

FEDERAL RESERVE BANK OF RICHMOND

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*The Federal Budget:  
Retrospect and Prospect  
Recent Developments in  
Fifth District Banking*



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# THE FEDERAL BUDGET: RETROSPECT AND PROSPECT

Since World War II, Federal government spending has increased steadily, both in absolute terms and as a proportion of total national output. In 1947, U. S. government spending had fallen sharply from its high wartime level of \$95.2 billion to 36.9 billion,<sup>1</sup> which represented about 16.8 percent of GNP. The 1973 Federal budget provides for an estimated \$250 billion in expenditures, about 20.8 percent of the estimated value of GNP for the fiscal year. Estimated 1973 Federal tax revenues amount to about \$223 billion, leaving a budget deficit of \$27 billion.<sup>2</sup>

## SHIFTING PRIORITIES

During the earlier part of the post-war period, national defense was primarily responsible for the growth in Federal budget expenditures. Defense spending accounted for about 56 percent of the \$75 billion increase in Federal government expenditures between 1947 and 1963. More recently, budgetary emphasis has shifted away from national defense toward civilian social programs. Defense spending has continued to rise, but non-defense spending has accounted for the major portion of budgetary increases. Between fiscal years 1963 and 1973, for example, budgeted outlays rose by \$139 billion, with non-defense spending accounting for \$113 billion, or 81.3 percent of the increase. As indicated in Table I, this increase in non-defense spending has been concentrated on programs designed to maintain and improve the nation's human resources. Almost two-thirds of the increase in non-defense spending, \$73.3 billion, has been allocated to the areas of education and manpower, health, and income security. As a result, the

proportion of total budget expenditures devoted to human resource programs is expected to rise to 40.1 percent in 1973 from 25.1 percent in 1963, as shown in Chart 1. Over the same period, the defense proportion is expected to fall to 31.3 percent from 46.9 percent. The chart also indicates that budgeted expenditures in the remaining categories—physical resources, interest on the national debt, and other items—remain virtually unchanged as a proportion of the Federal budget.

**Income security** Estimated 1973 expenditures on income security programs represent an increase of almost \$46 billion over the 1963 level. The \$29 billion hike in social security (old age, survivors, and disability) benefits constituted the single most significant factor contributing to the growth in civilian budget outlays. The rest of the growth in income security payments is distributed over various other programs designed to increase the standard of living for persons with low income levels. These programs

Table I  
BUDGET AUTHORITY AND OUTLAYS  
(fiscal year, billions of dollars)

Budget Category	Expenditures		Budget Authority 1972
	1963	1973	
NATIONAL DEFENSE	\$ 52.3	\$ 78.3	\$ 85.7
HUMAN RESOURCES			
Education & Manpower	1.5	11.3	12.4
Health	1.4	18.1	23.7
Income Security	24.1	70.9	75.6
Veterans Benefits	5.5	11.7	12.4
PHYSICAL RESOURCES			
Agriculture & Rural Development	5.1	6.9	7.7
Natural Resources & Environment	1.5	2.4	2.9
Commerce & Transportation	5.8	11.6	12.7
Community Development & Housing	-0.9	4.8	5.6
OTHER			
International Affairs & Finance	4.1	3.8	5.2
Space	2.5	3.2	3.4
General Revenue Sharing	—	7.2	7.8
General Government	1.8	5.5	5.7
Miscellaneous	-2.6	-7.4	-6.5
INTEREST	9.2	21.2	21.6
TOTAL	\$111.3	\$250.0	\$276.0

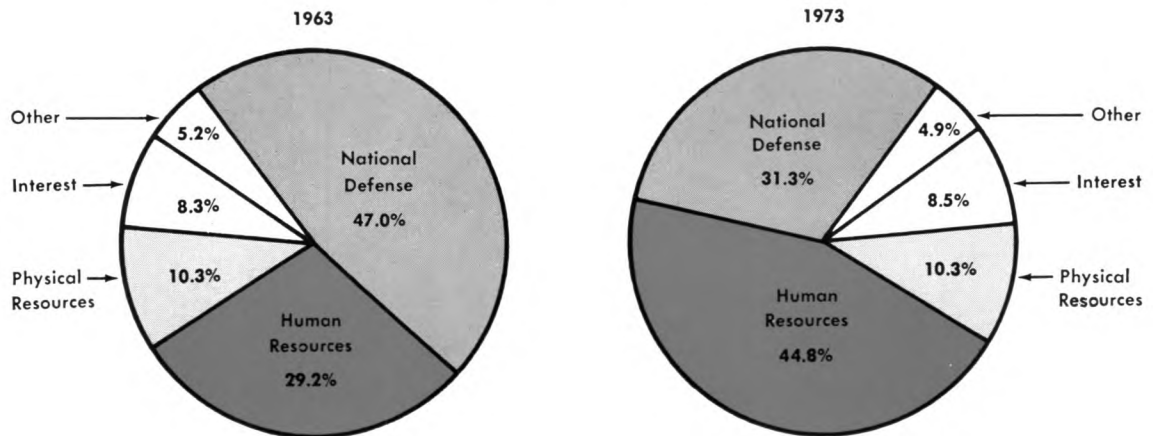
Source: The Budget of the United States Government, Fiscal Year 1973; Mid-Session Review of the 1973 Budget.

<sup>1</sup> This figure is based on the consolidated cash budget concept. All subsequent budget data are based on the unified budget concept. Both budgets are consolidated in the sense that they include expenditures and receipts of both Federal (government owned) funds and trust (government administered) funds. The earlier administrative budget concept did not give explicit consideration to these government-administered trust funds. The establishment of trust fund financing for newly instituted social programs in the 1930's meant that a growing proportion of Federal transactions were being excluded from direct budgetary consideration. The administrative budget thus gave an increasingly distorted impression of the Federal government's influence on economic activity. The administrative budget was consequently replaced by the consolidated cash budget, which with slight modifications was converted to the unified budget.

<sup>2</sup> All 1963 and 1973 budget data were obtained from the following sources: "The Budget of the United States Government, Fiscal Year 1973" (Washington, D. C.: Government Printing Office, 1972); "Special Analyses of the United States Government, Fiscal Year 1973" (Washington, D. C.: Government Printing Office, 1973); Executive Office of the President, "Mid-Session Review of the 1973 Budget" (Washington, D. C.: Office of Management and Budget, June 5, 1972). Data are on a fiscal year basis unless stated otherwise.

