# Voice

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# Changing Patterns in Check Collection

**Excerpts from an address by**

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**at**

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A familiar adage is that "necessity is the mother of invention." And I cannot think of a better example of the truth of this saying than in the race between the constantly growing volume of checks and the advancing technology to accommodate it. The volume of checks cleared has increased over 7 percent a year since the end of World War II. This large and steady increase in volume would have overwhelmed the nation's check processing system long ago had it not been for the constant technological improvements.

In spite of the many recent improvements, the cost of check collection is still rather staggering. Based on Federal Reserve Bank data, the aggregate cost to the banking system of processing and collecting a typical transit check is estimated to be over half a dollar. This figure consists of an aggregate banking system processing cost of 27 cents plus the 24 cents applicable to the bank customer's pro rata share of account maintenance cost. With these costs in mind, continued improvements in check processing have become essential.

Electronic funds transfer (EFT) was expected to make significant inroads into check processing by the late seventies. Although EFT has begun to reduce the growth of paper check volume, it has not eliminated the need for the checks, as was expected in the late sixties. On the contrary, the check collection system has had to handle an increasing volume, and it is still "alive and well." An indication of the continued importance of check processing is the $11 billion spent last year by financial institutions for check handling, compared with the roughly $100 million expended for EFT. Nevertheless, the evidence strongly suggests that EFT systems will continue to develop and gradually encroach on the number of paper checks although the pace of growth will be slower than originally predicted.

The total number of automated clearinghouses (ACH's) handling electronic funds transfers has grown to 32 since the first one was established in 1972. About 85 percent of the volume now being processed by these ACH's consists of direct payments made by the U.S. Treasury. This Government volume is expected to increase as more Treasury payments are made by direct deposit, moving funds via electronic messages from the Treasury's deposit account to deposit accounts of millions of recipients across the nation. As an example of the Government's EFT push, President Carter recently issued a directive to all Federal agencies to use direct deposit where feasible.

As you know, the Federal Reserve has been active in developing and improving EFT. One area still in need of improvement is the delivery mechanism between banks and their ACH's. Paper listings and magnetic tapes encoded for electronic payments must still be physically transported between banks and ACH's. To increase efficiency and accelerate transactions, the Federal Reserve System has developed guidelines for intrazone communication links to provide banks with direct data communication with its ACH processing center. The linkup enables banks and other originators of ACH items to send and receive them over telephone lines, avoiding the physical transport of tapes between banks and ACH's. A similar system is in effect at the New York Automated Clearing House Association.

The plan to provide these intrazone communication links is in different stages of development in the different Federal Reserve districts. Several pilot tests are planned to test the feasibility of the linkup, and the Federal Reserve Bank of Dallas and the SouthWestern Automated Clearing House Association will participate in one of the tests.

In the near future, about 35 to 40 banks will be linked directly to the ACH processing center in the Eleventh Federal Reserve District. Whether a a bank is linked directly to the ACH by telephone lines will depend on its volume of electronic transfers.

Another Federal Reserve proposal to improve EFT that has been published for comment would link the 32 ACH's across the nation into a coordinated system. Comments on the proposal have been overwhelmingly positive, and action on the proposal is expected soon. Currently, clearinghouses are clearing and settling electronic payments within their respective regions. Under the proposal, ACH transactions could be made nationwide. Two recent studies have found the connection of ACH facilities to be feasible. One study involved the Treasury's program of direct deposit of social security and other recurring Federal payments. In another study, the National Automated Clearing House Association and the Federal Reserve successfully linked nine ACH's and 24 corporations for electronic funds transfers.

The future development of EFT will depend heavily on the outcome of legislation now pending in Congress. The EFT bills, although different in specifics, are generally designed to protect consumers. The bills provide for receipts, periodic statements, liability on banks for certain errors, full disclosure when an account is opened or its terms changed, and restriction of government access to customers' financial records.

While EFT reduces the number of checks, another recent innovation, truncation, reduces the amount of handling and shipping of checks. Truncation involves passing payments information instead of paper. Check data are digitized at the point where the check enters the check collection system and are transmitted via telephone lines to the paying bank. The reconstructed image of the check is then used for further processing in lieu of the physical check.

Check truncation is now being used for all Government checks processed at the Reserve Bank in the Eleventh District, as well as in six other Federal Reserve districts. The truncation program for Government checks will be in effect nationwide by June 1978. The major advantages of the truncation program are a reduction in Treasury expenses and acceleration of claims processing.

Benefits gained from truncation and EFT are partially offset by several problem developments. One is remote disbursement, where payors make a concerted effort to maximize the time it takes for a check to be presented to their bank for payment.

Another problem area is the continuing increase in the amount of float. Average daily Federal Reserve float has risen steadily from $1.8 billion in mid-1975 to $4.7 billion at the end of 1977.

A third problem area is the growth in volume of return items. The Federal Reserve System alone spends about $9 million annually to process approximately 160 million return items. The cost of processing a returned check is about five times the cost of processing a check that is paid when presented. Survey results indicate that some banks tolerate the maintenance of many marignal accounts and depend heavily on income derived from charges made for returned checks. These practices place an unfair burden on other banks in the check processing chain, particularly those banks that are attempting to keep these costs in line as far as their own depositors are concerned.

Although these problem areas are serious developments, the overall outlook for the nation's check processing system is promising. The system is capable of handling the increasing volume of checks through the mideighties, when the growth in the volume is expected to slow as EFT starts replacing paper checks.

# Texas Cities Credited with Sound Financial Management

*By Art Ekholm*

While some cities have been receiving a bad press for their municipal finances in recent years, Texas cities, by and large, have been darlings of the municipals market. Texas cities' bonds for financing the expansion and replacement of municipal facilities have been sold readily at relatively low yields. These favorable sales reflect the fiscal health of Texas cities during a decade when municipal finances in many areas have been described in the bleakest terms.

Steady economic growth must receive substantial credit for the financial health of Texas cities. But sound management has been equally important to their financial well-being, as in most other cities. A number of older cities with declining populations and high unemployment, largely in the industrialized belt that extends from New York westward beyond Chicago, have been experiencing severe financial stress but have controlled it and generally maintained satisfactory credit ratings.

**The urban financial problem**

Cities have ongoing financing problems. Pressure to expand services is persistent; yet, increases in taxes and charges to finance services meet strong public resistance.

The problem is not unique to cities. Other governmental units, businesses, and households continually struggle with their respective budget constraints. All bemoan the tendency for their wants to surpass their resources.

If the financial problem of cities is no more nor less than the common circumstance of scarcity, why has the fiscal condition of the nation's cities received so much publicity? Certainly, a very prominent reason has been the continuing flirtation with default by New York City. The unfolding of New York's financial story in 1975 prompted an investigation into the state of finances for cities across the country.

It may be that city finances were spotlighted at their worst moment. In 1975 the national economy was bottoming out of the worst recession since the 1930's. A large portion of municipal revenues are derived from cyclically sensitive sources—sales and income taxes—and were at low levels. At the same time, pressure on expenditures continued unabated.

Given the bleak economic picture in 1975 and the continued fanfare for the urban fiscal problem, it may seem surprising that there has not been a wave of municipal fiscal failures or defaults. Technically, fiscal failure of a city occurs when the municipality's debt can be sold only at abnormally high interest rates; default occurs, of course, when current operating expenses are not paid or a scheduled interest or principal payment on outstanding debt is not made. In fact, no major city has defaulted on its general obligation debt in the post-World War II period. And the only major city tagged with "imminent bankruptcy" is New York, the largest of them all.

However, technical failure or default is not the focus of concern in discussions of the fiscal health of most cities. Rather, the focus has been on the financial stress flowing from budget pressures on cities adjusting to declines in population and employment. With revenue sources failing to grow relative to the costs of maintaining city services at existing or desired levels, these cities must reduce spending, increase taxes and charges, or, alternatively, enter onto the failure path—continued ex-

cesses of current expenditures over current revenues.

