FEDERAL RESERVE BANK

# BUSINESS REVIEW

OF PHILADELPHIA

Headquarters Have Human Problems

Inflation: Gainers and Losers

FEDERAL RESERVE BANK OF PHILADELPHIA

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Previous *Business Review* articles pointed to a decline in corporate headquarters in the Philadelphia region as one of the community's haunting economic concerns. Unfortunately, virtually nothing is known as to why the Delaware Valley is losing its stature as a headquarters center. Answers are not apparent in available economic data. Challenged by this conundrum, we took a personal approach to the headquarters problem and discovered that . . .

# Headquarters Have Human Problems

## by Elizabeth P. Deutermann

Between 1956 and 1965, Philadelphia lost its major corporate headquarters at a faster rate than any of the nation's other large metropolitan areas.[1] In addition, assets of corporations that retained home offices in the Delaware Valley grew at the slowest rate among the ten largest urban areas in the country. Nevertheless, Philadelphia was able over those years to hold on to its third-place position as a center of concentration for home-office activity. In spite of the fact that the region's relative decline did slow down a bit during the following three years, as shown in Chart 1, the Delaware Valley has now slipped from third to fourth, nationally, as a center for corporate headquarters.[2]

[1] References to Philadelphia throughout the article are to the Standard Metropolitan Statistical Area. It includes the counties of Bucks, Chester, Delaware, Montgomery, and Philadelphia in Pennsylvania; and the counties of Burlington, Camden, and Gloucester in New Jersey.

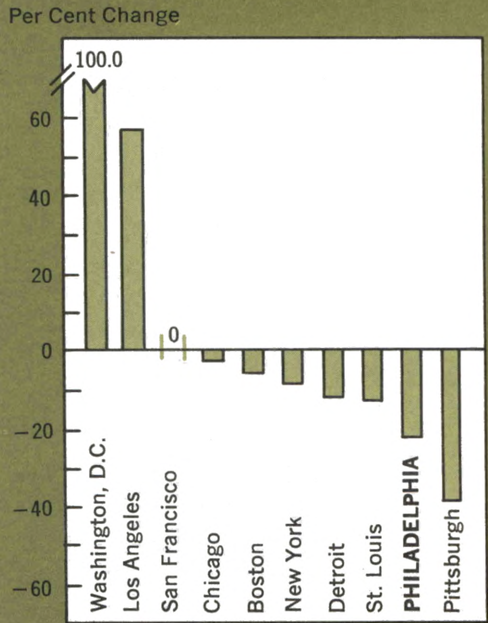
[2] A more detailed discussion of Philadelphia's changing headquarters climate is found in the following *Business Review* articles: "Headquarters: Centers of Corporate Control," May, 1967; "Philadelphia's Desire to Acquire," September, 1967; and "Where Corporate Headquarters Feel at Home," May, 1968.

Local government and business leaders throughout the region are disturbed by this loss of headquarters because of the possible adverse impact on the area's tax base and employment

**CHART 1**

**PHILADELPHIA'S HEADQUARTERS' LOSS EXCEEDS THAT OF MOST MAJOR METROPOLITAN AREAS.**

The chart shows the rate of increase or decrease in the number of headquarters in each area, 1956-1968*.




* Data refer to the 750 largest manufacturing and nonmanufacturing corporations in the nation.

Source: **Fortune** magazine.

opportunities. One group of businessmen is particularly dismayed because it has lost income as the number of large headquarters has declined. The group encompasses suppliers of Philadelphia's major business services—banks,

## TABLE 1

**How the Largest Regions Rank as Home Base for the Nation's Major Corporations**

| Standard Metropolitan Area | Ranking in Number of Major Headquarters* | | | Population Ranking 1968 |
|---|---|---|---|---|
| | 1968 | 1965 | 1956 | |
| New York | 1 | 1 | 1 | 1 |
| Chicago | 2 | 2 | 2 | 3 |
| Los Angeles | 3 | 6 | 8 | 2 |
| PHILADELPHIA | 4 | 3 | 3 | 4 |
| San Francisco | 5 | 4 | 6 | 7 |
| Detroit | 5 | 7 | 5 | 5 |
| St. Louis | 7 | 8 | 6 | 10 |
| Pittsburgh | 8 | 4 | 4 | 9 |
| Boston | 9 | 9 | 9 | 6 |
| Washington | 10 | 10 | 10 | 8 |

* Major headquarters refers to the 750 largest manufacturing and nonmanufacturing corporations in the nation.
Source: *Fortune* magazine and U.S. Bureau of the Census.

## RAISING PHILADELPHIA'S STATURE AS A HEADQUARTERS CENTER: GOAL FOR COMMUNITY ACTION

Community leaders in large metropolitan areas are aggressively promoting the attractiveness of their regions as headquarters centers. Philadelphians are no exception. For Philadelphia, however, achieving a goal of growth entails halting a downtrend in the number of local headquarters. Headquarters have been lost by moves from the region. They have been lost by corporate acquisitions. And because not enough new headquarters have been born in the area, nor attracted to it, the loss is a net one.

Local corporate executives have identified community attributes which detract from their satisfaction with Philadelphia as a headquarters location. Concerted community action has some leverage in turning these detractions into attractions which should help the region retain its headquarters base. But community action probably has less leverage in stemming the headquarters loss via acquisitions. More importantly, one may question whether losing home offices through acquisitions does more harm than good to the total regional economy.

Consequently, local community leaders are confronted with the ever-present problem of action priorities in seeking to elevate Philadelphia's stature as a headquarters complex. Two courses of action appear to deserve attention. The first is to rectify identified shortcomings in the regional environment which executives of today's headquarters feel dampen their enthusiasm with a Philadelphia location. The second is to concentrate on creating a business climate which stimulates the birth of new firms and home-grown headquarters. These two courses of action, fortunately, appear to be complementary.

advertising agencies, law firms, auditors and accountants, brokerage houses, public relations firms, and insurance companies. When a corporation shifts the location of its home office to another region, such service industries frequently lose a major client and a hefty chunk of income.

Industrial and civic leaders in the Delaware Valley hope that in some way the community itself may be able to halt Philadelphia's headquarters decline, and perhaps even reverse it. This is a tall order, but not necessarily an impossible one.

## STARTING WITH FIRST THINGS FIRST

Undoubtedly, many reasons for Philadelphia's loss of headquarters are primarily internal to the corporation. The community has little influence over these reasons. In numerous cases, however, there are factors in the regional environment that strongly influence corporate location decisions. Civic leadership can exercise some control over many of these factors.[3] There is a basic need for better understanding of what these environmental factors are.

What attributes of a community are most desirable for the location of headquarters? Which of the desired attributes are found in the Delaware Valley, and which are missing?

One approach to answers is to talk directly to executives of Philadelphia's major headquarters who make location decisions.[4] If the past trend continues, it will be, to a large degree, a result of these headquarters moving from the area or merging with companies headquartered outside of Philadelphia. In contrast, if these home offices remain in the region, there is reason to believe they can contribute to the birth of new firms (creating headquarters)[5] and serve as an attraction for headquarters seeking new locations.[6]

Twenty-five presidents or board chairmen of major corporations in the Delaware Valley, who play the key role in decisionmaking within their respective firms, were interviewed to see what they believe are the most important factors in choosing a headquarters location.[7] According to these executives, availability of quality housing for top management is the first priority item in demand. Minimizing the corporation's total tax burden is the second major consideration. Third is the availability and quality of corporate banking services in the region. Accessible and speedy air transportation for executives, a local labor pool of management and professional personnel, and high-quality law enforcement follow as most desirable community assets. Table 2 shows 18 factors, in order of relative importance, which carry the heaviest weight in the eyes of local executives evaluating a headquarters location.

**Philadelphia has many strengths.** Table 2 also shows how executives interviewed feel Philadelphia stacks up, compared to the nation's other

[3] For a discussion of leverage of local action in regional economic development, see Bertram W. Zumeta, "What Attracts Growth Industries?" *Business Review,* Federal Reserve Bank of Philadelphia, July, 1964.

[4] Obviously, executives of corporations headquartered outside of Philadelphia may hold different opinions than those interviewed in this survey. One of the chief objectives of this study, however, is to uncover factors that might lead to a continuing loss of Philadelphia's remaining headquarters. Furthermore, there is reason to believe the exclusion of interviews outside the region presents less of a problem than one might assume. (See footnote 11.)

[5] See Elizabeth P. Deutermann, "Seeding Science-Based Industry," *Business Review,* Federal Reserve Bank of Philadelphia, May, 1966.

[6] In a study of the economy of the Pittsburgh region, one of the chief locational advantages headquarters executives pointed to was the existing concentration of executive offices. See Ira S. Lowry, *Portrait of a Region* (Pittsburgh, Pennsylvania: University of Pittsburgh Press, 1963), p. 93.

[7] For a discussion of the methodology of this survey, see the Appendix.

