Proposals for Rechanneling Funds to Meet Social Priorities

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I support the primary and secondary thrusts of the recommendations of the President's Commission on Financial Structure and Regulation. The primary thrust of these recommendations is that each financial institution should decide for itself where its comparative advantage lies within the domain of financial intermediaries and that institutions that are doing the same things should be subject to the same regulations. The secondary thrust is that the amount of regulations should be substantially reduced. While it is easy to quibble about details and timing I think the Commission should be given the benefit of the doubt on these matters. They result from a balancing of objectives that no outsider can make and that no insider with vested interests should be allowed to make.

I do this despite my interest in channeling funds toward social priorities. First, the present institutions and regulations have not channeled funds toward social priorities in sufficient quantities to be worth the inequities that they have produced. The present arrangements are simply not worth preserving as a vehicle for meeting social objectives. Second, the present arrangements assume that you can compartmentalize financial intermediaries so that institutions that are under different regulatory handicaps do not compete with each other. This assumption has simply proven to be untrue. Moreover, there probably is no set of regulations that could stop poaching on the other guy's turf. As a result, all regulations should be across-the-board regulations on all intermediaries.

I also admit that all social priorities could be met with budgetary expenditures and/or tax credits (tax expenditures). I am convinced that in a perfectly functioning world most social priorities *should* be

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met with budgetary expenditures. Both complex tax incentives and financial regulations are apt to end up doing more for some intermediary than they do to promote the ultimate social objective. (Tax deductibility for state and local government bonds is probably the best current example of such a result.) The financial community is perfectly right in saying that in a perfectly functioning world, social priorities *ought* to be someone else's problem.

The recommendations of the President's Commission essentially spring from a vision of perfectly competitive capital markets. Each saver sends his savings into the capital markets and is paid a competitive (equal) rate of interest by the financial intermediaries. Financial intermediaries in turn allocate the savings to those lenders who are willing to pay the highest rate of interest. With the exception of allowing for differences in risk and the costs of making loans (economies of scale in handling large borrowers), all borrowers pay at the same rate of interest. Differences between lending rates and borrowing rates reflect the financial intermediaries' costs (including a necessary profit) of making loans. The level of the competitive interest rate insures that the demand for savings equals the supply of savings. In such a world no one cares to whom he lends or from whom he borrows. The same conditions are available everywhere. In such a world, social priorities are quite properly left in the government budget.

The question then becomes one of whether the real world is close enough to a perfectly functioning world so that we can afford to operate on the premise that the real world functions perfectly. Alternatively we could ask what changes would be necessary to bring the real world close enough to a perfectly functioning world to make the assumption valid.

Discrepancies

While a host of deviations between such a model and the real world could be noted, there are three major facts of life that are not in accordance with the ideal world. First, not all savings are allocated in the capital markets. In the ideal world they should be. Second, credit rationing is a pervasive fact of the real world. In the ideal world it does not and cannot exist. Third, customer relationships are thought to be important. In the ideal world the whole concept of a regular and valued customer does not exist. To some extent these are not three independent deviations. The latter two spring principally from the first.

Corporate retained earnings are the major source of unallocated savings within the capital markets. They enjoy special tax and legal advantages. They are subject to neither the allocation procedures of the capital marketplace or to the allocation desires of their owners (the individual shareholders). From the point of view of the arguments used to justify deregulation for financial institutions, all earnings (including depreciation charges) should be paid out as dividends and then brought back into the firm in the form of borrowings or equity issues. Corporate taxation could be abolished, but all dividends and depreciation allowances above the initial investment would be taxed as personal income. As a result, corporations would be forced to compete for all of their capital needs. Unless this is done, corporations have two major advantages in the country's capital markets. First, they have tied savings for which they do not have to compete. Second, their tied savings (cash flow) can be used as collateral to obtain extra funds in the capital markets. Conversely, the supply of savings for which others must compete is smaller than it should be.

Our actual financial markets are marked by credit rationing and by preferences for large regular corporate customers over small, irregular, non-corporate customers. Why? The answer lies in imperfect knowledge and in the tied savings of the corporate sector. Profit-maximizing financial intermediaries obviously want to cultivate the business of corporations with large flows of tied savings (cash flows). In our real world of oliogopoly relationships, such a connection is the best method for maximizing long-run profits. Yet such long-run profit maximization will result in too few funds being allocated to the infrequent non-corporate borrower from the point of view of economic efficiency.

Logically all of the assumptions that lead to the actual recommendations of the Commission lead to the abolition of retained earnings. Single economic efficiency considerations demand it, yet the Commission did not recommend it. Politically, I understand why such a recommendation was not made, but its absence leads to a report which at best must be described as self-serving. Given this large imperfection in favor of corporate borrowers, there are *only* two options. Create equal preferences within the financial markets for non-corporate borrowers or stop the preferences for corporate borrowers. I am willing to stop the special preferences for corporate borrowers, but I suspect that realistically we must focus on equal preferences for non-corporate borrowers. Without such preferences, credit rationing will allocate too many funds to the corporate sector and too few funds to the non-corporate sector. The question is how such a bias can be corrected in a manner that will not violate the primary and secondary thrusts of the Commission's recommendations. This is not a question of equity but of efficiency.

An Examination of Special Cases

Before examining the possible countervailing preferences that could be created for small, irregular, non-corporate borrowers, it is necessary to examine the special cases that are advanced for special financial regulations for special sectors. The areas usually cited include housing, state and local governments, agriculture, exports, and small businesses. In addition to its absolute merits, however, each case needs to be examined with an eye to alternative solutions. Are special financial regulations or institutions the best way to solve the problem?

