april

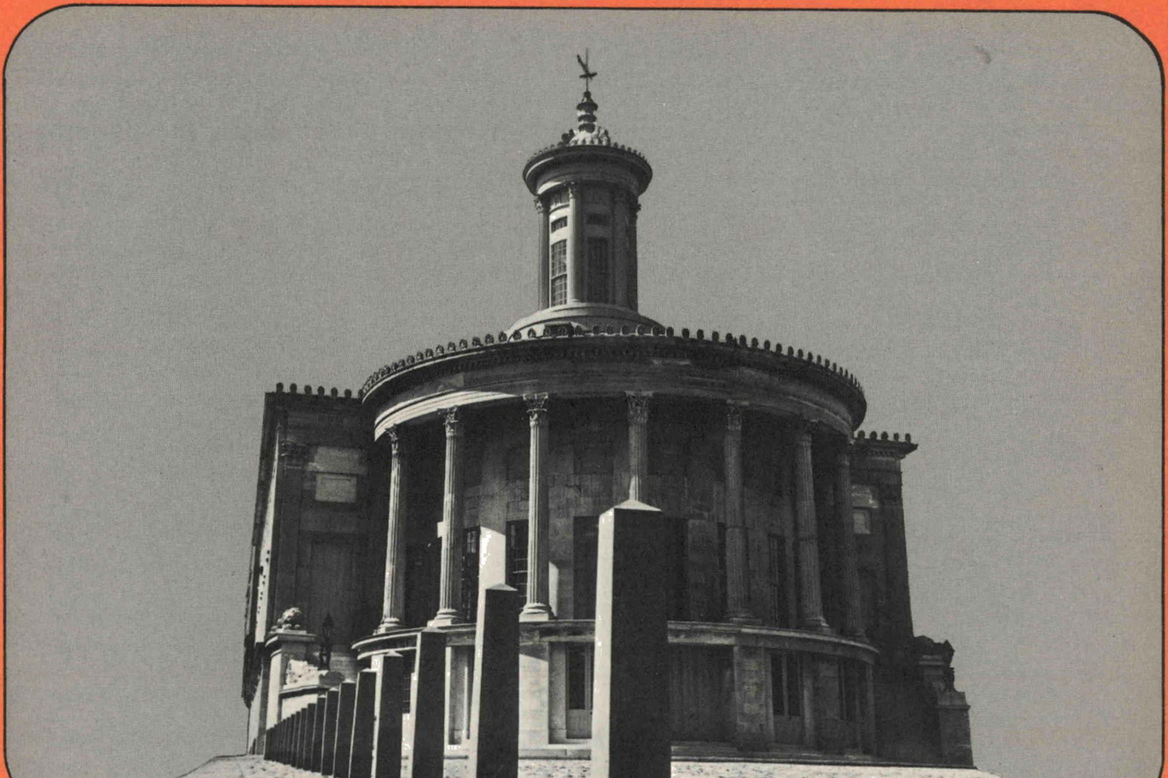
Stock Market Commission Fees:
Competition or Bust . . . or Be Busted?

Closing Uncle Sam's Trade Gap

Fiscal Alternatives for Philadelphia

FEDERAL RESERVE BANK of PHILADELPHIA

business review



1972

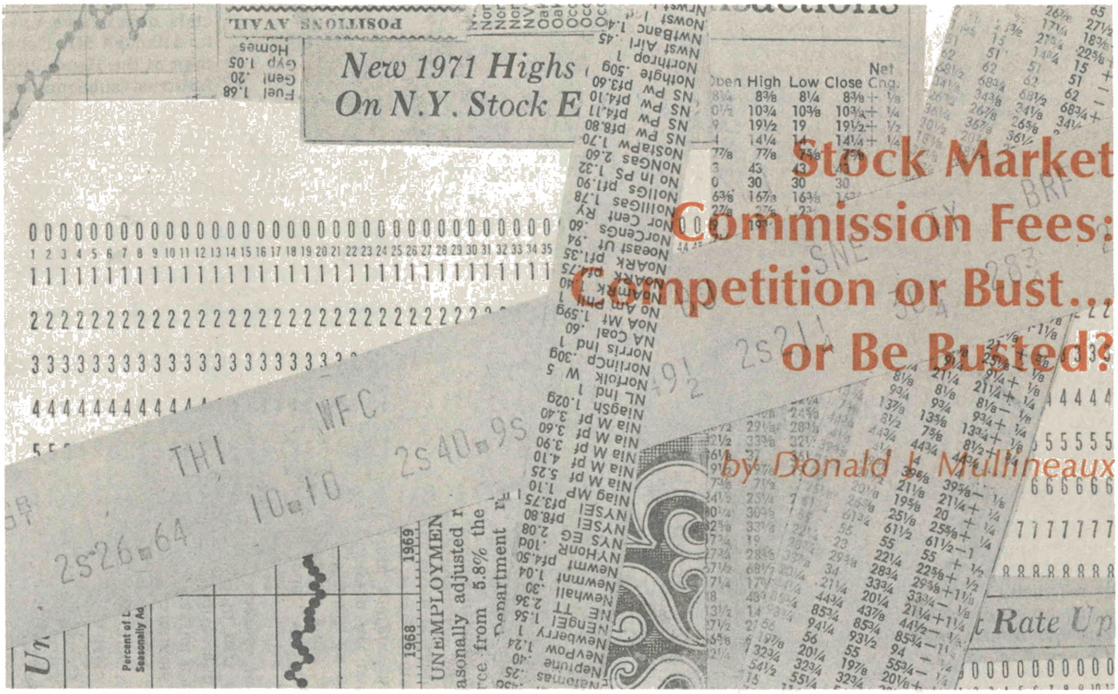
Stock Market Commission Fees: Competition or Bust . . . or Be Busted?
. . . Fixed-fee commissions on stock market trading are on the wane as institutional investors and others hasten the trend toward a competitive-fee system.

Closing Uncle Sam's Trade Gap
. . . Although America's '71 trade balance showed a deficit, currency realignments and controls on domestic inflation may enhance the prospects of reestablishing a surplus.

Fiscal Alternatives for Philadelphia
. . . Covering Philadelphia's fiscal deficit may involve not only using local funds, but also tapping the resources of the Commonwealth and Federal governments.

On our cover: Located at 3rd, Walnut, and Dock streets is the Philadelphia Exchange building. Designed by William Strickland and built between 1832 and 1834, it housed the Philadelphia Stock Exchange for many years. Only the exterior has been restored.

BUSINESS REVIEW is produced in the Department of Research. Ronald B. Williams is Art Director and Manager, Graphic Services. The authors will be glad to receive comments on their articles.
Requests for additional copies should be addressed to Public Information, Federal Reserve Bank of Philadelphia, Philadelphia, Pennsylvania 19101.



Stock Market Commission Fees: Competition or Bust... or Be Busted?

by Donald J. Mullineaux

In 1776 Adam Smith, the father of modern economics, wrote:

> People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.[1]

Less than two decades later, 24 securities traders gave lasting testimony to Smith's discerning view of businessmen's behavior when they gathered under a buttonwood tree at the foot of Wall Street to create a "regular market" in financial securities. Their first order of business was to *fix prices* by solemnly pledging that "we will not buy or sell from this day for any person whatsoever, any kind of public stock at less than one-quarter percent commission on the specie value." In such nonmarket fashion, a bulwark of modern American capitalism—the New York Stock Exchange (NYSE)—was born.

For nearly two centuries, Big Board brokers faithfully adhered to their ancestors' pledge. Today, they still resist the appeals of customers, regulatory agencies, and economists to let their charges be determined — like most other services — by the market forces of supply and demand. Member brokers' reluctance to open the Exchange to competition is grounded in their contention that free-market pricing will reduce their volume of business. Economists suggest, however, that competitively determined fees for purchases and sales of stock should *increase* NYSE business and that there is no logical justification for maintaining price floors in the market for equity shares.

While the movement to a competitive-fee system has finally been set in motion, there are several pitfalls that could slow its

[1] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations,* intro. M. Blaug (Homewood, Ill.: Richard D. Irwin, 1963), p. 103.