Chart 1

## DISTRIBUTION OF BUDGET OUTLAYS BY CATEGORY



Sources: *The Budget of the United States Government, Fiscal Year 1972; Mid-Session Review of the 1973 Budget.*

include unemployment insurance, civil service retirement, railroad retirement, public assistance grants to states, and food stamp payments.

**Health** Since 1963, budgeted health outlays have risen by \$17 billion, with the bulk of the increase attributable to Federal financing of medical services. Since the Medicare and Medicaid programs were instituted in the mid-1960's, Federal payments for the medical expenses of aged and low income individuals have risen to \$14 billion. The remainder of the increase has been allocated to programs designed to increase the supply of health services and improve the efficiency with which these services are distributed.

**Education and manpower** Federal aid to elementary and secondary education rose by about \$3 billion from 1963 to 1973, and aid to higher education rose by nearly \$1 billion. Manpower training outlays rose by almost \$4 billion. Increases in miscellaneous smaller programs bring the total expenditure growth in this area to \$10 billion.

**Defense** Budgeted outlays for national defense in fiscal 1973 were about \$26 billion higher than in fiscal 1963. Virtually all the increase came during the period of escalating hostilities in Southeast Asia, between 1963 and 1969. From 1969 to 1971, reduced expenditures on operations, maintenance, and military procurement resulting from diminished U. S.

involvement in Southeast Asia led to a drop in defense spending of almost \$4 billion. In the past two fiscal years, defense outlays have increased by only about \$.5 billion.

## ECONOMICS OF THE FEDERAL BUDGET

The increasing scope and relative size of the budget reflects the growing involvement of the Federal government in the economic affairs of the nation. The government's power to tax permits economic decision-making to be shifted from the market to the nation's political institutions, where considerations of national welfare, rather than market processes, determine the allocation of the public share of national output. Moreover, government expenditure and tax policies, and their relationship to each other, have an influence not only on the distribution of national output but also on the levels of national output, employment, and prices. Given the relative size of the Federal budget, this influence is substantial, and it is important that it be considered in the process of formulating the budget.

**Fiscal policy and the budget** The Federal budget affects economic activity by influencing the level of aggregate demand, which is the total spending, net of imports, of the household, business, government, and foreign sectors for goods and services. If aggregate spending is insufficient to achieve a full-employment

level of economic activity, additional government spending may be able to induce the utilization of otherwise idle human and physical resources. During periods of less than full employment, a budget deficit, that is, an excess of expenditures over revenues, may thus be defended on grounds that it stimulates output and employment without necessarily producing undue inflationary pressures. Moreover, if the economy should subsequently move closer to full employment, increased tax revenues resulting from rising income and profits would tend to reduce the deficit.

As the economy approaches full employment, however, the desirability of a budget deficit diminishes. In periods of near full employment, a deficit generally produces a level of aggregate spending that exceeds the value of aggregate output at existing prices.<sup>3</sup> This excess demand may be temporarily satisfied through a reduction in the stock of business inventories. Nevertheless, the ability of business inventories to absorb excess aggregate spending is limited. With the economy's productive resources fully utilized, continued excess demand beyond the absorptive capacity of inventories would eventually lead to upward pressure on the level of prices, without adding significantly to output or employment. Assuming the desirability of a relatively low rate of price inflation, Federal budget formulation procedures should reflect the general fiscal policy objective of preventing large budget deficits during periods of near full unemployment.

Fiscal policy objectives can also be expressed in terms of the full-employment budget, for which expenditures and revenues are estimated under the assumption of full employment (usually defined to be about a 4.0 percent unemployment rate). During periods of less than full employment, a moderate full-employment budget deficit might provide a desirable degree of economic stimulus, provided it did not persist into a period of actual full employment. At full employment, however, an actual (full-employment) budget deficit has generally undesirable inflationary implications. Since current budget decisions have a substantial impact on full-employment budgets in subsequent years, these decisions should take into

<sup>3</sup> The net expansionary effect of a budget deficit depends on the method of financing, which in turn depends on the extent to which additional reserves are supplied to commercial banks by the Federal Reserve System. At one extreme, the Federal Reserve System could purchase government securities in the amount of the entire deficit. This would be the most expansionary method of financing, with little offsetting effect on private spending. At the other extreme, the entire deficit might be financed through the sale of government securities directly, or through commercial banks, to the private sector, with no additional reserves injected by the Federal Reserve System. Even in this case, it is not likely that the entire security purchase would be made from current private income. Thus, total private income (net of taxes) would exceed private spending by less than the amount of the deficit, and aggregate demand would exceed aggregate output at existing prices.

account the relationship between future full-employment budgets and prospective economic activity. Ideally, budget decisions should not lock future full-employment budgets into a deficit position at a time when the economy is expected to be operating near full employment.

In practice, fiscal policy considerations are complicated by certain features of the process by which budget expenditures are determined. The Congressional appropriations process does not require that explicit attention be paid to the relationship between expenditures and the tax revenues available for the fiscal year under consideration. More often, revenue legislation is considered independently of budget authorizations. Rational budget-making also presupposes a degree of accuracy in intermediate- and long-term economic forecasting that is hardly achievable given the present state of the forecasting art. Nevertheless, budget decisions may frequently entail financial commitments requiring actual expenditures only after a considerable time lag. The resulting expenditures may often be "built in" to future budgets, a feature that tends to reduce the fiscal policy flexibility needed to deal with unforeseen economic conditions.

## THE BUDGET PROCESS

**Administration proposal** Each spring, the Office of Management and Budget obtains tentative budget estimates from each of the various government agencies. These preliminary estimates, which detail the financial requirements of existing and proposed programs for the fiscal year beginning approximately one year later, are compiled and presented for Presidential consideration. At the same time, revenue estimates are obtained from projections of economic activity made jointly by the Office of Management and Budget, the Council of Economic Advisers, and the Treasury Department. Fiscal policy decisions concerning the appropriate size of actual and full-employment budget positions can then be made. Given revenue projections based on existing tax legislation, adjustments in expenditures may be made to achieve the desired budget position. Alternatively, tax proposals may be made if existing programs warrant expenditures that would produce an unacceptably large deficit. In either case, agency budgets are subsequently revised to take account of the total expenditure level specified by fiscal considerations. Once approved by the President, the revised Federal budget for the fiscal year beginning July 1 is submitted to Congress the preceding January.

