Currents

Thank God It's . . . the SEC

A refreshing change in Washington in recent years is the sight of regulatory agencies resisting the temptation to use the day's headlines as an excuse to expand their powers. Take the case of the latest "problem" in the stock market—stock index arbitrage, which results in millions of dollars worth of stocks changing hands in a matter of minutes during the "Triple-Witching Hour" of "Expiration Fridays." Critics charge that big institutional investors and arbitragers, using new computer-directed strategies, are increasing stock market volatility and destroying the small investor's confidence in the market. In the face of these charges, and the sometimes wild swings in stock prices at the close of trading on Expiration Fridays, the Securities and Exchange Commission (SEC), in consultation with the Commodity Futures Trading Commission (CFTC), has calmly set about gathering evidence to determine whether there really is a problem and, if so, whether any of the possible remedies carry benefits that exceed their costs.

The issue at hand is the large-scale buying and selling of futures and options contracts on stock indexes, and the simultaneous selling and buying of the stocks that make up the indexes. Stock index futures and options allow investors to speculate on or hedge against movements in the stock market (or segments of the market) without having to buy or sell each of the stocks that make up the index. A portfolio manager who foresees a rally in the market, for example, can take a long position in index futures—buying, for example, Standard and Poor 500 futures—then buy individual stocks later, taking advantage of the change in market opportunities without having to determine immediately which stocks to buy. The commission on the futures transaction is low and some of the adverse price effects of trading large blocks can be avoided. Equity exposure can thus be adjusted quickly at low cost.

Offering this potential, stock index futures and options have caught on quickly. Introduced in 1982, the average daily volume of trading in these derivative products (measured in terms of underlying share equivalents) has exceeded the volume of trading on the New York Stock Exchange since 1983.

Stock index futures and options have also created new arbitrage opportunities between the markets in which they are traded and the cash stock market. The arbitrager compares the price of the futures contract (which is equal to the actual value of the index at expiration) with the cost of buying the stocks underlying the index and holding them until expiration of the futures, less any expected dividends. If the index future is overvalued relative to the cost of owning the stocks, the arbitrager simultaneously goes long (buys) the stocks and shorts (sells) the index futures. At a subsequent date, expiration or earlier, the arbitrager unwinds his position, which amounts to reversing the original transaction by selling the stocks and closing out the futures. When index futures are undervalued, the arbitrager shorts the stocks underlying the index and goes long the index futures. (There are similar strategies involving put and call options on stock indexes.) Each of these strategies amounts to buying a commodity cheap in one market and selling it dear in another market; the arbitrager pockets the difference and the alignment of market prices is improved.

Stock index arbitrage is not for everyone. A futures contract on the S&P 500 represents an underlying stock value in excess of $100,000 and a typical arbitrage transaction involves more than $1 million worth of stocks. (One firm, at various times, has held roughly $1 billion of shares in an arbitrage position.) And there are risks, of course—risks associated with having a portfolio of stocks that may not perfectly mirror the stocks in the index, and risks involved with having an arbitrage transaction executed at unfavorable terms. To be profitable, arbitrage strategies require fast, synchronized execution. The

advent of computer-directed programs is what makes stock index arbitrage a feasible and profitable strategy for some large investors. Only about 10 broker-dealers—representing their own house accounts and those of institutional customers (100 or so)—are active in this market; typically these are large proprietary brokerage accounts that can buy blocks of shares and futures at nominal commissions.

Arbitragers generally close out their positions and take their profits when the futures and options contracts expire. Since these contracts settle in cash and, on expiration day, settle at the closing value of the index, their prices must converge to the spot value of the basket of stocks underlying the index. Buying or selling at this time ensures that any gains or losses on the stocks—which would result from price changes after the initial arbitrage position was taken—are offset exactly by losses or gains on the futures. The arbitrager thus collects the profit locked in when the arbitrage position was initially established, no matter what the price is at which the trades are finally executed. (Bigger profits might be available at other times, but the arbitrager is then exposed to the possibility of losses.) Providing the opportunity for a low-risk profit with a return in excess of T-bill rates, stock index arbitrage has attracted large amounts of capital.