NYSE MINIMUM COMMISSIONS DEPEND ON VALUE OF THE TRADE*

	PRICE PER SHARE					
SIZE OF ORDER:	$10	$20	$30	$40	$50	$100
20 Shares	$ 8.40	$ 12.40	$ 16.40	$ 20.40	$ 23.00	$ 36.00
50 Shares	14.40	23.00	29.50	36.00	42.50	65.00
100 Shares	25.00	38.00	49.00	58.00	65.00	65.00
200 Shares	50.00	70.00	88.00	106.00	124.00	130.00
1000 Shares	172.00	262.00	322.00	362.00	402.00	602.00

*Schedule effective March 24, 1972.

extension to cover *all* stock transactions, regardless of size. These include the proposed legislation to exempt the NYSE from antitrust legislation and the view that small investors must be encouraged to deal in the market for common stocks by keeping the cost artificially low.

HOW THE COMMISSION SYSTEM WORKS

Under the fixed-commission arrangement, investors pay brokers a fee for executing orders to buy and sell shares of common stock. This fee depends on the price of the stock and the number of shares involved (see Table). The Board of Governors of the NYSE determines the minimum charge, subject to the approval of the Securities and Exchange Commission (SEC). If competition reigned, this charge would equal the cost to the firm of performing the brokerage function — arranging, executing, and clearing an exchange of equity shares — and would include a "normal" return for providing this service. The NYSE is a legally sanctioned cartel[2], however. This means that market incentives (such as entry of new firms) which would force commission charges to the level of the cost of performing an additional exchange are frustrated.

Brokers argue that the price floor does not eliminate competition, but merely shifts the battle for customers to the nonprice front. Most Exchange members offer "free" services such as custody of stock certificates, dividend collection, monthly statements, and investment advice to their customers. This method of doing business will prove satisfactory to the users of Exchange facilities provided they require these additional services, and their "price"—the premium of

[2] The number of "seats" on the NYSE is determined by the Board of Governors of the Exchange, a 33-man body which must approve all applications for membership. At the end of 1970 there were 572 member organizations in the Exchange.

actual brokerage charges above the cost of producing them — is not higher than it would be if these same services were obtained elsewhere.

The existence of this nonprice competition, however, does not mean the NYSE can ignore price competition. Shares of common stock can be traded anywhere, so that if the price of the NYSE's product (facilitation of exchange plus ancillary services) is pushed high enough, some customers will be driven away. Until 1968 there was little evidence that the fixed-commission system adversely affected the relative volume of business on the NYSE. Since then, however, increasing portions of NYSE-listed stocks have been traded on the 16 regional exchanges and on the "Third Market," where listed securities are traded "over-the-counter" (see Box for explanation of markets).

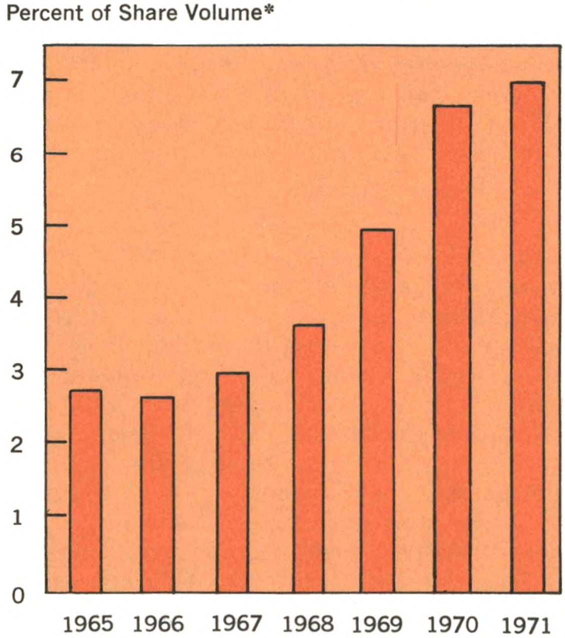
BUYING AND SELLING COMMON STOCK

Many of us know little about how shares of stock of established corporate giants and struggling neophyte firms are traded among the portfolios of some 30 million American investors. While stocks can be traded without the aid of an intermediary (broker), the high costs of locating a trading partner and negotiating an exchange means that most investors will use the broker's services. Stocks of well-established companies are typically accepted for trading ("listed") on organized "exchanges" such as the New York Stock Exchange and American Stock Exchange. On the NYSE, for example, some 1330 issues of domestic corporations have satisfied the requirements for listing. In addition to the NYSE and AMEX, there are 16 "regional exchanges" (such as the Pacific Coast and the Philadelphia-Baltimore-Washington exchanges). Their original purpose was to carry out transactions in stocks of *local* interest, but presently most trading on regional exchanges is in securities also traded on the NYSE. Although the relative volume of regional exchange business (excluding AMEX) has increased since 1965, the NYSE continues to account for the lion's share of exchange business — over 70 percent in 1970.

Trades on the organized exchanges are characterized by the "auction method." Brokers fill "market orders" to purchase shares of company XYZ by making bids at the "trading post" for XYZ on the floor of the exchange. The rules of business typically require that all bids to buy and offers to sell be made by open outcry and that *all* orders be brought to the floor. Thus, a purchaser obtains his stock at the lowest possible price at which someone is willing to sell. If there are no matching sell orders for XYZ at the time, the broker can obtain the stock from the "specialist," a special sort of exchange member who maintains an inventory of certain stocks for the purpose of buying and selling from the public.

Investors can only trade the issues of about 3000 companies on organized exchanges. Where, then, can they buy and sell the stocks of some 10,000 companies whose issues are not acceptable for exchange trading ("unlisted" securities)? The answer: in the "over-the-counter" (O-T-C) market. In this market, buying and selling orders are not matched at a centralized location such as an exchange floor, but rather through a massive network of telephone and teletype wires linking thousands of securities firms. The essence of the O-T-C market is that prices are arrived at by *negotiation* — by bargaining with the broker or dealer in question — and not by auction techniques. Listed securities can also be traded in the O-T-C market. Such transactions are referred to as "Third Market" trades.

CHART 1
THIRD-MARKET TRADES SOAR RELATIVE TO NYSE TRADES.



*Third-Market volume/NYSE volume.
Source: New York Stock Exchange **Fact Book,** 1971.

For example, share volume on the Third Market hit a new high in 1971, accounting for 7 percent of total NYSE trading volume as compared to only 2.7 percent in 1965 (see Chart 1). Moreover, while Third Market share trading increased at an average annual rate of over 34 percent from '67 through '71, NYSE volume increased only 8 percent yearly, and even declined in '69.

INSTITUTIONAL INVESTORS: CATALYSTS FOR COMPETITIVE RATES

When Wall Street historians begin tracing the decline and fall of the fixed-commission system, they will embark from the doorsteps of the institutional investors, such as banks, mutual and pension funds, and life insurance companies. Institutions have considerable incentive to scuttle the fixed-fee system, for the premium above cost these investors pay under such a system is considerably larger than that for small investors. Obviously, an order that is ten times as large as a round lot (100 shares) does not involve ten times as much telephoning, bookkeeping, execution, and delivery costs. Yet until this year, commission charges on a 1000-share order were ten times as large as the fees on the round-lot transaction. As the broker's profit per order increases with the size of the transaction, so does his customer's incentive to expropriate that portion of this profit he considers above "normal" for providing this service.