## TABLE 2

**Factors Influencing the Location of Headquarters—and How Philadelphia Stacks Up***

| Factors Influencing Location Choice in Order of Relative Importance | Philadelphia, compared with other major metropolitan areas, is . . . | | |
|---|---|---|---|
| | Above Average | Average | Below Average |
| 1. Housing for management and professional personnel | x | | |
| 2. Corporate tax burden | | x | |
| 3. Major corporate banking services | | | x |
| 4. Air transportation for personnel | | x | |
| 5. Local availability of management and professional personnel | | | x |
| 6. Community law enforcement | x | | |
| 7. Regional public schools | | x | |
| 8. Space costs | | x | |
| 9. Community image | | | x |
| 10. Colleges and universities | x | | |
| 11. Cultural environment | x | | |
| 12. Regional political environment (SMSA) | | | x |
| 13. Legal services | x | | |
| 14. Availability of other personnel (supporting office staff) | | x | |
| 15. Local transportation | | x | |
| 16. Local political environment | | | x |
| 17. Corporate legal structure | | x | |
| 18. Availability of scientific and technical personnel | | | x |

* Based on opinions of presidents or board chairmen of 25 major corporate headquarters in the Philadelphia metropolitan area. For details see Appendix.

major metropolitan areas, in supplying these desired attributes.[8] Two-thirds of the most important locational advantages for headquarters are judged to be satisfactory or better in Philadelphia relative to the nine other largest cities listed in Table 1. These data do not imply, for example, that chief executives in Philadelphia feel sanguine about the taxes imposed on them. It does mean, however, that they believe all large urban centers place heavy tax burdens on corporations. Consequently, they consider themselves as well off in this regard located in the Delaware Valley as they would be in other regions of similar size.

Philadelphia also satisfactorily meets most executive needs for air transportation service. Although many comments were offered with respect to an unsatisfactory physical plant at International Airport and an unattractive landscape leading to the airport, the chief plus factor for air transportation is the speed with which one can get off and on the ground. Interviewees are relatively pleased with the quality of public schools in areas of the region where they, or their headquarters employees, are most likely to reside. Costs of commercial space

[8] Not included in this study are comparisons of Philadelphia with smaller metropolitan areas, which rank lower than tenth in population size. Many headquarters which moved from Philadelphia over the past 20 years relocated in regions of smaller size. The nine metropolitan areas compared with Philadelphia were chosen because, by virtue of size, they have many of the same assets and liabilities as the Delaware Valley, they have the largest concentrations of major headquarters, and they are considered chief competitors for Philadelphia's position as a major headquarters complex.

are believed definitely comparable to those in other major urban centers.

The region also is considered to offer better-than-average opportunities for housing and living amenities for executives. We found the greatest consensus regarding this attribute, which weighs most heavily in location decisionmaking. Clearly, the Delaware Valley is judged superior to other regions in housing quality and quantity, at comparable costs.

In summary then, top corporate executives tend to look with satisfaction on Philadelphia as a headquarters location. Community amenities which are given greatest consideration in decisionmaking are rated at least satisfactory or better compared to regions of similar size. Nearly all business services which are most sought after in selecting a location are believed to measure up to, or excel, those available in comparable urban areas. Other tangible qualities desired for headquarters satisfaction, such as relatively low taxes and space costs, are rated in Philadelphia as adequate as, or superior to, those in alternative metropolitan areas.

**Where is the problem?** At this point we are somewhat puzzled. If the Philadelphia region is so satisfactory in meeting needs of corporate headquarters, why is the community steadily declining as a headquarters center? That is the riddle we face.

The best clue to unearthing the answer seems to be evidenced in those factors considered by executives as: (1) important in location decisionmaking, and (2) less than satisfactory in Philadelphia. The last column of Table 2 shows which factors meet these two tests. Something is believed lacking in the region's ability to provide adequate corporate banking services to meet requirements of large headquarters. In addition, there is thought to be an insufficient supply of high-quality management and professional personnel in the area. Philadelphia's "community image," viewed as unfavorable, is felt to have a damaging effect on top management's contentment with a Philadelphia location. The same holds for the political environment, particularly at the local level (city, county, or township) where headquarters are housed. Finally, chief executives consider the Delaware Valley somewhat inadequate as a source of first-class scientific and technical talent.

Where in these findings is the clue to the regional riddle? From responses of chief executives of area headquarters, a common thread runs through the bill of complaints against Philadelphia as a utopia for home offices. While the more tangible attributes of the Delaware Valley—houses, schools, taxes, space costs—are considered competitive with other metropolitan areas, the region is rated as less than competitive in the human qualities executives seek in locating home offices.

**A common denominator.** The six indicated shortcomings of Philadelphia just noted manifest a common denominator in the eyes of headquarters executives. In each case, those attributes rated less than competitive with other regions relate to factors of human quality. These factors cannot be underemphasized. Corporate decisionmakers clearly consider the human quality of a community to play a much stronger role in the location of headquarters than in the location of production and distribution facilities. Furthermore, psychological costs appear to have greater weight in locating headquarters than in site selection for other corporate facilities. That the problem is human in nature is more obvious in some instances than in others.

An obvious human problem is the unfavorable grade Philadelphia received as a source of management and professional personnel. Executives recognized the tight labor market nationally for such employees. But Philadelphia is still rated as slightly tighter than other major urban areas for top-notch personnel to fill high-level corporate positions. For such slots, headquarters recruit nationally wherever qualified personnel can be found. Based on our probe, the home town is not where local executives look first—unless they look within their own companies.

The great majority of presidents and board chairmen interviewed were critical of the talent managing Philadelphia's corporations, other than theirs. One executive went so far as to find fault with his own company's "lack of aggressiveness"—an exception to the rule. Cleverly, another interviewee turned the lack of management skills in the area into a personal locational advantage. Because of this shortcoming in *other* companies, "the Philadelphia environment satisfies the egos of our top corporate management."

The political climate of the Delaware Valley is not considered so conducive to the location of corporate headquarters as that of comparable metropolitan areas. This opinion reflects attitudes of executives toward the specific county, city, or township in which their headquarters are situated, plus the state—which, in this case, means New Jersey or Pennsylvania.

Local political leadership, in contrast to that at the state level, has a stronger impact on negative attitudes of executives toward their location. A community political environment which is unresponsive to business needs can strongly influence an executive's choice of home-office location. In this investigation, over three-fifths of the presidents or board chairmen interviewed offered strong, unsolicited criticism of the political environment which is felt to have a detrimental impact on corporate operations.

Political leaders are blamed for administrative mismanagement, "irresponsibility and shortsightedness," and held responsible for specific adverse zoning and tax interpretations executives personally have experienced. In the words of one interviewee, "there is a very serious need for improvement in business-government cooperation." A directly germane criticism of both state and local government is that "they [political leaders] try to *attract* industry, but won't try to *keep* it here."

Another "people problem" corporate leaders point to is a shortage in Philadelphia of top-quality scientific and technical personnel. Availability of these types of workers in a region is not one of the highest ranking factors evaluated in headquarters decisionmaking. But it still is considered of above-average importance in the ranking game. One reason it places no higher is—as with management personnel—that executives recruit nationally wherever they can find the best brains.[9] But, again, in the tight labor market of recent years, the local market is believed a less fruitful hunting ground than most other large urban areas. Three-fifths of the executives interviewed consider the Delaware Valley comparatively inadequate in providing needed scientific and technical personnel.

One case in which human problems are not so clear-cut is major corporate banking—as contrasted with routine depository services. Of the community attributes most desired, but considered relatively below average, banking receives

[9] One reason headquarters decisionmakers consider these personnel at all as a location influence is not necessarily for employment in the headquarters operation *per se*, but because top management appears to prefer R & D operations located close to such office functions as marketing and sales.

the least harsh criticism. And much of the criticism voiced pertains to the comparatively small size of banks in the Delaware Valley. Executives interviewed tend to sympathize with local bank efforts to merge. However, this question of size was frequently related to the quality of bank services, policies, and management. A lack of expertise "for my business" and, more specifically, in handling international transactions were frequently pointed to as human problems. Some credit was given for recent improvements in foreign services, but they still are not viewed as "up to par." The strongest and most frequent complaint was of local bankers' "unwillingness" to pool funds to met large corporate loan demands. Expressions of displeasure with banking service thus recognized legal constraints, but within these constraints the feeling holds that local bankers can be more cooperative and accommodating in meeting needs of large headquarters.

Finally, we come to the question of Philadelphia's community image. A community's image carries surprising weight in evaluating the preferred location for headquarters. Executives who make decisions for Philadelphia home offices view the region's image as inadequate. And they believe this inadequacy has a damaging effect on corporate operations. The present image, for example, is something managers feel they must work hard to overcome in order to recruit qualified employees from outside the region. The adverse image also necessitates a great deal of inefficient traveling time. Furthermore, an executive resents having to travel to other cities for his own board meetings because fellow board members prefer not to gather in the Delaware Valley. Of a total of 43 community attributes evaluated for their local adequacy (regardless of whether they were a "most important" location influence), "community image" achieved the greatest consensus for inadequacy.[10]

What does "community image" mean? It is basically the reputation a region has for being a favorable or unfavorable place in which to live and do business. The reputation may be based on facts or folklore. It may be created by experiences visitors encounter today, or by experiences encountered years ago. The reputation, however, may linger long after facts change. But regardless of how the reputation is created, people are the chief creators.

In assessing Philadelphia's community image, executives responded in terms of how they thought nonresident businessmen thought. Nevertheless, this probe of resident businessmen suggests that they consider that the unfavorable image is somewhat deserved. When it comes to the human quality of the region, local executives expressed dissatisfaction by assigning inadequate ratings to the attributes discussed earlier. If resident corporate leaders tend to feel Philadelphia is not competitive with other major metropolitan areas in political leadership, banking, scientific and technical personnel, and quality corporate management, it would be surprising if businessmen outside the area held a higher opinion of the human environment than do the very people who comprise it. The image, as it is relevant to commerce and industry, is created, to a large degree, by contacts with local businessmen. Their expressed dissatisfaction with human attributes of the community, which they find otherwise satisfactory for home offices, is bound to influence adversely the region's reputation outside the Delaware Valley.