Attracting all the attention in recent months is the Triple-Witching Hour—which is when stock index futures, stock index options, and options on individual stocks all expire at the same time. This happens only four times a year, on the third Friday of March, June, September and December, but when it does there is bedlam at the exchanges. Giant buy and sell orders are placed as arbitragers unwind their positions in the final minutes before closing. (Of the 140 million shares traded during Expiration Friday this past June, 40 million shares were traded in the final 30 minutes.) Huge imbalances in orders are not unusual. (During the same 30 minute period last June, IBM went from an imbalance of 30,000 shares to sell to an imbalance of several hundred thousand shares to buy). When the dust finally settles a few minutes after 4:00 p.m., the Dow Jones Industrial Average might have dropped as much as 25 points in the final hour of trading, as it did on March 21, or jumped by 14 points, as it did on June 20. So, for a few minutes on four Fridays a year, the usual forces of supply and demand, and the usual volume of activity on the stock exchanges, appear to be distorted by the actions of buyers and sellers who care not a whit about price or market fundamentals, only about transacting at closing prices.

The volatility of stock prices on Expiration Fridays—and on other days for that matter—has led some to push for the federal government to clamp down on program trading in general (which includes large index fund purchases and sales not related to futures and options trading) and stock index arbitrage in particular. Critics, including some individual investors and money managers, charge that the market is being overrun by institutional investors making money by gambling on price spreads. The small investor, they say, is caught in the cross fire as arbitragers, armed with computer-directed trading strategies, look for quick profits. Evidently, the sight of so much money moving so quickly between instruments that did not even exist five years ago is troublesome to many. The concern is that there is something artificial going on that is greatly increasing stock market volatility.

As part of a fact-finding and fact-disseminating mission, the SEC and the stock exchanges commissioned a major study of stock index arbitrage. Conducted by Hans Stoll of Vanderbilt University and Robert Whaley of Duke University, the study was released this Spring and discussed at a public meeting of the CFTC's Financial Products Advisory Committee. More recently, in July, the SEC held a round table with the principal exchanges and market participants on stock index arbitrage and alternative remedies for stock price volatility.

The facts gleaned from this inquiry should be taken to heart by those clamoring for government intervention. First, while there is substantially more volatility in stock prices on quarterly Expiration Fridays, most of these price effects are reversed on the following Monday mornings. A sharp decline in prices on Friday afternoon, for example, is generally followed by a sharp rise on Monday morning. Second, setting aside the Expiration Friday-Monday phenomenon, there does not appear to have been any increase in stock market volatility on a day-to-day basis since the derivative products were introduced. SEC Chairman John Shad suggests that overall price volatility may well be lower as a result of stock index arbitrage. Third, the price effects of other large block transactions frequently exceed those on expiration days (though they are concentrated in individual stocks). As the Stoll and Whaley study concludes, "The expiration day

phenomenon has the advantage of occurring at a predictable time, which gives investors the option of staying away."

The problem then is erratic swings in closing stock prices on four Fridays a year. What to do? Maybe nothing. Aberrations in markets are typically self-correcting. Price swings, to the extent they are anticipated, create profit opportunities, and as traders attempt to exploit these opportunities, the price swings should be dampened. Sophisticated investors are already beginning to place below-market orders at the close on Expiration Fridays in hopes of picking up some bargain shares. Brokerage firms have notified their institutional clients that they will be unwinding large arbitrage positions and have offered the clients the opposite side. (This keeps these shares from affecting the price at the close, allows the firm to earn commissions, and allows the clients the opportunity of possibly buying at a discount or selling at a premium.) Firms have also notified specialists that they would be willing to buy, at specified prices, any stock left at the close or sell any shares that are needed. To date those offers have been too high or too low to be executed, but competition for these profitable trades should cause firms to raise their bids and lower their asking prices. These market adjustments take time, of course, and, in the meantime, could be associated with increased stock price volatility on Expiration Fridays—by eroding the possibility of unwinding profitably prior to expiration, competition could result in the concentration of virtually all unwinding at expiration.

The success of these market adjustments may well depend on the flexibility of the rules and procedures governing trading on the exchanges. Concerns have been raised, by the SEC among others, that under present rules, the New York Stock Exchange may simply be unable to handle large and unexpected order flows in a way that would generate the information needed for markets to clear without wide price swings. Three proposals are now being floated among the exchanges.

Under one proposal, specialists would be required to disclose market-on-close order imbalances on Expiration Fridays. The problem with this option is that the new information generated would not necessarily be valuable to would-be traders. Market-on-close orders are cancelable, so arbitragers can decide to roll over their positions or make some other trades once the imbalance is disclosed. Likewise, "bluffers" can always enter the market with large sell orders when their intention is to buy (or vice versa). A difficult enforcement problem could be created.