Until 1968, NYSE member brokers could discourage large institutions from taking their business elsewhere by offering an assortment of rebates or kickbacks of commission charges (some rebates were as large as 75 percent of the commission fee). However, late that year, the SEC approved an amendment to the NYSE constitution which prohibited customer-directed "give-ups," but allowed for fixed "volume discounts" on orders exceeding 1000 shares. The per-

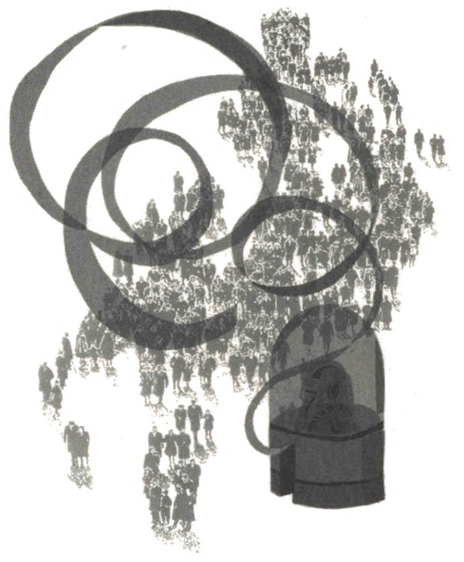
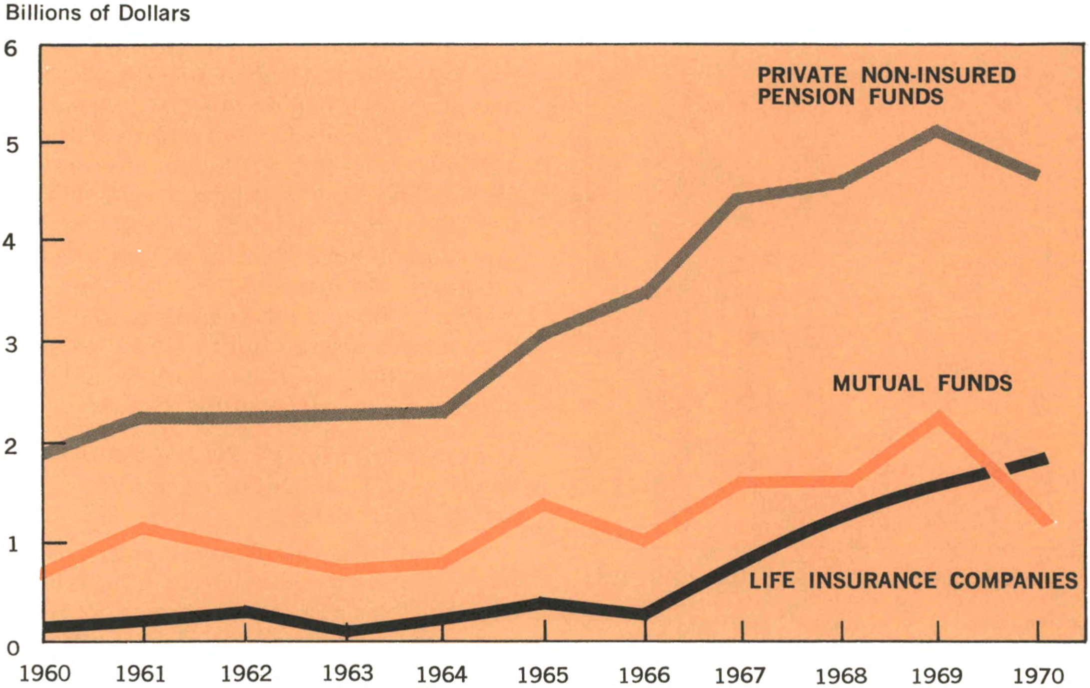


CHART 2
PENSION FUNDS PACE SPURT IN INSTITUTIONAL INVESTMENT.

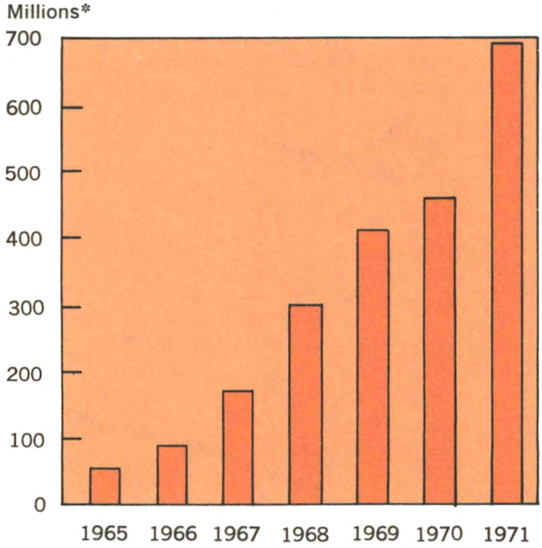


Source: **SEC Statistical Bulletin.**

centage discount on these large trades ranged from 48 percent for a $20 stock, to 8½ percent on $80 stocks, to nothing on stocks selling above this figure. Since the discount was inflexible and rebates were illegal, the incentive for institutions to trade off the floor of the NYSE grew, especially in high-priced stocks. Thus, most Third Market volume is accounted for by institutional investors, and a Fourth Market has arisen in which institutions deal directly with each other in negotiating exchanges and bypass the middleman altogether. In addition, large institutions have stepped up their campaign with the SEC to be admitted to the NYSE as member firms.[3]

[3] Institutions prefer to reduce trading costs by seeking exchange memberships rather than expanding the Fourth Market because dealing directly with potential trading partners requires disclosure of identity. Any prior exposure of interest is feared likely to affect price negotiations. Some *regional* exchanges do admit institutions (or subsidiaries thereof) as members. For instance, the Philadelphia-Baltimore-Washington Exchange lists the three largest insurance companies in the U.S. among its 42 institutional member firms. Until recently, the NYSE has been able to dissuade the SEC from permitting institutional membership, mainly by arguing that their admittance would induce these institutions to engage in "excessive" trading in order to generate commission income. This might conflict with customers' profit interests, member brokers contend. Last February the SEC announced that it favored exchange membership for brokerage affiliates of institutions, provided that a predominant portion of their business (more than 80 percent) comes from unaffiliated public customers.

CHART 3
GROWTH IN BIG BLOCKS REFLECTS INSTITUTIONAL ACTIVITY.



*Shares Traded in Units of Over 10,000.
Source: New York Stock Exchange **Fact Book,** 1971.

The pressures on the NYSE and the SEC to take action to stem the loss of large-customer business by instituting flexible commission charges were compounded by the expanded role these institutions have come to play in equity markets (see Charts 2 and 3). In the 1960s, institutional share volume grew almost five times as fast as individual investor volume. By 1970, institutions accounted for 56 percent of public share volume, compared to only 31 percent in 1960. And no one doubts that the trend of the '70s is toward more "institutionalization" of stock market activity.

In order to stem the flow of business away from the NYSE, member brokers moved toward flexible brokerage fees, but only after less-than-subtle prodding from the SEC and more-than-veiled threats from the Department of Justice. In April 1971 negotiated rates on the portion of trades over $500,000 ("overage") were established. This minimum transaction size for competitive fees will soon be reduced to $300,000, and the Chairman of the SEC recently announced that his Commission is aiming for a $100,000 cutoff for negotiated rates by 1974. Some observers have noted that since the Department of Justice has stated that it does not believe that fixed fees are either "required or justified," it may only be a matter of time until negotiated fees on *all* transactions are the norm. However, several pitfalls remain along the path to fully competitive pricing in securities markets.

FULLY COMPETITIVE FEES AROUND THE BEND — NOT IF BROKERS HAVE THEIR DRUTHERS

Though negotiated rates appear to be a juggernaut edging toward a fully competitive securities market, most member brokers and some stock market reformers (see Box on Martin Report) continue to resist the extension of competitive fees to smaller trades. The Exchange's official position is that elimination of minimum commissions would diminish incentive for Exchange membership, and thus *reduce* trading volume on the floor of the NYSE.[4] The maximum charge

[4] Another justification suggested by the NYSE for a fixed-fee mode of business was that the securities business constituted a "natural monopoly" such as electricity-supply and telephone companies. A monopoly is "natural" when the economic characteristics of an industry are such that competition automatically leads to all but one firm being driven from the market. As a result, entry into the industry must be regulated and prices determined in noncompetitive fashion. Economists have found the Exchange's statistical support for this contention to be severely wanting, however, and have presented contrary evidence which suggests that the securities industry is *not* characterized by economies of large-scale production. For a review of all the evidence, see R. West and S. Tinic, "Minimum Commission Rates on NYSE Transactions," *Bell Journal of Economics and Management Science,* 2 (Autumn 1971): 377-605.

THE MARTIN REPORT: REFORM OR THERAPY?

