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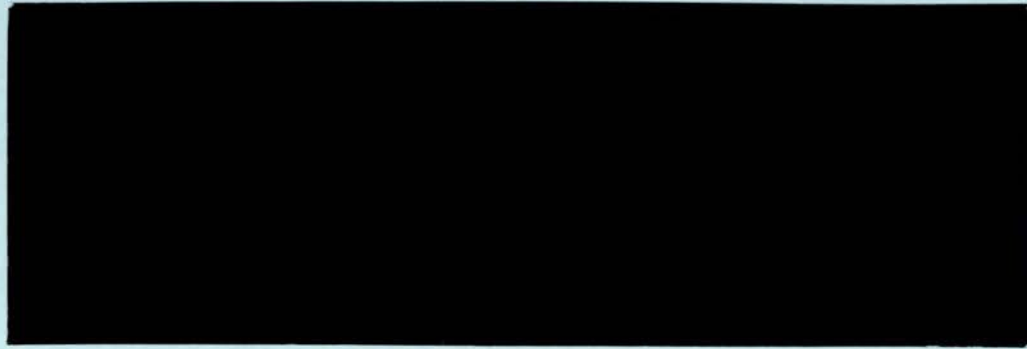

WORKING PAPER SERIES

COMPETITIVE EQUALITY AS A CRITERION FOR FINANCIAL REFORM

by

Thomas Mayer

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Department of Economics
University of California
Davis, California

Competitive equality is an issue that frequently arises in any discussion of financial reform, such as eliminating the higher Regulation Q ceiling of thrift institutions.[1] Those institutions that desire new rights claim that these are needed to achieve competitive equality, while their competitors claim that competitive equality requires that their special privileges be protected. A typical example is a Federal Reserve proposal to impose reserve requirements on transactions accounts (i.e., de facto checking accounts) at thrift institutions which met with the following response by the staff of the House Banking, Finance and Urban Affairs Committee: "Thrift institutions lack many of the powers which commercial banks have. They do not offer full banking services. Until such times as these institutions be given full banking powers, there seems to be no reason to treat them like banks."[2]

The Concept of Competitive Equality

But discussions of competitive equality are usually more a matter of assertions than of serious analysis. They do not explore what is meant by "competitive equality," and they do not explain why competitive equality is desirable, presumably treating the answers to both of these questions as self-evident. This paper tries to rectify this by discussing both of these issues in some detail.

The term competitive equality can be defined readily in one, but only one situation. Suppose that there are two institutions, say commercial banks, serving identical markets, and having identical production processes, and hence identical profits. Competitive equality then requires that no tax be imposed on one of these institutions if it is not imposed in the other institution too. This is fine as far as it goes, but it does not go far enough. Suppose, for example, that the two institutions do not have exactly the same production

processes, but that one has lower cost, and hence higher profits. The simple and intuitive answer that we should strive for "competitive equality" breaks down in this case. Essentially, the criterion of competitive equality tells us that we should treat equally situated firms equally. But are firms with different rates of return "equally situated"? The answer is far from clear.

Thus, even if two firms differ only with respect to their profitability, the competitive equality criterion no longer gives a straightforward answer. But discussions of financial reforms involve a much more complex problem in the sense that the firms being compared differ by much more than just a difference in profitability. Suppose that one firm is a commercial bank, and hence is allowed to make business loans, while the other one is a savings and loan association that has a one quarter of one percent higher Regulation Q ceiling than does the bank. Are these two benefits of the same value, and if not, which institution can claim that competitive equality entitles it to some other benefit, say a more generous tax treatment?

The problem in trying to find an answer to this question is, of course, that these benefits are not traded on any market, and hence we cannot observe a market price for them. Thus, we cannot determine what competitive equality means in this case in any <u>direct</u> way. In principle, there is an indirect way that might provide a very broad answer in the sense of telling us whether banks or thrift institutions have a competitive advantage in general. This is to see whether bank charters or thrift institution charters are harder to obtain. The greater the extent to which the regulatory authorties have to ration charters the greater presumably is the net benefit of having a charter. And since

the benefit of having a charter depends in large part on special benefits bestowed by government regulations, the severity with which charters are rationed potentially provides a presumption about which type of institution has been given a competitive advantage. But since the value of a charter depends not _only_ on government regulations; this is at most a strong presumption rather than proof. In any case, there are no data on the extent to which savings and loan association charters are rationed. (For mutual savings banks it is the FDIC capital requirement that inhibits the establishment of new institutions.) Thus, we cannot tell which type of financial institution currently enjoys greater privileges, and hence the criterion of establishing competitive equality between financial institutions cannot be applied.