The latter course of action was chosen in New York. Deficit spending for current operations was supported by borrowing. A persistent lack of financial discipline in New York eventually led to an overwhelming burden of short-term debt. The city's short-term debt increased from $896 million in 1965 to $4,884 million in 1975. That year, New York accounted for a fourth of all state and local government short-term debt in the United States. Elsewhere, short-term borrowing by municipal governments to cover deficits in current accounts has generally not been an acceptable practice. It is common that state constitutions or city charters provide prohibitions against it.

High unemployment and declining population, experienced by a number of older cities, principally in the Northeast and Midwest, have aggravated municipal fiscal pressures. Studies of city problems and finances in recent years have generally concluded that a number of cities have experienced even more unfavorable conditions than New York City. New York has been unique primarily in its continued failure to balance its operating budget.[1] Fiscal failure requires a continued inability or refusal by city administrators to recognize and acquiesce to budget constraints. Other cities with financial stress have raised taxes and charges and/or cut back on the level or rate of growth of services.

**Surpluses and deficits of cities**

The general fund accounts of cities record current revenues and expenditures related to the provision of general services. Cities usually tend toward a long-run balance in their general fund, with surpluses and deficits in individual years offsetting. The pattern of surpluses and deficits of the three largest cities in Texas—Dallas, Houston, and San Antonio—is representative of general fund patterns over time in Texas cities. The amount of general fund expenditures has increased steadily during the 1970's in each of the three cities, but, as illustrated by the accompanying chart, surpluses or deficits have been transitory. These Texas cities have not shown a persistent excess of expenditures over revenues.

In the wake of the accounting gimmicks used to delay expenditure recognition and inflate revenues in New York City, a distrust of the adequacy of general fund accounts as a diagnostic measure has prevailed. New York had a record of "balanced" general fund accounts, as legally required, but simultaneously it accumulated budget deficits of almost $5 billion in short-term debt. Nevertheless, New York was not placed under the scrutiny of an independent auditor until March this year. Confidence in the balanced general fund accounts of Dallas, Houston, and San Antonio is assured by the independent audits they have undergone and the lack of evidence of short-term debt accumulation representative of hidden deficits.

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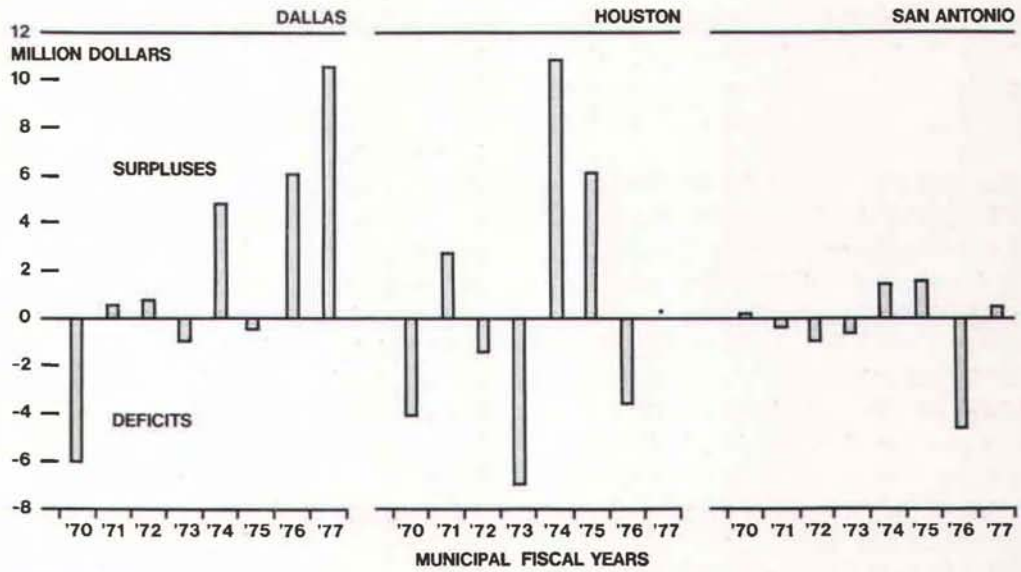
In Texas, a few cities have utilized short-term borrowing for the purpose of smoothing discrepancies in the timing of expenditures and revenues. However, no Texas city has persistently increased its short-term debt for this purpose, and most completely avoid short-term debt balances at fiscal year-end. Among the five largest Texas cities, only San Antonio normally has short-term debt balances at fiscal year-end; it undertakes short-term borrowing in anticipation of property taxes due following the end of the fiscal year. The city charter requires that this debt be retired by the end of a tax year. A change to a coincident tax year and fiscal year has been approved in a charter revision for San Antonio and is to be implemented within a few years.

In contrast to Texas cities, some other cities—Cleveland and New York, for instance—have sus-

1. Such studies include George E. Peterson, "Finance," in *The Urban Predicament*, ed. William Gorham and Nathan Glazer (Washington, D.C.: Urban Institute, 1976), pp. 35-118; Richard P. Nathan and Paul R. Dommel, "Understanding the Urban Predicament," *Brookings Bulletin* 14 (Spring-Summer 1977): 9-13; and Edward M. Gramlich, "The New York City Fiscal Crisis: What Happened and What is to be Done?" *American Economic Review* 66, no. 2 (May 1976): 415-29.

**Transitory general fund surpluses and deficits are the pattern for three largest Texas cities**




* Not available.

SOURCES: Annual financial reports for Dallas, Houston, and San Antonio.
*Moody's Analytical Overview of 25 Leading U.S. Cities.*

tained shocks to their fiscal systems in the 1970's. But Cleveland has met the strain with fiscal discipline. For example, after its general fund expenditures grew rapidly from $62,170,000 in 1965 to $105,847,000 in 1970, Cleveland reduced spending to $94,957,000 in 1971 and to $94,143,000 in 1972. This was in response to a decrease in municipal revenues from $105,396,000 in 1970 to $81,322,000 in 1971 and $94,145,000 in 1972. It was 1975 before revenues regained their 1970 level. The large decrease in revenues in 1971 resulted in a sizable deficit even though spending was reduced by 10 percent from the preceding year. However, in subsequent years, strong financial management produced annual surpluses.

A recent study of large U.S. cities developed indexes of urban hardship.[2] One of the indexes—the "urban conditions index"—was based on relative poverty, age of housing, and growth or decline in population. The average for 489 cities was set equal to 100. The relative value for Cleveland was 291; for New York, 180; for San Antonio, 100; for Dallas, 39; and for Houston, 37. Another computation was designed to measure "hardship" of cities relative to their suburbs. An index above 100 indicated a city was "worse off" than its suburbs, and below 100 indicated a central city was "better off" than its suburbs, in terms of six socioeconomic factors—unemployment, dependency (persons less than 18 or over 64 years of age as a percentage of population), education, income, crowded housing,

2. Richard P. Nathan, Paul R. Dommel, and James W. Fossett (staff members of the Brookings Institution), "Targeting Development Funds on Urban Hardship," in U.S. Congress, Joint Economic Committee, *Financing Municipal Needs, Joint Hearing before the Subcommittee on Economic Growth and Stabilization and the Subcommittee on Fiscal and Intergovernmental Policy of the Joint Economic Committee.* 95th Cong., 1st sess., 1977, pp. 54-64.

and poverty. The values were 331 for Cleveland, 211 for New York, 97 for Dallas, and 93 for Houston. (This index was not computed for San Antonio.) A number of cities other than Cleveland had indexes of urban hardship that were higher than the index for New York City. Since those cities have been able to contend with their budget constraints, the New York example apparently does not serve as an inevitable precursor of a wave of fiscal failures because of "overwhelming" city problems.

A lack of persistent current deficits or short-term operating debt indicates that Texas cities have had sound financial management during the 1970's. Moreover, this fiscal responsibility has prevailed in spite of rapid growth in expenditures.