In August 1971, the much-awaited study of securities markets prepared by William McChesney Martin, former Chairman of the Federal Reserve Board and onetime President of the NYSE, was released to the public. While the Martin Report offered several broad recommendations for the industry — including centralization of the various exchanges — the fixed-commission system (with negotiated rates on trades over $500,000) was endorsed for the present, and the merits of a more competitive structure of fees received little consideration. The Report's neglect of the commission-fee problem is unfortunate since many of the questions considered are intimately related to the type of commission structure which should exist in equity markets. For example, on the question of institutional membership (which the Report opposes), it should be emphasized that competitive fees would remove much of the incentive of the investment intermediaries to apply for Exchange membership. Likewise, trading volume on the Third Market (which the Report suggests should be eliminated) would probably be restricted to trades in large "blocks" (10,000 shares or more) under a negotiated-rate regime.* In essence, the Martin Report treats the symptoms of a "malaise" (fragmented stock markets) whose ultimate cause (the fixed-fee system) was, for the most part, only touched upon. It is probably best viewed not as an instrument for reform, but an attempt to shore-up the existing system by closing the various loopholes for reducing trading costs. Past experience has shown that this approach typically leads to the expenditure of additional resources to devise new methods for avoiding the artificial constraints on trade.

*Very large transactions (block positioning) in listed securities in the O-T-C market might not be eliminated by competitive fees because such trades typically require a search for matching interest on the other side of the market rather than mere acceptance of a bid or offer. They, therefore, constitute a different product than smaller transactions. If O-T-C dealers have a better "feel" of block markets than Exchange specialists (perhaps because of their continuous and well-developed relationship with large customers), their ability to execute large trades will be superior to that of member brokers.

members pay for trading on the Exchange is a small floor broker's fee; nonmembers pay the same high commission rates charged to the public. Competitive rates would narrow this differential and would supposedly induce some firms to surrender their membership. Investors would suffer, the Exchange argues, because trades transacted in other markets are "inferior" products compared to those on the NYSE. The NYSE's strict self-regulation policy purportedly results in more and better surveillance to insure proper trading procedures are followed than on the regional exchanges or in the O-T-C market. Partly on the basis of this argument, the Exchange is seeking to slow or halt the spread of the competitive-fee system by seeking explicit exemption from antitrust legislation.

Some basic economic logic suggests, however, that competitive pricing will *boost* relative trading on the NYSE rather than cause the decline in business that brokers fear. The reason is simple. Under the fixed-free system of the NYSE, Third Market and regional exchange trading provide savings to cost-conscious customers which attract them to these markets. Competitively determined fees will eliminate this cost advantage.

A simple analogy makes this point clear. Consider the case of Jones, Smith, and Farnsworth, who make their living selling identical shoelaces in the same market area. Jones and Smith agree to form a trade association whose primary purpose is to fix the price of shoelaces. If they set the price above the cost of producing an additional pair of laces, however, Farnsworth will capture the entire market by setting a lower price, assuming everyone is aware of it. The reason that Smith and Jones can typically stay in business, despite the pesky Farnsworth, is that information concerning the markets is costly to obtain and the association may succeed in "differentiating" its product from Farnsworth's (different colors, longer guarantee, and the like). Should Smith and Jones allow competition to determine the price, however, the cost advantage accruing to Farnsworth's customers would be eliminated.

In the securities business, the "Third Market" dealer/broker has played the role of Farnsworth to the hilt. For once an investor decides to buy or sell shares of some listed stock, a complementary decision on where it should be traded is also required — on or off the NYSE (not all listed stocks are traded in the Third Market). The investor would naturally prefer to execute the transaction at the best available price and the lowest cost, including the cost of his time and effort as well as the nominal trading charges of the broker. Except for very large blocks of stock, however, trades on the floor of the NYSE are typically executed with lightning speed — perhaps before the customer hangs up the telephone after placing his order. The advantage of Third Market trading thus lies principally in its lower cost.[5]

Investors can achieve cost advantages in Third Market trades because the middleman often acts as a principal (dealer) in the transaction rather than an agent (broker). In such a case, the intermediary buys and sells shares for its own account at a "net" (retail) price which includes a "markup" over the (wholesale) price it paid to acquire the stock. Under the present commission system, this markup — which covers the cost of performing the brokerage charges — can be adjusted by Third Market firms to make their retail prices less than the sum of the NYSE price plus the fixed commission. But if NYSE commission charges were competitively determined, Third Market dealers could not profitably maintain their charges below those of the NYSE members. Trading volume on the Exchange would *increase* as many institutional customers returned to purchase the "superior" services of the NYSE. Member firms would consequently have little incentive to surrender their seats.

Thus, economic logic suggests that fixed-commission fees are neither necessary for the continued existence of an organized stock exchange nor vital for making its self-regulation policies effective. Consequently, passage of the proposed antitrust exemption would only grant the force of explicit government sanction to the present noncompetitive-pricing procedures of the Exchange and impede or reverse the movement toward competitive pricing in securities markets.

BUTTONWOOD IN REVERSE: MAXIMUM FEES?

A watchful government eye may also be required to prevent another potential pitfall in the movement toward a flexible-fee system. As the cutoff size slowly[6] declines to lower levels, the remaining fixed commission

[5] Lack of public disclosure of transactions *volume* constitutes yet another incentive for institutional trading of listed securities in the O-T-C market. Hopefully, this motivation will soon be eliminated when the SEC promulgates rules that all Third Market price and volume data be reported by dealer-brokers to the National Association of Securities Dealers for release to the public news media on a daily basis.

[6] The SEC's justification for moving to competitive rates in step-by-step fashion is that a "precipitate movement" toward a negotiated structure would effect such a severe decline in revenues in the securities industry that a "crisis of confidence" would be inevitable.

charges may attain a new rationale as the *maximum* (rather than minimum) charges permitted to be assessed for brokerage services. The argument may be advanced that price *ceilings* are necessary to stimulate small-investor participation in equity markets in order to insure the "depth, breadth, and liquidity" of the market. That such maximum charges will result in the same inefficiencies as the present system should be evident. If small investor charges are fixed below the cost of producing an additional exchange, brokers will either refuse to process small orders or attempt to offset their losses on smaller trades by charging their large customers prices which include premiums above the costs of production. Forcing brokers to accept unprofitable small trades will thus create incentives for large investors to expend resources in avoiding NYSE trading in precisely the same fashion as a *minimum* commission system.

If it becomes desirable to subsidize small trades for whatever reasons, methods involving tax deductions for commissions paid or direct subsidies likely will be more efficient than price fixing, which often results in a poor use of society's resources. Moreover, those who would argue that "large" investors should subsidize "small" investors on income-distribution grounds should recall that the *customers* of large institutional investors such as mutual and pension funds (who would finance these transfers) are typically less wealthy than those individuals who manage their own investment portfolios.

AFTER COMPETITIVE RATES: "SHAKEOUTS," "UNBUNDLING," AND HIGHER FEES FOR SMALL INVESTORS?

While large investors will benefit from a competitive-fee structure thanks to lower trading charges, many small investors may find their commission savings minuscule or possibly discover they are paying *higher* charges than under a fixed-fee system. For instance, some brokers have suggested that current total charges on small orders may be less than the processing cost of execution and delivery. Competitive rates would then drive these charges up since low rates on small transactions could no longer be supported by "excess" profits earned on large orders.

But even if commission charges remained at the current level or declined, many small investors would find that their *total* costs of dealing in the stock market had risen. For a competitive fee structure would force brokerage firms to assess separate charges for formerly "free" services such as certificate custody, dividend collection, and investment research and advice. Individual investors could then choose from this "unbundled" package only those services they wanted. But unless the cost of the ancillary services purchased was offset by a decline in trading fees, total trading costs would increase. As a result, the proportion of public trading accounted for by noninstitutional investors would probably decline even more rapidly than at present.

A completely flexible commission regime will likewise affect the structure of the brokerage industry. Inefficient firms cannot survive under the "discipline of the market." Thus, the trend to a flexible rate structure will be accompanied by a gradual "shakeout" of the least efficient securities firms, mostly through merger or acquisition. This does not mean, however, that, once all firms have adjusted to the competitive setting, a handful of giant firms will shape the securities industry. Just as thousands of "mom-and-pop" grocery stores compete with mammoths like A & P and Safeway, smaller securities firms will attract customers by emphasizing specialized services, convenience, and "the personal touch." For example, some firms might focus on investment counseling and portfolio management or other areas in which they can stress the "customer-relationship" aspect of their product.