A second proposal would move the expiration of the stock index futures and options contracts to the opening. This would allow the New York Stock Exchange to delay openings if necessary, as is often done because of order imbalances, and also would allow price effects in the stock market to be corrected during the same day. This change could not be implemented for over a year, however, unless existing contracts were modified. It would also pose a problem of contemporaneous trading in derivative products before meaningful prices for the underlying indexes and shares are available.

A third proposal under consideration would involve trading halts at the close so that indications of order imbalances could be disseminated. This could improve the dissemination of information and provide for an orderly close. The problem is that it would create uncertainty about the timing of close, which would impose costs on the exchanges as well as on the derivative products markets that remain open after the exchanges close.

Evidently, each option carries a cost—even if only that associated with uncertainty caused by changing the rules for some very successful products. And the costs are by no means distributed equally (or even in proportion to the benefits that might accrue) across the exchanges or across traders. Modified disclosure requirements, for example, concentrate the costs on the New York Stock Exchange and thus are attractive to the futures and options exchanges, which see the problem (if one exists) as residing in the stock market. Modified expiration dates for futures and options concentrate the costs on the futures and options exchanges and thus are attractive to the New York Stock Exchange, which argues that any problems that exist are caused by the derivative products. Expirations at Friday's close, says the exchange, causes volume surges at the worst possible time and the derivative products should be conformed to long-established New York Stock Exchange procedures. Among stock market participants, specialists and others profiting under the current system stand little to gain, and possibly much to lose, from reform. A political consensus is likely to be difficult to forge.

But if price volatility on Expiration Fridays

has a measurable cost and the rule changes under consideration are cost-effective, we should expect there to be private incentives to implement one of these proposals. The market response might involve a voluntary, independent adjustment of rules by the stock exchanges, for example, or some joint action by the stock, futures and options exchanges. Since stock index arbitrage involves trading in more than one market simultaneously, there may well be changes that are mutually beneficial. (The threat of federal action can make a market solution difficult to achieve, however, since political contingencies must be taken into account and some affected parties—possibly those with weak claims—will have the incentive to hold out for a political resolution.)

The challenge for the SEC and the CFTC is to avoid "killing the goose that lays the golden egg," says SEC Commissioner Joseph Grundfest. Stock index arbitrage provides pricing efficiencies that benefit all markets. Traders in the stock market are benefitted because the price of index shares more accurately reflects the information provided in the futures and options markets. Because of arbitrage, share prices fall and fall more quickly when expectations are bearish; conversely, share prices rise and rise more quickly when expectations are bullish. Arbitrage also causes the prices of the futures and options to track more closely movements in the underlying stocks. This permits fund managers to hedge their portfolios against market risk or to assume more market risk through transactions in derivative products. Improved fund performance, in turn, generates benefits for all those who contribute to, or have income derived from, the giant mutual and pension funds that participate in stock index arbitrage. As Mr. Shad has put it, stock index arbitrage "has increased the breadth and liquidity of the entire marketplace for all securities, which has been beneficial to small investors as well as to the large."

The jury is still out on whether Expiration Friday price volatility is a problem worth fixing and, if so, whether the proper remedy involves more intervention in the marketplace. To this point, the SEC, in consultation with the CFTC, has been studying the situation carefully and searching for least-cost remedies. This is admirable given the political pressure they undoubtedly feel to "do something." Many a regulator has been moved by much less to do much more.

Nonbanks and Nonproblems

Congress is considering banking legislation again. Many banks and thrifts in agriculture and energy states are in serious difficulty, and the Federal Savings and Loan Insurance Corporation needs to be recapitalized. The urgency of these problems has provided House Banking Committee Chairman Fernand J. St Germain and Senate Banking Committee Chairman Jake Garn with a new opportunity to push for action on several proposals that have been simmering within their committees since 1982, when the last banking bill was enacted. The two differ on most banking issues, but both would like to close the "nonbank bank loophole."

What is a "nonbank bank"? As Undersecretary of the Treasury George Gould said recently, "even the name, along with its accessory, 'loophole,' is designed to evoke opposition." But nonbank banks—called limited service banks by nonopponents—are less pernicious than they sound. According to the Bank Holding Company Act, a bank is an organization that accepts demand deposits and makes commercial loans. A firm that does only one or the other is not a "bank," which means that the firm's parent company is not a "bank holding company." The lending or borrowing activities of a nonbank are regulated just as if it were a "bank," but its parent company is free of federal restrictions on business and geographic diversification. A bank holding company may not own a butcher, baker, or candlestick maker, or even a company that sells most other financial products, but just about anybody can own a limited service bank. Even bank holding companies may operate limited service banks in states where they are forbidden to operate "banks." For them the limited service bank is a vehicle for interstate expansion.