Furthermore, it is of interest to see how local executives evaluate certain other attributes of the area which help outsiders shape their im-

[10] See Appendix.

age of the region. Local presidents and board chairmen rate area hotels as the second (behind "community image") most inadequate regional asset among 43 choices. Good dining spots for entertaining rates sixth in inadequacy. In between second and sixth are the "people problems" already discussed. Consequently, area executives tend to agree that food and shelter awaiting business visitors to the area are not so enticing as in other large metropolitan regions.

If the resident executives of Philadelphia's large headquarters evaluate human qualities of the environment, plus bed and bread for visitors, as somewhat less than adequate, there may be real substance behind the region's poor reputation. If not, then opinions held by local executives, if voiced, tend to perpetuate a poor image anyway.

### FEELINGS AND FACTS

As is true in any study of attitudes, we know that people's views of the facts frequently do not coincide with the facts. Attitudes of executives are no exception. Nevertheless, these subjective attitudes often count more than objective facts when decisions are made. How presidents and board chairmen of Philadelphia's corporations *feel* about the region as a desirable location in which to maintain their home offices can play a major role in whether they remain in, or leave, the area.

### SUMMING UP THE STATUS QUO

From the viewpoint of decisionmaking executives of headquarters in the Delaware Valley, the region has many tangible advantages. The following attributes are judged as competitive with those of other large metropolitan areas: good-to-outstanding living arrangements; most needed business services; a supply of supporting office workers; and measurable costs of doing business, as reflected in the tax burden and space costs. An overall air of satisfaction with the region as a home-office location seems to endure at the same time that the region continues to lose major headquarters.

This part of our investigation leads us to conclude that the apparent cloud of satisfaction has holes in it—holes made by people. The more obvious pattern of relative advantage, or competitiveness, of the region as a headquarters center is incomplete. Executives interviewed do not have a high opinion of the abilities of their counterparts in other local home offices. Top management and professional personnel do not measure up to those available in comparable metropolitan areas, nor do scientific and technical personnel. Similarly, interviewees do not hold a high opinion of political leaders of the region and their attitudes, especially as they concern problems of commerce and industry. Expressed shortcomings in human qualities of the environment are reflected in the community image. The chief tangible assets of the Delaware Valley for headquarters are not believed to be matched with vital human inducements most highly desired by executives for a satisfactory headquarters location.[11]

### NATIONAL CHALLENGE TO A HEADQUARTERS COMPLEX REMAINS

Executives of Philadelphia's major headquarters believe that rectifying specified shortcomings in the community can make Philadelphia a more attractive location for home offices. If these shortcomings can be turned into regional assets, perhaps the Delaware Valley will improve its prospects of retaining the headquarters

[11] In footnote 4, we noted that if corporate executives outside the region had been included in this study, responses may have altered our findings. The only other known survey relating directly to our findings did include 400 top policymakers located outside, as well as inside, the Delaware Valley. In unanticipated agreement, they viewed Philadelphia as unfavorable for industrial

it now has. This statement is obviously, but of necessity, cautious.

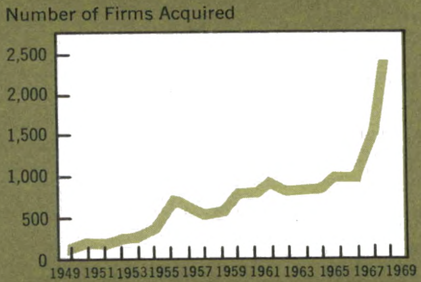
The reason for caution is that Philadelphia's stature as a headquarters complex depends on factors other than just keeping today's corporate executives happy in their community environment. Business and civic leaders who are trying to halt the decline in home offices not only have local problems with which to contend, but national ones as well.

A nationwide challenge to arresting the decline in Philadelphia headquarters is the stepped-up pace of mergers in today's economy, as shown in Chart 2. Any merger automatically kills off a headquarters operation some place.

**CHART 2**

**THE INCREASE IN MERGERS ELIMINATES EXISTING HEADQUARTERS.**

The chart shows the stepped-up national merger movement in manufacturing and mining industries between 1949 and 1968.




Source: Bureau of Economics, Federal Trade Commission.

If two corporations in the Delaware Valley merge, only one headquarters survives. If a corporation outside of the region acquires a local firm, another home office disappears from Philadelphia. The national increase in mergers is a significant threat to the number of area headquarters.

In the past few years, most of Philadelphia's major corporations were directly approached with merger offers. Some accepted, and their home offices in the region closed shop. A number of corporate executives interviewed, who remain headquartered in Philadelphia, reported that merger offers came as frequently as once a week. Although offers were rejected, 64 per cent of these decisionmakers did give consideration to the offers to merge.

Corporate presidents or board chairmen pointed to two main reasons for rejecting merger offers. One was that "the price wasn't right." Some executives explicitly said that if the stock market had been booming when an offer came, they definitely would have sold. But the other major reason for not merging has little to do with the national economy or the economics of the firm. The reason can be summarized as "family considerations." Family tradition, family pride, and family refusal to relocate outside of Philadelphia—which a merger might necessitate—loomed large in decisions of Philadelphia's corporate leaders who contemplated, and rejected, offers to merge.

But how about executives of Philadelphia headquarters who did accept merger offers and elected to become subsidiaries of corporations headquartered outside of the region? Why did they accept? They based their decisions on the same considerations that the still-headquartered executives did in rejecting a merger. Top management of companies which were acquired believed a merger was in the best interest of the family, and that the price was right.

location with respect to the impact of "governmental and community attitudes." See "The Impact of Labor-Management Climate on Facility Location Decisions in the Greater Philadelphia Area," (Report of the Southeastern Pennsylvania Economic Development Corporation, May, 1967).

These were general reasons given for merging by executives of 13 local subsidiaries included in our survey.[12] The subsidiaries were once Philadelphia-headquartered firms. Between 1951 and 1967 they were acquired by corporations whose home offices are outside the metropolitan area. The firms in the survey, therefore, no longer have a local headquarters but do have the main subsidiary office and other operating facilities within the Delaware Valley.

In all 13 interviews with chief executives of subsidiaries, the best interest of the family, which owned the formerly-headquartered corporation, was given as a prime consideration in choosing to become a subsidiary of another corporation. In some cases, executives said the family was anxious to dump a dying firm. Most of the firms, however, were not at death's door. The reason for merging, which was noted with greatest frequency, was for tax-free diversification for "the family." The Philadelphia firm, previously, had concentrated its output in one major product line to the point where speedy diversification was essential to remain, or again become, profitable. The family owning the company, or the bank managing the family trust, concluded that the quickest way to diversify and avoid the distant death knell was to sell to a larger and more diversified corporation. Members of the family-held corporation, or executors of estates, were the key decision-makers in selling all 13 firms.

The majority of companies, which did not feel ready for burial, were most anxious to obtain financing for expansion—not available to them as closely-held family concerns. The merger opened new financing channels through the larger, better-known, or more profitable parent company. Additional benefits said to have resulted from the merger were needed managerial expertise and accessibility to research and development resources provided by the acquirer.

## COMMUNITY RESPONSE IN QUESTION

Philadelphia's civic leaders who are seriously disturbed at the loss of home offices to the region tend to "blame" the loss on acquisitions. Some local action already has been planned to try to prevent "outsiders" from acquiring firms headquartered in Philadelphia. No doubt mergers are a source of disappearing headquarters. But whether the costs to the regional economy of a disappearing home office, via acquisition by a non-Philadelphia corporation, outweigh benefits resulting from the newly constituted subsidiary has not been previously explored.[13] If the answer is not clear-cut, perhaps there is a better alternative to maintaining the region's headquarters complex than in trying to halt acquisitions of Philadelphia firms by corporations whose home offices are out of the area.

**Probing cost experience.** There is evidence of some acquisition cost to the local economy in the experience of the 13 subsidiaries surveyed. One cost appears to be a regional "brain drain." In the case of headquarters which are closed following acquisitions, top-management talent is forced out of the local office as headquarters functions are cut back, abolished, or relocated. Executives caught in this squeeze tend to look to the

[12] For details, see the Appendix.

[13] There are many difficulties involved in assessing the economic impact on a region of acquisitions. No research is known to exist which has tackled the problem in depth. Findings reported in this article are based on interviews with top executives of local firms which were once headquartered in Philadelphia and are now subsidiaries as a result of acquisitions. Obviously, no one knows what the experience of these firms would have been had they not been acquired.

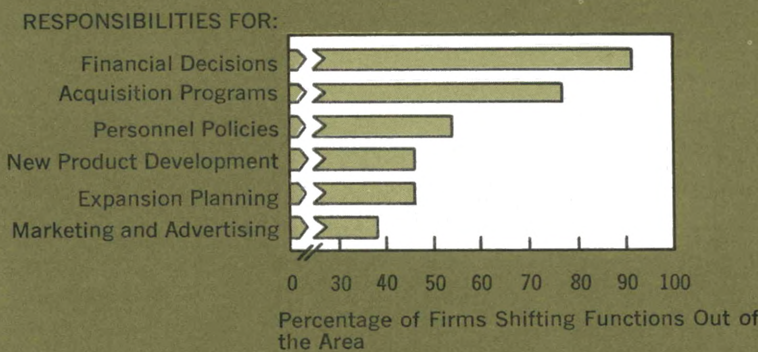
national market for the best professional opportunities. If these opportunities are not found in the Delaware Valley, executives may leave the region. Some may move to the home office of the new parent firm, which in the surveyed group is not in the Philadelphia area.