The initial 1973 Federal budget proposed to Con-

gress in January 1972 provided for expenditures of \$246.3 billion and revenues of \$220.8 billion, leaving a deficit of \$25.5 billion. On a full-employment basis, the initial budget was approximately balanced. It provided for full-employment revenues of \$245 billion, and expenditures (reduced by the decline in unemployment compensation) of \$244.3 billion.<sup>4</sup>

**Congressional appropriations** After the President has submitted the proposed budget, Congress can amend or delete Administration proposals or add its own. Once Congressional action begins, however, there are no established procedures that provide for explicit consideration of the overall fiscal impact of the budget. Each program is considered on its own merits, independently of its effect on total budget expenditures and independently of any revenue constraint.

Congress does not actually vote on expenditures as such though it does determine how much is ultimately to be spent. In general, after a program has been authorized by Congress, separate legislation must be enacted granting appropriations of budget authority.<sup>5</sup> The budget authority for a particular program establishes the amount of financial obligations that the agency in charge can incur for that program over some specified period of time. Most programs are authorized on a yearly basis, and their budget authority appropriations are granted for expenses over the fiscal year for which the program is authorized. Generally, the appropriations specifically limit the amount of financial obligations the agencies in charge can incur for these programs over the fiscal year. Any unobligated budget authority expires at the end of the fiscal year.

In some cases, budget authority is provided automatically on an annually recurring basis without further Congressional approval. Congress can also specify indefinite budget authority for situations in which the level of expenditures is determined by factors outside the control of Congress. If necessary, the duration of the budget authority may run for a specified number of years, in the form of multiple year appropriations, or even be open-ended. The social security program provides an important example of indefinite, open-ended appropriations. Cur-

rent social security legislation automatically grants budget authority every year. The authority is indefinite, since the amount of the annual appropriation is determined not by Congress but by the legislative provision that the appropriation be equal to the amount of payroll tax contributions to the social security trust funds over the fiscal year. For 1973, the social security appropriation is about \$46.2 billion, which is equal to estimated trust fund receipts. Since the appropriation is open-ended, \$42.3 billion in unspent budget authority balances from previous years are added to the current appropriation to obtain the total 1973 social security budget authority balance of \$88.5 billion. After an estimated \$45.5 billion in social security benefits are distributed in 1973, the remaining \$43 billion in budget authority will in turn be available for expenditure in future years.

**Dynamic features of the budget** Appropriations legislation often permits, or requires, spending to occur as much as several years after the approval of the appropriation. Multiple year and open-end appropriations allow unobligated balances of budget authority to be carried forward from one fiscal year to the next without further Congressional action. Also, obligated balances need not be expended during the year the obligations are incurred. These authority balances (obligated and unobligated) constitute one dynamic feature of the budget process relating future expenditures to decisions made in the current and past Federal budget periods. Chart 2 shows the relationship between estimated 1973 outlays and past appropriations, and also the balances of authority available from the current and past budgets for future expenditures. Approximately 39.3 percent of 1973 outlays can be attributed to appropriations made in earlier budgets. And about 45 percent of the \$276 billion in fiscal 1973 appropriations is programmed for expenditure beyond that fiscal period.

Another dynamic feature of the Federal budget is the influence of permanent authorizing legislation, which automatically appropriates budget authority on a recurring basis. As indicated in Chart 2, approximately \$85.6 billion of the \$276 billion in 1973 budget authority is permanent authority. The major sources of permanent authority are the social security trust funds (including Medicare), accounting for about \$53 billion in permanent authority, and interest on the national debt, which accounts for about \$21 billion. The highway trust fund and the unemployment insurance trust fund together account for another \$10 billion.

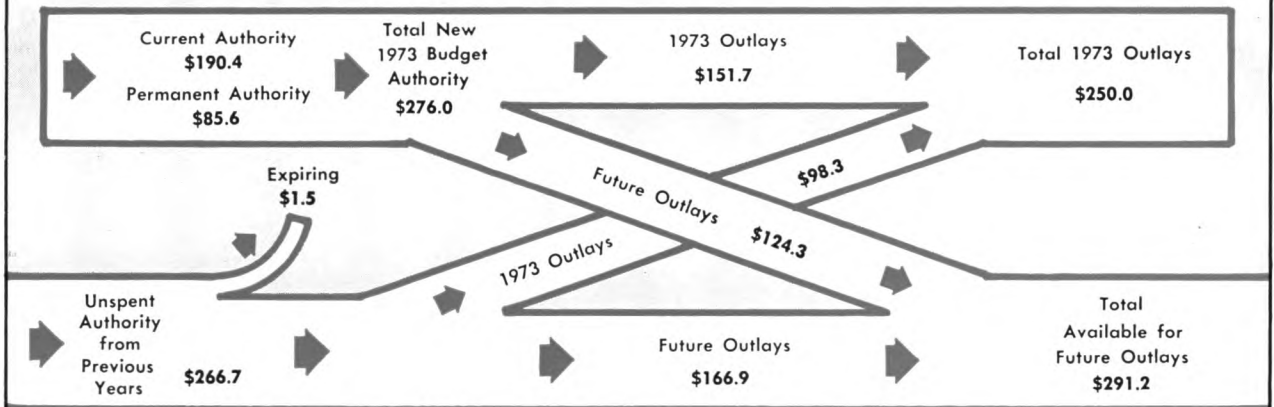
The appropriations process itself thus imparts to budget expenditures a significant degree of year to

<sup>4</sup> The fiscal policy implications of a full-employment budget deficit are discussed in the *Economic Report of the President* (Washington, D. C.: Government Printing Office, 1962), pp. 77-81. The Administration's stated policy goal is: "Except in emergency conditions, expenditures should not exceed the level at which the budget would be balanced under conditions of full employment." *The Budget of the United States Government, Fiscal Year 1973*, p. 14.

<sup>5</sup> There are two sources of budget authority outside the appropriations process. Contract authorization permits agencies to enter into contracts prior to the appropriations eventually required to satisfy contractual obligations. Authorization to spend debt receipts permits agencies to borrow funds and to obligate and spend the proceeds. These two sources of non-appropriated budget authority are relatively minor, contributing about \$11 billion to the 1973 total.

Chart 2

**RELATION OF BUDGET AUTHORITY TO OUTLAYS, 1973 BUDGET**



Sources: The Budget of the United States Government, Fiscal Year 1972; Mid-Session Review of the 1973 Budget.

year interdependence and renders a substantial portion of the budget relatively inflexible on a short-term basis. Moreover, expenditures for programs which are authorized on a current basis are not completely flexible. Current, as well as permanent, authorizations provide funding for programs that are based on previous policy decisions. Unless policy changes occur, and such changes generally occur only gradually, the existing programs must be adequately funded to carry out their legislated objectives. After the necessary requirements of implementing these programs are also taken into account, budgetary discretion is in fact quite limited in the short run.