About 80 limited service banks are operating around the country. They are owned by such firms as Merrill Lynch, Dreyfus, J.C. Penney, Sears Roebuck, American Express, Gulf and Western, Control Data, and John Hancock. Many other commercial firms, and several hundred bank holding companies, have applications pending with the Comptroller of the Currency to open additional limited service banks.

Firms interested in offering banking services may also acquire savings and loan associations. By law, a company that owns one savings and loan is not restricted in its other business activities. Sears Roebuck, Ford, ITT, Parker Pen, and

Weyerhauser, for example, now own savings and loans, even though they cannot own full service banks. Savings and loans, however, are subject to asset and growth restrictions which make them less attractive than banks for most purposes.

The list of companies acquiring limited service banks or savings and loans suggests that the financial services business is in store for some radical changes. Some of these firms are, or plan to be, nationwide suppliers of a full-line of financial services, and are already emerging as formidable competitors. They believe they can lure customers away from traditional banks by adding deposit instruments to the financial services they already offer.

Other firms have more limited objectives. For example, automobile finance companies may want to lend you money for your house as well as for the car in your garage. Others aim to reduce costs by integrating production with banking. Only depository institutions have access to the interbank payments system, through which millions of account payments are settled each day. Major retailers, insurance companies, mutual funds, and others who make or collect large numbers of individual payments believe they can operate more efficiently by being part of the payments system than by purchasing payments services from banks.

The various strategies of firms seeking banking affiliates have yet to prove themselves, and some of them, no doubt, never will. The question is whether they will be given a chance.

The Federal Reserve Board is responsible for regulating bank holding companies. Chairman Paul Volcker does not like the idea that limited service banks can be owned by companies operating beyond the Fed's purview. In 1984 the Fed attempted to expand its jurisdiction to cover services offered by some limited service banks by redefining the terms "demand deposit" and "commercial loan," but in January of this year the Supreme Court held that the Fed had overstepped its bounds. Despite this ruling, the Comptroller of the Currency remains temporarily enjoined from chartering new limited service banks by a Florida district court ruling in a separate case. This has bought time for opponents of limited service banks to plot strategy before so many of these banks become established that halting or reversing their growth becomes politically impossible.

The most visible of these opponents has been Mr. Volcker himself, who has said that closing the nonbank bank loophole is his "top priority" and the "core of a coherent effort" to ensure the safety of the banking system. "Breaking down the distinctions," according to Mr. Volcker, "would fail to respect the uniqueness of banking. The ensuing questions of conflict of interest, undue concentration of resources, unfair competition, and the transmission of unregulated risks to the financial system would hardly be consistent with long-standing public policy and the operation of the federal safety net."

Mr. St Germain has weighed in with similar arguments. "The attractiveness to a company of owning its own 'pocket bank' is clear. . . .Funds can be thus obtained for the company's use or benefit at a lower government-subsidized interest rate by selling federally insured deposits in the open market and relending the funds to the company's other subsidiaries or to its suppliers. Competitive pressures, ultimately, would cause all companies to want to own a pocket bank. . . . Most fundamentally there is a conflict of interest in being at the same time both a lender and a borrower. Such a situation becomes a public policy concern to Congress when the funds being lent represent federally insured deposits."

The American Bankers Association, the Independent Bankers Association, and the U.S. League of Savings Institutions also favor loophole closing (although some of their members do not). Here as elsewhere it is easy to criticize business groups seeking government protection from competition, but the traditional banks do face a dilemma—one that is typical of regulatory politics. They are prohibited not only from commercial endeavors but also from many financial activities closely related to banking, such as operating mutual funds and underwriting and brokering securities and insurance. Their anxiety over the appearance of rival banks that can do all of these things is justified. Even banks that would prefer having their own restrictions removed to having the new competition snuffed out must pause to consider that "loophole closing" may be more popular in Congress than abolishing banking controls established in the Depression.

The emergence of the nonbank bank presents a slightly different dilemma for the Reagan administration. The administration's position is that nonbank banks are procompetitive and beneficial to consumers. Indeed the Treasury and Justice Departments opposed the Fed's position in the Supreme Court—an unusual ma-

neuver. Yet the administration has been working for several years on a "comprehensive" reform proposal which would permit banks, through holding companies, to engage in *some* financial activities but not others. (For example, the Administration's 1984 bill would have permitted banks to engage in limited securities and insurance activities, and would have continued the prohibition on all commercial undertakings.) Having put so much effort into crafting a "balanced" bill, negotiating with the various interest groups, and weighing the pros and cons of permitting banks to do this and that, it must be distracting for policymakers to be confronted with the appearance of banks that are free to do anything. So the administration has said it will support closing the nonbank bank loophole in the context of a financial reform bill that is sufficiently "comprehensive."