Among subsidiaries in this study, 69 per cent of the executives interviewed reported a reduction in managerial and/or research and development personnel at the top and middle-management levels following mergers. Types of personnel phased out as a result of the loss of the home office is indicated by the headquarters functions which were shifted away from the Philadelphia metropolitan area. Our findings, as shown in Chart 3, suggest that local employees responsible for high-level corporate decisions lost responsibilities after acquisitions.

For example, in 92 per cent—or all but one—of the subsidiaries surveyed, major financial planning and decisionmaking is now carried out at the parent headquarters, not in the Delaware Valley. Prior to the merger, professional personnel were employed in the local home office to perform these financial functions. Similarly, acquisition planning and performance was the function of Philadelphia executives prior to the merger. In 77 per cent of the cases, this headquarters activity shifted out of the region when the merger was consummated. Over half of the local subsidiaries lost responsibility for personnel and salary policies to a nonregional headquarters following acquisitions.

Less than half, or 46 per cent, of the subsidiaries were stripped of responsibility for planning for expansion and for development of new products in the post-merger period. The majority of the subsidiaries, consequently, still retain management personnel to perform these

ACQUISITIONS OF FIRMS HEADQUARTERED IN PHILADELPHIA ARE FOLLOWED BY A SHIFT IN HOME OFFICE FUNCTIONS TO HEADQUARTERS OUTSIDE THE REGION.




Source: Survey of the Federal Reserve Bank of Philadelphia, 1969. See Appendix.

functions. However, one would expect some reduction in top personnel to perform these activities since final decisions on expansion and new products depend on financial decisions made by executives at the parent headquarters outside Philadelphia.

As such home-office responsibilities are reduced or phased out following an acquisition, so too are the executives performing them. If they move from the region, the quality of the local labor force is weakened. This is what is meant by a brain drain. Many secondary effects on the economy follow this movement. Payrolls and the tax base are reduced. Upper-income families out-migrate with the breadwinners. This is the start of a detrimental rippling impact on area retail sales and services which can become far-reaching.

Another cost to the region of losing executives, as a result of acquisitions, is believed to be a decline in business support of civic and cultural activities. Local folklore holds that not only does the loss of management personnel to the region have an adverse impact on these activities, but that headquartered corporations are more civic-minded *per se* than are subsidiaries. This study, however, did not find a decline in community involvement to be a serious cost consideration stemming from the loss of headquarters via merger.

Top executives of subsidiary offices in Philadelphia were questioned as to their firms' participation in specific civic and cultural activities in both the pre-merger and post-merger periods. Such activities included different types of support of area colleges and universities; participation in the Greater Philadelphia Chamber of Commerce; contributions to the United Fund; personal and financial support of cultural activities; and participation in nonprofit development corporations and other similar urban affairs.

Based on interviews with resident managers of subsidiaries, civic and cultural activities experienced a very slight cutback in support from a few firms in the post-merger period while some activities, in contrast, received increased involvement following acquisitions. Over one-half of the subsidiaries, however, reported no change in their participation in any community activities. And today, two-thirds of the firms are not actively involved in any specific civic endeavor. The majority of companies reporting "no change" indicated no change from nothing to nothing. As Philadelphia-based headquarters, they made virtually no active contribution to the civic and cultural life of the community. As subsidiaries, their contribution is largely unchanged.

Some interviewees tended to be apologetic for their lack of civic participation. The majority of executives, however, expressed the opinion that the degree of business involvement in community affairs was not strongly influenced by whether the firm was a headquarters or a subsidiary. The viewpoint of respondents is that geographical location and type of industry has a greater impact on community involvement of business than corporate structure. If a firm is located in the core city, it is more likely to be active in civic affairs than if it is located in a suburban area where commuting time to center city is a very high cost. Executives also stated that if they could expect their companies to be direct beneficiaries of civic and cultural improvements, they would be more active.

All but one of the subsidiaries included in this survey are in manufacturing as opposed to service industries. Their top executives claim that if they were operating such services as hotels, banks, transportation facilities, or retail outlets, their concern with urban affairs would be greatly enhanced. Opinions also reflect the fact that all of the subsidiaries, but one, are located outside of center-city Philadelphia. Of these, half are in suburban communities of the metropolitan area and half are in outlying areas of the city. Downtown meetings necessary for active participation in civic and cultural affairs of the community are not conveniently accessible to offices of executives.

The cost to the region of acquisitions most frequently noted is a substantial loss of income to local business services. Twelve out of 13 types of business which receive income from supplying headquarters' needs lost clients after an acquisition, as shown in Chart 4. When firms were headquartered in Philadelphia, prime suppliers of 88 per cent of their service needs were located in the region.[14] Following acquisitions, the subsidiaries discontinued buying from many of these Philadelphia industries. Post-merger, local industries were prime suppliers for only 53 per cent of the services required by the reorganized subsidiaries. The region's loss of headquarters was followed by a shift in buying of business services to other parts of the country.

Some industries were harder hit than others after acquisitions. Philadelphia insurance companies lost the largest number of clients when locally headquartered corporations merged. Eighty-three per cent of the merged companies shifted the bulk of their insurance purchases to companies outside of the metropolitan area, as shown in Chart 4. Fifty per cent or more of the acquired firms, which had previously purchased services primarily from local public relations firms, brokerage houses, auditors and accountants, banks, and advertising agencies, switched to other firms outside the Delaware Valley after they became subsidiaries.

[14] If a local service industry received over 50 per cent of the firm's budget for that service, the industry was considered a "prime supplier."

**The benefit side of the ledger.** There is reason, however, to question the damage done to the total regional economy because of mergers. It is very possible that companies which have been a drag on the local economy may be greater assets to the area if they are acquired, even though headquarters may be lost in the process. If better management, new capital investment, and greater national competitiveness result from acquisitions, local economic benefits may far outweigh the cost of fewer corporate headquarters.

In the survey of subsidiaries, today's operating executives unanimously agreed that merging was the only hope for growth. For four of the 13 companies, the stated choice facing the firm was either be acquired or die. On the basis of information provided by interviewees, all of the acquisitions were followed by growth, or at least stabilization, of subsidiary operations in the Delaware Valley.

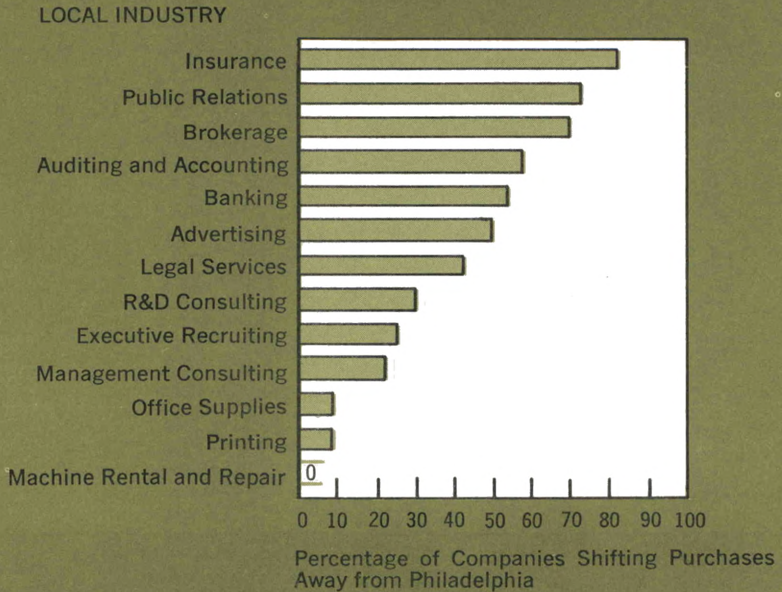
All subsidiaries were able to improve, modernize, expand, or develop new products as a result of financial resources made available by the acquiring corporation, not available prior to the merger. Eighty-five per cent of the subsidiary executives said that local production became more competitive in the national market as a result of improved management assistance and R & D expertise provided by the parent company.

Data to back up these claims are not easy to come by. Survey results show, however, that both assets and sales of the Philadelphia subsidiaries increased following acquisitions in 92 per cent of the cases. Employment within the Delaware Valley increased at 69 per cent of the subsidiaries in the post-merger period. The remaining companies which reported a decline in regional employment attributed the drop to long-overdue modernization programs which substituted capital for labor. All subsidiaries,

## CHART 4

**FOLLOWING ACQUISITIONS AND THE LOSS OF AREA HEADQUARTERS, PHILADELPHIA BUSINESS SERVICES LOST BUYERS.**

Percentage of companies shifting local purchases to firms out of the region in the post-merger period, 1951-1968.




Source: Survey of the Federal Reserve Bank of Philadelphia, 1969. See Appendix.

but one, made capital investments in the metropolitan area after the acquisition.

Almost two-thirds of the subsidiaries, post-merger, invested in new plants or in major expansions or modernization of existing facilities in Philadelphia. In only two cases were physical facilities actually closed in the area after the merger. In the first case, the personnel in the core city headquarters moved to the suburban plant. In the second case, three obsolete factories were closed, and these operations were consolidated under one roof in a new suburban location.