But fortunately this is no great loss because the numerous appeals to competitive equality have ignored a basic point. What matters is not equity _to institutions_ per se, but two other things, treating the owners and customers of various financial institutions equitably, and setting the relative regulatory burdens on financial institutions so that they maximize the efficiency of the financial industry.

The Criteria for Competitive Equality

It is not clear what equitable treatment of the owners of financial institutions means. In general, one might say that fairness requires that the reasonable expectations held by the owners when they acquired their equity not be disappointed by the government changing the rules arbitrarily.[3] But what do we mean by arbitrary changes? One possibility is to say that the owners did not expect _any_ changes in laws and regulations, so that fairness to them requires that, at

least insofar as it does not conflict with other important goals, there be no change in regulations. But an alternative interpretation is that owners expected that the status quo be maintained, not in the sense of unchanged laws and regulations, but with respect to the competitors in the markets; in other words, that they expected the government to change laws and regulations to prevent other institutions from entering their markets when changing economic conditions or technological advances allow them to do so. A third possibility is that owners acquired their equity in the strong and entirely reasonable expectation that the law would be changed, so that equity to them now requires these changes. But while this last possibility may be plausible for some specific cases, it is not likely to be a frequent occurrence.

It is more difficult to decide between the first two possibilities. While the general presumption in the American economy is that the government will not protect particular markets, in the financial sector as well as in other heavily regulated industries, market protection is common. For example, if those who bought stock in domestic banks, say ten years ago, had been asked at that time what they think would happen if foreign banks, faced with less restrictive regulations than domestic banks, would substantially expand their share of the U.S. banking market, the majority might well have replied that they expect the law to be changed at least to the extent of removing the special privileges of foreign banks. On the other hand, permitting competition between industries, as well as between firms, is part of the American ethos, and this provided perhaps a basis -- though admittedly only a very speculative basis -- for asserting that fairness to owners requires that the laws and regulations be kept unchanged even if this allows one type of financial intermediary to invade the traditional territory of another.

Changing regulations also involve a problem of fairness to the institution's customers and potential customers since they stand to lose if an institution's costs are raised, or if it is prevented from offering some service. But the equity problem here is very different from that for owners. Since customers usually have made no large investments in setting themselves up to deal with a particular institution, the problem of disappointing legitimate expectations is not significant. Instead, the equity problem is that if certain costs are arbitrarily imposed on any product or service consumed by certain households, this is just as inequitable as levying an arbitrary direct tax on these households, and this is true also if a service they want is prohibited. This does not mean of course, that every financial institution must be permitted to offer every service; equity to customers is not the sole criterion by which regulations are judged, and potential effects on economic stability, for example, may well justify prohibiting the provision of certain types of financial services.

Aside from their equity aspects, regulations must, of course, also be judged on the basis of their efficiency. Efficiency requires that the burdens placed on competing activities be equal, unless one of these activities happens to have greater "externalities"; for example, degrading the environment. If the burdens are not equal, production will be inefficient. Imagine, for example, that there are two firms, one of which can produce the product at a cost of $1, and the other at a cost of $2. If we now impose a $2 tax per unit, or some other equivalent cost-raising burden on only the first of these two firms, its price will rise toward $3, and hence all production will tend to shift to the less efficient firm. Hence, quite apart from its equity aspects, competititve equality is also desirable on efficiency grounds. And it should be interpreted

as a situation that imposes equal burdens on competing activities. This is also what is required by the fairness to customers criterion, so that these two criteria always give the same answer.