A. State and Local Governments

The basic problem of state and local government finance is not one of borrowing power, but one of taxing power. The relevant question is not "How do we borrow more?" but "How do we raise more tax revenue?" Revenue sharing and more use of the personal income tax completely dominate special borrowing provisions as a method of solving the financial problems of state and local governments. States are large institutions that can compete in the credit markets and they can easily establish financial intermediaries to obtain borrowing economies of scale for small local governments in their jurisdictions. If the taxation problem were solved, the borrowing problem would not exist. Unless the tax problem is solved, there is no way to solve the borrowing problem.

B. Exports

Exports are a peculiar case in that arguments for special aid revolve around what is given in other countries. The operative problem then becomes one of countering these provisions with equal and offsetting preferences or by devaluations which take these incentives into account. From an efficiency standpoint it is clear that setting exchange rates in such a manner as to offset these special provisions is preferable. If this is not done, however, there remains a case for special financial provisions for exports.

C. Agriculture and Small Business

Agriculture and small business would benefit from any general program to insure equitable treatment for the small, irregular, non-corporate borrower, but the case for special provisions over and beyond this must rest on the argument that small independent enterprenuers contribute something to the country over and beyond their economic output. This may be true (it is a question of value judgements), but I think that I would agree with the President's Commission that the non-economic benefits different sectors produce should be rewarded in government budgets and not in regulations of the financial system. There simply is no method of regulation that yields everyone a gain equal to his non-economic benefits. In addition the whole society, not just savers, should be forced to compensate for such non-economic benefits.

D. Housing

If housing generates positive or negative externalities, private money markets will provide too little or too much housing since all of the benefits or costs of housing are not considered in each individual investment decision. Housing is probably subject to two types of externalities. First, a whole set of sociological externalities may flow from housing. These are popularly thought to include crime, alienation, and other factors. As a result, when social benefits are included, too little is invested in housing. Second, housing is subject to financial externalities through the neighbor's house. Knowing this, each individual in the neighborhood has an incentive to undermaintain his own home since doing so will have little effect on its value as long as all of the other homes in the neighborhood are well-maintained. Conversely, it does little good to maintain your own home if others are not maintaining theirs. The result of individual economic rationality, however, is collective irrationality. Too little is invested in housing maintenance and housing (and commercial properties) deterioate much faster than economic rationality would warrant.

Social costs and benefits are also created by the seasonality of construction in northern climates. Each person wishes to build his home in the good weather period when construction costs are lowest; each person legitimately ignores the social costs of idle resources during periods of bad weather. Some of these costs are absorbed by the factors of production in the industry, but many are absorbed by society through unemployment compensation, inflation, and restrictive work rules. Rational social policies may call for much more bad weather construction than will ever occur as a result of individual decision making.

As a result, even in a world of perfect markets, some government program would be necessary to stop such collective irrationality from taking place. Individual housing decisions will lead to too little being invested in housing. Some form of incentive is needed to inject the sociological benefits of housing into the private economic calculus and to prevent the social costs of seasonality and neighborhood deterioration.

In addition, when a society decides upon its optimum distribution of private money incomes through its tax policies, society is defacto deciding on its optimum distribution of marketable economic goods. There may be goods, however, that society wishes to distribute in a different manner. Such goods are "merit wants" and the usual preference is to distribute them more equally than the general basket of goods and services. There is no method for doing this through the private market mechanism, however, since there can only be one distribution of money incomes. Consequently, these goods are furnished through government policies even though they do not meet the classical tests of pure public goods. The most common such merit wants are education, housing, and health care. In each of these cases society seems to have indicated that it wants these particular goods to be more equally distributed than other marketable economic goods. If you like, we are more communistic with respect to some goods than others.

Thus the question arises as to how housing can be more equally distributed than the distribution of money income. Private market mechanisms will never bring about such a distribution without government interference of some sort.

As a result, a strong case can be made that private market mechanisms will not lead to an optimum (from an efficiency or equity viewpoint) investment in housing or to an optimum distribution of this investment across the population even if the current preferences for corporate borrowers were eliminated. I agree with the President's Commission that the merit want, seasonality, and sociological externalities aspect of this question should most properly be handled through the government budget. They reflect social benefits. But what about the neighborhood financial externalities? Too little will be invested in housing simply from the point of view of private economic efficiency. Given this situation, I think that it would be completely in accordance with the Commission's desires to improve markets if one were to establish special provisions for housing. Internalizing economic externalities is a completely legitimate and necessary role for government regulation of financial markets. According to the economic theory to which the Commission subscribes, these externalities *should not* be reflected in government budgets.

As a result, I would agrue that the Commission's own vision of perfectly functioning private capital markets should have lead it to recommend the creation of a general preference for small, irregular, non-corporate borrowers (or the elimination of retained earnings and depreciation allowances) and a special provision for housing to internalize the private economic externalities.

The Second Best

Considerations of the second best might also have lead the Commission to reflect a bit more on how society should engender the social benefits (as opposed to private benefits) that flow from some of these areas. Theoretically, it is clear that such incentives should reside in government budgets. This is the correct place to spread the burdens of paying for them. In a perfect world, taxing savers (by imposing special financial regulations) to pay for social benefits is unfair. In a less than perfect world, taxing savers may be a "better" (more progressive, fewer horizontal inequities, etc.) tax than the actual income tax. Perfect taxes are better taxes than perfect regulations, but actual regulations may be better taxes than actual taxes. To me it is not obvious that a general tax on savers would be more "unfair" than the current structure of taxes. A general tax certainly would be more progressive and have fewer horizontal inequities than the current tax structure. (Bad regulations may of course be worse than bad taxes.) In any case, the Commission has completely forgotten to think about what role financial regulation may play in our complete structure of taxes. It is a better tax or a worse tax than our current structure of taxes.