**Two faces of Janus.** This look at some of the costs and benefits of acquisitions of firms headquartered in Philadelphia, by corporations outside of the region, only scratches the surface. But that surface needs some scratching. Since most major metropolitan areas are losing corporate headquarters through the merger process, it is important to recognize that the regional economic impact need not be all bad. There are two sides to the coin. If local firms become more competitive nationally as a result of a merger, benefits to the Philadelphia economy may far outweigh the loss of headquarters.

## A RETURN TO THE CHALLENGE AT HOME

Nevertheless, legitimate reasons were noted for Philadelphia's community leaders to be concerned with the decline in local headquarters. But is the concern focused on the major problem? Some headquarters have moved from the region because the grass was greener elsewhere. Others have been lost in the merger process. And this loss is a hard battle for Philadelphia civic leaders to fight. A serious question for the community is why the loss of headquarters has been a *net* one, which reduced Philadelphia's stature as a headquarters complex. Home offices today may be gone tomorrow, but the area's stature as a headquarters center can only slip if the loss is not replenished by new headquarters coming on stream.

This is exactly what has not been happening in the Philadelphia metropolitan area. The local economy has not been generating enough new headquarters to offset its losses. Of the 32 locally headquartered corporations and subsidiaries included in this survey which were founded in Philadelphia, the average year of birth was 1882. The most recent birth was 1947—but that was a real standout. Prior to that *one,* the most recently formed corporation dates to 1929.

The average year of founding of all headquarters in the study, which make up the region's home-office complex today, is 1879. Corporations which were headquartered in the area prior to acquisition (after 1950) have birth dates averaging around the year 1889. Apparently, Philadelphia's headquarters complex is a result of a boom in entrepreneurship which preceded the 1929 depression.[15] With few new major corporations postdating the depression, Philadelphia's net headquarters loss is understandable. The Delaware Valley needs to grow its own home offices if a continuing net loss in headquarters is to be arrested.

## FIRM FOUNDATION FOR A HEADQUARTERS COMPLEX

In exploring the decline of Philadelphia as a headquarters center, two underlying reasons have been probed in depth. First, factors in the community environment which may influence existing headquarters to move were pointed out by local corporate executives. If identified shortcomings can be turned into assets, the region's present headquarters complex should have stronger reasons for remaining intact.

Rectifying observed shortcomings in human qualities of the environment might even have some influence in attracting headquarters on-the-move to the Delaware Valley. But this popular panacea of attraction is highly overrated. Certainly in Philadelphia, efforts to attract new offices have not been very successful. In this study, of the 38 companies surveyed, only six were born outside the region. These six were not attracted here in the usual sense of the term. A more typical example of an outside firm relocating its headquarters in Philadelphia is the case of the Philadelphia resident who bought a New York firm and moved it here. It is an atypical case when corporate management of a firm surveys alternative communities for headquarters relocation and settles on Philadelphia.

[15] A check of all manufacturing companies in the Philadelphia SMSA which have no headquarters outside of the region shows 73 per cent were founded prior to 1929. See the Appendix for a description of the universe from which the sample of interviewees was drawn.

A second major force behind the region's headquarters decline is the national increase in acquisition activity. How effective community action can be in mitigating the local impact of this national trend is questionable. As pointed out, there are reasons to challenge whether such a goal is in the best interest of the regional economy as a whole. It seems highly probable that the Delaware Valley will continue to lose home offices through acquisitions by corporations headquartered outside the area.

Holding on to today's headquarters complex is an important thumb-in-the-dyke objective to maintain Philadelphia's home-office strength. But it is still just a holding operation. A further loss in headquarters by acquisition appears very probable. The most likely chance Philadelphia has of preventing a further net loss is by growing its own headquarters at home through a resurgence in human enterprise.

Philadelphia's "concerned community" cannot form new firms to create local headquarters. But it can make conditions in the community more amenable to a corporate baby boom. For example, new venture-capital corporations, which recently have appeared on the local scene, are a response to a vital need. Turning Philadelphia's shortcomings in human qualities into regional assets can make the area a more attractive climate for business generation and healthy growth. Incubator facilities which provide management assistance, such as those available at the Regional Development Laboratory in West Philadelphia, can aid new businesses in getting off the ground.

Philadelphia's civic and business leadership can go a long way to improve the area's climate for new-firm formations and concomitant headquarters generation. Unfortunately, leadership cannot force new entrepreneurs to step forth. Human venturesomeness is a fundamental necessity for new-business enterprise. An entrepreneurial renaissance, of the pre-depression variety, is essential if the community's net loss of headquarters is to turn into a net gain in the future. Generating home offices within the region is basic to a firm foundation for a major headquarters complex in Philadelphia.

## Methodology Of This Investigation And The Meaning Of The Findings

Findings reported in this article are based on data collected through personal, in-depth interviews with key executives of 38 business firms in the Philadelphia area. These 38 were respondents in a sample of 40 firms selected from a universe of all firms (manufacturing and nonmanufacturing) in the Philadelphia eight-county area (SMSA) which: (a) are listed by Dun and Bradstreet as having a corporate headquarters office or a headquarters office of a subsidiary located in the SMSA; (b) have a net worth of \$1,000,000 or more; and (c) are classified in two-digit SIC groups which have an aggregate employment of 10,000 persons or more. The universe may be described as those business firms in industry groups upon whom the economic health of the region most heavily depends and who have made headquarters location decisions relating to the Philadelphia area.

Within this segment of the business community, four separate sub-groups of firms were identified for subsequent sampling.

Sub-group (A) consisted of all 13 firms in the region which employ 10,000 persons or more. The total number of employees reflects the number of people employed by firms whose corporate or subsidiary headquarters are located in the SMSA, without respect to the number of employees who actually work in the area. Of chief executives of the 13 firms included in the sample, one refused to be interviewed. Findings reported in the text, then, include all headquarters and subsidiaries in the region, except one, which employ 10,000 persons or more.

Sub-group (B) consisted of ten two-digit SIC groups in which firm employment ranged between 3,000 and 9,999. The firm in each SIC group with the largest number of employees was selected for inclusion in the study. Eight of these firms have corporate headquarters, and two have their subsidiary's main office in the Philadelphia area.

Sub-group (C) consisted of all remaining companies (employing fewer than 3,000 people) in the universe which have their corporate headquarters in the area. Seven of these were selected for inclusion in the study by using systematic sampling procedures. One, however, did not respond to the interview.

Sub-group (D) consisted of all remaining firms in the universe which have the main office of the subsidiary located in the area. Ten of these were selected for inclusion in the study by the same sampling procedures used with sub-group (C).

Taken together, we assume the sample of 40 firms to be representative of all large firms with corporate or subsidiary headquarters offices located in the Philadelphia SMSA. We assume the sub-sample of 27 firms with corporate headquarters and the sub-sample of 13 firms with subsidiary headquarters located in the area to be representative of all such firms in these two respective groups.

The 25 headquarters included in the survey equal 4.4 per cent of all corporations headquartered in the area and employ 50.6 per cent of all people employed by corporations having headquarters in the region. The 13 subsidiaries included in the survey equal 26 per cent of all subsidiaries with their main office in the area. They employ 93 per cent of all persons employed by subsidiaries with main offices in the region.

Data used for the article were obtained through personal interviews, ranging between one and a half and three hours, with the president or chairman of the board of each headquartered corporation, or in the case of subsidiaries, with the top local executive. To insure comparability, each person interviewed in the headquarters sub-sample and in the subsidiary sub-sample was asked the same questions by the same interviewer. However, interviews were open-ended. Executives expressed themselves freely and at length.

The first part of this article draws heavily on a section of the headquarters questionnaire in which executives were first asked to select and rank, in order of relative importance, the ten attributes in a community which would weigh most heavily in the selection of a location for their headquarters. Interviewees had 45 attributes (plus an option of "other") from which to choose. They were then asked to rate every attribute, whether most important to them or not, as superior, satisfactory, or inadequate in the Philadelphia SMSA, in terms of their own needs, relative to the nine other largest metropolitan areas in the nation. These adjectives used for rating are treated synonymously, in the text, with above average, average, and below average, respectively.

Table A shows the 18 factors most frequently chosen as most important in location decisionmaking. The table records the number of times each factor was ranked as one of the ten prime considerations. As shown in Table A, there was wide variation in relative weights executives assigned to locational factors. Interestingly, the table indicates that many attributes which tend to rank high in *plant* location choices, such as proximity to markets and suppliers, labor-management relations, wage rates, labor productivity, and transportation for materiel, are relatively unimportant in decisionmaking for locating headquarters offices. The

## TABLE A

**Factors Influencing the Location of Headquarters**

| Factors Influencing Location Choice in Order of Relative Importance | Number of Respondents Placing Factor in the Top Ten | Philadelphia was judged to compare with other major metropolitan areas as: | | |
|---|---|---|---|---|
| | | Superior | Satis-factory | Seriously or Somewhat Inadequate |
| 1. Housing for management and professional personnel | 19 | 19 | 6 | 0 |
| 2. Corporate tax burden | 16 | 2 | 18 | 5 |
| 3. Major corporate banking services | 14 | 7 | 9 | 9 |
| 4. Air transportation for personnel | 13 | 1 | 18 | 6 |
| 5. Local availability of management and professional personnel | 12 | 3 | 11 | 11 |
| 6. Community law enforcement | 12 | 14 | 9 | 2 |
| 7. Regional public schools | 11 | 8 | 14 | 3 |
| 8. Space costs | 10 | 7 | 16 | 2 |
| 9. Community image | 9 | 0 | 6 | 19 |
| 10. Colleges and universities | 8 | 13 | 8 | 4 |
| 11. Cultural environment | 8 | 11 | 10 | 4 |
| 12. Regional political environment (SMSA) | 8 | 0 | 12 | 13 |
| 13. Legal services | 8 | 12 | 10 | 3 |
| 14. Availability of other personnel (supporting office staff) | 7 | 8 | 15 | 2 |
| 15. Local transportation | 7 | 10 | 14 | 1 |
| 16. Local political environment | 7 | 1 | 9 | 15 |
| 17. Corporate legal structure | 6 | 2 | 21 | 2 |
| 18. Availability of scientific and technical personnel | 6 | 4 | 6 | 15 |

cutoff point of 18 out of 45 factors was arbitrarily set by any factor receiving a larger number of "relative importance" checks than one would expect if checks were evenly distributed between the 45 options—in which case each factor would have received 5.6 checks.