A MANDATE FOR COMPETITIVE FEES?

Despite efforts on the part of the NYSE to retain the fixed-fee system, the Buttonwood Tree Agreement appears to be dying — a victim of competition. But while the regulatory agencies consider and debate the least painful path to interment, the death papers have not yet been signed. A firm commitment to fully competitive pricing would erase the current uncertainty concerning the future structure of securities markets and thereby smooth the process of adjustment within the industry. In the absence of such a mandate from the regulatory agencies, Congress may have to declare the present commission structure in explicit violation of U.S. antitrust laws. Only then could the public rest confident that the inequities and inefficiencies of the current noncompetitive system will not be perpetuated through antitrust exemption or small-investor subsidies. ■

NOW AVAILABLE BROCHURE AND FILM STRIP ON TRUTH IN LENDING

Truth in Lending became the law of the land in 1969. Since then the law, requiring uniform and meaningful disclosure of the cost of consumer credit, has been hailed as a major breakthrough in consumer protection. But despite considerable publicity, the general public is not very familiar with the law.

A brochure, "What Truth in Lending Means to You," cogently spells out the essentials of the law. Copies in both English and Spanish are available upon request from the Department of Bank and Public Relations, Federal Reserve Bank of Philadelphia, Philadelphia, Pennsylvania 19101.

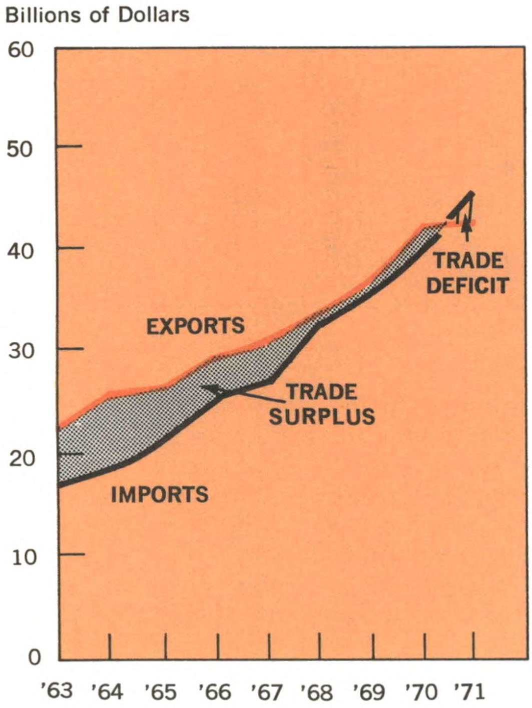
Available in English is a film strip on Regulation Z, Truth in Lending, for showing to consumer groups. This 20-minute presentation, developed by the Board of Governors of the Federal Reserve System, is designed for use with a Dukane project that uses 35mm film and plays a 33 RPM record synchronized with the film. Copies of the film strip can be purchased from the Board of Governors of the Federal Reserve System, Washington, D. C. 20551, for $10. It is available to groups in the Third Federal Reserve District without charge except for return postage.

Persons in the Third District may direct requests for loan of the film to Truth in Lending, Federal Reserve Bank of Philadelphia, Philadelphia, Pennsylvania 19101. Such requests should provide for several alternate presentation dates.

Closing Uncle Sam's Trade Gap

by Alan J. Krupnick

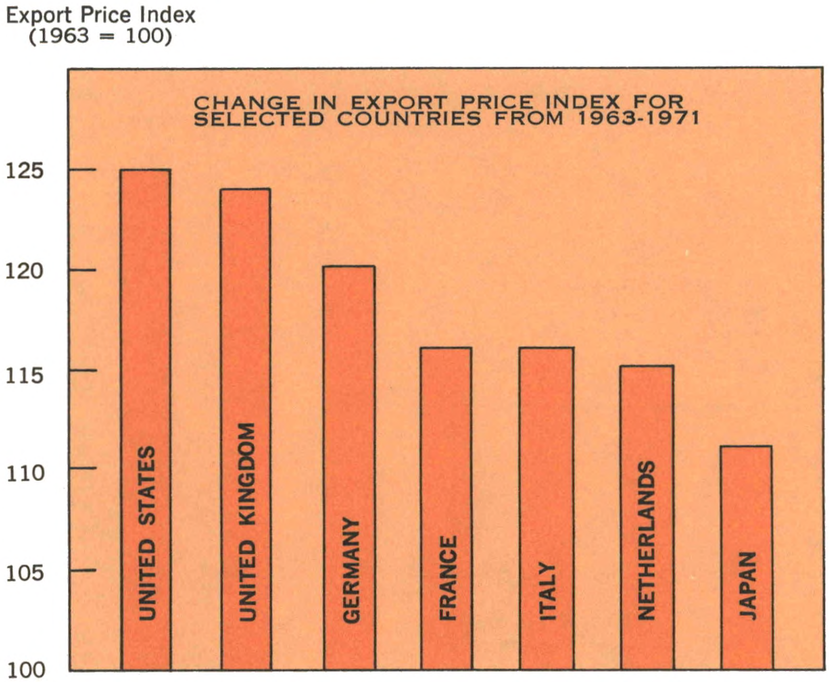
THE FIRST U.S. TRADE DEFICIT IN 77 YEARS . . .



Source: International Financial Statistics

Tried-'n-true formulas almost never seem to hold anymore. For years the U.S.'s international economic formula called for large trade surpluses offsetting large long-term capital outflows to keep the balance of payments reasonably in line. But as imports burgeoned in the late sixties our trade surpluses dwindled. Finally in 1971, with the additional effect of dock strikes, our trade account moved into a deficit.

RESULTED IN PART FROM AN INFLATIONARY SPURT IN EXPORT PRICES.

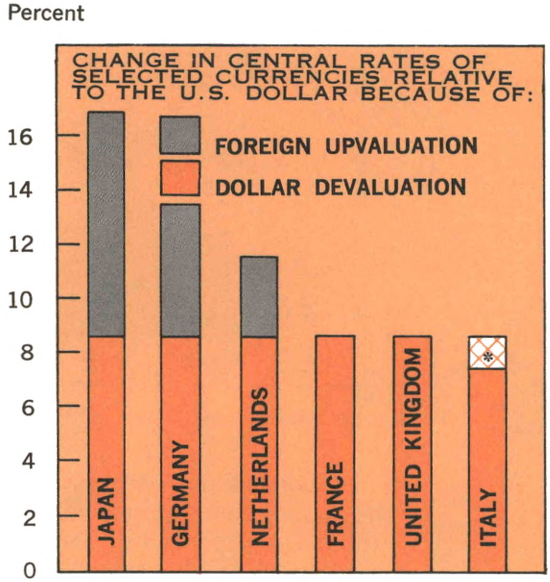


Source: International Financial Statistics

While several related forces contributed to the trade deficit, one has been gnawing at our trade surpluses for a number of years — domestic inflation. As a result, U.S. export prices have risen more rapidly than those of most other industrial nations. U.S. goods, therefore, have had fewer foreign buyers. Moreover, as inflation continued at home, American consumers found Volkswagens, Sonys, and bottles of Bordeaux relatively cheaper than their domestically produced counterparts. Hence, imports surged ahead of flagging exports.

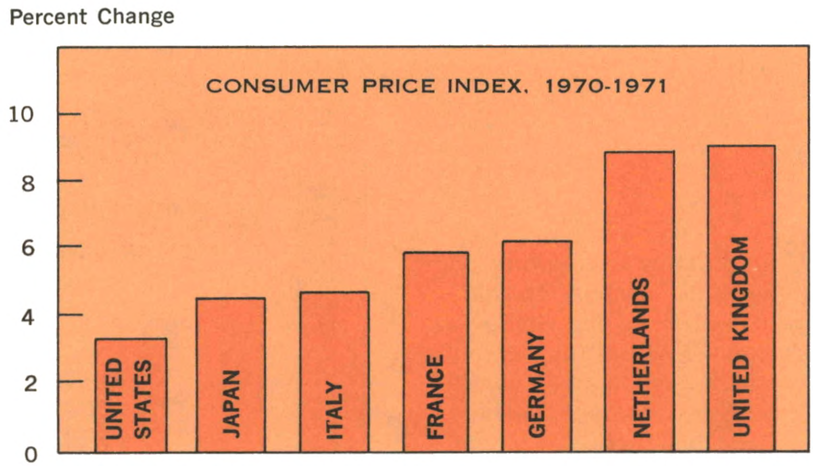
THE U.S. LOOKS TO A REALIGNMENT OF EXCHANGE RATES . . .