Tax reform (the Commission's recommendations are in fact a form of tax reform) is a perfectly appropriate consideration, but unfortunately it is impossible to recommend that a tax be eliminated without proving that the replacement taxes are better than the tax they are replacing. Financial regulations are not the world's best tax, but they may be better than most of the world's actual taxes.

Policy Options

Given the Commission's primary and secondary goals of letting each institution determine its own actions while equalizing and reducing regulations there are essentially two policy options. One is based on fiscal powers and the other is based on regulatory powers.

The fiscal option is the one recommended by the Commission. The government is simply told that it must raise taxes, capture some fraction of savings, and lend this money to those borrowers whom society decides to aid. Unfortunately, once again the Commission does not follow its own logic and spell out the tax implications. To the extent that the aid was designed to compensate for non-economic social benefits, taxes should be raised in accordance with the general structure of taxes. (If society started with an optimum tax system, an across-the-board surtax would be appropriate.) To the extent that the aid was designed to offset deviations in the financial markets from an economic optimum, across-the-board tax increases are not appropriate. To the extent that the fiscal mechanism is correcting for the preferences given to large corporate borrowers in the marketplace, the necessary taxes should be placed on corporate cash flows and corporate borrowings. The resulting revenue would then be lent to small, irregular, non-corporate customers. The taxes necessary to compensate for the financial externalities of property investments should properly be placed on existing property owners. Property taxes should be levied and the revenue lent to those maintaining or improving existing properties and those building new properties.

These special taxes are appropriate since they are the only taxes that will bring capital markets into conformity with perfect capital markets. The existence of large, tied corporate cash flows means that too much savings go to corporations. The fiscal mechanism for correcting this is taxes on corporate savings and lending that stop this excessive flow. Similarly, property owners should pay for the financial externalities of housing investments since they are going to reap the financial gains if property is well-maintained, improved, and well-built. This is the appropriate fiscal mechanism. In neither case is the appropriate mechanism a general tax increase.

Alternatively there is the asset reserve requirement. Under a system of asset reserve requirements, the government places a 100 percent reserve requirement of some fraction of each financial institution's assets unless this fraction is invested in the desired sectors. If national goals called for investing 25 percent of national savings in housing and other preferred sectors, each financial institution would have a 100 percent reserve requirement on that fraction of its assets. As long as it invested 25 percent of its assets in housing, however, it would not have to leave any reserves with the government. If it had only invested 20 percent of its assets in housing, 5 percent of its assets would have to be held with the government as required reserves. If it invested nothing, 25 percent of its assets would be held as reserves. Thus, financial institutions are essentially given the option of making interest paying loans in the housing field or making an interest free loan to the government. Different asset reserve requirements are essentially different tax rates.

The asset reserve requirement has several advantages over the present system for aiding housing. First, it works. It can insure that housing gets whatever fraction of total funds policymakers think housing should get. Credit crunches have no effect on its effectiveness. Funds cannot flow away from housing since there are no financial institutions that can avoid housing investment. Every financial institution is required to be a housing institution to some degree. (This does not mean, however, that every financial institution must operate in the housing field at the retail level. Specialized housing institutions could issue bonds for those institutions with no expertise in housing and no desire to get into this business.) Second, it is a simple straightforward regulation that does not require the cumbersome and complex set of regulations necessary to maintain the present system. Third, it does not discriminate bewteen the small saver and the big saver. Each can receive the same interest returns. Fourth, institutions are not locked out of other areas. If a savings and loan society has a good industrial lending opportunity, it can make such a loan. Fifth, the government does not have to raise the taxes necessary to finance the fiscal alternative and does not need to build a bureaucracy large enough to manage a large direct involvement in the housing field. In sum, it is consistent with the equal regulation goals of the Commission.

To the extent that asset reserve requirements are used to correct the two capital market imperfections on which I have been focusing, they are regulations called for by simple economic efficiency. No equity considerations emerge. To the extent that asset reserve requirements were used to stimulate non-economic social benefits, there is an equity issue. It is fair to force savers to invest part of their funds for social, as opposed to private, goals. Once again this comes back to the previous second-best question as to whether an asset reserve requirement is a better or worse tax than other taxes that might be used to obtain the same goal.

The answer to this question is obviously a matter of value judgement that I have not been elected to make. Relative equity, however, is often easier to determine. Let me venture the hypothesis that a system of general asset reserve requirements that shifted into these sectors by the present system of regulations would be more equitable than the present system of rules and regulations. Horizontal inequities among savers would certainly be eliminated. Given the progressivity of savings rates, such a regulatory tax on savings would certainly be a progressive tax.

Finally, it must be noted that asset reserve requirements (formal or informal) are used in many developed countries. Based on two studies conducted by myself and some colleagues at M. I. T. for the U. S. House Banking and Currency Committee, they seem to be the only effective regulatory mechanism for moving funds into priority areas.[1] This does not eliminate the need to choose between the fiscal and regulatory approach, however, since the fiscal approach can also work. Nor would adoption of the asset reserve requirement allow the elimination of all budgetary expenditures for the same areas. Asset reserve requirements can move funds into particular areas, but they really cannot be used to move funds to particular individuals. If the goal is low income housing, as opposed to just housing, for example, expenditure programs and asset reserve requirements would need to be coordinated. Without programs to move the necessary funds into the desired areas, however, distributional policies simply cannot work. If there are no funds to build houses, new houses cannot be distributed.