Are diversified financial services firms an insidious influence or just a better mousetrap? Those who wish to maintain the separation of banking and commerce cite several potential abuses, but few have actually been found. Consider the conflicts-of-interest problem. Potential conflicts of interest abound in finance and indeed throughout the modern economy, but market and legal constraints discourage exploitation of those conflicts; those related to banking are not a special case. A manufacturer *cum* bank cannot make money by lending money to itself at a below-market interest rate, since the benefit to the manufacturer is exactly offset by the foregone market rate to the bank. Indeed if this feat were possible any firm could do it without being a "bank." A bank's transactions with affiliates, moreover, are heavily regulated. Severe civil and criminal penalties apply to bank officers and employees who misuse funds with improvident affiliate loans. Under current law a bank with the required 6 percent capital may devote no more than about one percent of its assets to loans and purchases with all affiliates.

But now consider Mr. St Germain's concern over implicit subsidies from the federal deposit insurance program. Won't this subsidy—which arises from a bank's ability to attract capital (deposits) at lower interest rates than if it did not have government-backed insurance—give the manufacturer with a "pocket bank" an unfair competitive edge over its commercial rivals? The answer is no: any insurance benefit to the manufacturer would still be an opportunity cost to the bank. The federal insurance subsidy presumably does distort banks' lending decisions, but the distortion exists whether borrowers are independent or affiliated. If Mr. St Germain is concerned that "funds being lent represent federally-insured deposits," he should be concerned that such funds are being lent now by all banks, and have been since the introduction of government insurance. Subsidized deposit insurance provides no special benefits to businesses integrated with banks.

Mr. Volcker's concern over undue concentration of resources is unwarranted. If the integrated financial services firms grow at the expense of traditional banks it will be because this form of organization turns out to be relatively more efficient. If the new firms gain such a large share of their markets that they acquire power over pricing or terms of service, they will be as liable to antitrust suits as any other businesses. In fact, financial service monopolies are about as likely as a return of the railroad trusts. Most all financial services markets are highly unconcentrated and competitive, even "atomistic." The major exception—the only context in which the Antitrust Division still attacks bank mergers, for example—is banking in small rural communities, where there is often one bank per town or less. Here the successful entry of nationwide, diversified financial service firms will have a substantial effect in *reducing* market concentration.

As to the safety and soundness of the banking system and the "transmission of unregulated risks" into that system, there is in truth nothing the regulators can do to prevent such transmission, integration or no; all they can do is issue insurance against it. Banks exist, after all, to exchange financial stakes with the rest of the world, most of it unregulated. This is a risky business—as the recent spectacular failures of many undiversified, unintegrated banks and thrifts attests—and is not systematically less risky than other sorts of businesses. But, the risks involved in banking are often different from those in other businesses, so the "transmission" of risks between affiliates is likely to reduce the riskiness of the integrated enterprise, not increase it.

If there is a present danger to the soundness of the financial system, it does not lie in permitting banks to affiliate with companies in other lines of business. It lies in trying to maintain distinctions between banking and other services that are being inexorably worn down by technological change. Such efforts are almost certain to

be self-defeating, leading to a further erosion of the competitive position of traditional banks and thrifts—and higher systematic risks—as customers turn to unregulated banking substitutes. The time for loophole closing is past.

Incomparable Worth

The central idea behind the "comparable worth" movement is that women are systematically underpaid in the labor market, and that something other than the forces of supply and demand must be relied on to ensure women are paid according to the "intrinsic value" of their work. To date the debate has focused on the size of the gap between men's and women's earnings. The rallying point for comparable worth advocates is that working women, as a group, earn 60 percent of what working men earn. Critics respond that group differences narrow as factors other than sex are taken into account, such as education, work experience, seniority, riskiness of the job, continuity of work history, and number of hours worked. Advocates reply that group differences prevail because women tend to be concentrated in occupations (such as nursing) which are underpaid relative to male-dominated occupations which have no greater "intrinsic" or "social" worth (such as truck driving). Relatively little attention has been devoted so far to the second half of the comparable worth idea: that "something else"—which in practice means a government agency—can actually produce fairer and more equitable pay scales than old-fashioned supply and demand.