**Expenditures of Texas cities**

During the 1970's, city budgets have continued to reflect relentless pressure from residents for more and better services. For the 28 Texas cities with populations over 50,000, municipal general expenditures per capita increased from $134.28 in fiscal 1970-71 to $242.61 in fiscal 1975-76.[3] Six-tenths of this 81-percent increase resulted from higher prices for the goods and services purchased by the municipalities. Real expenditures per capita increased about a third.

The $242.61 of per capita expenditures in Texas cities stands in sharp contrast to the figure of $594.11 for cities of comparable size in the rest of the United States. However, the comparability of expenditures of municipalities in Texas and those in other states is quite limited. The types of services provided by municipal governments vary from state to state and from city to city as functions are split among the state, county, city, school district, and special district. In addition, there are no definitive measures of differences in quality and quantity for most municipal services, such as police protection and parks and recreation.

A large portion of the difference between per capita expenditures of municipalities in Texas and those in other states is explained by the more limited scope of operations for Texas municipal governments. The nature of this specialization is revealed by an examination of per capita expenditures for specific services performed by the 48 largest cities in the United States (Table 1). New York City is separated because of its uniqueness and heavy weight in a composite of cities outside Texas.

Per capita expenditures of the 5 Texas cities included in the 48 largest cities have been especially small in the specific functions of public welfare, education, health and hospitals, and housing and urban renewal. In Texas these activities are generally undertaken by governmental units other than municipalities. Public welfare expenditures are administered by the state, supported by Federal grants. Public education receives substantial aid from state and Federal funds and is operated by local school districts, separate and apart from city budgets. This or a similar financing arrangement is fairly common in other states also. Government health and hospital expenditures are concentrated in state, county, and special districts. And housing and urban renewal are generally administered by special districts.

Among the functions undertaken by cities, four are substantially involved with the redistribution of income. Public welfare expenditures are the purest case. Other functions, portions of which are clearly redistributive, include equal opportunities in education, health care for the poor, and housing assistance. In many states, these functions are administered by city governments. Funding is heavily supported by intergovernmental transfers from state and Federal governments, especially for the welfare and education functions. For New York City, the four functions have accounted for as much as 62 percent of general expenditures. The five large Texas cities have directed an average of only 4 percent to these functions. The average for the rest of the 48 largest U.S. cities has been 26 percent.

Redistribution of income from those with high incomes to those with low incomes may be considered a desirable social goal both nationally and by the inhabitants of a region. But regions are relatively open, allowing flows of people and other mobile resources across borders. Hence, migration in response to redistributive programs can be expected unless they are carefully monitored for uniformity among regions. Whether through direct redistribution (by transfers of cash) or through

3. Data are derived from the U.S. Bureau of the Census, *City Government Finances in 1970-71*, Series GF71, no. 4, and *City Government Finances in 1975-76*, Series GF76, no. 4 (Washington, D.C.: Government Printing Office, 1972, 1977). Municipal fiscal years ended as of June 30, 1971, and June 30, 1976, are included. General expenditures exclude utility expenditures and employee-retirement or other insurance trust expenditures.

**Table 1**

**Texas cities relatively specialized in function**

(Per capita general expenditures of 48 largest U.S. cities, fiscal 1975-76)

| Function | Five Texas cities[1] | New York City | Other 42 cities |
|---|---|---|---|
| Public welfare | $ 0.26 | $ 469.98 | $ 28.06 |
| Education | .25 | 361.47 | 61.21 |
| Health and hospitals | 7.69 | 164.98 | 36.10 |
| Housing and urban renewal | 1.31 | 66.14 | 16.09 |
| Police and fire protection | 66.27 | 132.75 | 105.81 |
| Sewerage and sanitation | 38.83 | 66.45 | 54.33 |
| Highways and streets | 25.14 | 22.41 | 36.54 |
| Parks and recreation | 21.74 | 20.47 | 29.30 |
| Other general expenditures | 92.25 | 411.87 | 169.74 |
| TOTAL | $253.74 | $1,716.52 | $537.18 |

1. Dallas, El Paso, Fort Worth, Houston, and San Antonio.
NOTE: Based on municipal fiscal years that closed within the 12 months ended June 30, 1976.
SOURCE: U.S. Bureau of the Census.

the pricing of services (such as housing or health care) at prices below cost, the greater the effort to redistribute income within a region, the greater the incentive for in-migration of low-income people. Similarly, the heavier taxes on high-income people and business firms to provide the revenues for welfare and other redistributive programs will encourage migration from an area in their own self-interest even though they may in principle support the social goal of income redistribution.

It would be better if income redistribution efforts were completely financed and administered by the Federal Government in such a manner as to equalize the burden and benefits of income redistribution among areas. The concentrations of poverty that are the result of differences in the benefits and burdens of income redistribution at different locations would be eliminated. However, other incentives for concentrations of the poor, such as the availability of low-cost housing, would still exist.

Texas cities concentrate on providing traditional city services, such as police and fire protection, sewerage and sanitation, highways and streets, and parks and recreation. Expenditures for these services involve redistribution of income to a degree, but they are more clearly directed to the provision of services that would not be supplied in socially desired quantities by private markets.

**Revenues of Texas cities**

Municipalities have been pressed to increase revenues to keep pace with the rapidly increasing expenditures during the 1970's. From fiscal 1970-71 to fiscal 1975-76, Texas municipalities with populations over 50,000 obtained general revenue increases of $111.19 per capita, reflecting a 92-percent gain.[4] This was accomplished with increases of 64 percent in general revenues per capita from the municipalities' own sources—property taxes, sales taxes, current charges, and other revenues—and 494 percent in revenues from "outside" sources, such as grants from the state and Federal governments. The portion of total general revenues obtained from own sources decreased from 92 percent to 78 percent in five years.

The slowest growing component of own revenues has been the property tax, the mainstay of municipal income. Residents have demanded an increasing flow of municipal services but have resisted paying for them by additional levies on their property. Thus, muncipal property taxes per capita moved up $25.84 in Texas cities with populations

4. General revenues include all city revenues except utility revenues and employee-retirement or other insurance trust revenues. In states that operate liquor stores, revenues from that source are excluded.

over 50,000, accounting for only 23 percent of the total increase in revenues from 1970-71 to 1975-76.

The second largest component of own revenues for Texas cities, sales and gross receipts taxes, grew 75 percent over this period. But the most rapid growth in own revenues has been in current charges for specific municipal services—for example, parking fees, sanitation charges, and sewerage charges. These charges more than doubled from 1970-71 to 1975-76, increasing their share of own revenues from 17 percent to 21 percent.

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The growth of per capita expenditures at a much more rapid rate than per capita own revenues of Texas municipalities was funded by the state and Federal governments. From $7.39 in 1970-71, the Federal per capita contribution to Texas cities over 50,000 jumped almost sixfold to $44.21 in 1975-76. By that time, 19 cents of each dollar of general revenues of these cities came from Federal grants. During the same period, state per capita transfers to these cities increased 252 percent to $4.43, a tenth of the Federal contribution.

The availability of Federal funds for large portions of the growth in Texas municipal expenditures can be expected to decline in the late seventies. During the 95th Congress, a coalition of northeastern and midwestern legislators was able to change the distribution formula for Federal funds to be provided for community development projects. A new factor in the revised formula, number of houses built prior to 1939, weights allocations more heavily in favor of the older cities of the Northeast and Midwest. Under the revised formula, Texas cities will experience only minor increases in these funds. Similar gains in allocations to the Northeast and Midwest for public works, welfare, and other Federal aid programs will also constrain the growth of Federal funds disbursed to Texas cities.

**Efficiency of municipal bond markets**

It has been conventional to consider long-term debt financing appropriate for municipal capital projects. The irregularity and long-term nature of capital investments make it convenient that debt financing be undertaken for capital projects. As with households and businesses, debt financing allows an efficient use of resources over time when the expected stream of benefits exceeds the cost for capital projects.