**Revenues** While the recent emphasis on civilian social programs has contributed to the growth in budget expenditures over the past decade, tax legislation has had the effect of reducing the growth of available tax revenues. Tax measures enacted in 1964, 1969, and 1971 have diminished the potential growth in individual income and corporate profit taxes over the past 10 years. Social security payroll taxes, however, have been increased in a series of Congressional amendments to existing social security legislation. The most recent amendments for 1973 established a 5.85 percent payroll tax, paid by both employer and employee, on the first \$10,800 in annual income; for 1974, the income base will rise to \$12,000. In 1963, the rate was 3.63 percent on the first \$4,800 in annual income. The resulting change in the distribution of Federal tax revenues by source, based on 1973 budget estimates, is shown in Table II. As budgetary emphasis shifts to the payroll tax,

which applies to a declining proportion of income as income rises, the progressivity present in the individual income tax becomes less pronounced in its effect on the growth of Federal revenues. Consequently, Federal tax revenues are an estimated 18.5 percent of GNP in 1973, a proportion virtually unchanged since 1963, despite the fact that real GNP has increased by about one-half over the period. The increased reliance on payroll taxes is no less important than accelerated spending as an explanation of the so-called budget crisis that has developed in recent years.

**FISCAL IMPLICATIONS OF THE 1973 BUDGET**

The basic revenue and expenditure decisions of the past decade will continue to have their fiscal impact in coming years. It is, of course, impossible to determine precisely the characteristics of future budget decisions, since these decisions will depend in part upon future political and economic events. Nevertheless, it may be useful to examine the partial influence that the current budget by itself may exert on future budgets.

In its January budget proposal, the Administration projected the changes in full-employment revenues and expenditures that are likely to occur between 1973 and 1977. These projections were based on the assumption that no new expenditure (or revenue) programs would be instituted other than those proposed in the 1973 budget, mainly general revenue sharing, welfare reform, and national health insurance. Thus, projected expenditure growth over the

Table II

## FEDERAL TAX REVENUES

(fiscal year, amounts in billions of dollars)

Source	1963		1973	
	Amount	Percent of Total	Amount	Percent of Total
Individual Income	47.6	44.7	95.5	42.8
Corporate Profit	21.6	20.3	36.0	16.1
Social Insurance	19.8	17.8	63.9	28.7
Other	17.6	16.5	27.6	12.4
Total	106.6	100.0	223.0	100.0

Source: *The Budget of the United States Government, Fiscal Year 1973; Mid-Session Review of the 1973 Budget.*

period depended on: (1) inflation, (2) the effect of population growth on Federal government workloads, and (3) the growing number of beneficiaries eligible for rising benefits under the various income security programs. Assuming also that the economy would reach full employment by the end of fiscal 1973 and grow by 4.3 percent (in real terms) thereafter, existing tax legislation would provide an excess of about \$23 billion in revenues over expenditures through 1977. These revenues would constitute the "budget margin" available for the implementation of new expenditure programs through 1977.

Subsequent budget analyses by several research organizations have arrived at more conservative estimates of the budget margin available for new programs in the near future. Based on approximately the same conditions assumed in the Administration's estimate of the budget margin, the Brookings Institution arrived at somewhat higher expenditure estimates and slightly lower revenue estimates, and concluded that the budget margin through 1977 would be only about \$5 billion.<sup>6</sup> In a similar study, the American Enterprise Institute concluded that, on a full-employment basis, expenditure growth would actually exceed revenue growth by over \$2 billion through calendar year 1977.<sup>7</sup> The AEI study, how-

ever, was conducted on the basis of the 1973 budget as modified by legislation through mid-August 1972. Thus, the AEI estimates of the budget margin differed in one important respect from the previous two.

The quantitative accuracy of the budget margin estimates is dubious, at best, since they do not take into consideration future economic and political events. The ultimate validity of two major assumptions, the enactment of welfare reform and national health insurance programs, is questionable. The diverse estimates of the 1973-77 budget margins also testify to the difficulty involved in estimating the potential effects of a constantly changing Federal budget. Moreover, it is not now possible, given the current state of economic forecasting techniques, to determine accurately the future economic conditions upon which fiscal and budget policy decisions should be made.

Nevertheless, should the current economic expansion continue and economic activity begin to approach full-employment levels, these budget margin estimates do at least suggest there will be little, if any, excess revenues available for new programs. The establishment of expenditure programs beyond those proposed in the 1973 budget would probably threaten the modest revenue surpluses projected through 1977.

Budget deficits can be eliminated by reducing expenditures or increasing tax revenues, or both. A rational budget process should evaluate each expenditure program in terms of competing programs, and not simply on its own merits. Moreover, all programs should be judged in terms of the total resources available to the Federal government on a long-term basis. If enduring budget deficits are the prospect for periods of near full employment, low priority programs should be evaluated to determine whether or not their continued support is important enough to warrant increased taxes. Such a process would entail difficult political and economic decisions at the Executive and Congressional level. But the recent sequence of budget deficits and future budgetary prospects also involve the implicit decision to allocate through inflation, rather than taxation, the nation's output between the private and public sectors. Since such important decisions are involved, it is desirable that they be made deliberately and not by defaulting to exigencies imposed by past budget decisions.

Glenn Picou

<sup>6</sup> For details of the Brookings projections, see Charles L. Schultze, *et. al.*, ed., *Setting National Priorities: the 1973 Budget* (Washington, D. C.: The Brookings Institution, 1972), pp. 410-20.

<sup>7</sup> Details of the AEI projections are discussed in David J. Ott, *et. al.*, *Nixon, McGovern, and the Federal Budget* (Washington, D. C.: American Enterprise Institute for Public Policy Research, 1972), pp. 3-7. The AEI budget model estimates Federal revenues and expenditures on a National Income Account (NIA) basis. The NIA Federal sector account is obtained by adjusting the unified budget for government employee retirement contributions, financial transactions, time of defense purchases, and other miscellaneous items. The 1973 adjustment is shown below:

	Expenditures	Receipts	Deficit
Unified Budget	236.6	197.8	38.8
Adjustment	1.2	5.0	
NIA	237.8	202.8	35.0



# RECENT DEVELOPMENTS IN FIFTH DISTRICT BANKING

Banking in the United States has been as dynamic as the economy it supports. From 1790, when there were only four commercial banks, until the present day, when there are nearly 14,000, the banking system has attempted to adapt to the needs and demands of a changing society and an expanding economy. At no period in the history of this nation has commercial banking been more adaptable and innovative than in the past 15 years.