Comparable worth has not caught on in the courts, but has made headway with state governments and with the management consultants being called in to perform job evaluations. Comparable worth pay scales have already been implemented for state workers in Iowa and Minnesota; Washington will soon follow suit; and several other states—Vermont, Massachusetts, Michigan, New Jersey, New York, Kansas, and Oregon—are in the study phase. These efforts provide a potentially valuable source of information for determining whether the intrinsic value of jobs can be objectively determined by means other than the market. How is the valuation to be done? Will it produce pay scales that are reasonably consistent across states? Richard Burr, a research analyst at the Center for the Study of American Business at Washington University in St. Louis, has arrived with the first study in what promises to be a lively literature on the subject. Published in July, this study concludes that comparable worth plans are highly subjective and produce results that vary widely among the states that have used them.

Deciding abstractly about the worth of particular jobs turns out to be a complex—and slippery—business. Jobs must first be assigned to categories of work, since determining the intrinsic worth of every state employee would be out of the question. Then each category must be assigned a relative worth, which is done by settling on relevant "job factors" to be evaluated (skill requirements, working conditions, accountability, etc.), weighting those factors according to relative importance, and then, through a point system, evaluating the worth of each job category. And then comes the interesting part: Revising everybody's salary to fit the number of points assigned to their job category.

Even the seemingly mundane task of classifying jobs has turned out to have many pitfalls. A number of states found that existing job descriptions were too numerous and varied to be manageable and thus chose to supplement or replace them with job descriptions collected from employees themselves. This naturally raised the question whether workers would embellish their job duties. In New York State, the Center for Women in Government (which conducted the study for the Governor's Office of Employee Relations and the Civil Service Employees Association) considered having supervisors check employee job descriptions, but decided against it. Supervisors, the CWG concluded, would be at least as subjective as their employees, and might not have an accurate picture of what their employees really did; moreover, supervisor reviews "would jeopardize crucial union support for the study." Economics as well as politics intruded. In Michigan, job interviews were limited to employees in Detroit and Lansing because of cost limitations; in Iowa, job classifiers made final selections based on five or fewer employee questionnaires per category.

The selection of job evaluation factors was no less problematic. Each state study team had its own views about how to divide jobs into factors that could be compared across jobs. Iowa's study (which ended up with 13 different job factors) thought "Working Environment" and "Unavoidable Hazards" should be measured separately; Kansas' (which ended up with eight

factors) grouped them together into a single "Environmental Conditions" factor. Iowa thought using redundant factors would enhance statistical reliability and accuracy; Michigan feared redundancy would lead to biased results because redundant factors might be associated with jobs held by individuals of one sex. New York's CWG was unfazed by such difficulties: "In making decisions," it said, "statistical outcomes provided information that was used to arrive at conceptually and substantively sensible solutions.... Even the choice of statistical outcome itself is a judgmental one."

And weighting the job factors was even more judgmental. Iowa, for example, thought the knowledge required for a job should count for 25 percent of a job's value, while Michigan thought knowledge should count for only 11 percent. Kansas thought personal contacts should count for 21.25 percent, while in Iowa contacts counted for only 10 percent. Nevertheless, Mr. Burr finds that certain adjustments to definitions and weights of job factors were made with "unwavering certainty"—those to correct for sex discrimination as perceived by the study teams. He cites the Michigan study which changed the standard physical-demands factor "to include a physical dexterity subfactor and increased emphasis on continuously performed activities approximately equivalent in energy expenditure requirements to less frequently performed but more strenuous activities." The weighting schemes presented in Mr. Burr's study all give low weights (10 percent or less) to such factors as supervisory responsibilities, physical demands, work environment, and hazards, and higher weights (10 percent or more) to such factors as personal contacts and "complexity."

The final step, that of assigning points to job categories, appears to have been the most subjective of all. In Maine, instructions to job evaluators explained that a hypothetical "First-Line Supervisor job" could be scored 152, 175, or 200 points for the "Know-How" factor. "Your final decision," read the instructions, "is to choose one of these numbers based on your 'feel' of the strengths and weaknesses of the factors." This get-in-touch-with-your-feelings methodology yielded pervasive differences in the points awarded by different evaluators.