Table 2 in the text was developed from raw data in Table A. In summarizing the ratings executives gave attributes in Philadelphia relative to other regions, ratings of superior, satisfactory, and inadequate are referred to as above average, average, and below average, respectively. The rating receiving the most responses for each attribute was arbitrarily assigned that overall rating. When a tie score for the most checks occurred, if satisfactory plus superior

## TABLE B

**Extent to Which Community Attributes Were Judged Inadequate by 25 Interviewees**

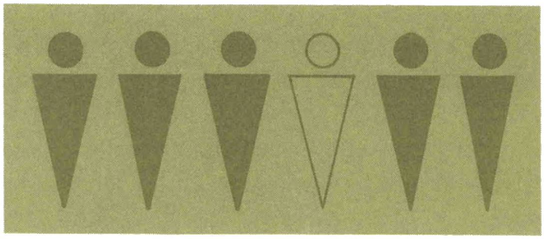
| Community Attribute | Rated as Inadequate by: | Community Attribute | Rated as Inadequate by: |
|---|---|---|---|
| Community image | 19 | Taxes | 5 |
| Hotels | 17 | Labor-management relations | 4 |
| Local political environment | 15 | Cultural environment | 4 |
| Availability of scientific and technical personnel | 15 | Colleges and universities | 4 |
| Regional political environment (SMSA) | 13 | Regional public schools | 3 |
| Dining | 12 | Corporate legal services | 3 |
| Proximity to other area headquarters | 12 | Space requirements | 3 |
| Highways (for personnel use) | 11 | Rail transportation (for personnel) | 3 |
| Availability of management personnel | 11 | Proximity to suppliers | 2 |
| International transportation | 10 | Law enforcement | 2 |
| Banking: major corporate services | 9 | Space costs | 2 |
| Executive recruiters | 9 | Availability of supporting office staff | 2 |
| Public relations services | 8 | Corporate legal structure | 2 |
| Advertising services | 8 | Cost-of-living | 2 |
| Brokerage services | 7 | Recreation | 2 |
| Zoning | 6 | Transportation for materiel | 2 |
| State political environment | 6 | Fire protection | 1 |
| Labor productivity | 6 | Proximity to other units of corporation | 1 |
| Proximity to markets | 6 | Local transportation | 1 |
| Air transportation (for personnel) | 6 | Housing for management | 0 |
| | | Salary levels | 0 |
| | | Banking: routine depository services | 0 |
| | | Regional private schools | 0 |

was less than satisfactory plus inadequate then "inadequate" or "below average" received the summary evaluation in Table 2 of the article.

Since the first part of the text dealt at length with community attributes executive decision-makers of corporate headquarters felt were less than satisfactory, Table B contains all 43 attributes amenable to rating, in declining order of relative dissatisfaction. ("Blue laws" and "family ties of top management," included on the questionnaire, were not rated as superior, satisfactory, or inadequate.) The table also shows the frequency with which executives judged each attribute to be comparatively inadequate in the Delaware Valley for their specific needs. In 25 interviews, the maximum number of "inadequate" responses any attribute could receive is 25.

# Inflation: Gainers and Losers

by W. Lee Hoskins



How much is inflation costing you? When the cash register rings, the Pavlovian response of most Americans is "plenty." This reaction, reinforced by news media, civic leaders, and street-corner philosophers, may not be wholly warranted, for the burden of rising prices, like almost everything else, is not distributed equally among us. In fact, a sizeable number of Americans may actually gain from inflation.

## EXPECTED VS. UNEXPECTED INFLATION

What people believe about the course of future events influences their present actions. Expectations about future inflation are no exception. If people, looking ahead, expect inflation, they may be able to adjust their *present* earning, purchasing, lending, and borrowing activities. By doing so, they may overcome the expected depreciation in the value of money. This process, recently dubbed "inflationary psychology," continues until people have reason to foresee or expect a stable price level.

One example of inflationary psychology in operation would be that of a lender who includes in his loan charges the expected or anticipated rate of price inflation. His reason for doing so is obvious. Suppose you loan $1,000 to a friend for one year, and you expect the price level to rise by 10 per cent during that period. What rate of interest would be appropriate if you wanted to earn a real return (in terms of constant purchasing power) of 5 per cent? Answer: about 15 per cent. This monetary return would allow you a *real return* of 5 per cent, and you would avoid a loss of wealth, but perhaps not of a friend. If, however, in making the loan, you underestimated the rise in prices, the return you would receive would be insufficient to compensate fully for the reduced purchasing power of the repaid loan plus interest, and you would have joined ranks with inflation losers. Your failure to foresee accurately the rate of inflation would result in a redistribution of your wealth from you to your friend. Your friend would be an inflation gainer because he does not repay as much in terms of purchasing power as he borrowed.

Not all people are equally able to make the necessary adjustments in their earning, purchasing, lending, and borrowing activities to compensate for inflation they see on the horizon. Even if they were, that would not be the end of the story, for it is because inflation is incorrectly foreseen that gains and losses are often incurred. All people do not have equal ability or luck at predicting future events or doing something about it. Consequently, inflations in the United States have not been *fully* anticipated by all, and wealth redistribution has occurred. One key to this redistribution is the relationship between debtors and creditors.

## THE ADVANTAGE OF DEBT

The reason wealth is taken from some and bestowed on others by unforeseen inflation stems from the fact that there are two kinds of assets, monetary and real, linking debtors and creditors. Monetary assets include bonds, certificates of deposit, promissory notes, accounts receivable, and other legal contracts that promise a *fixed number of dollars.* Of course, for every monetary asset there is a monetary liability. For instance, to the landlord a lease represents a monetary asset, while to the tenant it is a monetary liability—a promise to pay a fixed number of dollars. In return for this promise to pay, the tenant receives a real asset—living space. People may issue monetary liabilities in order to finance purchases of real assets (cars, houses, inventories, and factories) or for consumption.

The crucial difference between the two is that a real asset is a claim to a *fixed amount of goods or services* whose money value is tied to inflation, while a monetary asset represents a claim to a *fixed number of dollars* regardless of inflation.[1] During an unexpected inflation, the dollar value of a real asset increases as prices rise, leaving its *real* value in terms of purchasing power unchanged; while the amount of dollars in a monetary asset (savings certificate) remains constant, and its real value falls. An investor holding a monetary asset loses purchasing power or wealth. (See Table 1.) The person who holds a monetary liability (in other words, who is in debt) during an unexpected inflation gains unexpectedly because he repays his debt in dollars that are worth less in terms of purchasing power.

[1] The market value of the asset may vary but the number of dollars it promises to return remains fixed. Corporate and Government bonds are good examples of this type of monetary asset. A share of common stock represents ownership in an equity composed of both real and monetary assets. The extent to which the share price changes as a result of an unanticipated inflation depends on the relative holdings of these assets. Suppose a hypothetical firm has $200 million of monetary assets consisting of cash on hand, loans to other firms, Government securities, and accounts receivable. It also has $800 million in monetary liabilities (bonds, loans, and accounts payable). The firm is a net monetary debtor to the tune of $600 million. If 30 million shares of stock were outstanding, each would bear a debt of $20. Suppose the stock sold for $40. Then each share would represent a claim for real goods of $60 (the $40 received for the share plus $20 borrowed by the firm) and a 10 per cent rise in the price level would increase the equity of a shareholder by 15 per cent (10 per cent of $60 represents a 15 per cent rise in a $40 equity), unless other people anticipated the inflation and previously bid up the share price of the stock.

## TABLE 1

**The Change from 1958 to 1968 in Monetary Value of Selected Assets in Unadjusted Dollars and in Dollars of 1957-1959 Purchasing Power**

| Asset | Percentage Change in Value | |
|---|---|---|
| | Unadjusted $ | 1957-59 $ |
| Cash | — | −23.7 |
| Bonds: | | |
| U.S. Treasury* | −19.9 | −35.3 |
| N.Y. City** | −21.4 | −36.4 |
| Preferred Stock Average | −23.2 | −37.9 |
| Common Stock Averages: | | |
| Industrials | +91.7 | +55.0 |
| Public Utilities | +61.0 | +30.2 |
| New York City Banks | +104.3 | +65.2 |

The table shows changes in the value of various types of investments for the period 1958-1968. These changes are shown unadjusted for price level changes and in dollars of 1957-1959 purchasing power. An indication of the change in value that may be attributed to inflation is found by comparing the unadjusted change in value and the change in dollars of 1957-1959 purchasing power. Monetary assets (cash, bonds, and preferred stock) have all suffered declines in value ranging from approximately 23.7 per cent to 37.9 per cent in terms of 1957-1959 dollars. For example, holding $100 in cash for the ten year period would have resulted in a 23.7 per cent loss in purchasing power. The common stock averages have all realized an increase in value. However, the increase is considerably less when inflation is taken into account.