That competitive equality requires that equal burdens should be imposed on competing activities may seem ovvious, but it has an important, and frequently neglected implication. This is that the burdens should be equalized for each competing activity, and not necessarily for each institution. For example, the fact that savings and loan associations are not allowed to make most types of consumer loans may seem to provide a justification for giving them a higher Regulation Q ceiling. But this is inefficient. If a savings and loan association offers a higher passbook rate than a bank, a depositor has an incentive to keep his deposit there even though, in terms of easy access etc. a bank may be more convenient for him. This is a loss in efficiency. To be sure, the fact that the savings and loan association cannot make a standard consumer loan results in an inefficiency too, but these two inefficiencies do not cancel each other out; on the contrary, they are additive. Both the potential borrower and the potential depositor have additional costs and inconveniences imposed on them, and removing, say the higher Regulation Q ceiling while still keeping the restriction on consumer loans enchance efficiency. This does not mean, of course, that efficiency grounds can never justify granting a special benefit to a financial institution. This may conceivably be the best way to subsidize some particular industry. But what matters here is only efficiency as an aspect of competitive equality between financial institutions, and not efficiency in a broader context. It follows from this that the standard argument that a certain type of institution should be given a particular privilege to make up for the fact that a rival institution has another -- quite different -- privilege is very questionable on efficiency grounds.

Applications

Thus once one abandons the simplistic idea that competitive equality means the equal treatment of various institutions, it turns out that there are three criteria that capture the desirable aspects of competitive equity, (1) fairness to owners, (2) fairness to customers, and (3) unless there are significant externalities, the imposition of equal burdens of competing activities. And the latter two can be treated jointly. To see whether these three criteria are operational, they will now be applied to four specific problems, the treatment of foreign banks, permitting thrift institutions to make third party payments, the imposition of reserve requirements on such transaction accounts, and the higher Regulation Q ceiling for thrift institutions.

This discussion will deal only with the competitive equality aspect, and will not consider such other aspects as the possible existence of large external benefits to, say mortgage loans. Moreover, the discussion will be confined to the narrow issue of competitive equality between the specific institutions being considered, e.g., foreign banks vs. domestic banks and banks vs. thrift institutions. It will, therefore, ignore the much broader and complex questions that arise when one compares more than two assets at a time. For example, the discussion of imposing a reserve requirement on the transaction accounts of thrift institutions, will ignore completely the complication that arises because other types of assets, e.g., currency do not have a reserve requirement. This limitation is justified because the competitive equality criterion is usually invoked in the context of comparing the powers and privileges of two very specific financial institutions, rather than in a general equilibrium framework involving

the whole economy. However, this limitation does mean that the efficiency criterion used here may give an answer that is wrong when viewed in a broader framework. For example, consider a proposal to eliminate the Regulation Q ceiling for state chartered, but not for federally chartered savings and loan associations. If one considers only the efficient allocation of deposits between these two institutions, such a proposal would be rejected as inconsistent with competitive equality. But when one includes other unregulated borrowers in one's purview such a proposal <u>may</u> seem desirable on efficiency grounds.

Looking first at the treatment of foreign banks, the efficiency criterion, and hence also the equity to owners criterion, suggest that they should have the same burden imposed in them as domestic banks, so that a depositor does not patronize what may be a less efficient foreign bank rather than a more efficient domestic bank. The remaining criterion, equitable treatment of bank stockholders, creates a more difficult problem. First, it is not clear whether stockholders in domestic banks obtained the major part of their stock at a time when they knew about the expansion of foreign banks. Moreover, even if we knew the answer to this question, there is still the troublesome question of whether the equity was acquired in a reasonable belief that the relevant laws would be unchanged, or else that the market share of domestic banks would be protected. And these questions arise also with respect to the average dollar of equity owned by stockholders in the invading foreign banks. Thus, two of the three criteria of competitive equality, the efficiency criterion, and equity between customers, suggest that foreign and domestic banks should be treated equally, but the third criterion, equity to owners does not give a clear-cut answer.

The next issue is whether thrift institutions should be allowed to offer transaction accounts, i.e., third party payment accounts. Though one may want to prohibit them on grounds of stabilization policy, the efficiency criterion and the equity to customers criterion favor permitting such accounts. By allowing thrift institutions competitive equality with commercial banks in this way, deposit services would be produced where their costs are lowest. But equity to owners implies the opposite. Most owners of both banks and thrift institutions presumably acquired their equity at a time when they could reasonably expect that thrift institutions would not be allowed to have transaction accounts, so that equity interpreted as avoiding changes in laws and regulations implies that these accounts should not be allowed now. The alternative version of the equity to owner criterion, protecting each institution's market, gives the same result in this case, since transaction accounts allow thrift institutions to invade the banks' markets. Thus, the equity to owners criterion points in the opposite direction from the other two criteria of competitive equality.