Conclusions

Thus the country faces three choices – maintain the present complex, cumbersome, and ineffective regulations for aiding social priorities; nationalize social lending; or adopt general across-the-board asset reserve requirements. As an economist, I would opt for the nationalization of social lending with the appropriate surtaxes

[1] For the discussion of how various foreign countries attempt to aid sectors of social priority see:
Activities by Various Central Banks to Promote Economic and Social Welfare Programs. A Staff report of the Committee on Banking and Currency, U. S. House of Representatives, Dec. 1970.
Foreign Experiences with Monetary Policies to Promote Economic and Social Welfare Programs. A Staff report of the Committee on Banking and Currency, U. S. House of Representatives, 1972.

(i.e., taxes on corporate savings and borrowings, and taxes upon property owners). It is the most efficient economic solution. As a political economist, I would opt for general asset reserve requirements.

I do this because I think it is politically naive to believe in the possibility of abolishing all regulations designed to aid sectors of social priority without real compensation – i. e., a better system than the present one. In our political system the decisions to abolish financial regulations and substitute budgetary expenditures and taxes are not made by the same people at the same time and in the same place. Who would allow his favorable financial regulations to be abolished in exchange for a vague statement urging someone else to do something? The nationalization of social lending and the abolition of special financial regulations simply cannot be tied together to be voted up or down together. If they could, they might be a viable package. As it is, they are not. On the other hand, the elimination of the present regulations and the substitution of general asset reserve requirements can be considered as one package. The two sets of regulations are in the same domain, made by the same people at the same time and in the same place.

DISCUSSION

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If a discussant's job is to foment controversy, there is a heaven for discussants and Lester Thurow's paper has brought me to its gates. I cannot imagine laying my hands on a professional-quality paper with whose anaylsis and policy recommendations I could disagree more. First, I dispute Professor Thurow's analysis of why large corporations receive advantaged access to credit in tight money. I trace this phenomenon primarily to the prohibition of interest on demand deposits, the maintenance of which is presumably one of the "details" of the Hunt Commission program on which Thurow urges us "outsiders" to give the Commission the benefit of the doubt. Although I will concede him his views on agriculture and exports, I further reject both his diagnosis of what constitutes the nation's fundamental housing problem and the specific reform which he proposes as a remedy. Finally, I find the empirical evidence on the success of asset reserve requirements abroad that he cites with such assurance to be thin and unconvincing. It consists ultimately of a casual review of data covering a handful of years in a single country whose continuing housing shortage is among the worst in the world (Sweden) and ignores a long record of U.S. experience with detailed intervention in capital markets under the Federal Reserve System. This latter record is so unremittingly dismal that, even if the success of the Swedish experiment were to be established scientifically, it is hard to see how or why a serious reformer would want to hand the Fed yet another selective control.

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I. Corporations' Capital-Market Advantages

Professor Thurow attributes the favored treatment that large corporate customers receive in intermediary-loan markets to the existence of sizable tied savings in the form of undistributed corporate profits that do not flow explicitly through capital markets. Ignoring the concept of opportunity cost, he suggests that corporations planning capital investments do not have to compete for these tied savings. Surely corporate managements must weigh expected returns on such investments against those available from other uses. Stock-market pressures and competition in the market for corporate executives should see to it that managers who ignore opportunity costs are replaced.

I am also puzzled that Thurow would think that financial intermediaries would be dazzled by tied savings *per se*. What matters is not the *savings* flow, but the transactions flow and the deposit balances a firm must hold to facilitate its transactions. Whether profits are eventually distributed to stockholders or invested in new plant and equipment, additional funds accumulate between major disbursements. These temporary accumulations and regular transactions balances are what lead financial intermediaries "to cultivate the business of corporations." Moreover, with price competition ruled out for demand deposits and greatly restricted for time deposits, it is only natural that large depositors exact compensation in other ways.

This transferral of pressure from the demand-deposit market to the loan market illustrates the well-known principle that restrictions on competition in one market create pressure counter to the restriction in whatever related but unregulated markets happen to exist. It is akin to the way that squeezing one end of a balloon forces air to rush into the other or "unregulated" part of the balloon and to place it under strain.

Because banks are forbidden to pay explicit interest on demand deposits, they compete for profitable accounts through offers of *implicit* interest instead. This implicit interest takes the form of price and service concessions to valued demand-deposit customers in other areas of bank activity. As a kind of tied-sale agreement, a bank stands ready to perform special or routine accounting and financial services for valued customers at charges well below marginal costs. A bank is also expected to grant loans at favorable interest rates and/or to commit itself to furnish loan funds to these customers, no matter how tight the bank's current financial condition may be.

With these as its origins, it is plain that the favored treatment of large depositors would not be abolished by forcing corporations to pay out all profits in dividends. Nor do "economic-efficiency conditions demand it [this abolition]." Except for complications due to the preferentially lower tax rate on stockholders' capital gains, the direct investment of retained earnings is analogous to a farmer's reservation demand for his produce. Holding back enough product to meet his seed and consumption needs saves a farmer trucking and marketing costs. If invested according to marginal principles, retained profit contitutes a similar market bypass, one that reduces a corporation's capital-market transactions costs (including lender information costs). This saves resources, and the savings are greater the less competitive capital markets prove to be.