A recent report on the fiscal condition of 67 of the 75 largest cities in the United States by the staff of the Joint Economic Committee warns of an impending "structural crisis for many of our nation's cities."[5] This conclusion was based on the fact that from fiscal 1976 to fiscal 1977, capital expenditures were reduced in many large cities while, at the same time, 50 cities reported $22.4 billion of unmet capital "needs." But the message of this JEC report does not square with the strong aggregate surplus in the budgets of state and local governments or the recent boom in municipal debt issues.

The JEC staff also reported that while 16 cities with low unemployment and growing populations showed an increase of 30 percent in capital expenditures, 23 cities with high unemployment and declining populations had a decrease of 13 percent. Some participants in congressional hearings related to the staff report argued that malfunctions in the municipal bond market tended to limit market access of cities in the latter group and, thus, contributed to decreases in their capital expenditures. A suggested solution was Federal support to the municipals market through a National Urban Development Bank.

However, except for a brief disruption due to uncertainties arising from the initial exposure of New York City's financial situation, the municipal bond market has shown no evidence of failure in its allocative function in the form of interest rate differences stemming from sources other than differences in maturity and risk. The large and diversified pools of lenders and borrowers and the extensive dispersion of information in the national

5. U.S. Congress, Joint Economic Committee, *The Current Fiscal Condition of Cities: A Survey of 67 of the 75 Largest Cities, A Study Prepared for the Use of the Subcommittee on Economic Growth and Stabilization and the Subcommittee on Fiscal and Intergovernmental Policy of the Joint Economic Committee.* 95th Cong., 1st sess., 1977, p. 2.

market for municipal bonds provide a strong base for effective performance. The flow of information in the municipal bond market is not perfect, but there is no reason to believe that there would be major reallocations of borrowing capacity among cities if it could be made more perfect. And it is by no means clear that Federal intermediation would improve the quality of information.

A more plausible explanation for capital expenditure cutbacks in many major cities has been the squeeze on budgets resulting from rapid expenditure increases and weak economic conditions. Prudent financial management has precluded commitments of additional debt in these situations.

National activity in municipal bonds increased sharply in 1977 as interest rates on municipals stabilized at a level more than 1 percentage point below the average in 1975 and general economic conditions continued to improve. In Texas an especially vigorous economy and growing municipalities added further support to a surge of new bond issues. Bonds approved by the Attorney General of Texas for sale by cities totaled $1,122 million in 1977, an increase of about 87 percent over a relatively high level of debt issuance in 1976. There was a substantial increase in the proportion of bonds that represented refundings. Nevertheless, total new money for capital expansion increased over 70 percent.

About three-fourths of the bonds issued in Texas in 1977 were revenue bonds, which are payable strictly from the earnings of specific enterprises. For the most part, these bonds finance waterworks and sewerage facilities, but they also involve transportation facilities, hospitals, and other revenue-producing facilities. The rest of the bonds issued in 1977 were tax-supported general obligation bonds, which are secured by the "full faith and credit" of the issuing cities and are used for the construction of a wide range of municipal facilities—streets, bridges, fire stations, and many others.

The flexibility a city has in adapting its finances to changing conditions is constrained by a heavy debt load. A buildup of debt service charges relative to revenues may lead a city into a precarious

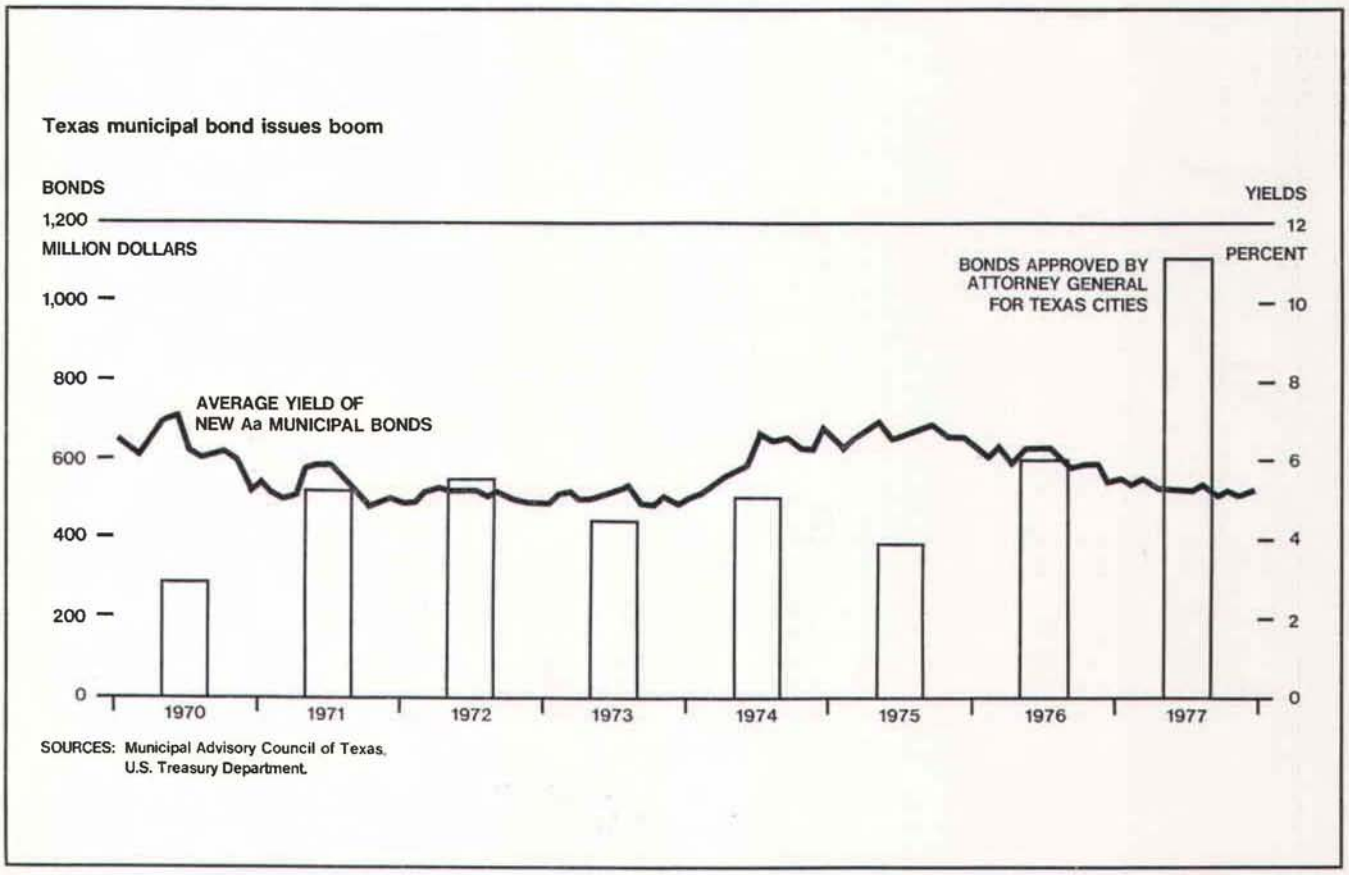


**Table 2**

**Debt service of five largest Texas cities increases less than revenues**

| City | Debt service[1] per capita | | Debt service as percent of revenues[2] | |
|---|---|---|---|---|
| | Fiscal 1970-71 | Fiscal 1975-76 | Fiscal 1970-71 | Fiscal 1975-76 |
| Dallas | $55.74 | $70.95 | 25.8 | 22.5 |
| El Paso | 16.08 | 16.71 | 14.0 | 10.5 |
| Fort Worth | 45.94 | 52.39 | 32.3 | 22.6 |
| Houston | 34.13 | 50.68 | 24.6 | 18.8 |
| San Antonio | 43.65 | 64.82 | 19.6 | 14.3 |

1. Long-term debt retired, short-term debt outstanding, and interest on debt.
2. Own general revenues plus utility revenues.
NOTE: Based on municipal fiscal years that closed within the 12 months ended June 30, 1971, and June 30, 1976 respectively.
SOURCE: U.S. Bureau of the Census.