* U.S. Treasury 3-1/4s, 6/15 /78-83
** N.Y. City 4-1/4s, 3/1 /81

Most families have real assets, monetary assets, and debts (monetary liabilities). The relative holdings of these items during periods of unanticipated increases in the price level determine whether or not a given family gains or loses from inflation. If a family holds more monetary liabilities than monetary assets, it gains. Conversely, if monetary assets exceed debts, the family loses. (See box.) So, being in debt can have advantages during periods of unexpected inflation. This statement does *not* mean that saving makes no sense. Savings held in nonmonetary form do not lose value. Moreover, savings held in monetary form may lose value only when inflation is unanticipated. If inflation were accurately anticipated, adjustments could be made so that savings held in monetary asset form (except cash) would make sense as well.

### TAKING ACCOUNT OF INCOME

A family's status as a net monetary debtor or creditor is not all that determines whether inflation robs it or blesses it. Income also fits into the picture. Let's focus first on income from certain pension plans, insurance policies, and other types of programs which promise to pay a *fixed number of dollars per year*. These promises to pay are monetary assets to the pensioner, and the *amount* they pay is unaffected by a rise in the price level.[2] People

[2] Social Security payments do not appear to fall in this category. As prices climbed during the 1960's, Congress periodically raised the allowable monthly payments.

## CALCULATING GAINS AND LOSSES

The redistribution of wealth accompanying an unanticipated inflation can be better understood by tracing through some relatively simple examples. Suppose a hypothetical balance sheet for an individual before an unanticipated inflation is:

Balance Sheet—Inflation Gainer
Market Value *before* Unanticipated Inflation

| **Assets** | | **Equity + Liabilities** | |
|---|---|---|---|
| Cash | $ 500 | Mortgage | $40,000 |
| House | 40,000 | Equity | 500 |
| | $40,500 | | $40,500 |

If a particularly severe inflation occurs and the price level doubles, this individual would be in an enviable position indeed! Let's look at his new balance sheet:

Balance Sheet—Inflation Gainer
Market Value *after* Unanticipated Inflation

| **Assets** | | **Equity + Liabilities** | |
|---|---|---|---|
| Cash | $ 500 | Mortgage | $40,000 |
| House | 80,000 | Equity | 40,500 |
| | $80,500 | | $80,500 |

The dollar value of his house rises with the price level, since it is a real asset. (The extent of the rise may vary depending on how the inflation is introduced into the economy and on other factors affecting the housing market). His $40,000 debt, a monetary liability incurred in purchasing the house, remains an obligation to repay $40,000. Equity has increased from $500 to $40,500 which, in terms of pre-inflation dollars, is a $19,750 increase in wealth. The increase in wealth is found by dividing the post-inflation equity, $40,500, by the new price level, which in this case is 2 (the old price level, taken as 1, plus the percentage increase in the price level), and subtracting from the result the original equity of $500.

Where did the gain come from? It came from the wealth of the creditor who lent $40,000 to finance the purchase of the house, but who failed to foresee that the price level would double. Some $20,000 was gained at the expense of the creditor; however, the value of the $500 cash dropped $250, leaving a net wealth gain in terms of constant purchasing power of $19,750. If the lender had foreseen the inflation, he would have made adjustments in the amount to be repaid or in the interest charge upon granting the loan.

Losses result from holding more monetary assets than monetary liabilities. Let's suppose this is the balance sheet of the lender who loaned the money for the house before the unanticipated inflation:

Balance Sheet—Inflation Loser
Market Value *before* Unanticipated Inflation

| **Assets** | | **Equity + Liabilities** | |
|---|---|---|---|
| Cash | $ 500 | Debt | . . . |
| Mortgage Held | 40,000 | Equity | $40,500 |
| | $40,500 | | $40,500 |

Now, if the price level were to double, the balance sheet would be unchanged.

Balance Sheet—Inflation Loser
Market Value *after* Unanticipated Inflation

| Assets | | Equity + Liabilities | |
|---|---|---|---|
| Cash | $ 500 | Debt | . . . |
| Mortgage Held | 40,000 | Equity | $40,500 |
| | $40,500 | | $40,500 |

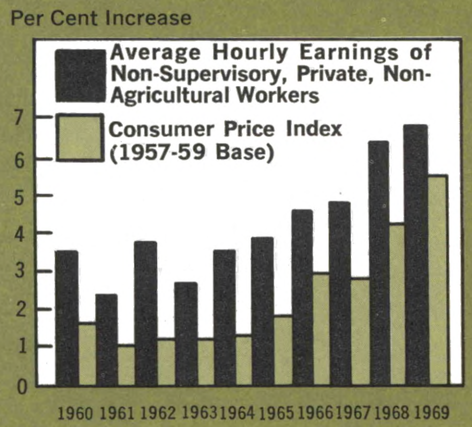
Since no real assets were held, equity did not increase. But, because of the higher price level, the $40,500 equity will not purchase as much in goods and services as it would have before the inflation. The loss in wealth is $20,250 in pre-inflation dollars or $\left(\frac{\$40{,}500}{2}\right)$—$40,500. The lender lost $20,000 to the borrower, plus $250 as a result of holding $500 in cash.

Additional balance sheet examples can be found in Armen A. Alchian and William R. Allen, *University Economics,* 2nd Edition (Belmont, California: Wadsworth Publishing Company, Inc. 1967), Chapter 32.

holding such assets are said to be on "fixed incomes;" hence, they suffer a loss from unanticipated inflation. However, the person on a "fixed income" may hold other monetary assets and liabilities as well. And it is the relative holdings of all of these that determine whether or not a person's wealth expands, shrinks, or is unaffected when the price level climbs unexpectedly.

Undoubtedly, the most important source of income for most families is wage and salary earnings. Unforeseen inflation can have an impact upon this type of income too. For example, a wage contract promising to deliver a specified number of hours of labor for a fixed number of dollars may cause the laborer to lose, for such a contract represents a monetary asset to him. Moreover, wages are bid up faster in some sectors than others because of the manner in which the inflation is introduced and transmitted through the economy. Consequently, some redistribution does occur. But generally, wages and salaries simply reflect what we receive in return for the sale of real assets (hours of labor), and as such are usually bid up during an inflation. For example, during the current period of rising prices, average hourly earnings increased at a faster pace than consumer prices, as indicated in the chart. From 1965 through 1969, average hourly earnings soared 24 per cent while the Consumer Price Index jumped only 16 per cent. Of course, some of the increases in wage rates may have been caused by workers as they anticipated some

DURING THE '60'S, AVERAGE HOURLY EARNINGS ROSE FASTER THAN THE CONSUMER PRICE INDEX.



but not all of the inflation. It is not clear, therefore, that even unanticipated inflation robs the average working man of his wage.

When income is taken into account, the problem of calculating gains and losses becomes more complicated, but the principle remains the same: The gainer is the guy who owes more money than is owed to him during an unforeseen inflation.

### REDISTRIBUTION ON WHAT BASIS?

The household sector of the economy has been, by far, the leading net monetary creditor since World War II, while the Federal Government has been in the enviable position of the number one net monetary debtor. (See Table 2.) The nonfinancial corporate sector also has been a net monetary debtor but to a much smaller degree than the Federal Government. To the extent that the household sector holds monetary debts and liabilities of the Federal Government, unanticipated inflation results in a gain for the Government and a loss to the household sector. This transfer of wealth is often called an inflation tax. But this does not end the process, because the Government (which belongs to all of us) passes its gain along to someone. The gain in the corporate sector goes only to net debtor firms. And since people own business firms, they ultimately realize most of the fruits, be they bitter or sweet, that corporations receive from an unexpected rise in the price level.

More importantly, however, both the business and household sectors are composed of monetary creditor and debtor units, and it is the unexpected price level increases which cause redistribution of wealth and income within these groups that many people find objectionable about inflation. Redistribution of wealth and income on some criterion which is in accordance with our concept of fairness or equity is commonplace—witness the numerous subsidy and aid programs, not to mention that allegedly great equalizer, the progressive income tax. When inflation redistributes wealth, however, no consideration is given to individual circumstances, such as poverty, health, or number of dependents. Unanticipated inflation, unlike Robin Hood, takes from some and gives to others, be they poor, rich, young, or old. As a consequence, redistribution may not be on the basis of social goals or objectives.

Aside from its lack of social conscience, inflation has another trait which is reason for further concern. Use of money as a medium of exchange is an integral part of a high-output,

## TABLE 2

**Estimated Net Debtor and Creditor Status (in Billions of Dollars) of Household, Corporate Business, and Government Sectors, 1945-1967***

| Sector | Year 1945 | 1952 | 1959 | 1967 |
|---|---|---|---|---|
| Households | +213.8 | +237.9 | +306.4 | +505.0 |
| Corporate Business (nonfinancial) | − 4.2 | − 26.7 | − 42.0 | − 96.5 |
| U.S. Government | −221.8 | −193.1 | −208.1 | −234.9 |

* Positive sign indicates net creditor and negative sign indicates net debtor.

specialized, and complex economy. Money makes possible the efficient flow of goods and services by eliminating the costly barter system. However, inflation makes the use of money more costly, and if severe enough, may cause a reduction in the real output of goods and services. People and business firms, in attempting to economize on the use of money, may resort to practices which tend to reduce specialization. They may spend time and effort searching out exchanges of goods and avoiding organized markets (for example, business firms integrating vertically to bypass supplier's and distributor's markets). Such actions would slash productivity in the economy. In a sense, society would be a loser.