**Economic Conditions** Many of the dramatic changes that have taken place in banking since the mid-fifties can be attributed to economic conditions during the period. A time of great social and economic change in the Fifth District and in the nation, this period witnessed a high rate of growth in both population and income. In a number of Fifth District states especially, shifts in the population from rural to urban areas had enormous economic, as well as social, impact. Both the expansion of existing industries and the development of new ones have also had substantial effects on the economy, and hence on banking. Although the economic growth of the last 15 years has generally meant increases in bank deposits, profits, and size, a concomitant demand for banking services has also arisen. For instance, alterations in population distribution have resulted in the demand for banks in new areas. Likewise, a burgeoning population has created a need for greater emphasis on consumer banking. The expansion of industry has generated demands for increasingly higher levels of credit. Changing economic conditions have, therefore, imparted new challenges to the banking industry in recent years.

**The Statutory Environment** Although a number of economic factors have indeed contributed to alterations in the banking structure, the chief determinant of changes in recent years can probably be found in the altered statutory environment in which banks operate. Regulated by both the Federal government and state governments, the banking system in this country has been greatly influenced in the last 15 years by significant changes in the banking laws. The most important recent legal changes on the national level have been passage of the Bank Holding Company Act of 1956, which was substantially amended in 1966 and 1970, and enactment of the

Bank Merger Act of 1960, which was also subsequently amended in 1966. Basically, this legislation delineated the criteria for evaluating external growth in banking markets and demarcated permissible lines of nonbank activities. Since most of the external growth of banking organizations—both nationwide and in the Fifth District—has been either through the merger of existing banks or through bank holding company formation or acquisition, the importance of these Federal laws and their amendments should not be underestimated. This legislation has not only broadened the avenues of bank expansion, but it has also provided standards for approval of bank activities by the appropriate regulatory authority, whether this be the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, or the Comptroller of the Currency. On the state level, too, statutory changes have generally moved in the direction of clarification and definition.

In addition to growth in existing banking offices and the creation of new banks, which must be approved by the Comptroller for national banks and by the state banking authorities for state banks, an existing bank organization can expand its operations by three possible means: (1) branching, (2) merger, and (3) holding company acquisition. *De novo* branching is not only subject, in most cases, to approval by one of the Federal regulatory agencies but is also governed by state banking laws.<sup>1</sup> In fact, branching is chiefly regulated by state laws, a situation that results from the currently accepted, though sometimes contested, principle that all branches, whether of state or national banks, must conform to the branching laws established by the respective states.<sup>2</sup> Bank mergers are also regulated by state banking authorities and Federal authorities. At the present time, Federal agencies have the principal authority for regulating bank holding company acquisitions.

State banking systems can be generally categorized according to the degree of branching allowed in the state. In some states only unit banking, which means no branching, is allowed; but in other states either

<sup>1</sup> The only exceptions to this are banks not insured by the Federal Deposit Insurance Corporation. At the end of 1971, there was only one such bank in the Fifth District.

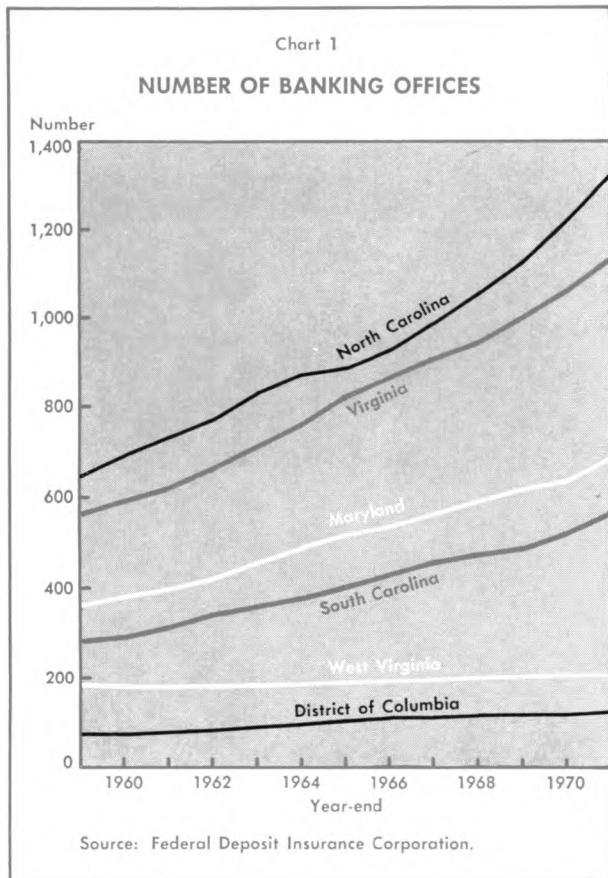
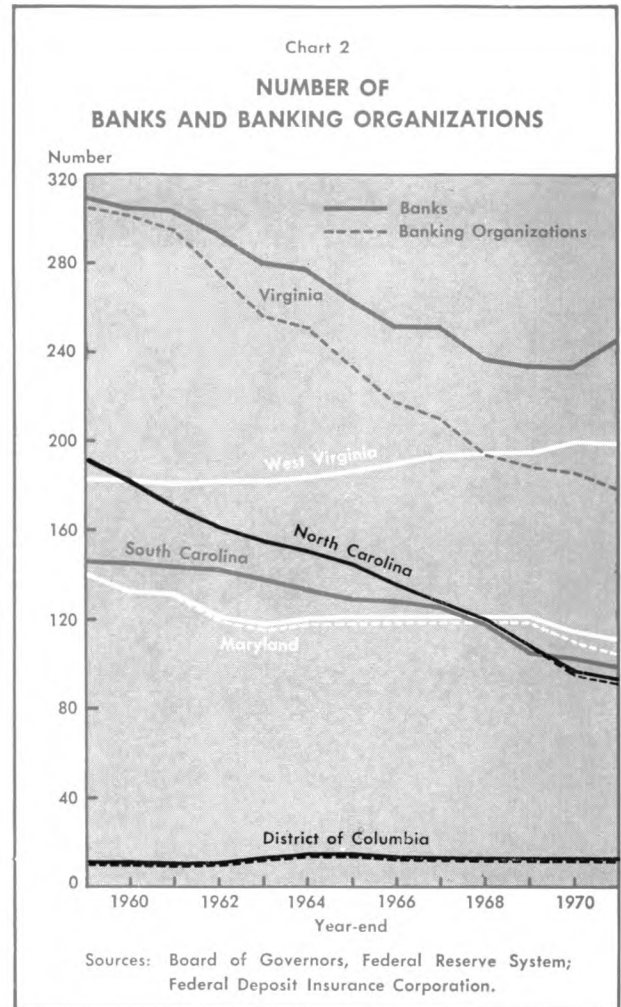
<sup>2</sup> Branching by national banks requires only the direct approval of the Comptroller's Office.