**Table 3**

**Control of financial stress by most U.S. cities reflected in credit ratings**

(25 largest cities, June 30, 1977)

| City | Rating | City | Rating |
|---|---|---|---|
| Dallas | Aaa | Seattle | Aa |
| Houston | Aaa | | |
| Indianapolis | Aaa | Baltimore | A 1 |
| Los Angeles | Aaa | Jacksonville | A 1 |
| Milwaukee | Aaa | New Orleans | A 1 |
| San Francisco | Aaa | | |
| | | Cleveland | A |
| Chicago | Aa | Pittsburgh | A |
| Columbus | Aa | St. Louis | A |
| Denver | Aa | | |
| Kansas City | Aa | Boston | Baa |
| Memphis | Aa | Detroit | Baa |
| Phoenix | Aa | Philadelphia | Baa |
| San Antonio | Aa | | |
| San Diego | Aa | New York City | B |

NOTE: Moody's rating scheme assigns the Aaa rating to bonds carrying the smallest degree of investment risk. Bonds rated Aaa and Aa are generally known as "high grade bonds." Ratings then descend in grade through A, Baa, Ba, B, and so on through C. Moody's describes Baa bonds as "medium grade obligations, i.e. they are neither highly protected nor poorly secured"; B bonds "generally lack characteristics of the desirable investment." Those bonds judged strongest in a class have a *1* after the letter rating, as in A 1.
SOURCE: Moody's Investors Service.

financial situation. All of the five largest Texas cities expanded debt service charges per capita from 1970-71 to 1975-76. However, the debt service relative to ability to pay appears to have improved. In each of these cities, the debt service charges were a smaller percentage of own general revenues plus utility revenues in the later fiscal year (Table 2).

Credit ratings of cities provide an index of factors affecting their financial situation. And the growing concern with the viability of city finances has put increased pressures on the credit-rating firms to evaluate each city carefully. Also, increases in the number of cities submitting to independent audits, complying with standardized municipal accounting procedures, and publishing more detailed accounting data have provided a better flow of information to the credit-rating firms.

Moody's credit ratings of the 25 largest cities in the United States reflect the concentration of financial stress in the older cities of the Northeast and Midwest (Table 3). Also reflected are sound credit ratings for many of the older cities and the absence of any general breakdown in the creditworthiness of the nation's largest cities. Texas cities have relatively high credit ratings, as illustrated by the Aaa ratings for Dallas and Houston and the Aa rating for San Antonio.

## Summary

Administrators of Texas cities have performed admirably thus far in the 1970's, maintaining the balance between revenues and expenditures necessary for a sound financial status. Favorable economic conditions and limited activity in the most explicitly redistributive functions have been conducive to this performance.

Most cities in the rest of the nation have also received strong financial management. And, particularly in some cities of the Northeast, fiscal discipline has usually been maintained amid distressed local economies and concentrations of poverty. Where recurrent overextension of a city's budget has occurred, it has not been because these problems were overwhelming but, rather, there was failure to recognize and acquiesce to budget constraints.

# Inflation Stimulates Demand for Farmland

"Buy land. They ain't making it anymore." This observation has been attributed to Will Rogers some 50 years ago. It is true, of course, that only limited amounts of farmland are "made" anymore by carrying water to deserts, pushing back forests, or draining swamps. But the development of hybrid seeds and animals, mechanical power, and chemical control of weeds, diseases, and plant behavior—largely within the past 50 years—have had effects comparable to tremendous increases in acreage of farm and ranch land. Absent such developments, the pressure of population growth upon land prices undoubtedly would have been greater.

Nevertheless, it has become customary to cite farmland as a classic example of a resource with a fixed supply and a growing demand and to conclude, therefore, that its price inevitably must rise. Fairly long interludes of declining farmland prices, such as the 1920's and early 1930's have not shaken the popular view captured in Will Roger's comment.

Farmland prices in the United States currently average more than seven times what they were in 1949. In the Southwest, prices have shown a similar rise. Farmland in Louisiana, New Mexico, Oklahoma, and Texas is now selling for 6.9, 5.4, 7.7, and 6.7 times, respectively, more than in 1949. A large portion of this price rise has occurred in recent years. Between November 1971 and November 1977, U.S. farmland rose 133 percent while average values in the four southwestern states nearly doubled.

Aside from the impact of inflation, technology has been the key driving force boosting the demand for farmland. As advancing technology made it feasible for individual farmers to work larger acreages, competition forced them along that path in order to earn acceptables incomes. And as existing farmers, as well as individuals desiring to become newly established as farmers, bid for the land coming on the market, prices have risen. The bidding has been sharpened also by those who desire to own land as an investment, speculation, or inflation hedge. And finally, population growth and rising aspirations have increased demand for land for residential and recreational sites and such public uses as roads, schools, airports, parks, and the like. All these have had some effect on farmland prices.

Except for inflation, these have been evolutionary forces and would not be expected to cause sharp spurts in land prices. There is strong reason, therefore, to believe that inflation has played an increasingly important role in the rise in land prices, particularly since 1971. As farmland came to be viewed as a viable hedge against inflation, investors in both the United States and many other countries sought farmland acquisitions in the United States.

**Returns to land have surpassed alternatives . . .**
In terms of current income plus actual or unrealized capital gains, farm real estate has produced very impressive yields in recent years and has generally outperformed other investments. Since 1971, returns to farmland—consisting of current income estimated to average about 4 percent and price rise estimated to average about 15 percent—have been around 19 percent per year in the United States.

In this respect, farmland has been a better performer than the broad averages of stocks or bonds. Using Standard and Poor's index of 500 common stocks, rates of return (dividends plus capital gains) on common stock have averaged 5 to 6 percent since 1971. With wide fluctuations in gains and losses, investment returns for stocks also have not been as stable during this period as for farmland or bonds. Average stock values declined in three of the past seven years.

The average annual yield on bonds since 1971 has been about 8 percent, based on Moody's seasoned Aaa corporate issues. The average annual rate of inflation in this period has been 6.9 percent. Adjusting for inflation, the return since 1971 has been about 12 percent per year for farmland, about 1 percent for bonds, and about a 2-percent loss for stocks.

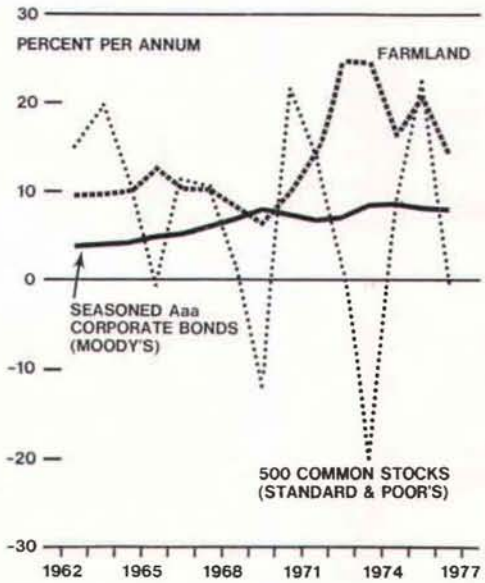
Capital gains in southwestern farm and ranch land have not been as large as the national average. Since 1971, average annual price increases for Louisiana, New Mexico, Oklahoma, and Texas have been 9.0, 9.7, 13.0, and 10.7 percent, respectively. But adding income to appreciation, it is clear that the return to land in the Southwest has also been greater than for most stock and bond averages.

Land purchases by foreigners have received much publicity recently in newspapers and magazines. The latest estimate of foreign ownership of U.S. farm and ranch land was made by the Department of Commerce in 1974. The survey revealed that 4.9 million acres in units above 200 acres were owned by foreigners, or less than 0.5 percent of U.S. farmland. The proportion owned by foreigners probably is somewhat higher now since foreign purchases may have been fairly numerous in recent years. But the amount of farm real estate currently owned by foreign investors, while not known, probably is still relatively small.

