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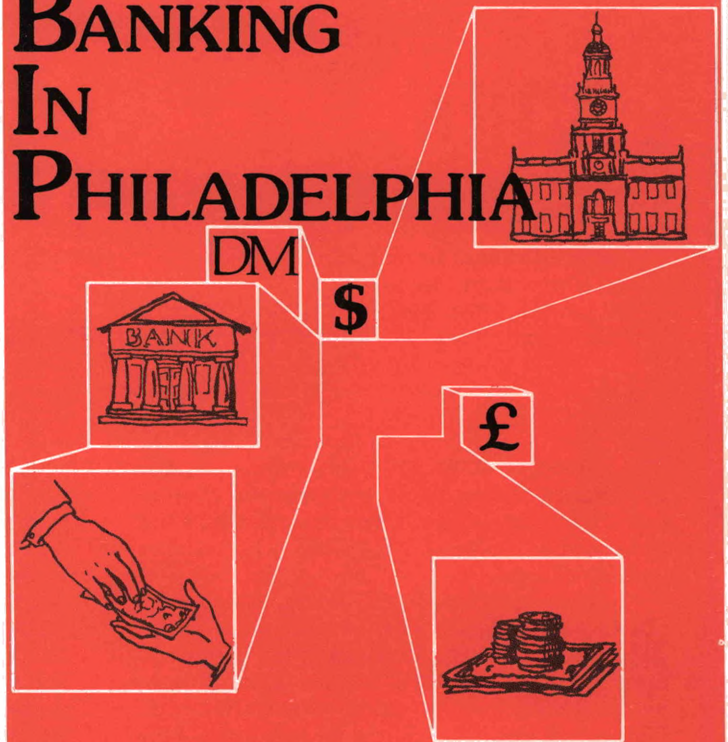
INTERNATIONAL BANKING IN PHILADELPHIA



A New Job Map for the Philadelphia Region & The Fed in Print

VOLUNTARY INFLATION RESTRAINT: A COMMENTARY

JANUARY/FEBRUARY 1979

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COMMENTARY

VOLUNTARY INFLATION RESTRAINT AND CORPORATE SOCIAL RESPONSIBILITY*

By David P. Eastburn, President
Federal Reserve Bank of Philadelphia

What responsibility does a corporation have voluntarily to fight inflation? I suppose there is not a corporate official in the country who is not asking this question today. The answer will largely determine the success of President Carter's anti-inflation program.

The arguments pro and con have been made for years. Pro: corporations stand to gain along with the rest of us if inflation can be brought under control. Con: a corporation's main job is to make profits for its stockholders, and competition prevents it from waging the inflation fight on its own (President Carter's analogy of one person's sitting down in the stadium while everyone else is standing).

I have nothing to add to these arguments, but I believe there is an important aspect of the question which has been overlooked. This is the impact of inflation on activities of corporations to improve social conditions. High inflation rates threaten to reduce these activities severely.

To explain why this is so, let me paint with a rather broad brush a contrast between two eras. A decade or so ago, perhaps a little less, a debate was raging about corporate social responsibility. Business journals were full of articles about whether corporations should help solve such problems as hard-core unemployment, slum housing, and lack of minority participation in business, or whether, simply, the "business of business is business." The *New York Times Magazine* published an article by the Nobel prize winning economist, Milton Friedman, which argued that corporate officials who use their corporate power to try to solve social problems are playing fast and loose with stockholders' money and hastening the day of socialism. The Com-

*Adapted from remarks delivered before the Business Honor Society Colloquium, La Salle College, Philadelphia, Pennsylvania, November 14, 1978.

mittee for Economic Development cast its enlightened eye on the question and concluded that corporations *should* actively try to improve social conditions because it is in their long-run self-interest to do so.

The debate was interesting, especially because of the environment in which it took place. The nation had just gone through an exciting, if stormy, period. Civil rights had taken a tremendous forward stride, a war on poverty had been declared, and the Vietnam war had raised sensitivity about moral issues to new heights. The economy was growing so rapidly that the material well-being of those in lower income groups was measurably improved; official definitions of poverty were successively revised upward.