statewide or more limited branching is permitted. In the Fifth District, West Virginia is a unit banking state, although "facilities," such as drive-in-teller windows, are now allowed by state law.<sup>3</sup> Virginia law permits limited statewide expansion—by merger throughout the state and by *de novo* branching in local areas. Statewide branching is allowed in Maryland, North Carolina, and South Carolina; branching is also permitted throughout the District of Columbia.

**Fifth District Developments** In the Fifth District the most important single development in banking structure in recent years has been the increased concentration of banking organizations. Between December 31, 1959, and December 31, 1971, the total number of Fifth District banks declined from 981 to 764, although the number of banking offices in the District rose 90 percent—from 2,112 to 4,015—as shown in Charts 1 and 2.<sup>4</sup> The largest nu-

<sup>3</sup> Although West Virginia law currently prohibits bank branching, one limited-service "facility," which must be located within 2,000 feet of the main bank's building, is allowed. Six of these facilities were operating in West Virginia at the end of 1971.

<sup>4</sup> Although six West Virginia counties are not officially included in the Fifth District, all data for West Virginia and the District include these counties, for the sake of simplicity.



merical increases in banking offices occurred in North Carolina, Virginia, Maryland, and South Carolina, in that order, with the number of offices in both North Carolina and Virginia more than doubling during the period. At the same time, the total number of banks declined in each of these four states, while the District of Columbia, which registered the smallest gains in total banking offices, and West Virginia showed net increases. Since West Virginia is a unit banking state, each new office, with the exception of "facilities," also represented an increase in the number of banks.

Holding company activity in the Fifth District, which was primarily centered in Virginia, has accounted for a great deal of the increased concentration of banks. At the end of 1971, 88 Fifth District banks were controlled by 11 multi-bank holding companies; whereas at the beginning of 1960, only nine banks were subsidiaries of two multi-bank

Table I

## CHANGES IN THE NUMBER OF BANKS IN THE FIFTH DISTRICT

	Banks in Operation (Dec. 31, 1959)	New Banks	Mergers Absorptions, Consolidations	Liquidations & Suspensions	Banks in Operation (Dec. 31, 1971)	Net Change
District of Columbia	12	4	2	—	14	+2
Maryland	140	19	47	—	112	-28
North Carolina	192	11	108	—	95	-97
South Carolina	145	14	59	1	99	-46
Virginia	309	65	128	1	245	-64
West Virginia	183	22	6*	—	199	+16
Fifth District	981	135	350	2	764	-217

\* Branches are considered "facilities" under West Virginia law.

Sources: Federal Deposit Insurance Corporation and Board of Governors, Federal Reserve System.

holding companies.<sup>5</sup> By December 31, 1971, there were 67 multi-bank and one-bank holding companies in the Fifth District, which can be compared to the national total of 1,567 bank holding companies, with control over 55.1 percent of all deposits in the nation's commercial banking system.<sup>6</sup>

Structural changes among Fifth District banking systems were the result of rather diverse expansionary activities in the five states and the District of Columbia. On an individual basis, the banking sys-

tems of Virginia and North Carolina underwent the most dramatic changes during the period. The proliferation of bank holding companies was the most significant factor in Virginia, which does not permit statewide *de novo* branching. Changes in the North Carolina banking structure, on the other hand, almost solely resulted from statewide branching and bank merger. These routes to expansion were also used by banking systems in Maryland and South Carolina. The activity in North Carolina was somewhat more extensive than in the latter two states, however. Because of legal limitations in West Virginia and geographical restrictions in the District of Columbia, banking systems in these two areas experienced much more modest structural change.

<sup>5</sup> Unless otherwise stated, all references to bank holding companies in this article are to multiple-bank (multi-bank) holding companies. Prior to enactment of the 1970 amendments to the Bank Holding Company Act, only multi-bank holding companies came under the legal definition of a bank holding company.

<sup>6</sup> "Banking Offices and Deposits of Banks in Holding Company Groups, December 31, 1971," *Federal Reserve Bulletin*, 58, No. 8 (August 1972), A101.

Table II

## BANKING ORGANIZATIONS

	December 31, 1959				December 31, 1971			
	Multi-Bank Holding Companies		One-Bank Holding Companies & Independent Banks	Total Banking Organizations	Multi-Bank Holding Companies		One-Bank Holding Companies & Independent Banks	Total Banking Organizations
	Number	Banks		Number	Banks			
District of Columbia	1	2	10	11	1	2	12	13
Maryland	1	1	139	140	2	9	103	105
North Carolina	—	—	192	192	1	3	92	93
South Carolina	—	—	145	145	—	—	99	99
Virginia	2	6	303	305	9	74	171	180
West Virginia	—	—	183	183	—	—	199	199
Fifth District	2*	9	972	974*	11*	88	676	687*

\* One multi-bank holding company controlled banks in D. C., Maryland, and Virginia.

Source: Federal Deposit Insurance Corporation.

Table III

## TOTAL BANK OFFICES

	Dec. 31, 1959	Dec. 31, 1971	Absolute Change	Percent Change
District of Columbia	76	122	+46	61
Maryland	365	679	+313	86
North Carolina	644	1,319	+675	105
South Carolina	279	558	+279	100
Virginia	564	1,132	+568	101
West Virginia	183	205	+22	12
Fifth District	2,112	4,015	1,903	90

Source: Federal Deposit Insurance Corporation.