In part, the United States is counting on currency realignments to reverse its trade deficit. Lowering the price of the dollar in terms of other currencies makes our exports more competitive in foreign markets while making foreign goods less competitive here at home.



*Italian Devaluation of 1.09 Percent.
Source: International Monetary Fund, **International Financial News Survey,** December 22-30, 1971.

AND CURBING OF DOMESTIC INFLATION TO BALANCE ITS TRADE POSITION.



Source: International Financial Statistics

Controlling inflation at home, however, remains a key element in the U.S. trade balance. Using consumer prices as one measure of inflationary pressures, the most recent international comparisons show the U.S. doing a better job of slowing rising prices than most of our major trading partners. Additional progress in dampening the pace of inflation, of course, would enhance the prospects of reestablishing a trade surplus. ■

Fiscal Alternatives for Philadelphia[1]

by Anita A. Summers

As we try to devise ways of dissolving and resolving Philadelphia's financial deficit, we should recognize that we are not alone. We are not alone in having the problems, and we do not stand alone in attempting to provide relief. In every large city in the country, needs, as they are now defined, have become greater than the capacity to raise revenue. As people interact in an increasingly urbanized environment, needs assume new dimensions. Demands for public services become more sophisticated and more insistent. This unremitting pressure for additional revenue poses a clear-cut challenge to a decentralized form of government — because political influence and control tend to gravitate to that level of government that experiences the least political difficulty in raising revenues.

There are a number of basic fiscal problems which Philadelphia has in common with those of all large cities: Local tax receipts are sluggish without frequent increases in rates (property and other taxes increase no more than income but expenditures increase much more). The tax base has been moving to the suburbs. Nonresidents enjoy many City services, including transportation, but do not pay for them. And city governments rush in where others decline to tread. Where other governmental levels and the private sector have not taken on responsibilities, municipalities have picked up the check for services, some of whose benefits extend way beyond city boundaries.

What can be done, then, about Philadelphia's large and growing deficit that reflects, among other things, a long laundry list of civic distresses? Before reviewing the alternatives, I would like to make two points

[1] Text of an address before the Committee of Seventy Assembly at Sugarloaf, Philadelphia, Pennsylvania, February 4, 1972. The Committee of Seventy is a 68-year-old citizens' watchdog group concerned with research and education on subjects related to Philadelphia government.

that might be useful to keep in mind as we look at urban problems through the urban budget.

First, though individual budget items are located on separate lines, each item is not separate unto itself. The full implication in any budget allotment — or change in allotment — cannot be looked at in a fragmented way. Interrelationships exist among the items. In my first graduate course in economics the professor began the semester by saying that the most profound insight we could have into the structure of the economy was to consider it as a perfectly balanced aquarium — if you move any part, effects are experienced by other parts. Elements of the budget should be viewed similarly. If you increase the budget of the streets department by increasing streetlighting, you may reduce the need for some police expenditures. If you reduce the allotment for the hospital care of drunks, you may need to increase the allotment for the police department. Each element of the budget, as you appraise it, needs to be considered in terms of its impact elsewhere.

Second, it is important to recognize, as you look at operating budgets, that emphasis is usually placed on the year ahead. But we need to display some concern with the long run — first aid is essential, but cures depend on dealing with basic medical problems. Successful, forward-moving business concerns allocate funds for research and development. They look ahead — so, perhaps, should city governments.

ALTERNATIVE 1: INCREASING TAX REVENUES

Raising Taxes. An obvious alternative for narrowing the deficit is that of increasing tax revenue — either by increasing the rates now in existence or by adding new taxes. However you put it, this means more taxes — something the present Administration has vowed not to levy and something taxpayers have resisted in recent years. (These are not unrelated events!) But taxpayers, despite resistance, have, on the whole, accepted incremental increases in taxation — how much more they will accept to help meet the deficit is something you will need to make a judgment about. It is important to point out, however, that while the sluggish movement of local taxes is an element of the growing deficit, the greatest source of the problem is on the side of overburdened expenditures, not underburdened revenue.

Reforming Taxes. Apart from directly raising taxes, some growth in revenue might be forthcoming if administrative procedures on existing taxes were improved. Improved procedures do not necessarily raise more revenue. They may, however, change who pays the tax to a more equitable basis — and, in so doing, if equity has been the source of protest, some taxes might be increased with less resistance. The real estate tax and the wage and earnings tax are the two leading sources of city revenue and, as such, they warrant some procedural review.

Property taxes are under attack from many circles these days; so perhaps we should join the fray. Lack of equalization and irregularity of assessment are the two chief procedural problems. In some wards in Philadelphia, the assessment ratio was 39.5 percent, and in some, 66.3 percent. A man owning a $10,000 house in the first ward would have an assessed valuation of about $4000 and pay about $180 in real estate taxes; a man owning an identically priced house in the second ward would have an assessed valuation of about $6500 and pay about $300 in taxes! To put this in another perspective, Philadelphia ranks eighth out of the ten largest cities in the United States in achieving equalization. Seven of the ten achieve greater equality than we. Whether or not more revenue is raised by equalization depends upon the rate at which you equalize. If you equalize at the average ratio of assessed value to market value, the revenue will be unchanged; if you equalize at 65 percent — a number which is often stated as an objective — then $55 million additional revenue will be forthcoming, according to last year's report of the Director of Finance. But it should be clearly recognized that this, in every way, is equivalent to an increase in taxes.

The second point about assessment procedures is that they are irregular. It frequently comes as a surprise to learn that Commonwealth law requires that assessments be done annually. Just how infrequently they are reviewed is difficult to pin down, but several members of the Board of Revision of Taxes have stated that Philadelphia real estate is reassessed every three years — on paper. The significant cost of irregular, infrequent, or nonexistent reassessment is that it results in a very slow response of the property tax to changing economic conditions. The loss of revenue is caused by not capturing the changes in value which have occurred in real estate — and these have been large in the past decade.

The resolution of both these problems appears to lie in computerized procedures for automatic reassessment and equalization, such as the procedure now being introduced in Montgomery County and elsewhere in the country. But before too much attention is lavished on the reform of this tax, I would offer two caveats. First, the real property tax as a local tax has been brought into question. Recent court decisions in California, New Jersey, Texas, Michigan, and Minnesota call for an equalized revenue base for education beyond local government boundaries. Such a case has not been tried yet in Pennsylvania, but many lawyers here are preparing to enter the fray. Secondly, there can be no doubt that the property tax is a regressive tax. It is an American adaptation of a medieval fiscal arrangement. Long ago, when a man's total income and wealth were closely connected with real estate, it may have been a progressive tax. But now, when so much of wealth and income is divorced from real estate, it is an unambiguously regressive[2] tax. This is, perhaps, the only opinion upon which you could get a unanimous vote from members of the American Economic Association.

The second, and major, source of revenue in Philadelphia is the wages and earnings tax. Here, let me just mention that it might be worthwhile to consider a collection procedure used by many communities in the country. In several states, local communities have piggy-backed their local income taxes to the state income tax. Now that the Commonwealth has an income tax, the procedure of tying local taxes to the state tax liability calculated on the state income tax form might be advantageous. The preparation of tax returns is simpler, collection is more efficient since only one collection system is required, and income (not just wages and salaries) can be tapped. But, I would remind you, again, that we are talking about procedural improvements here, which will not significantly increase the City's revenues unless the changes make the tax more palatable.

ALTERNATIVE 2: CURTAILING EXPENDITURES

A second candidate for closing the gap is curtailing expenditures. Recessions have a way of causing much attention to be paid to this side of the ledger.