The third issue is the imposition of a reserve requirement on the transactions accounts of thrift institutions. A reserve requirement amounts to the institution being forced to máke an interest-free loan to the Federal Reserve, and thus operates like a 100 percent tax on this interest income. This tax is presumably largely passed on to depositors. The efficiency and equity to customers criteria are, therefore, violated if this tax differs for various depository institutions, so that depositors are given an incentive to patronize the one with the lowest tax rate, and not necessarily the most efficient one. And competitive equality for owners too argues in favor of the imposing the same reserve requirement on transaction accounts in banks and in thrift institutions. Presumably most

of the owners of thrift institutions acquired their ownership at a time when these institutions were not allowed to make third party transfers. Hence, the legalization of transaction accounts already given them a windfall, and permitting them to escape a reserve requirement would just increase this windfall. Moreover, the establishment of transaction accounts at thrift institutions results in a windfall loss to stockholders of commercial banks, and imposing reserve requirements on transactions accounts would somewhat reduce this windfall loss. Thus, in this case all three criteria give the same answer.

Turning to the differential ceilings of Regulation Q, the efficiency aspect of competitive equality implies that this discrimination is undesirable since it may cause a depositor to use a less efficient, or less convenient, institution. Equity to customers also argues against the differential ceiling.

The equity to owners criterion again suggests a more complex story. While the fact that thrift institutions have a higher ceiling hurts banks, the existence of an effective deposit rate ceiling also helps many, though certainly not all, banks by limiting competition for deposits. The prevention of windfall gains or losses to bank stockholders, therefore, probably implies the abolition of the Regulation Q ceiling altogether, rather than just equalizing the ceiling for banks and thrift institutions.

But suppose the ceiling cannot be abolished completely, and the question is merely whether to set it at the same level for banks and for thrift institutions. From the viewpoint of one version of the equity to owners criterion the answer is to choose that policy that leads to the smaller absolute windfall gain or loss. Unfortunately, it is hard to determine empirically which policy this is.

The alternative version of this criterion, prevention of loss of market share, also does not give a clear-cut answer since neither banks nor thrift institutions have faced a drastic shrinkage of their market shares, nor are they likely to if the Regulation Q ceilings are equalized.

Hence the efficiency and equity-between-customers criteria of competitive equality suggest that the Regulation Q ceiling, if it is to be kept, should be equalized for banks and for thrift institutions, while the equity to owners criterion does not provide any clear answer in this case.

Conclusion

Competitive equality is frequently invoked in discussions of financial reform, but it is usually treated more as a slogan than as a seriously explicated argument. This paper tried to rectify this by considering first the definition of competitive equality. It pointed out that as it is generally used -- that is, as equity between different types of institutions -- competitive equality can only be defined in very general terms. But fortunately this does not matter because competitive equality between institutions is irrelevant. The relevant definition of competitive equality involves three criteria, equity for owners of financial institutions, equity between their customers, and the efficiency of the financial system. These three criteria were then applied to four practical problems. Two of the three criteria inform us that thrift institutions should be allowed to offer transaction accounts; however, the third criterion tells us the opposite. But if such transaction accounts are to be allowed, then all three criteria agree that a reserve requirement should be imposed on them. In two other cases, the treatment of foreign banks and the equalization of the Regulation Q ceiling for banks and for thrift institutions

two of the three criteria give a determinate answer, but the third one, equity to owners does not.

All in all, the problem of determing what reforms are consistent with competitive equality is more complex than is implied by the fervent and rather dogmatic appeals usually made to this principle.

FOOTNOTES

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1. See for example, U.S. Congress, House Committee on Banking, Currency and Housing, Subcommittee on Financial Institutions, Supervision, Regulation and Insurance, Hearings, August 29, 1975, p. 2340, September 10, 1975, pp. 2333-2334, and

2. U.S. Congress, House, Committee on Banking, Finance and Urban Affairs, H.R. 13847, Staff Report, Washington, D. C. August 1978, p. 12.

3. This definition of fairness is, of course, arbitrary in the sense that it assumes that the distribution of income that prevailed when the stockholders bought their equity is desirable. This larger issue will be avoided here. Throughout this paper equity will be interpreted as equitable treatment of the owners (and customers) of financial institutions relative to each other, and not necessarily relative to the whole society.

4. U.S. Bureau of the Census, Historical Statistics of the United States, Colonial Times to 1970, p. 1019.