II. The Housing Problem

In view of the federal government's immense and long-standing efforts to assist would-be homeowners, mortgage lenders, and the construction industry, Thurow's pre-occupation with providing an abstract welfare-theory justification for singling out housing for special tax-transfer or capital-market assistance seems terribly out of focus. The operative policy problem is to determine in what specific ways current federal programs are failing and to design reforms to remedy these failures. To substitute for this question an abstruse welfare-economics exercise burlesques the very role of an advising economist.

Most observers (incluing the Kaiser Committee in 1968) hold that the overriding housing problem facing the United States today concerns how to provide more and better low-income homes. This requires increasing the production and rehabilitation of decent housing and somehow distributing it to persons who have traditionally been red-lined out of our nation's subsidized mortgage markets. The goal is to make available some income in kind and then (to avoid slips between the cup and the lip) to force feed it to the poor. In this process, financing is only one obstacle. It looms as a large obstacle primarily because of red-lining, a practice that makes subsidizing the mortgage market an ineffective way of getting at the problem.

What we want are both: (1) incentives to improve the quality of new and existing housing; ways to lessen the alienation the poor feel toward current and replacement homes so that these will be adequately maintained or even improved, and (2) incentives to undertake appropriate new construction; ways to give low-income persons sufficient income to divert resources to meeting their housing needs, backed up by methods for insuring that the prospective income will in fact be spent on improved housing. Although Thurow neglects the first problem altogether, progress on the second problem should help to alleviate the first. Environmental alienation would be lessened by giving low-income persons tangible opportunities to link up with "visible" owners and to become owners themselves. Anyone who has been both a homeowner and a renter knows how differently one regards – and makes one's children regard – a dwelling unit that is one's own. For most individuals, an owned home becomes a veritable extension of oneself. Anyone who has done much renting also knows how differently one feels about a rental unit that is owned by an absentee landlord as against one whose owner lives nearby and takes an active interest in the condition of the place. Moreover, a move to resident ownership should increase the competition for occupants in low-income areas, competition that should in part take the form of product improvement. Replacing slumlords with owner occupants should therefore be high on the social agenda. The greater the extent to which low-income apartment buildings can be made owner-occupied, the more fully we can tap individual incentives to maintain and improve the low-income housing stock.

Better urban and rural environments require a better distribution of income: nothing more nor less than sizeable transfers of wealth. It is wishful thinking to suggest – with or without coordination with expenditure programs (see Thurow, p.p. 187-9) – that the problem can be approached with nearly equal efficiency by forcing financial institutions to hold more mortgages. The federal government has been subsidizing mortgages in this way for years. The evidence on the distributional effects of this policy is very dismal.[1] Low-income persons who wish to be either homeowners or resident owners of apartment buildings are consistently pushed out of the institutional mortgage markets by higher-income individuals of negligible default risk. Distributionally, it is bad enough that high-income persons get disproportionately more low-interest mortgages, ironically often to buy commercial property. But low mortgage rates also spell low returns for thrift institutions (currently constrained to specialize in mortgages) and for the low-income saver who has few alternative

[1]See the patterns of asset-holding and real-estate debt by income class tabled in my "Short-Changing the Small Saver: Federal Government Discrimination Against Small Savers During the Vietnam War," *Journal of Money, Credit and Banking, II* (Nov. 1970), pp. 513-522.

outlets for his savings. From the point of view of the average consumer, the great virtue of the Hunt Commission *Report* is that it recognizes the harm caused by placing this system of constraints on lenders and seeks to eliminate it.

Besides these distributional problems, mortgage-reserve proposals suffer from the fatal flaw that the mere use of real-estate collateral and a mortgage instrument in no way guarantees that the funds being borrowed are used to finance a real-estate venture of any sort. Even when they are, the funds may simply be marked-up by the borrower and passed along to higher-risk borrowers. In many cases, to become a resident owner of a low-income apartment building, an individual is forced to pay an inflated purchase price and usurious interest rate to a high-income seller who is his only realistic source of finance. With the building's rental income determining the terms of the sale and finance agreements, any advantage the lender might get by borrowing on real-estate collateral in subsidized markets is unlikely to be passed on to his low-income mark.

Financial markets can contribute to solving our low-income housing problems most effectively by lessening their tendency to discriminate against low-income persons. This requires relaxing existing restraints on the payment of interest on deposits of all sorts.

Discrimination against households in the market for commercial-bank loans is rooted in the prohibition against paying interest on demand deposits; the obvious first step is to repeal this prohibition. This would allow banks to compete openly rather than covertly for profitable demand-deposit accounts and should shift the competitive focus of banks and business customers away from the loan market. The second step is of course to free savings-deposit rates at all depositary institutions, both so that low-income savers who have few other accumulation opportunities can earn the opportunity cost of their funds and so that the specialized mortgage-lending industry can compete freely for funds and mortgages.

In contrast, introducing additional portfolio restrictions on mortgage lenders may well worsen the discrimination against low-income savers and borrowers. This possibility serves as the principal focus for the rest of my comments.

III. Second-Best Solutions

Professor Thurow's remedies for commercial banks' tendency to favor corporate customers and for the housing problem involve introducing new portfolio restrictions: prohibitive taxes or marginal reserve requirements designed to force a particular response from the firms subject to the restriction. It seems to be an article of faith among social activists that any and all shortfalls in policy performance derive from society's not yet having seen the wisdom of giving government authorities still another set of controls. They seldom bother to investigage whether the policy difficulties can be traced to structural defects or excesses in the controls authorities already have: to an instrumental keyboard that is too big rather than too small. Interventionists typically act as if the contrapositive of the Le-Chatelier Principle holds in public administration: that one can improve processes of social and economic adjustment more by adding a new policy restraint than by relaxing a preexisting one.

