a government bureau? If the board and the districts have different incentives, then we might expect to see clear differences between the growth trajectories of the district banks and that of the Board of Governors. We do see clear differences, in fact, between the trajectories of employment and operating budgets between the district banks and the Board of Governors from 1986 through 2014. The data are from the Board of Governors' annual reports. Given all the talk about the bureaucracy and growth of the Fed in recent years, as well as all the evidence for it being a government agency, it may seem surprising that overall employment only increased for the Board of Governors, not for the district banks (see figure 3). Every single district bank had fewer employees in 2014 than in 1986.

Declining employment over twenty-eight years is hardly the mark of a government agency. Neither is introducing new technology: government agencies rarely advocate new technology. But the district banks have repeatedly adopted new technology to provide better services to their customers at lower cost. Check imaging, interdistrict specialization, and external audits are just three examples (Bauer and Hancock 1993, 1995; Bauer and Ferrier 1996; Berger, Hancock, and Marquardt 1996; Adams, Bauer, and Sickles 2004).

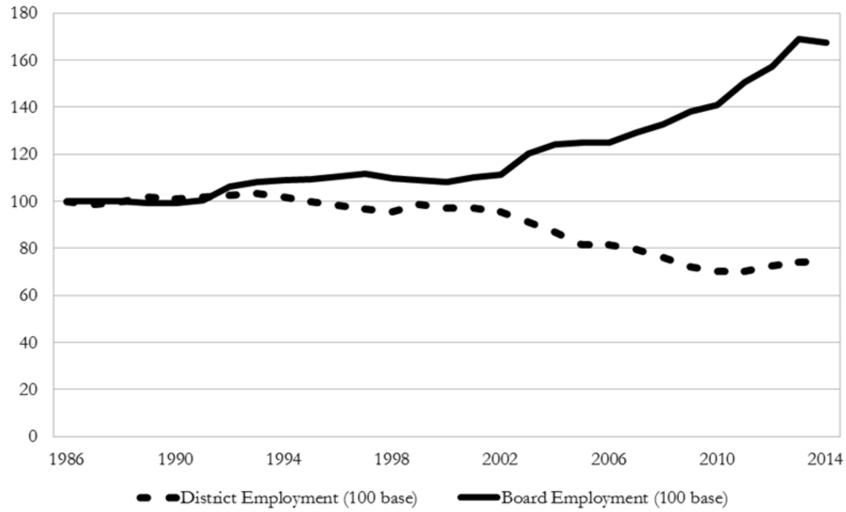
Similarly striking is the fact that the district banks' operating budgets have only grown at a moderate pace, in real terms, from 1986 through 2014 (see figure 4). The real operating budget of the Board of Governors grew at a yearly rate of 4.13 percent annually for a total of 210.84 percent over the period (see table 2). And its budget was projected to reach 250 percent of its 1986 level, in real terms, in 2015.[5] The average real growth of the district banks' operating budgets, on the other hand, was 1.43 percent yearly and 48.9 percent overall.

Unlike the district banks, the board saw high and consistent growth in its employment and operating budgets year after year. This

[5] The board historically undershoots its budget. For example, in 2011, the board's actual expenses came in more than 7 percent under their "budgeted" amount. If the pattern continues, the board's budget in 2015 relative to 1986 would be 226 percent, not 250 percent.

outcome is not surprising given that it does not have to worry about satisfying customers or providing valuable services.

Figure 3. District Bank Employment versus Board Employment



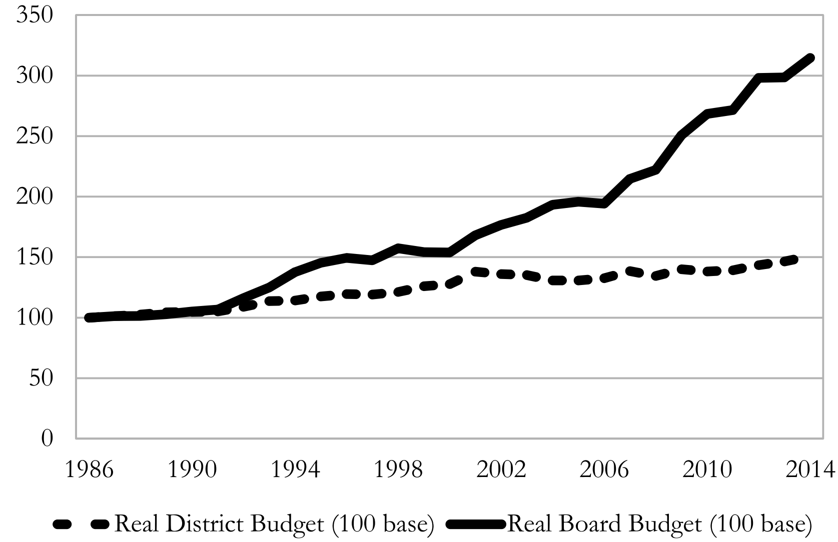
Source: Author's calculations based on data from the Board of Governors' annual reports.

Table 2. Federal Reserve Employment and Budget Growth Since 1987

	Percentage growth in employment 1987–2014	Percentage growth in real operating budgets 1987–2014	Average yearly budget growth
Boston	–34.60	48.34	1.47
New York	–17.50	82.58	2.25
Philadelphia	–27.30	44.97	1.38
Cleveland	–30.80	7.98	0.28
Richmond	–22.90	83.28	2.27
Atlanta	–27.10	46.39	1.42
Chicago	–47.90	11.57	0.41
St. Louis	–23.50	120.75	2.98
Minneapolis	5.10	52.99	1.59
Kansas City	–15.60	33.07	1.06
Dallas	–19.40	31.37	1.02
San Francisco	–35.90	18.66	0.64
All Districts	**–25.40**	**48.90**	**1.43**
Board of Governors	**67.41**	**210.84**	**4.13**

Source: Author's calculations based on data from the Board of Governors' Annual Reports.