In short, the debate about corporate social responsibility took place in an era of great social concern and considerable social improvement. It was a time when people were looking outward to other people's problems. At the risk of overdrawing the point, one might say it was an era of growth and generosity.

Since then, corporate social responsibility has become an accepted fact. It is seldom debated. It has become institutionalized. Corporations are engaging in a myriad of activities to improve their communities and to help the disadvantaged.

But now we have serious inflation and the threat of serious inflation into the indefinite future. In contrast to the expansionary, outward-looking environment of the earlier period, we face the prospect of two developments, both of which would be inimical to the exercise of corporate social action.

One is the pressure of inflation on real corporate profits. Although it might appear that profits are rising, this appearance is illusory, because profits are overstated as a result of current accounting practices. Corporate officials see through this money illusion, and inflation uncertainties make them more cautious. Furthermore, if the President's program fails, a likely course would be to fight inflation by overall monetary and fiscal action alone. And success in bringing inflation under control along that course would require a recession or at least very slow growth for a long period. What all this adds up to is an unpromising outlook on the *wherewithal* for corporate social action.

The other development is the impact of inflation on corporate *willingness* to engage in these activities. Inflation spawns an attitude of inward-looking and selfishness. Businessmen accuse labor of pushing up wages; labor accuses business of raising prices to make bigger profits; all accuse government. There is nothing new here, but inflation aggravates it. What is new, and even more symptomatic of the mood of the country, I believe, is the emergence of a variety of proposals to slash taxes. I am convinced that many sincere advocates of these proposals are motivated by a concern to limit the growth of government or a desire to stimulate economic growth. But I am also convinced that at least as many are concerned only about how inflation is picking their pockets.

Corporations cannot help but be touched by all this. Inflation forces them to look to their immediate self-interest rather than their long-run welfare. It could force them to take the position that their business *is* only business. It could win the ideological war for Professor Friedman after all.

So, for those who would like to see society continue to move ahead in solving its many social problems and who are eager to continue harnessing the power of corporations to that end, there is real reason for fighting inflation. I would hope that corporate executives will find this rationale further justification for entering the lists.

International Banking in Philadelphia

*By Janice M. Westerfield**

Over the last few years, Philadelphia bankers have made substantial strides in international banking. The volume and breadth of international services have grown, and foreign earnings have grown, too, until now they make up an appreciable part of total earnings for some Philadelphia banks.

What caused this advance? Primarily, the expansion of world trade, which brought with it a new demand for financial services. Philadelphia is a major port city with a natural entree to international commercial circles. And Philadelphia bankers provide a large share of the financial services used in foreign trade locally. But there are other sources of growth as well—sources that can't be measured in tonnage passing through the port or in pallets lifted over local piers. As American manufacturing and service firms have gone abroad, they have continued to rely on American banks for financing. And where those bankers have followed, they have found new opportunities for profit. Philadelphia bankers have been in the forefront of this movement.

What does the future hold? That depends not only on commercial conditions but also on the legal environment in which financial services are provided. Trade may get a boost from Philadelphia's International City project, which already is bearing fruit. And foreign bankers are moving into the Delaware Valley. Developments like these, however, pose new issues for the regulatory and supervisory authorities here and abroad, who are working to preserve both the soundness and the competitiveness of the international banking community. As the trading world becomes more tightly knit, their cooperative efforts in

*Janice M. Westerfield, who received her Ph.D. from the University of Pennsylvania in 1974, writes frequently on international finance and trade.

this area will help to shape the course of international banking in Philadelphia.

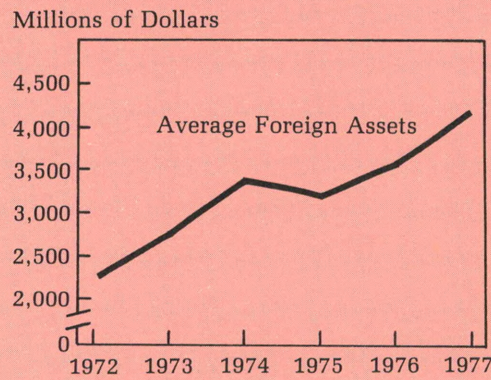
PHILADELPHIA BANKS ON THE MOVE

New opportunities for international finance during the 1960s spurred many Philadelphia bankers to initiate foreign operations. Once the benefits from exploring new markets became apparent, they moved rapidly to expand.[1]