The surge in farmland prices in recent years apparently has not been associated with any striking change in purchases of land. Active farmers purchased about two-thirds of all tracts sold in 1976-77, according to data compiled by the U.S. Department of Agriculture. Nonfarmers bought about one-fourth of all tracts sold, about equally divided between "in-county" and "out-of-county" residents. Foreign investors account for an indeterminate share of the out-of-county buyers. Retired farmers bought about 2 percent, and about one-tenth were reported purchased by an "all other" category. These proportions have not changed significantly during recent years for which data are available.

On the selling side, active and retired farmers sold over one-half of all tracts sold, and about one-fifth were estate sales. So, the farm real estate market is predominantly a market among farmers. However, being a thin market—there were only 43 farm title transfers per 1,000 farms in 1976-77—fairly small changes in offerings or demand can have a disproportionate effect on prices.

**Returns from farmland investment have exceeded stock returns and bond yields in recent years**




1977 preliminary.

NOTE: Land returns are based on changes in November 1 index values and on the average annual rent for 1960-76. Stock returns include capital gains or losses plus dividends. Bond yields are annual averages.

SOURCES: Board of Governors, Federal Reserve System. Economic Indicators.
U.S. Department of Agriculture.
U.S. Department of Commerce.

**Rates of change in farmland values slow down in the Southwest**

| Year | Year-to-year percent changes in indexes of farmland values as of November 1 | | | |
|---|---|---|---|---|
| | Louisiana | New Mexico | Oklahoma | Texas |
| 1963 .... | 11.4 | 11.1 | 5.5 | 9.5 |
| 1964 .... | 2.6 | 7.5 | 6.5 | 8.6 |
| 1965 .... | 7.5 | 8.1 | 13.4 | 5.7 |
| 1966 .... | 4.7 | 5.4 | 5.4 | 6.5 |
| 1967 .... | 16.7 | 6.1 | 7.1 | 4.0 |
| 1968 .... | 2.9 | 5.8 | 4.8 | 9.7 |
| 1969 .... | 4.6 | 7.3 | 4.6 | 4.4 |
| 1970 .... | 8.0 | 5.9 | .0 | 3.4 |
| 1971 .... | 9.0 | 5.6 | 11.3 | 5.7 |
| 1972 .... | 9.8 | 8.3 | 7.8 | 14.0 |
| 1973 .... | 10.3 | 25.9 | 22.5 | 21.4 |
| 1974 .... | 17.4 | 6.7 | 23.7 | 17.1 |
| 1975 .... | 3.2 | 5.2 | 7.2 | 3.0 |
| 1976 .... | 8.2 | 7.9 | 9.8 | 10.7 |
| 1977p ... | 5.2 | 8.3 | 8.9 | 3.1 |

p—Preliminary.
SOURCE: U.S. Department of Agriculture.

**. . . but immediate prospects are less attractive**

Barring a world crop shortage, farm income prospects for the next two or three years are not particularly bright. It appears that prices for major crops—corn, wheat, grain sorghum, cotton, and soybeans—will be constrained by the large supplies on hand and in prospect, and production costs will likely continue to rise. Net farm income per acre and—over a longer period—capital gains will be affected. Government income- and price-support programs may prevent any further reduction in total farm income.

Inflation may be the greatest source of uncertainty in the outlook for farmland prices. Presumably, it will be lower than the record pace of late 1972 through early 1974, but it may well be higher than in the 1960's for some years to come. And since the pace of inflation appears to strongly influence the trend of land prices, capital gains in U.S. farmland may range nearer the average of 5 to 6 percent that prevailed in the 1950's and 1960's, a period when net farm income was also being supported extensively under Government programs and inflation averaged 2 to 3 percent per year.

*Alan M. Young*

# Officer Credit-Card Limit Increased

The limit on lines of credit on credit cards for executive officers of member banks has been increased from $1,000 to $5,000. This amendment to Regulation O was effective March 24, 1978.

The change was made in response to increased consumer prices (prices have almost doubled) since the $1,000 limit was adopted in 1967 and in response to the expanded use and acceptability of bank credit cards since that time.

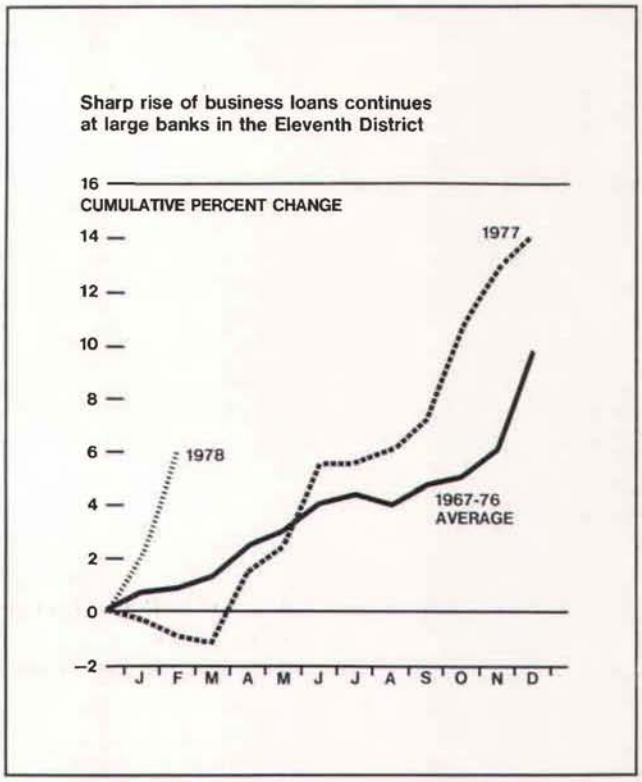
# Business Loan Demand Running at Record Rate at District Banks

Business borrowings from large commercial banks in the Eleventh District increased sharply last year. At year-end, business loans totaled $6.8 billion, up 14 percent from the year-earlier level. The record growth was 15 percent, in 1972. Moreover, the rapid growth has continued in 1978; commercial and industrial loans rose almost 6 percent in January and February, a record for those months. The previous record for the two months was 4 percent in both 1969 and 1973.

The current sharp rise in business loans began in the second quarter of 1977, when businesses found that internally generated funds could not meet the fast-rising demand for capital expenditures and inventories. In contrast to the first two years of the recovery, when businesses relied heavily on long-term bond and equity markets, many corporations returned to short-term markets for a larger share of their external financing needs last year.

As businesses returned to short-term markets, they turned increasingly to commercial banks for their financing needs because bank loans became more competitive. Banks raised the interest rate charged on short-term loans to prime commercial and industrial customers from 6¼ percent at the beginning of 1977 to 7¾ percent at year-end. However, because other short-term rates rose more rapidly, the spread between the prime lending rate and commercial paper narrowed by 45 basis points.

The expansion in business loans in the District since the first quarter of last year has been broad based. Record loan demands were evident for the fabricated metal, chemicals and rubber, and transportation industries. Many other types of commercial and industrial borrowers—such as manufacturers of transportation equipment, textiles, and apparel and the mining, wholesale trade, construction, and public utilities industries—also increased their demands for bank funds more than usual.



Despite the sharp overall growth, there were some sectors of sluggish business loan demand last year. For example, loan demand by firms in the primary metal, petroleum refining, retail, communications, and food, liquor, and tobacco industries was weak. Demand for bankers' acceptances was also weak.

Loan demand by manufacturers of primary metals and producers of food, liquor, and tobacco have rebounded sharply this year, however. The sharp growth in demand for bank loans by primary metal firms reflects the increased demand for steel and aluminum by a wide range of machinery and fabricated metal producers. And the recent "trigger price" system for reducing imports of steel is helping further to increase orders to domestic steel plants. With the strengthening business outlook, firms in these industries have begun to raise production levels, and a large portion of their increased financing needs is being met through the use of credit lines at commercial banks.

