Commentary

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In the 15th and 16th centuries, Florence, Genoa and Venice were the financial capitals of the Western world. When they declined, financial leadership shifted to Amsterdam, then to London and finally to New York, whose supremacy went unchallenged from 1945 until the end of the 20th century.

In the new millennium, however, it is showing cracks. A decade ago, companies fought for the privilege of being listed on the New York exchanges, but interest has dropped significantly since the tech bubble burst in 2000. The credit crisis has only made things worse. Will the city be able to retain its title as the world's finance king? What will Wall Street look like in 2015?

Geography alone guarantees that New York will remain one of the world's financial leaders. A globalized economy spanning 24 time zones offers room for at least three major financial centers. With one center likely in Europe or the Middle East and a second in East Asia, New York would be the natural third pillar in a hemisphere that offers little competition for the job.

If we look beyond the Americas to the broader world, however, New York's enduring supremacy is not a foregone conclusion. Besides the power of inertia--people like to trade where others trade, so they trade in New York--the city has benefited from three comparative advantages in the past: a sophisticated and well trained workforce, reliable but not intrusive regulations and (at least since Ronald Reagan's presidency) a favorable tax and political environment. All these advantages have shrunk, if not vanished.

New York's skills advantage eroded long before the 2008 crisis. Thanks to its early deregulation of brokers' commissions in 1974, New York took the lead in the quality and reliability of trade. Global companies came to the city to be traded and judged by New York's analysts. But during the 1990s, most European stock exchanges caught on. Their tardiness allowed them to adopt the most recent trading technology easily, and they moved faster and more decisively into electronic trading, creating markets that were at least as liquid as the traditional exchanges. Most of the daily trading in cross-listed companies--companies traded on both the traditional and electronic exchanges--moved back to the country of origin, eliminating one of New York's advantages.

Over the last 20 years, American business schools also helped close the knowledge gap between New York and the rest of the world by admitting more students from abroad, to the point that over 30% of the schools' populations were foreign-born. Most of these students chose to return to their home countries after they finished school, bringing new ideas and techniques with them. The financial crisis has only accelerated this process. Restrictions against hiring foreign workers imposed by the federal government's Troubled Asset Relief Program (TARP) ensure that a larger flow of talented people will head back to their native countries, further reducing the skills gap between America and the rest of the world.

New York's competitive advantage has also eroded on the regulatory front. For financial markets to work properly, the regulatory regime must strike a delicate balance between preventing fraud and abuse, on the one hand, and jeopardizing the freedom to innovate, on the other. For many years, the U.S. appeared to have achieved this balance. No longer. From Enron and World-Com to Bernie Madoff and the subprime meltdown, the Securities and Exchange Commission's reputation as an effective enforcer is in tatters.

Once, foreign companies were happy to list in New York because subjecting themselves to American regulators signaled to investors that they were transparent companies with reliable accounts. But what's the certification value of being listed on a New York exchange if the New York policians don't detect fraud? Meanwhile, the restrictions imposed ex post facto on TARP recipients, Congress' confiscatory tax on executive bonuses and contemplated populist financial reforms have made clear that regulators will heavily interfere with private business. In fact, from both a political and a regulatory perspective, the U.S. of the future will look like a continental European country. That's not an environment conducive to financial innovation.

Finally, the crisis will have major effects on New York's competitive edge in the tax area. Despite New York City and New York state's heavy taxes, the federal government's low top tax rate and favorable treatment of hedge-fund income long made New York an...
attractive place for financiers to live and work. Prospective tax increases (at both the federal and state levels) and the likely closing of tax loopholes will make New York very unattractive, especially for resident aliens who can avoid higher taxes by moving abroad. New York's main consolation is that the U.K.'s fiscal deficits will prevent the British from competing too aggressively on the tax front. But new financial centers, such as Singapore or Dubai—or even old ones, like Zurich—could become a real threat.

One might argue that New York maintained its world dominance during the high-tax years of the Johnson and Nixon administrations, so higher taxes can't hurt more. But the delocalization of trade brought about by technology and the Internet has made global competition much more intense than it used to be. Bermuda, the capital of reinsurance, could easily become the capital of the hedge-fund industry as well.

The biggest threat of all to the Big Apple's financial supremacy, however, comes from Washington. The Founding Fathers wisely decided that the nation's political capital should be separate from its financial capital (in both senses of the word). Now this splendid segregation has ended. If the outcome of the Chrysler bankruptcy is any indication, Washington is willing to flex its muscle in financial decisions, altering the substance of contracts freely agreed to by private parties. In so doing, the national government has undermined the certainty of the rule of law, which was the American capital market's strongest asset.

Unfortunately, since Washington is the source of the problem, New York City can do little by itself to defend its position. Perhaps the city's best bet is to offer favorable tax treatment to the financial industry—but to do that, it had better first put its finances in order.

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