The state of Virginia restricted *de novo* branching from 1948 until the enactment of the Virginia Banking Act in 1962, which greatly liberalized the state's branching laws. Before 1962, a Virginia bank could only branch *de novo* in the city or county where its main office was located, although branching through merger with banks in the same or adjoining counties, or within 25 miles of the resulting bank's main office, was permitted. The Virginia Banking Act of 1962, often referred to as the Buck-Holland Bill, loosened these restrictions by allowing branching through merger statewide and *de novo* branching, with some limitations, into counties and cities contiguous to the locale of a bank's main office.<sup>7</sup> This legislation also provided for the regulation of holding companies under Virginia state law. The result of this legis-

<sup>7</sup> The law specifically provides that banks can branch *de novo* "in cities contiguous to the county or city in which the parent bank is located and in counties contiguous to the city in which the parent bank is located." If the parent bank is situated in a city, branches in the contiguous county may not be established more than five miles outside the city limits. A parent bank whose main office is located in a county cannot open a new branch in a contiguous county. See *Laws of Virginia Relating to Banking and Finance* (Charlottesville, Virginia: The Michie Company, 1972), pp. 22-25.

Table IV

## TOTAL COMMERCIAL BANK DEPOSITS

(Dollars in Thousands)

	Dec. 31, 1959	Dec. 31, 1971	Percent Change
District of Columbia	\$1,459,974	\$2,951,573	102.2
Maryland	2,338,779	5,940,883	154.0
North Carolina	2,788,034	8,371,967	200.3
South Carolina	1,010,624	2,789,596	176.0
Virginia	3,196,486	9,210,785	188.2
West Virginia	1,259,511	3,298,014	161.8
Fifth District	12,053,408	32,562,818	170.2

Source: Federal Deposit Insurance Corporation.

lation was a sharp increase in merger and holding company activity; and by 1969, a number of statewide banking organizations were serving Virginia.

During the period 1960-1971, 128 bank mergers were consummated in Virginia—more than in any other Fifth District area. The effects of these mergers on the state's banking structure were moderated to some extent, however, by the formation of 65 new banks in the years 1960-1971. The state nevertheless experienced a net decline of 64 banks (including one liquidation) during the 1960-1971 period. At the same time, the total number of banking offices in the state more than doubled, increasing from 564 to 1,132 or 101 percent. Since the parent bank of two merged systems cannot open any additional branches in the areas of the absorbed bank, some Virginia banks decided, in the early and mid-sixties, to form multiple-bank holding companies.<sup>8</sup> This type of ex-

<sup>8</sup> It should be noted that between 1956 and 1970 some banks in Virginia, as elsewhere, formed one-bank holding companies, which permitted them to engage in activities denied to multiple-bank holding companies. In 1970, amendments to the Bank Holding Company Act eliminated the distinction, at least for regulatory purposes, between single- and multiple-bank holding companies, thereby subjecting both to the same regulations.

Table V

## POPULATION PER BANKING OFFICE

	1960			1970		
	Population	Banking Offices	Population per Banking Office	Population	Banking Offices	Population per Banking Office
District of Columbia	763,956	76	10,052	756,510	114	6,636
Maryland	3,100,689	366	8,472	3,922,399	613	6,399
North Carolina	4,556,155	644	7,075	5,082,059	1,125	4,517
South Carolina	2,382,594	279	8,540	2,590,516	485	5,341
Virginia	3,966,949	564	7,034	4,648,494	998	4,658
West Virginia	1,860,421	183	10,166	1,744,237	200	8,721
Fifth District	16,630,764	2,112	7,874	18,744,215	3,535	5,302
United States	179,323,175	23,130	7,753	203,184,772	33,858	6,001

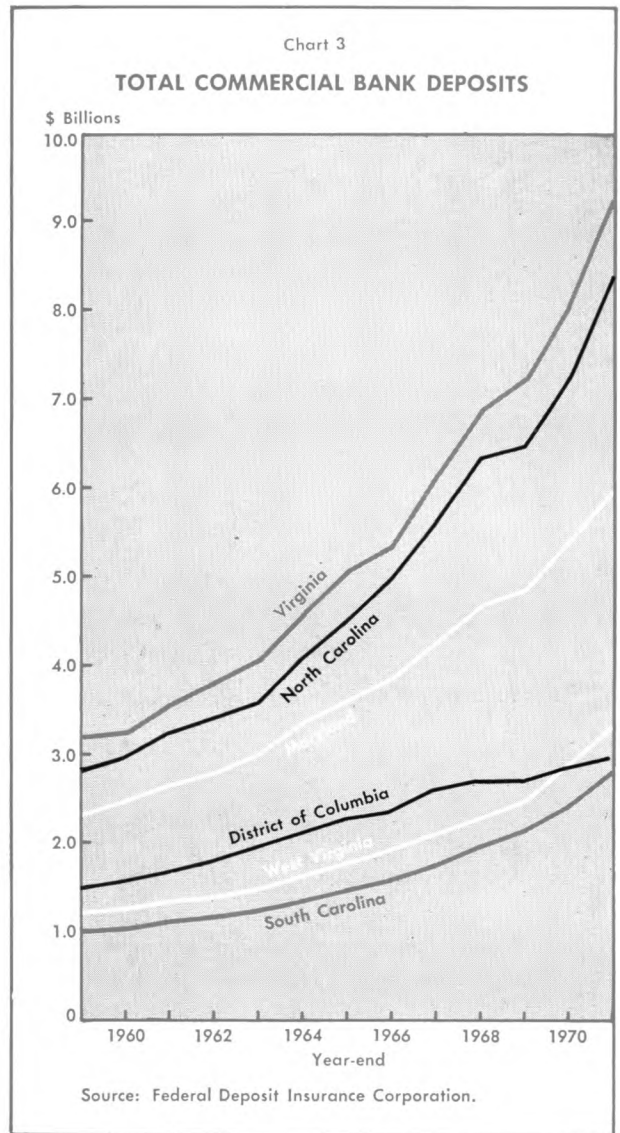
Sources: Bureau of the Census and Federal Deposit Insurance Corporation.

pansion does allow Virginia bank holding company organizations to branch *de novo* through acquired banks in those banks' areas following acquisition. By the end of 1971, 26 bank holding companies (including one-bank and multi-bank companies) controlled 82 banks in the state. Overall, the extensive merger and holding company activity within Virginia resulted in a decrease in the number of independent banking organizations from 303 on December 31, 1959, to 171 on December 31, 1971, as shown in Table II.