Figure 4. District Bank Operating Budgets versus the Board Budget



Source: Author's calculations based on data from the Board of Governors' Annual Reports.

The growth of its operating budget and employment since 1986 affirms the governmental nature of the board. With minor exceptions, its growth follows an almost perfectly steady trajectory: *consistent growth* year after year, adding to the previous year's base. Its growth does not fluctuate with other economic variables and it matches federal spending growth fairly closely. But does this pattern just show the board centralizing power at the expense of its subsidiaries, the district banks? In the next section, I will argue that it does not.

IV. Contrasting Hypothesis

Let me strengthen my case, and put lingering doubts to rest, by showing how a competing explanation of why the district banks and the Board of Governors have had such strikingly different trajectories of employment and budget growth—the centralization hypothesis—is implausible. The centralization story claims that faster board growth can be explained by treating the district banks as its subsidiaries. If the board and the FOMC control the district banks, their private "ownership" would be irrelevant. The reasoning for this hypothesis proceeds in the following manner: the Board of Governors has been centralizing its operations by systematically extending its scope and influence while reducing the district banks' status. This centralization involves *both* increasing its resources and reducing or limiting those of the district banks. At first glance, the centralization story seems to match the trends of employment and budget growth pretty well. Yet, this explanation has a few problems and inconsistencies.

If district banks are simply board subsidiaries, the reduction in their employment and their moderate real budget growth should be the *direct result* of decisions made by the Board of Governors. We do not see much evidence that this is the modus operandi. District bank presidents do not protest the curtailment of their staff and budgets as we would expect if the board was explicitly attempting to curtail them. Also, we might expect to see a negative correlation between the employment and operating budgets of the district banks and that of the Board of Governors since, under this theory, the board is making decisions for both relative to one another.

Furthermore, the centralization story requires that the board take over the prerogatives and services of the district banks—transferring responsibility, and therefore authority and resources, to itself. District banks' primary expenses come from providing services to their member banks. Could it be that the trends of moderate budget growth and declining employment at the district banks are a result of those services being appropriated by the board? Few services have been transferred to the board in the past three decades. The district banks still do most of what they did in 1987; they just do it more efficiently using new technology. The board, on the other hand, still does not provide direct services to banks. Its growth has primarily been in the branches of research, regulatory oversight, and support staff. So centralization of services is, at best, an inadequate explanation for the decline in district bank budgets and employment.

Finally, the centralization theory has a major internal inconsistency. If the board is increasing its control of the Federal Reserve System because it wants more power and influence, it will not focus on strengthening itself *at the expense* of the district banks, but only *relative* to them. If the board maintains its dominant position in the Federal Reserve System, all else equal, it should want larger district banks beneath it, just as any other government agency would prefer more and larger departments to fewer.

That is a big inconsistency. District banks have had declining employment and relatively low budget growth for twenty-eight years. Even if the board staged an internal coup at some point, it surely would not have lasted twenty-eight years! This story only makes sense if the district banks are not board subsidiaries.

One last inconsistency with the centralization story is the troubling case of the New York Fed. If the board was trying to centralize power at the districts' expense, why did they not clip the wings of the most powerful district bank? If anything, the New York Fed has grown more influential in the past decade. There are two reasons why the New York Fed is more like a government agency than all the other district banks are. First, it has a permanent seat on the FOMC like the governors do. Second, it is the primary organization carrying out the FOMC's directives, such as open-market operations. Because the New York Fed is tied so closely with the FOMC and the board, its growth could be considered an example of the board extending its influence through one of its "departments." The other district banks remain more independent.

V. Conclusion

This paper has addressed several common misconceptions about the Federal Reserve System. It is not a unitary organization but a composite one. When most people refer to the Fed, they are talking about the chair of the Board of Governors or the FOMC. The Board of Governors is not a private organization. It is a government agency—though with far less oversight and accountability than most government agencies. The district banks are not merely branches or subsidiaries of the board (not yet, at least). They sell services directly to banks and compete with private alternatives. They are owned by their member banks and are directed by business and community leaders. And they have a strong history of introducing new technology, reducing costs, and reducing their employment—all uncharacteristic of government.

I have also argued that the preponderance of theory and evidence supports the claim that district banks are like private organizations while the Board of Governors is a government organization. In the past twenty-five years, the board has seen its employment increase 67 percent and its operating budget grow 214 percent in real terms. In stark contrast, the district banks saw their total employment *fall* 25 percent while their operating budgets only grew 51 percent in real terms over the same period. Although both are lumped under the label of "the Fed," in practice, they have distinct incentives, goals, and accountability. These differences may have important implications for what monetary policy is chosen, how regulations are enforced, and which is more likely to act on useful knowledge and respond more quickly to the market's needs. Uniform policies implemented by the board are less likely to meet the various needs of local areas than policies made by district banks because the board lacks clear market feedback and competition.

The shortcomings of board policies become more severe as it grows more powerful. The board's staff and budget have grown tremendously, along with its authority and discretion. What implications does this have for the Federal Reserve System and for society? The district banks will likely become less and less independent over time. As the board forms a larger and larger share of the overall system, its influence on the district banks will continue to grow. And since it wields veto power over their budgets and over the FOMC, district presidents do not have the de jure or the de facto power to reverse the board's growth. Only a sea change in public opinion toward greater economic freedom and financial deregulation, as Calabria (2014) describes, can reverse this trend through congressional action. But as the board continues increasing in power and discretion, we can expect less effective policies and less accountability for the monetary system as a whole.

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