Eliminate Functions. Eliminating functions is popular in the abstract, but, as you look at specific activities such as the police, fire, and welfare departments, it is hard to find a candidate. Functions can be "eliminated" in

[2] A regressive tax is one that results in persons in low-income brackets paying a higher proportion of their income in the tax than those in high-income brackets. The head tax is a classic example of a regressive tax. Progressive taxation, such as the Federal income tax, results in persons in low-income brackets paying a lower proportion of their income in taxes than those in high-income brackets.

a different way, however — they can be transferred. Here, I am talking about expenditures that should be made, but not by the city alone. The fundamental question here is: Which level of government is most appropriately responsible for which function? Ideally, each type of service should be voted on and paid for by the residents of the area benefitted. But, in the real world public services are not so easily classified — that is, it is not so easy to determine the beneficiaries — and political jurisdictions clearly do not necessarily coincide with the benefitting areas.

City Line Avenue, for example, may delineate Philadelphia from Lower Merion Township politically, but it is not the line between those who benefit from City services and those who do not. Certainly, some consideration should be given to having surrounding communities contribute to municipal expenditures from which they clearly benefit. It would be possible to go much further than we now do in having the users' services charged accordingly. The public transportation system, the Art Museum, and the streets of Philadelphia all benefit many more than Philadelphians. We need to determine whether the users are realistically tapped.

Functions can be eliminated by transferring them to higher levels of government. There are two major candidates for this functional transfer — education and welfare. Recent court cases point strongly in the direction of transferring the revenue aspect of education to the state, but the implications of this for the administration of expenditures are not yet clear. In any case, the notion of raising more money for urban education by extending tax boundaries into the surrounding areas, or by consolidating with nearby districts, would now not seem to be a permanent resolution of the problem. Welfare is another possibility for transfer, with the Federal Government as the most likely candidate. Most of Philadelphia's welfare expenditures are not for needy families, but involve institutional care of children, the aged, and prisoners. If the Federal Government took over this responsibility, the principal relief to Philadelphia would come indirectly through eased pressure on the Commonwealth budget.

Increase Efficiency. Another way to cut expenditures is to increase efficiency, and we're all for that! The City Controller has recently issued two reports containing recommendations on how to reduce the deficit in the City budget and on how to realize savings from coordinating many functions performed by the City and School District of Philadelphia. Clearly, these efficiency proposals should be implemented where desirable but, in appraising the desirability, two thoughts should be kept in mind.

First, the *full* consequences of each of the proposals need to be explored. What losses will occur elsewhere when some of the cost-cutting activities occur? If you transfer all custodial work in schools to night work to improve efficiency — one of Mr. Gola's proposals — will you find yourself unable to attract the nighttime work force because of the dangers in going to work at odd hours? If you close school libraries, and have students use the public libraries — another proposal — you will, indeed, have a savings in the school budget equal to the cost of libraries. But, it will be offset elsewhere, in the city budget, by increases in the cost of public libraries.

Second, even if savings are taken where considered appropriate, the deficit will not be entirely removed, though it will be lowered. The unremitting concern for higher quality municipal services, the eroding tax base, and the burdens the city carries for others, still dominate the deficit.

Perhaps, then, there is a need for another kind of efficiency investigation. Management consultants usually come in to search for efficiency improvements in response to crises. Shouldn't we give some thought to the desirability of having a group that will seek continuing systematic improvements, that will think as designers, not as repairmen? We need to engage, perhaps, in social engineering. If we are to respond to the multiple urban demands — equalization of opportunity, more efficient municipal services, citizen participation — then we must consider devoting resources to improving radically our ability to predict the effects of our public policies.

In New York City, and elsewhere, some work of this sort is being done by staffs of professional social scientists. Two million dollars has been spent on this research in New York City, and it is estimated that twenty million is now being saved annually. In the Fire Department, for example, a computerized system for deploying fire equipment (based on a statistical analysis of the likelihood of certain types of alarms occurring at various locations and times of day) has improved responses where needed, without adding to capacity. This redeployment, if freely implemented, could save New York over $10 million a year. Similar investigations into the effectiveness of patrol activities, efficiency in the courts, and public hospital utilization are being made.

In all these procedures the purpose is to examine the policy to see if the real objectives are being achieved. We have too often seen Cinderella's coach become a pumpkin: Much money has been spent on education, but the community does not feel its objectives have been attained. Some thought needs to be given to long-run improvement,[3] so that we do not think only in terms of existing procedures, and so that we do not take a myopic view of our alternatives.

ALTERNATIVE 3: INCREASE COMMONWEALTH RESPONSIBILITY

Another relief proposal is to have the Commonwealth take on new functions — by raising revenue for local governments or by raising revenue and spending it. This decision — the decision as to which functions might be assumed by the State — should not be based on playing the game of tag, where one unit of government says to the next higher unit — "You're it!" The decision should be based either on having the responsible governmental level related to the area over which the benefits are spread or on the desirability of guarding equalization of opportunity. Education is a prime candidate for the shift on both counts, as recent court decisions in many states suggest.

The relief for local governments will not be equal to the amount of spending taken over by a higher level of government. How Philadelphia would fare depends on which tax would be chosen. The final effect on a taxpayer will depend on the changes in who bears the tax burden as a consequence of moving from the local tax to the chosen state tax. If a move is made to finance public education with a statewide property tax, then large cities, if they have high real estate taxes, will get relief. If they do not (Philadelphia's tax rate for public education is way below the average for the state, it should be noted), then real estate taxpayers will end up paying more. The formula for returning the money to local districts would, however, determine whether there is a net benefit to the city. If the movement is away from the real estate tax to a proportional income tax, then there will be a movement away from regressivity. The poor will benefit, and cities, with a high proportion of poor, will get tax relief (though higher-income residents will be worse off). If the move is to a graduated income tax, then there will be an even stronger movement from regressivity to progressivity. The relief to areas with a large concentration of poor will be even greater, though high-income residents will pay even more.

[3] For a discussion of a broad concept of productivity — urban productivity — see David P. Eastburn, "Productivity in Urban Areas," *Business Review* of the Federal Reserve Bank of Philadelphia, February 1972, pp. 3-9.

ALTERNATIVE 4: INCREASING FEDERAL RESPONSIBILITY

A sought after source of relief is the Federal Government. It could assume new functions or it could take on more revenue-raising responsibilities. Though revenue raising for education has received a good deal of support, the leading candidate for functional transfer is welfare. The case for the transfer relates to the criteria already mentioned: Who are the beneficiaries (who should pay?), and is there a need to insure equalization?

Who *are* the beneficiaries of welfare support? Those who favor moving the welfare function to the Federal Government argue that help to the disadvantaged in Philadelphia has benefits which clearly do not accrue just to Philadelphians, or to Pennsylvanians — but to Alaskans and Hawaiians too. To put it another way, supporters would argue that, while the fact that Abington is close to Philadelphia may be good reason to call upon its residents to contribute to commuter facilities, it is not a good reason for Abington to pay a disproportionate share of the City's welfare costs. These are spill-ins from national problems.

The argument for Federal assumption of welfare functions rests on a second basis — the desire to equalize among states. The disadvantaged in Tennessee, it is argued, should be helped in the same manner as the disadvantaged in Philadelphia.

There is another form of relief, apart from assuming direct responsibility for new functions, that is under active consideration — revenue sharing. Revenue is raised via Federal taxes and returned, in one form or another, to state and local governments.

Currently, this is done through direct grants, which is really revenue sharing with strings. In this form of aid, considerable emphasis is placed on the objective of insuring equalization of opportunity throughout the country. The allocation of the aid is related to this objective. Those who favor this form of aid argue that the Federal Government is appropriately concerned with nationwide benefits and minimum expenditure levels for "merit" goods, such as school lunches — but that across-the-board help, supporting any or all services, is not justifiable.

Revenue sharing, with untied funds, is advocated by many. Those who favor this form of aid argue for it on two bases. First, it is argued, the Federal income tax is the "best" of all taxes. Anything which operates in the direction of substituting Federal taxes for state and local taxes is an improvement. The objective is to change the tax burden arrangements, so that any Federal revenue-raising arrangement which is agreeable to state and local governments — in this case, untying funds — is preferred. Second, it is argued, state and local governments are closer to the people and, therefore, untied money enables the maintenance of a Federalist form of government. It protects the political integrity of a decentralized form of government.