With comparable worth depending on so many personal judgments, it should not be surprising that *identical* jobs turned out to have very different worths in different states. Comparing the job value scales—which determine comparable-worth pay—in Iowa, Minnesota, and Vermont (those states that have completed the most thorough studies to date), Mr. Burr finds that a photographer is valued more than twice as highly in Vermont as in Iowa, and 25 percent higher in Minnesota than in Iowa. A Minnesota librarian is valued 30 percent more than a Vermont librarian, who in turn is 20 percent more valuable than an Iowa librarian. In Minnesota, a registered nurse, a chemist, and a social worker are valued identically. In Iowa, a nurse is 29 percent more valuable than a social worker, who in turn is 11 percent more valuable than a chemist. Chemists also come in third in Vermont but social workers outrank nurses: social workers are 10 percent more valuable than nurses, who in turn are 10 percent more valuable than chemists. Although Mr. Burr doesn't say so, these pay disparities appear to be much larger than those identified by comparable worth advocates as arising between men and women in the market.

It is difficult to explain these disparities in terms of differences in the "intrinsic value" or "worth" of the occupations in the three states. Librarians, it would seem, should be about equally valuable in Minnesota, Vermont, and Iowa—each state features long winters and large student populations. Perhaps photographers are uniquely valuable in Vermont because of its lovely, photogenic landscapes; on the other hand, Vermont's landscapes will lose much of their charm if they become cluttered with Iowa photographers lined up at the state employment office.

According to Mr. Burr, the comparable worth studies are consistent in two respects that have nothing to do with sex: They generally find many more cases of undervalued jobs than overvalued jobs (by a ratio of over two to one in Iowa and over six to one in Vermont), and call for increasing the pay of undervalued workers but not reducing the pay of overvalued workers (those in the latter category would have future raises modified or postponed, at least according to current intentions). If there is a message to be gleaned from recent comparable worth studies, it seems to be the following approximation of Garrison Keillor's description of one Minnesota town: all the women are strong, but nearly *everybody* is above average.

Reagan FTC Fights Price Cutting on Pencils, Paper Clips

The headline above is not a spoof. Last winter the Federal Trade Commission (FTC) found the Boise Cascade Corporation liable for "knowing receipt of price discounts" in its office supplies business. The FTC is in court defending its cease-and-desist order against the company. The case arises under the Robinson-Patman Act, that most anticompetitive of antitrust statutes, which the FTC has enforced in court only rarely since the early 1970s—and not at all, until now, during the Reagan administration.

Robinson-Patman forbids price discrimination. To an economist this term has a precise meaning: charging different customers different margins over costs of production (something only a firm with a very strong market position can do, and which may or may not be harmful). To the FTC it means, literally, charging different customers different prices for the same product (something most all firms do, as when customers purchase different quantities or when costs of production otherwise vary from customer to customer or from time to time). The FTC does recognize a "cost-justification defense" to a Robinson-Patman charge, which saves many volume-discount programs, but the defense is a narrow one and very costly to meet once the commission has set its enforcement machinery in motion. The statute also says the commission must demonstrate not only that price discrimination exists but that it may "injure, destroy, or prevent competition." But the commission neatly elides this requirement by *assuming* that any differences in price paid by competing firms (for example, two retailers of office supplies paying different prices per carton of file folders) *ipso facto* injures competition.

Boise Cascade got into hot water because it is a "dual distributor," operating both as a wholesaler and retailer. It purchases office supplies—about 25,000 different items—from over 1,000 different manufacturers; stores these supplies in 27 distribution centers around the country; then sells them—about half (in dollar volume) to stationary and office supply retailers and the other half directly to customers. Some of Boise's suppliers charge according to purchase volume (with lower unit prices for larger purchases); others charge according to customer function (with lower prices for wholesalers than retailers, and lower prices for retailers than retail customers). The obvious logic of the latter pricing scheme, known as "functional discounts," is that it is cheaper to sell to wholesalers, who perform their own costly distribution services (maintaining large volumes of inventories, marketing to numerous retailers, breaking bulk to service retailers' orders) than it is to sell to retailers, who need these services provided for them. Functional discounts are lawful under Robinson-Patman—not because they are economically justified by differences in manufacturers' costs of supply, but because the different prices are charged to firms at different levels of distribution, and therefore do not produce visible "price distortions" among firms that are direct competitors. Boise, however, paid the lower "wholesale" price for all products, including those it resold at retail. *In other words, Boise paid "wholesale" for some products it eventually sold at retail, in competition with independent retailers who had to pay the higher "retail" price!* The FTC found that this violated a policy it called "competition as fairness."