Differing from the experience of Virginia, the North Carolina, South Carolina, and Maryland banking systems underwent similar structural changes from 1956 to 1971. All three states had allowed statewide *de novo* branching and merger for a number of years prior to 1960. Consequently, there was no particular incentive for banks in these states to expand by means of the holding company structure, as was the case in Virginia during the sixties. As of December 31, 1959, only one multi-bank holding company was operative in the three states; this company held interests in one Maryland bank, as well as in one Virginia bank and two District of Columbia banks. By the end of 1971, the number of multiple-bank holding companies in the three states had only increased to three. Two controlled nine Maryland banks, and one controlled three North Carolina banks. The additional Maryland company was not formed until 1970, and the North Carolina company did not come into existence until 1971. No multiple-bank holding company had entered South Carolina banking by the end of 1971.

Merger and branching activity in the North Carolina, South Carolina, and Maryland banking systems has been considerably more intense than holding company activity. Total bank offices in these states increased by 105 percent, 100 percent, and 86 percent, respectively, between year-end 1959 and 1971, as shown in Table III. North Carolina led the District in both absolute and relative increases in bank offices over the period. The number of offices in this state increased from 644 to 1,319 or 105 percent. Over this same period of time, 108 bank mergers took place in the state. Offset by only 11 new bank formations, the consolidation of existing banks resulted in a net decline of 97 banks, leaving only 95 commercial banks in operation in North Carolina at the start of 1972. The North Carolina banking system thus experienced, because of extensive merger activity, the largest proportional decrease in the number of banks of any Fifth District area.

Mergers, although not expressly prohibited by



West Virginia law, are restricted by the same limitation that affects branching in this state's banking system. Not only is branching forbidden in West Virginia but two merging banks, once merged, must close one of their two offices. As a result, practically all of the structural change that occurs in the West Virginia banking system is caused by new bank formations. In 1959, West Virginia had a total of 183 banking organizations; by 1971, this figure stood at 199, representing a net change of 16, which was the highest increase in the Fifth District. Total bank offices, however, only rose by 12 percent, from 183 to 205, which was the lowest rate of increase in the District.<sup>9</sup>

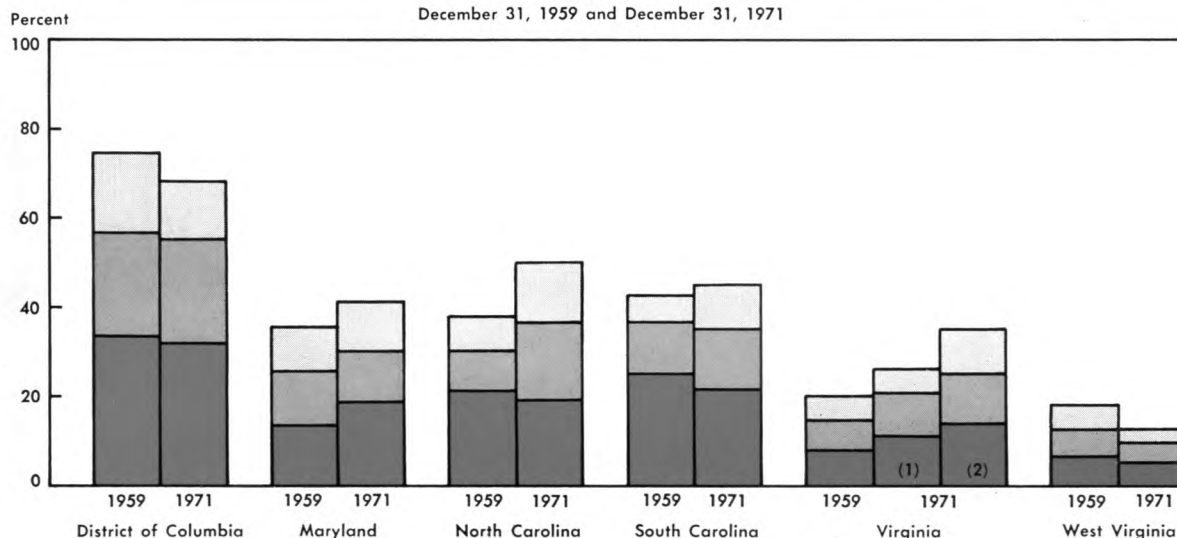
<sup>9</sup> In 1971, West Virginia, despite severe limitations on branching, had more banking offices than banks, because of the addition of six limited service "facilities." See footnote 3.

Chart 4

**SHARE OF TOTAL COMMERCIAL BANK DEPOSITS HELD BY THREE  
LARGEST BANKS AND BANKING ORGANIZATIONS\***

FIFTH DISTRICT

December 31, 1959 and December 31, 1971



\*On December 31, 1959, the three largest banking organizations in each Fifth District state and D. C. were the three largest banks. At year-end 1971, two of the three largest banking organizations in Virginia were holding companies with two or more banks, as shown in Virginia's column 2 for 1971.

Sources: Board of Governors, Federal Reserve System; Federal Deposit Insurance Corporation.

The District of Columbia is also restricted in its external expansion, but here the restricting factor is geography. Since the District of Columbia encompasses a relatively small area, bank expansion is naturally limited. In 1959, there were 11 banking organizations in D. C.; in 1971, there were 13, which represented the second highest rise in the Fifth District. Total bank offices in D. C. rose from 76 in 1959 to 122 in 1971, an increase of 61 percent.

**Effects of Changes** Banking structure changes in the Fifth District in the last few years have to some extent paralleled banking developments nationwide. Largely influenced by Federal and state legislation, most areas in the District have experienced sharp reductions in the number of banks in operation but significant growth in the size of banks and banking organizations. The increased share of total commercial bank deposits held by the three largest banks and banking organizations in each Fifth District state, shown in Chart 4, illustrates the increased concentration of deposits in the largest banks in the Fifth District and the degree of change in concentration. Another significant development in the District has

been the expansion of the number of offices serving the public. Although the total number of banking organizations declined from 974 in 1959 to 687 in 1971, the number of bank offices in the District increased from 2,112 to 4,015 during this period. Moreover, the population per banking office has declined from 7,874 persons per office in 1960 to 5,302 in 1970. This change compares favorably with the national averages of 7,753 in 1960 and 6,001 in 1970.

Despite the clear tendency towards greater concentration of banking resources in the Fifth District, there is no evidence that this trend has significantly reduced overall banking competition in the area. In fact, in some localities in the District, aggressive and innovative banking organizations may be stimulating competition. It should also be remembered that this increased concentration reflects not only an altered statutory environment but also underlying changes in broad economic conditions and demographic patterns. The overall effect of these changes, moreover, has generally been an increased range of banking services in the Fifth District.

*Thomas Y. Coleman and Bradley H. Gunter*

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