What is the present status of revenue sharing? The present Federal Administration is supporting revenue sharing, with the allocations to state and local governments related to population and tax effort. Wilbur Mills has opposed this plan and favors much greater restrictiveness. Funds would be returned to states on the basis of the extent to which they rely on state income taxes, and to local communities on the basis of the number of low-income families. One possible compromise may take the form of grouping the 400-odd direct grants we have now given to states and local governments into much broader groups.

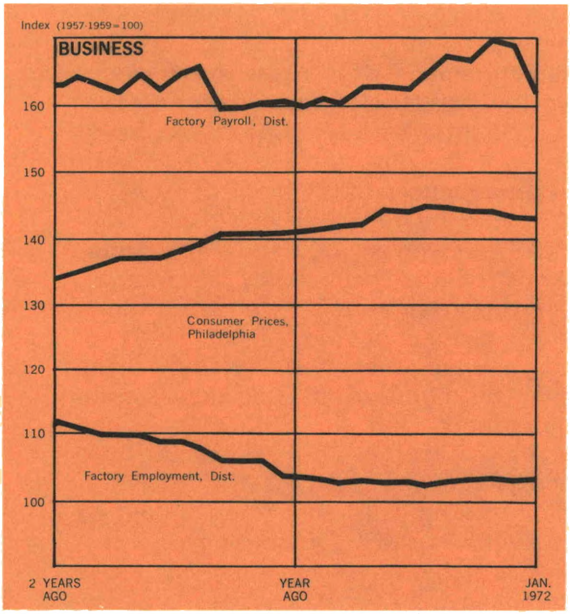
President Nixon's new budget contains a $5 billion allocation for revenue sharing for fiscal 1973. (Some of this, however, may substitute for categorical grants.) Based on last year's budget figures and the Administration's proposal for sharing, it is estimated that Philadelphia would receive a little less than $40 million. This certainly appears to represent a real contribution to Philadelphia's fiscal problems. But it is essential to recognize that this is a *gross* benefit estimate, not a *net* benefit estimate. If any Federal expenditures which were allocated to the City in a direct grant form were cut, or if any new money which would have been allocated in the form of direct grants was rechanneled, then the $40 million would not be all new money. If Federal revenue-sharing funds are not merely replacements for direct, already-existing, grants, then additional Federal taxes will be required (the President has suggested the possibility of a value-added tax). Relief to Philadelphia, then, will be offset, in a way which depends upon the Federal tax chosen, by the additional burdens of Federal taxation.

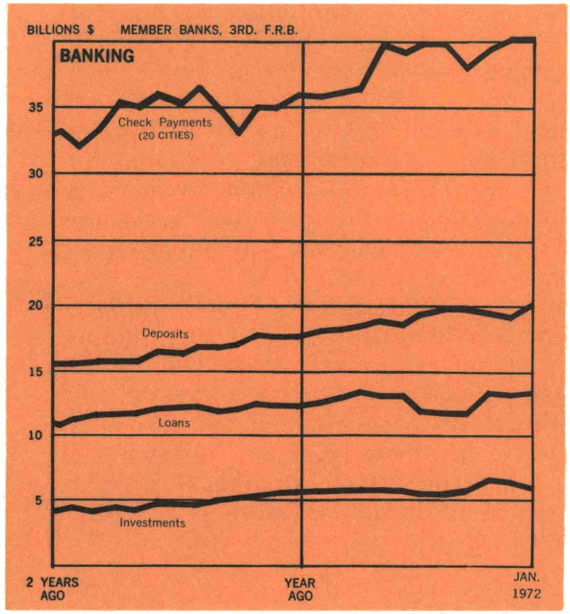
CONCLUSIONS

These, then, are the alternatives to be weighed. Reality calls for the recognition that progress in dissolving Philadelphia's expected deficits will result from the use of a number of the alternatives. No one choice will be adequate or acceptable. Increasing tax revenues has to be appraised mainly in terms of improving tax procedures and the possible effect of taxpayer resistance. Curtailing expenditures has to be appraised in terms of potentiality for increasing efficiency within the present structure of City government operations — but a sharp eye needs to be kept for any losses that may occur as a consequence. Curtailment of expenditures should be reviewed by "social engineers," those who appraise the expenditures in terms of the real policy alternatives. Transferring revenue raising or, even more, transferring functions to higher levels of government are other alternatives now being sought. The merits of insuring equalization of opportunity and the definition of the geographical area of the beneficiaries are *the* criteria to be used as the basis for decision-making. Full recognition should be given to the fact that, in shifting responsibility to a higher governmental level, a shift in who is paying how much taxes is occurring — the local taxpayer is not freed of his tax burden for the service.

Education and consensus-taking on the issues discussed here need to be done throughout the community. The path to action in urban problems is something of a minefield producing scars on the way. But, it is the only path open, if our fiscal problems are to be alleviated. ■

FOR THE RECORD...





SUMMARY	Third Federal Reserve District			United States		
	Percent change			Percent change		
	Feb. 1972 from		2 mos. 1972 from	Feb. 1972 from		2 mos. 1972 from
	mo. ago	year ago	year ago	mo. ago	year ago	year ago
MANUFACTURING						
Production	....	....	....	+ 3	+ 3	+ 3
Electric power consumed	+ 3	+ 5	+ 4	....	....	....
Man-hours, total*	+ 1	− 3	− 3	....	....	....
Employment, total	0	− 3	− 3	....	....	....
Wage income*	+ 1	+ 3	+ 4	....	....	....
CONSTRUCTION**	+ 7	+49	+16	−10	+14	+27
COAL PRODUCTION	− 2	− 1	− 3	− 4	− 8	− 7
BANKING (All member banks)						
Deposits	+ 1	+14	+16	0	+12	+12
Loans	+ 2	+12	+10	+ 1	+10	+10
Investments	0	+15	+17	0	+11	+11
U.S. Govt. securities	− 4	+ 2	+ 4	− 1	+ 1	+ 1
Other	+ 2	+23	+24	+ 1	+17	+18
Check payments***	0†	+15†	+17†	N/A	N/A	N/A
PRICES						
Wholesale	....	....	....	+ 1	+ 4	+ 4
Consumer	0‡	+ 3‡	+ 3‡	0	+ 4	+ 4

*Production workers only
**Value of contracts
***Adjusted for seasonal variation

†15 SMSA's
‡Philadelphia

LOCAL CHANGES	Manufacturing				Banking			
Standard Metropolitan Statistical Areas*	Employment		Payrolls		Check Payments**		Total Deposits***	
	Percent change Feb. 1972 from		Percent change Feb. 1972 from		Percent change Feb. 1972 from		Percent change Feb. 1972 from	
	month ago	year ago	month ago	year ago	month ago	year ago	month ago	year ago
Wilmington	− 7	− 9	− 8	−11	+17	+21	0	+14
Atlantic City	− 2	− 2	+ 2	+10	+ 1	+14	+ 1	+28
Bridgeton	0	0	N/A	N/A	....	....	N/A	N/A
Trenton	+ 1	− 3	+ 3	+ 7	+16	+32	0	+11
Altoona	0	− 7	0	− 3	− 2	+ 7	+ 2	+10
Harrisburg	0	− 1	+ 1	+ 7	0	+23	0	+12
Johnstown	+ 1	− 6	+ 2	+ 4	− 3	+27	0	+ 8
Lancaster	0	− 3	+ 1	+ 7	− 4	+ 2	0	+14
Lehigh Valley	0	− 2	+ 5	+14	+ 2	+10	+ 1	+16
Philadelphia	+ 1	− 2	+ 2	+ 5	− 4	+12	+ 1	+14
Reading	+ 1	− 1	+ 3	+ 7	+ 7	+16	0	+ 8
Scranton	+ 1	+ 4	0	+ 9	+ 7	+ 2	+ 1	+18
Wilkes-Barre	+ 1	− 2	+ 2	+ 7	+ 5	+34	+ 1	+23
Williamsport	N/A	N/A	N/A	N/A	− 5	− 2	N/A	N/A
York	− 2	+ 2	− 1	+ 8	0	+41	0	+13

*Not restricted to corporate limits of cities but covers areas of one or more counties.
**All commercial banks. Adjusted for seasonal variation.
***Member banks only. Last Wednesday of the month.