Retailers also have stepped up their borrowings in recent weeks, as evidenced by the near-record rate of growth in loans to retail firms in February. Following a better than expected volume of Christmas sales last year, inventories at many retail establishments—particularly department stores—were drawn down to low levels at year-end. Many retailers are now in the process of replenishing stocks, and their financing needs are rising. On the other hand, some automobile dealers are finding it necessary to carry—and, thus, finance—larger than desired inventories of some slow-selling models. As the economy continues to grow, rising prices of goods in inventory and perhaps an increase in the amount held will raise the need for external financing.

Increased expenditures for plants and equipment in the Southwest will also boost business needs for external financing. The latest survey of the U.S. Department of Commerce indicates that businesses, overall, plan to boost their expenditures for new plants and equipment by 11 percent in 1978, compared with an increase of almost 13 percent in 1977. With growth in the District's economy continuing to outpace that of the nation, a disproportionate share of those expenditures will be in the Southwest.

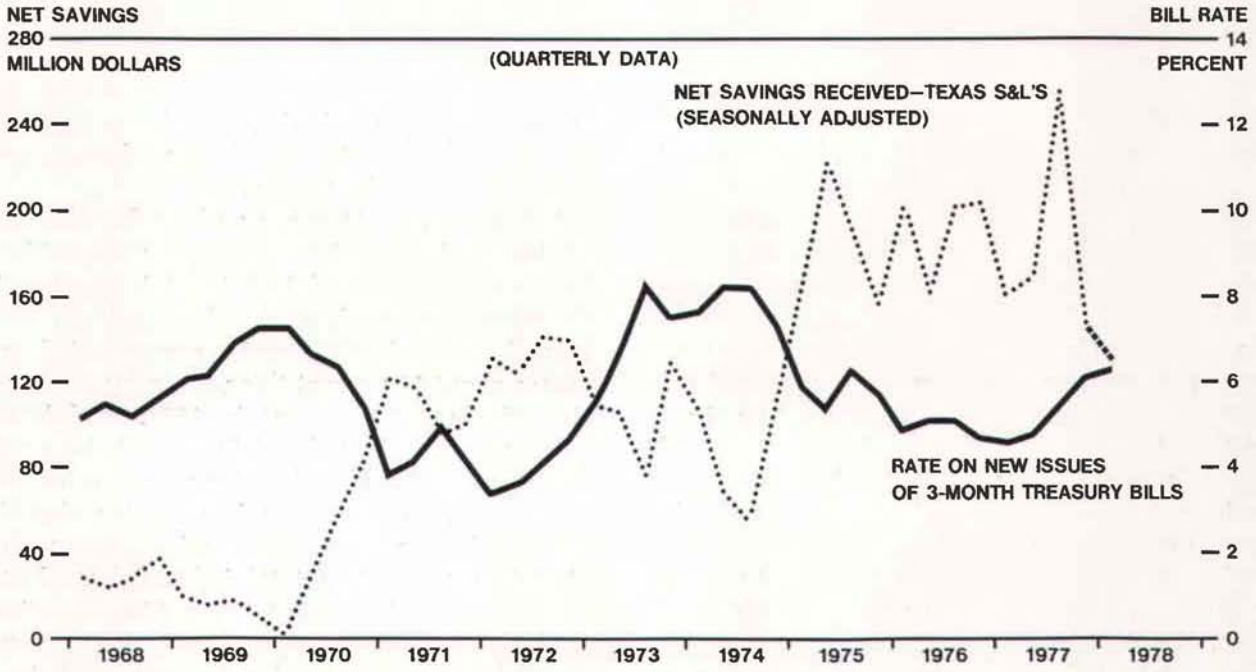
Comparatively stronger outlays for plants and equipment in the District this year are evidenced in spending plans of individual industries. The Commerce survey indicates that capital expenditures by the mining industry are expected to increase about 14 percent this year, compared with a rise of about 12 percent in 1977. And because mining—which includes drilling and the production of oil and gas—is heavily concentrated in the District, an outsized gain in spending should be forthcoming. In Texas alone, mining accounts for almost 30 percent of total industrial production, compared with less than 7 percent in the nation.

The Commerce survey indicates that manufacturing businesses also plan to increase their capital outlays at a slightly slower rate this year than last. However, some industries plan to speed up plant and equipment expenditures. Nonelectrical machinery, for example, is one industry where capital outlays are indicated to rise rapidly this year. In Texas, nearly half the output of the nonelectrical machinery industry is oil field equipment. The aircraft and chemical industries also plan sharp increases in capital outlays this year. And because both are major industries in the Southwest, the District economy should benefit greatly.

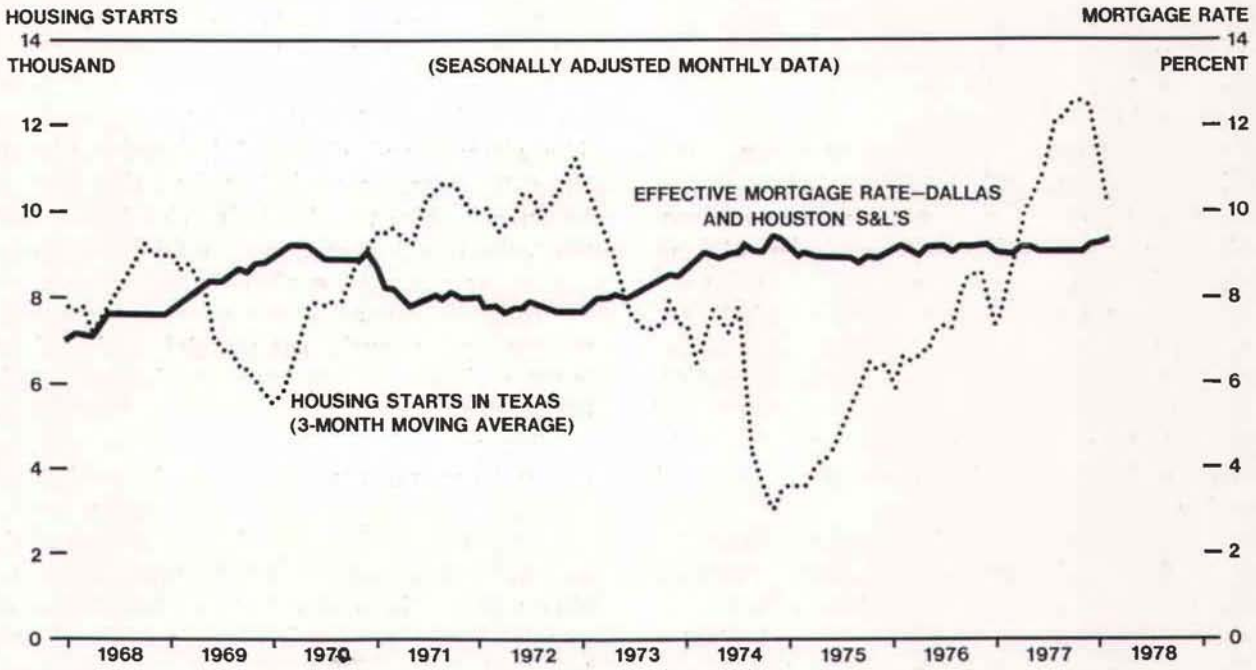
If expectations for capital expenditures materialize (actually, expenditures may well exceed the survey indications), commercial and industrial loans at large District banks probably would increase at a record rate in 1978. Although the prime lending rate will likely rise somewhat as credit demand continues to strengthen, interest rates on alternative sources of short-term funds would be expected to rise also. In light of the current rising cost of bond and equity financing, businesses probably will continue to rely more heavily on commercial banks for much of their external financing needs this year. And District banks generally have sufficient liquidity to meet additional credit demands.