Relying on the LeChatelier Principle, I believe that Thurow's reforms would make capital markets even less efficient and socially effective than they are now. What we need is not more interference with capital-market mechanisms but *less*. We need to wipe out corporations' privileged "relationships" with commercial banks at their source by abolishing the prohibition against paying competitive interest on demand deposits. Introducing price competition into the market for demand deposits would break the incestuous link between a bank's willingness to accommodate a customer's loan request in tight money and the deposits that the customer brings to the bank. This reform would increase the attractiveness of mortgages to banks at such times. Given the size of bank portfolios, even a small increase in banks' propensity to acquire mortgages in tight money would greatly ameliorate the cyclical instability of mortgage flows.

I regret having to harp on a single theme. I do so because demand-deposit interest was rejected by the Hunt Commission and its distributional and allocational effects so poorly analyzed in the Commission *Report* that apparently even well-trained and socially conscious economists fail to grasp just how this reform would improve competition for bank loan funds between the corporate and the noncorporate sectors.

IV. Asset Reserve Requirements

I have no quarrel with asking the Federal Reserve to concern itself with the distributional impact of monetary policy. This impact can and should be bettered. I take issue instead with two naive presumptions: (1) that introducing new restrictions on the detailed operations of U.S. capital markets is any way to improve this impact, and

(2) that the nation could rely on the "independent" Federal Reserve System to administer the new controls effectively.

On the contrary, it can be shown: (1) that much of the unequal impact of tight money on various sectors grows out of current restrictions on various institutions' ability to compete for deposit funds, especially on commercial banks' freedom to compete for profitable demand-deposit accounts; and (2) that (whatever its success in stabilizing the national economy) in its fifty-odd years of operation, the Federal Reserve System has proved spectacularly unsuccessful in its attempts to intervene in *specific markets.* Its efforts at detailed intervention – such as the real-bills discounting policy, the almost-identical February 2, 1929 and September 1, 1966 letters to member banks, and Regulations V, W, X, and (most recently) Q – have gone sour time and time again. Counting upon the Fed to regulate the flow of credit among competing sectors is like counting upon a major-league Washington baseball team to finish in first place. When the Capital's erstwhile Nats last became strong enough to vie for a pennant, they were bid away to Minnesota and replaced with a much weaker team. Then last autumn even this weaker team became valuable enough to be auctioned off to Texas. So too with the staff of the Federal Reserve. Before the Fed could assemble a team of administrators strong enough to handle the job Thurow seeks to thrust upon them, these able administrators would be bid away to richer positions in the private economy.

The Fed's staff is simply no match for the market economy. Consider how the Federal Reserve's efforts to enforce Regulation Q led to a veritable epidemic of controls, with each stopgap policy action begetting several others until the control system partially broke down (on large CD's) and the underlying problem passed away of its own accord. To plug leaks, new restrictions were introduced in markets for Eurodollars, Federal Funds, commercial paper, and Treasury bills; the U.S. savings-bond program was allowed to run down and its market invaded by bank mini-bonds and participation certificates, and threatened by Sears Roebuck and A.T.&T.; mortgage markets required huge injections of federal money even to operate at very low levels. When open-market rates fell below Regulation Q ceilings, new problems were revealed. The industry's former pattern of mortgage-rate and depositary-savings-rate price leadership had been destroyed, and with the backlog of mortgage demand, it proved almost as hard to get these rates to move down with open-market rates as it was to hold them down when open-market rates were rising.

No matter what bureaucratic obstacle the Fed placed in the market's way, survival demanded that firms locate a reliable loophole. With apologies to the exceptionally able and dedicated public servants gathered here today, loopholes were found because on balance private firms recruit better talent, train and motivate this talent more carefully, and when the going gets tough, can drive their staffs far harder. Employees and managers of private firms outnumber and have personally much more at stake than their counterparts at the Fed.

However, the economic case against the asset-reserve proposals goes beyond the Federal Reserve's institutional weakness and can be summarized in a few sentences. First, no one knows enough either about social priorities or about how credit, goods, and factor markets interact to use financial markets as an effective vehicle for allocating funds among competing sectors in accord with social priorities. Such programs as the tax-exemption of interest income on state and local securities and federal government interventions in the mortgage markets have on balance reduced the effective progressivity of our tax system and generally helped the rich at the expense of the poor. Second, besides having a miserable track record in administering selective controls, the Federal Reserve has allocated precious little research effort to the important task of learning from its individual past mistakes. Third and most importantly, specific restrictions tied to the amount borrowed or the size, purpose, or location of the borrower as envisaged in asset-reserve proposals are based on partial-equilibrium thinking: they can be justified only by ignoring affected parties' natural inclination to take actions directed at getting around the legislated restrictions. In particular, such controls can be largely and easily offset by bank and borrower adjustments in related markets, adjustments that lead frustrated regulators to extend the range of their controls to more and more loan instruments and lender activities. To this list of economic counterarguments, realistic political economists ought to add a fourth: New selective controls inevitably introduce windfall gains and losses, with these being shaped by legislative and administrative decisions closely influenced by the unsatisfactory current distribution of political and economic power whose correction is being sought.

The case for greater Federal Reserve intervention in loan markets has no firm economic foundation. Growing Congressional pressure on our "independent" Federal Reserve System to do something about the distributional problems tearing at our society grows out of popular pressures focusing increasingly on Congress. The problems are fundamentally *political* ones and best handled by honest reform of our tax and welfare systems. Everyone should recognize that to assign these unsolved problems to the Fed is to compromise and politicize this institution to a degree that not only is inconsistent with its basic charter but even threatens its future viability.