The commission should not have been alarmed. A dual distributor such as Boise incurs the same wholesaling costs regardless of whether it eventually sells through its own retail outlets or through independent retailers. In either case, the distributor provides the same services to the manufacturer—marketing and distribution services from the factory gate to the ultimate customer—and, in a competitive market, will receive the same price for these services in the form of a discount from the price charged retailers. Whether Boise Cascade retails through its own retail outlets or someone else's has as much bearing on the prices it pays manufacturers as whether it owns or leases its delivery trucks. There is no discrimination and no unfair disadvantage to independent retailers. If a competing, unintegrated retailer pays a higher price than Boise for a box of file folders or adding machine ribbons—whether purchased from the manufacturer, Boise, or another wholesaler—it does so because it has not incurred the same costs of wholesaling.

The FTC might have seen this obvious point if it had considered the economic function of functional discounts, rather than getting caught up in the empty terminology of "wholesale" prices on products later sold at "retail " by the same firm. At one juncture the commission did appear to glimpse the real issue in the case. This

is when it asserted that Boise's wholesaling services could not have been the reason for its discount on goods it sold at retail because there were some large, integrated retailers who bought directly from manufacturers and yet did not receive the same discounts. But here the commission had the record wrong: integrated retailers warehouse only a fraction of the products that large wholesalers such as Boise warehouse—typically 2,000-6,000 items as opposed to 25,000—and rely on Boise and other wholesalers to keep stock of the rest (many with limited or seasonal demand, such as calendars and specialized accounting and filing systems).

Unfortunately, the FTC's treatment of this issue was no deeper than the rest of its opinion. In 40 pages of text the commission shows not the least curiosity about the economics of distribution in general or dual distribution in particular, or about when price differences are likely to be harmful and when benign. Boise Cascade is portrayed as the behemoth of the office products business—the "country's largest distributor" and "one of the two largest wholesalers"—without mention that the office supply business is highly unconcentrated and that Boise's total sales account for about 2 percent of the market. This is much too small a share of the market to empower Boise to obtain discriminatory discounts, and should have led the commissioners to inquire into the economic causes of the discounts it did receive. The opinion rejects every opportunity to inquire into whether and how Boise's discounts actually injured competition, defending its lack of interest in the economics of the case with hoary FTC precedents that have been condemned by a generation of antitrust scholarship. And the result is manifestly silly: Boise must either leave the wholesale or retail markets, arrange to pay higher prices for the products of manufacturers that use functional pricing systems, or arrange to pay different prices to these manufacturers for identical products depending on who ends up selling them at retail.

Whatever the eventual result, one thing is clear: the decision will bring higher prices to consumers and comfort to only one group—Boise's competitors. Boise's competitors were the ones that initiated the case in the first place by lodging a complaint with the FTC, which should have been enough to tip off the commissioners about the merits of the case. One competitor, a large Boston retailer, testified to the FTC:

> Now, when a dealer loses a large account, which is usually the type that Boise goes after, they immediately go out after something else. And they end up playing the same game that Boise plays. And by that I mean they are in there with extremely low prices, in my opinion.
>
> So instead of everyone operating on a business-as-usual manner for the period before Boise came in, they have sort of created this monster, as I see it.

The *Boise Cascade* case was a splendid opportunity for the FTC to reformulate its interpretation of the Robinson-Patman Act. The commission could have provided economic content to the law's application to functional discounts; it could have required evidence that price differences "injure competition" as opposed to injuring less efficient competitors (on this point the commission actually stretched the statute in the wrong direction); or it could have introduced a market-share test as a threshold for actionable price discrimination. The last reform would not have been a radical step—a unanimous Supreme Court, speaking through Justice Brennan, did exactly this in an antitrust "group boycott" case last year involving, ironically, stationary wholesaling. Most of the important antitrust reforms of the past decade have come through incremental, common law changes such as these. The commission's inexplicable failure to apply the law sensibly in such a onesided case was a missed opportunity of large proportions.

Robinson-Patman orders have become a form of cruel and unusual economic punishment—imposed rarely and randomly, punishing economic efficiency, and filling no evident, contemporary political need. No government, not even a Metzenbaum administration, will enforce it thoroughly or even routinely: to do so would impose fabulous costs on consumers and would not even benefit "small business" (the law's supposed beneficiary), which has been a frequent loser in Robinson-Patman cases. Under the circumstances the law should not be enforced at all. Daniel Oliver, the new FTC chairman who arrived after the *Boise Cascade* case had been decided, should propose that the law be repealed, and revive a controversy that has been dormant since repeal was last proposed—by the Carter administration's Justice Department.