## ANTICIPATING INFLATION—HOW MUCH, FOR HOW LONG, AND AT WHAT COST

While there is little evidence that today's economy is coming apart at the seams, there are unmistakable signs that people, after experiencing four years of soaring prices, have come to expect future price increases. In order to protect themselves against the wealth-robbing effects of inflation, many people have acted upon their expectations. Consequently, we have high interest rates, built-in wage increases in some industries, reduced holdings of money balances by corporations and individuals, and wealth losses by those of us unfortunate enough to have had more money owed to us than we owed during these years.

Two considerable problems face the prospective anticipator of inflation. First, he must be able to estimate not only the amount or degree of inflation, but also its duration. That estimation is tough to make because the range of possible combinations of amounts and duration is infinite. For example, will prices rise 4 per cent for the next 20 years and then stabilize, or will they rise 6 per cent next year and then fall for several years? Even the best guru has trouble here. A correct answer would require an accurate forecast of future Government monetary and fiscal decisions in addition to any major event or disaster that would affect the physical stock of goods and services available. Instead of making crystal-ball estimates, many people simply negotiate contracts with escalator clauses tied to the cost of living or acquire assets with an equity "kicker" (such as convertible bonds). Increased use of such clauses and kickers in recent years is a rough gauge of how uncertain people are about the degree of expected inflation.

But an accurate estimate of expected changes in the price level is only the first obstacle to be overcome in anticipating inflation. The second and perhaps even more difficult problem centers on the ability of an individual to alter his asset and liability holdings to avoid being hurt by the coming inflation. For example, a person may not be able to reduce his holdings of monetary assets if they are of the nonnegotiable type, such as certain pension plans and insurance policies. Furthermore, he may not be able to contract enough debt to offset his holdings of monetary assets. In either case, even though the individual foresees the inflation, he is unable to forestall a loss in the purchasing power of his wealth when inflation occurs. Closely associated with this problem is that of the cost entailed in altering the form in which wealth is held. The cost of altering asset holdings depends upon the types of assets held; consequently, the cost of anticipating inflation differs among individuals holding different sets of assets.

Anticipating inflation for fun or profit is no easy matter. In addition, it is an expensive game to play because of the time and energy spent in calculating likely price level changes and attempting to alter the form in which wealth is held. If the costs and uncertainties entailed in anticipating inflation are added to those inefficiencies and inequities associated with inflation itself, it is easy to understand the merit of a stable price level. Price stability insures that gainers and losers will be determined on traditional values of thrift, hard work, and enterprise, rather than on the ability to anticipate and respond to price level changes.

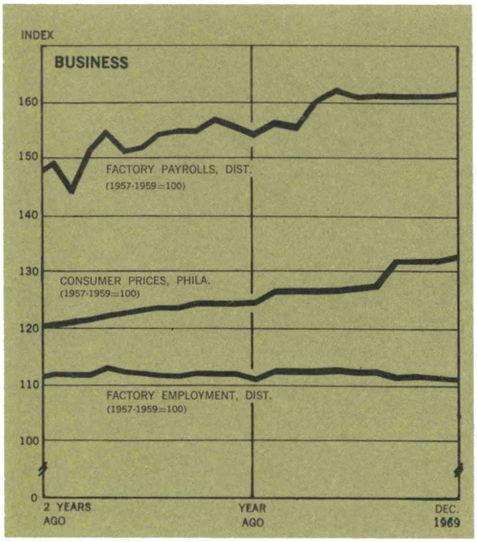
## NOW AVAILABLE: FILM STRIP ON TRUTH IN LENDING FOR CONSUMERS

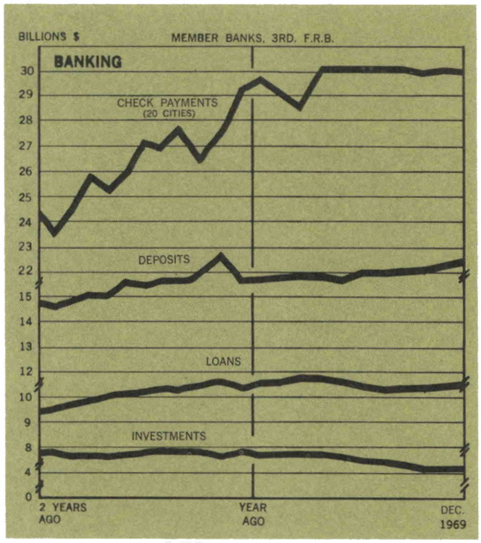
A film strip on Regulation Z, Truth in Lending, for showing to groups of consumers has been developed by the Board of Governors of the Federal Reserve System.

The 20-minute presentation is designed for a Dukane projector which uses 35mm film and plays a 33 RPM record synchronized to the film. Copies of the film strip can be purchased from the Board of Governors of the Federal Reserve System, Washington, D.C. 20551, for $10.00. It is also available to groups in the Third Federal Reserve District without cost except for return postage.

Groups in the Third District may direct requests for loan of the film to Truth in Lending, Federal Reserve Bank of Philadelphia, Philadelphia, Pennsylvania 19101. These requests should provide for several alternate presentation dates. Others not in the Pennsylvania, New Jersey, or Delaware area should direct requests to their nearest Federal Reserve Bank or branch.

# FOR THE RECORD . . .




| SUMMARY | Third Federal Reserve District: Per cent change, Dec. 1969 from mo. ago | year ago | 12 mos. 1969 from year ago | United States: Per cent change, Dec. 1969 from mo. ago | year ago | 12 mos. 1969 from year ago |
|---|---|---|---|---|---|---|
| **MANUFACTURING** | | | | | | |
| Production | .... | .... | .... | − 3 | + 1 | + 4 |
| Electric power consumed | | | | .... | .... | .... |
| Man-hours, total* | 0 | 0 | 0 | .... | .... | .... |
| Employment, total | 0 | − 1 | − 3 | .... | .... | .... |
| Wage income* | + 1 | + 6 | + 7 | .... | .... | .... |
| **CONSTRUCTION**** | + 3 | +15 | − 8 | +19 | +15 | + 9 |
| **COAL PRODUCTION** | 0 | + 3 | + 2 | − 6 | + 1 | 0 |
| **BANKING** | | | | | | |
| (All member banks) | | | | | | |
| Deposits | + 5 | − 1 | + 4 | + 6 | − 1 | + 3 |
| Loans | + 4 | +10 | +11 | + 3 | +10 | +12 |
| Investments | − 1 | − 9 | 0 | 0 | −10 | − 2 |
| U.S. Govt. securities | 0 | −16 | − 9 | − 1 | −17 | −11 |
| Other | − 2 | − 4 | + 8 | 0 | − 3 | + 6 |
| Check payments*** | − 2† | +10† | +18† | + 1 | + 9 | +15 |
| **PRICES** | | | | | | |
| Wholesale | .... | .... | .... | 0 | + 5 | + 4 |
| Consumer | 0‡ | + 6‡ | + 5‡ | + 1 | + 6 | + 5 |

*Production workers only
**Value of contracts
***Adjusted for seasonal variation

†15 SMSA's
‡Philadelphia

| LOCAL CHANGES — Standard Metropolitan Statistical Areas* | Manufacturing: Employment, Per cent change Dec. 1969 from mo. ago | year ago | Manufacturing: Payrolls, Per cent change Dec. 1969 from mo. ago | year ago | Banking: Check Payments**, Per cent change Dec. 1969 from mo. ago | year ago | Banking: Total Deposits***, Per cent change Dec. 1969 from mo. ago | year ago |
|---|---|---|---|---|---|---|---|---|
| Wilmington | 0 | 0 | + 1 | − 1 | − 8 | +14 | +11 | + 2 |
| Atlantic City | .... | .... | .... | .... | + 4 | +17 | + 1 | + 5 |
| Trenton | 0 | + 1 | 0 | + 2 | − 1 | +17 | + 6 | +13 |
| Altoona | + 1 | + 4 | 0 | + 8 | + 4 | + 7 | + 3 | + 7 |
| Harrisburg | + 1 | + 2 | + 5 | +13 | + 4 | +16 | + 3 | + 8 |
| Johnstown | 0 | + 8 | + 1 | +20 | − 1 | +11 | + 3 | +12 |
| Lancaster | 0 | + 2 | + 1 | +12 | + 3 | +12 | + 2 | +12 |
| Lehigh Valley | 0 | 0 | + 2 | +12 | + 3 | + 6 | + 1 | − 7 |
| Philadelphia | 0 | − 3 | 0 | + 3 | − 2 | + 8 | + 8 | − 1 |
| Reading | 0 | 0 | − 1 | + 2 | − 2 | + 6 | + 1 | + 6 |
| Scranton | + 3 | + 1 | + 3 | + 6 | − 5 | − 2 | +15 | +14 |
| Wilkes-Barre | 0 | + 3 | − 1 | +10 | − 2 | + 7 | + 2 | −20 |
| York | − 1 | + 1 | − 1 | +11 | +18 | +20 | 0 | + 5 |

*Not restricted to corporate limits of cities but covers areas of one or more counties.
**All commercial banks. Adjusted for seasonal variation.
***Member banks only. Last Wednesday of the month.