V. Summary

I have argued that allowing freer competition among depositary institutions for all types of deposit funds is a far more promising way of reducing inequalities in sectoral access to funds than introducing still-another set of restraints on institutional portfolio allocation. I recognize that any movement to free interest rates at depositary institutions will be resisted by financial trade associations that pack considerable political muscle. But what is the alternative? Can anyone claim that the Fed would know how to manipulate asset reserve requirements so as to allocate funds and resources in accord with the social priorities even assuming that these priorities were clearly established? Can the Fed conscientiously count upon Congress to inform it as to social needs? I think not. In fact, I view Congressional interest in imposing responsibility for distributional problems on the Federal Reserve System as a cynical political gambit designed to buy time and reelection without having to confront the searing political problems of our time. The Fed cannot itself make the hard choices necessary to effect sizeable changes in the distribution of income and opportunity. It can only consent to serve as a scapegoat for particular Congressmen and for the powerful banking, defense, oil, and other lobbies that influence their decisions. Congressmen want to be able to assure their constituents that *something* is being done to improve the distribution of income and opportunity. At the same time, the lobbies wish to forestall any real change. The Fed's dismal record in administering selective controls in the past makes it a candidate that can meet both objectives, combining the appearance of action with little probability of success. In view of the electorate's lack of economic sophistication, the Fed's public acceptance of this new responsibility could carry Congress and the lobbies through another business cycle without open conflict.

If there were reason to believe that Congress would use this period of grace to develop a new workable consensus on national priorities, the game might be worth the candle. But as matters stand, I would recommend lighting a flame somewhere else.

DISCUSSION

ELI SHAPIRO*

I found Professor Thurow's paper an interesting and provocative one. It deals with an important and popular topic. His initial comments favoring the primary and secondary thrusts of the Hunt Report are views with which I would concur. There are many parts of his argument with which I disagree, however. In particular, I do not think that financial regulation in general and asset reserve requirements in particular ought to be advanced as a practical or effective way of furthering so-called social objectives.

My comments are in four parts. First, I have objections to many specific points in the paper; second, a more general comment on Thurow's analysis of the Commission's taxation proposals, or lack thereof; third, and most importantly, an analysis of what I believe to be a misconception by Thurow about the role played by savers in the savings-investment process which pervades the paper and which leads the author to several mistaken conclusions; and finally, a statement of my personal view about the problems of articulating social objectives and using the financial regulatory system to advance these objectives.

Specific Criticisms

There are many specific statements in the paper whose validity is less obvious to me than it seems to be to Professor Thurow. For example, he states that "present institutions and regulations have not channeled funds toward social priorities in sufficient quantities to be worth the inequities they have produced." First, I am not sure how to measure the inequities produced by the regulations affecting the savings institutions which have supplied the bulk of finance to the residential mortgage market. More importantly, it is also not clear

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that these institutions did not facilitate the development of substantial amounts of residential construction over the 1950's and 1960's. Admittedly, the past six or seven years have shown once again that the regulations exascerbate the cyclical swings in housing production. However, I know of some, though not very convincing, evidence that is inconsistent with the argument that our attempts to channel funds into housing have not produced more single family housing units on average over the past 20 years than would otherwise have been the case.

As a second example, Thurow argues that corporate retained earnings are "subject to neither the allocation procedures of the capital market place or to the allocation issues of their owners (the individual shareholders)." While the existing structure of corporate taxes does create an incentive for internal finance, it is not clear that these funds are not allocated and used rationally given this incentive. If share prices reflect the profitability with which retained earnings are used relative to the after personal income tax return requirements set by shareholders, and if corporate decision makers act in ways designed to maximize their share price, then Thurow's conclusions about no economic allocation are not correct. Under these conditions, corporations would be induced to use retained earnings as efficiently as any other form of finance. Given our uncertainties about how share prices are determined and the motivations of corporate decision makers, I think it premature to draw Thruow's conclusions on this point.

The Role of Taxation in Savings and Investment

The second major area of my comments on the paper relate to the discussion of the role of taxation in the savings and investment process. Thurow is quite correct in emphasizing the importance of this factor. He centers his discussion on the distortions caused by the current tax treatment of retained earnings. He argues that the Commission should have pushed its logic to the recommendation that current tax treatment of corporate earnings be abolished and that what he would define as corporate income should be imputed to shareholders and taxed as personal income. I should say in passing that Thurow defines corporate income to include depreciation. As such, he opens the whole question of taxation of capital or a possible capital levy.

He suggests that the reason that the Commission did not do this was political. One could perhaps be more charitable to the Commission's intellectual integrity. The current tax laws exert numerous effects on the savings and investment process. The different taxation of capital gains and income discriminates in favor of returns from equities and against debts, especially short debts. The existing tax laws induce individuals with marginal tax rates less than the corporate tax rate to buy shares in corporations which issue debt rather than issue that debt directly. They induce individuals in high marginal tax brackets to invest in mortgages through the acquisition of shares in REIT's rather than through the acquisition of, say, shares in publicly held savings and loan associations. On a larger scale, the use of a tax system based on income taxation discriminates against saving itself and thus has an obvious impact on the size of savings.

Perhaps, the Commission was well aware of these many ways in which the current tax laws affect the savings and investment process and deemed it beyond the scope of its responsibility to propose an overall tax reform package. Perhaps they were unable to isolate those few key provisions of the tax structure which caused the greatest distortions. It may have been for these reasons, rather than out of timidity that the Commission chose to limit its taxation proposals to those that directly affected financial institutions.