*Mary G. Grandstaff*

**Despite the record of strong economic growth in Texas, the growth of savings deposits usually slows when money market rates rise . . .**




**. . . which leads to tighter mortgage terms and declines in new housing starts in the state**




1978 quarter estimated for net savings.

SOURCES: Bureau of Business Research, University of Texas.
Federal Home Loan Bank of Little Rock.
U.S. Department of Commerce.
Federal Reserve Bank of Dallas.

# Move Toward Full Employment Portends Cyclical Decline for Residential Construction in Texas

Residential construction in Texas faces increasing competition for labor, materials, and credit as the economy approaches full employment of its resources. The higher degree of capacity utilization as the economy approaches full employment creates increased demands for plant expansion on the part of businessmen, which, in turn, generate larger demands for credit. As the demand for credit expands relative to the supply, interest rates rise, and some consumption and investment expenditures financed by credit tend to be postponed.

One major category of such postponable expenditures is housing. Moreover, the effect there is accentuated by distortions due to the interest rate ceilings imposed on deposits at mortgage lending institutions. When other interest rates are higher, savings are diverted from these institutions, and mortgage terms are tightened more severely than they otherwise would be. The withdrawal of savings from mortgage lending institutions in this case is commonly known as *disintermediation*.

During the past 16 months, money market rates have risen sharply. The three-month Treasury bill rate, for example, rose from a five-year low of 4.35 percent in December 1976 to nearly 6.50 percent in early 1978. The rise in these rates, specially on U.S. Government securities, has provided an attractive alternative to placing money in time and savings accounts at savings and loan associations (S&L's), as maximum yields on these accounts are limited by regulation.

But the mortgage market in Texas has weathered the rise in interest rates since December 1976 rather well, with net gains in deposits still running well above those evident during most of the early seventies. Net savings inflows slowed in the past year, and S&L's began to draw on supplementary sources of funds to an increasing extent. A greater number of mortgages were sold in the secondary market, and borrowings from the Federal Home Loan Bank rose. However, loan repayments remained strong, and, all in all, sufficient funds were available to meet demand, with new commitments remaining at a high level.

Texas S&L's moved the prime rate on conventional mortgages—offered only to customers with the highest credit ratings—to 9½ percent early this year. Initial fees were also raised to bring mortgage loan demand and the supply of funds into balance. Moreover, some S&L's restricted mortgage lending to owner-occupied properties.

The relationship between housing starts and the general business cycle has usually been contracyclical—that is, housing activity has entered a period of contraction even as overall economic activity has continued to expand, and housing begins to recover in a recession ahead of the rest of the economy. Residential construction declined approximately one year before the peak in economic activity in both 1968 and 1972. Similarly, housing activity entered a period of expansion in late 1969, approximately one year before economic activity picked up in late 1970.

A pickup in residential construction activity, however, did not lead the turnaround of general business conditions in 1975 because a large over-

hang of unsold new homes deterred builders from increasing starts. Residential construction did not get going again until that inventory of unsold homes was drawn down.

Although money market rates have fallen back somewhat from their January peaks, there is good reason to expect they will begin climbing again. Business borrowing at Eleventh District banks is growing at a record rate. Government expenditures have been well below budgeted levels recently but should pick up sharply in coming months, specially since large budget deficits are forecast for both fiscal 1978 and 1979. Therefore, as the demands for funds grow outside the housing industry, interest rates should move up, diminishing the flow of funds to residential construction.

However, unlike earlier periods of such disintermediation, S&L's currently have a larger share of their total deposits in certificates of deposit (CD's). CD's are of longer term and offer higher yields than regular savings accounts. And because penalties for early withdrawal of CD's have been stiffened in recent years, there should be fewer customers cashing in these types of deposits for reinvestment in such securities as Treasury bills if interest rates rise further.

Despite the fact that Texas faces another round of disintermediation that could cause residential construction activity to turn down, history suggests that a recovery is inevitable as soon as mortgage funds again become plentiful. And unlike the last downturn, there are few signs of overbuilding that would lead to a prolonged weakness in activity. The growth of the state's economy continues to outpace growth in the nation. And a steady flow of new jobs and income should supply both the funds and demand for a renewed expansion in the stock of new housing.

*Charles N. Walush*

## Fed Proposes Additional Activities for Bank Holding Companies

The Federal Reserve Board has proposed allowing bank holding companies and their nonbank subsidiaries to sell money orders, travelers' checks, U.S. savings bonds, and financial management courses for consumers.

Currently, many bank holding companies sell these items, but the Fed has approved such requests on a case-by-case basis. The proposal, an amendment to Regulation Y, would allow all bank holding companies to engage in these activities. The proposal was made in connection with an application by Citicorp to sell the items through its eight Person-to-Person Financial Centers in Utah.

# Purchase and Sale of Securities Available to Member Banks

One of the services available to member banks from Federal Reserve offices in the Eleventh District is the purchase and sale of securities. The Federal Reserve will purchase or sell any Treasury or agency security for a member bank.

Sales proceeds are credited to the member bank's reserve account or transferred in accordance with instructions. Purchases are charged to its reserve account, and the securities may be held in safekeeping or pledged as collateral for loans, Treasury tax and loan accounts, or other public funds. Securities already held in safekeeping are readily available for sale upon request.

A purchase or sale can be initiated by a telephone call to a Federal Reserve office. The Fed contacts up to four brokers, the number depending on the dollar amount of the transaction, and the most favorable price is executed.

For further information, contact J. A. Clymer, (214) 651-6340.

# Seminars Scheduled to Explain New TT&L Investment Program

Legislation enacted in 1977 authorizes the U.S. Treasury to collect interest on its tax and loan accounts at financial institutions and requires the Treasury to pay fees for certain services performed by the institutions, such as handling tax and loan accounts, accepting tax deposits, and issuing savings bonds.

To aid banks in the Eleventh District in understanding the new Treasury Tax and Loan Investment Program, the Federal Reserve Bank of Dallas and its branches have tentatively scheduled several seminars to be held as follows:

### *Head Office territory*

| | |
|---|---|
| April 24 ..... | Wichita Falls |
| April 25 ..... | Amarillo |
| April 26 ..... | Lubbock |
| April 27 ..... | San Angelo |
| | Texarkana |
| April 28 ..... | Abilene |
| | Sherman |
| May 2 ..... | Monroe, Louisiana |
| | Dallas (two meetings) |
| May 3 ..... | Shreveport, Louisiana |
| | Dallas (two meetings) |
| May 4 ..... | Tyler |
| | Waco (two meetings) |

### *El Paso territory*

| | |
|---|---|
| Week of May 1. | El Paso (one meeting) |
| | Midland (one meeting) |

### *Houston territory*

| | |
|---|---|
| April 24 ..... | Houston |
| April 25 ..... | Houston (two meetings) |
| April 26 ..... | Houston (two meetings) |
| April 27 ..... | Houston (two meetings) |
| May 1 ..... | Bryan |
| May 2 ..... | Palestine |
| May 3 ..... | Lufkin |
| May 4 ..... | Beaumont (two meetings) |
| May 5 ..... | Victoria |

### *San Antonio territory*

| | |
|---|---|
| April 24 ..... | San Antonio (two meetings) |
| April 25 ..... | San Antonio |
| April 27 ..... | Austin (two meetings) |
| May 2 ..... | Corpus Christi |
| May 3 ..... | Harlingen |
| May 4 ..... | McAllen |
| May 16 ..... | Del Rio |

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Prior to the seminars, letters will be sent to invite bankers to attend a meeting in their area.

For further information, contact J. A. Clymer, (214) 651-6340, at the Head Office; Joel L. Koonce, (915) 544-4730, Ext. 41, at the El Paso Branch; Sammie C. Clay, (713) 659-4433, Ext. 42, at the Houston Branch; or Thomas C. Cole, (512) 224-2141, Ext. 13, at the San Antonio Branch.