Image of Savers

The third of my comments relates to the image of the saver or wealth holder which is contained in this paper. Professor Thurow states that the saver "send his savings into the capital market." A more appropriate description is likely to be that wealth accumulators allocate new savings and existing wealth among competing alternative forms of real and financial assets in an attempt to maximize some objective. This mistaken image of savers as passive agents rather than as active decision makers leads Thurow into several problems. First, he sees (nonfinancial) corporations as almost evil, as savings hoarders. An alternate view is that savers see the benefits of saving through the corporate form and invest part of their wealth in corporate equities in full anticipation that those corporations will act in ways to benefit them as savers – retaining earnings and thereby postponing income tax payments as well as transforming what might be income into capital gains.

A second example of how this mistaken image of savers leads Thurow astray is contained in his remark that financial regulation has not worked in the past because there is "no set of regulations that could stop (such) poaching on the other guy's turf." Rather than see the big bad financial institutions as "poachers," it might be more appropriate to see them as businesses which try to sell financial assets to rational and responsive savers who attempt to allocate their wealth among assets on the basis of risk, return, and liquidity. In such a competitive environment, "poaching" seems a strange term to give to the search for assets with better risk and return characteristics.

Aside from these relatively minor problems of semantics, however, the reality of savers as active maximizing decision makers causes even more serious problems for the asset reserve requirement which Thurow advances. He argues that, among other things, asset reserve requirements for financial intermediaries for the purpose of channelling funds to social priorities (1) will work, (2) are simple to administer, and (3) do not discriminate between the small saver and the big saver. I disagree with all three of these comments.

As Thurow describes them, asset reserve requirements will not work. Savers will still be free to acquire the debts and equities of real investors directly as well as to acquire the financial liabilities of intermediaries. Constraining intermediaries to invest a specific fraction of their (new?) funds in specific assets will not assure any specific dollar flow of finance or resources to that activity. Real investors who do not receive what they consider to be sufficient funds will be induced to attract savings by the issuance of direct securities (debt or equity). Households will be induced to buy these assets by their relatively attractive returns. Since the regulated financial institutions do not account for all of household financial asset accumulation (even excluding corporate retained earnings), controlling them does not control the total flow of savings.

Thurow also states that these asset reserve requirements would be simple to adminster. This is patently untrue. Take his example, that of housing. Someone must decide what kind of housing is to be financed – will it be single family, multi-family, apartments; and where – urban or suburban; or first home, vacation home; or high cost, low cost; or renovation or new construction? Will the financing of raw land acquisition, development expenses, or construction finance be acceptable or is it just mortgages? Beyond this myriad of choices as to the *activities* to finance, there is another nest of problems regarding the decision as to *which businesses* will be subject to the regulation? Within the more or less standard categories of financial institutions, will mutual funds be subject to these requirements? Will pension funds which are entirely in equities, such as

College Retirement Equities Fund? Will private finance companies, such as CIT? Will captive finance companies, such as General Motors Acceptance Corporation? What about corporations which finance accounts receivable without the explicit use of a finance company? With corporations extending about \$200 billion of trade credit (\$60 billion net trade credit) compared to commercial bank loans of \$160 billion, this is no trivial problem.

From another point of view, will underwriters have to do a specified volume of their participation in fund raising for specific purposes?

Looked at realistically, establishing an administrative structure to deal with these problems in order to channel funds to housing is *not* simple. Neither would it be for education or health or any other of Thurow's objectives.

Finally, this asset reserve requirement need not result in equal treatment of small and big savers. For example, if the real asset acquirers who issue direct securities find that distribution costs require large unit sales, rather than widespread retail distribution, then savers with large amounts to invest will still have better alternatives than those savers who must acquire the financial assets created by the intermediaries subject to the asset reserve requirements.

Thus, the rational behavior of savers and real asset acquirers means that asset reserve requirements affecting only something called "financial institutions" are not likely to be simple or effective ways to allocate savings.

Social Priorities and the Design of Financial Regulation

Let me conclude my comments with some remarks on the general topic of social priorities and the design of financial regulation. First, social priorities are devilishly hard to establish. In addition, as the recent Brookings study reveals, we are often not at all sure how to allocate resources to achieve what we thought were our objectives. Second, implementing social objectives in the United States through financial regulations is likely to be especially difficult. As I have suggested, businesses which many people do not regard as financial institutions often perform the functions of those institutions. Regulating them all would be very difficult and regulating only some would be ineffective. Moreover, much of our regulation of financial institutions is divided between the federal government and the states. As such, any attempt to establish federal controls would have to create a federal overlay over the state regulated agencies. Finally, savers are not constrained to acquire only the financial liabilities of what we formally think of as financial institutions. They are free to acquire real assets directly or to acquire claims to the income streams from real assets others acquire by direct investment.

For these reasons, it is my view that we should:

(1) set only modest objectives for allocating some expenditures differently from the pattern the income distribution would bring about and
(2) center our attempts in this direction on tax and expenditure policies rather than on financial regulation.

Professor Thurow seems to set up the alternatives of perfect competition or nationalization. Seeing the lack of perfect competition, he states that, as an economist, he is for nationalization. An alternative would be to try to improve the economic process so that it comes close to the competitive ideal. This was the Commission's view and it is mine. The way to make our financial system most responsive to whatever our social objectives may be is to make it as competitive as possible rather than hobble it with what would be an administrative nightmare.