Expansion . . . At first it seemed that foreign operations could be handled adequately by setting up correspondent banking relationships—arrangements to provide services through banks in other localities. But by 1972, Philadelphia banks had decided to establish their own branches in London, the Virgin Islands, and the Bahamas, and foreign assets had reached $2.2 billion.[2]

During the following five years, Philadelphia banks broadened and deepened their commitment to international banking. Foreign assets increased substantially, to $4.2 billion, and the banks cultivated customers in a variety of markets (Figure 1). Loans were up from slightly less than $1 billion in 1972 to $2.7 billion in 1977—a compound growth rate of 22.8 percent per year. And even though bankers have proceeded more cautiously since 1975, growth rates have held up at just under 20 percent annually. Further, the ratio of average foreign loans to average total loans increased steadily from 14 percent in 1972 to 24 percent in 1977 for Philadelphia banks as a group.

FIGURE 1
PHILADELPHIA BANKS SEE THEIR FOREIGN ASSETS RISE



SOURCE: Delaware River Port Authority.

Also, Philadelphia banks have set up corporations, expressly for conducting international banking operations, under the Edge Act.[3] Some of these corporations have remained in the Third District, while others have opened offices in New York—the traditional home of international finance in the United States.

Thus additional foreign branches and subsidiaries, as well as representative offices, have expanded the network of Philadelphia banks. And foreign earnings, which now account for over 40 percent of total earnings at the banks most heavily involved, have kept pace with this expansion.

. . . With a Pattern. Philadelphia bankers as a group prefer relatively short maturities for their foreign loans, placements with banks, and other claims. Nearly 70 percent of these

[1]Fidelity, First Pennsylvania, Girard, Philadelphia National, and, to a lesser extent, Provident National are the Third District banks that have substantial foreign operations. Several other area banks have branches in the Cayman Islands.

[2]A correspondent banking relationship with a foreign bank provides a U.S. bank with services in return for fees and compensating balances. These services enable banks that don't have their own international departments to transact foreign business for their customers. Where foreign volume is low, using a correspondent bank may be less costly than establishing a foreign branch or an international department in house.

[3]Edge Act Corporations are U.S. corporations that banks may establish, under Section 25(A) of the Federal Reserve Act, to engage in foreign banking and finance. They accept deposits, make loans and investments, and offer other services, but only in international transactions.

claims have a year or less remaining to maturity. But the distribution among individual banks is uneven, with some banks having as much as 85 percent in short-term claims while others have as little as 50 percent.

Different kinds of borrowers tend to be associated with claims of different maturities. U.S. bank claims on foreign banks typically are short-term placements or loans; and these account for over 60 percent of total foreign claims. Claims on nonbank public borrowers—foreign governments and their agencies—are mostly medium to long term and make up about 20 percent of the total. The final 20 percent have various maturities and are distributed mainly among private, nonbank borrowers.

Philadelphia bankers are active in developed and developing countries in many parts of the world. In the late 1960s, the largest portion of credits went to Latin America, and that area still accounts for nearly one-third of total claims. Growth in claims over the last ten years has been strongest in Europe, which now accounts for 42 percent. Asian claims, once strong, have been reduced from over a third to about 18 percent. And Africa accounts for about 4 percent.[4]

In short, foreign banking is big business in Philadelphia. Recent years have seen dollar involvement rise dramatically, with area bankers seeking out profit opportunities around the world.

SOURCE OF GROWTH: WORLD TRADE

The main contributor to the growth of international banking has been the upward movement in the volume of trade. Exports and imports of goods both have risen, and so has the volume of financial transactions such as movements of bonds and currencies. Domestic banks finance the foreign operations of many U.S. corporations. In the course of providing financial services to these multinational clients, U.S. bankers have learned that they can make profits in foreign countries and that sometimes they can acquire funds there at a lower cost than at home. Philadelphia banks, because of their nearness to a riverfront port, have been especially well situated to benefit from trade growth.

Financing Trade and Capital Flows. There are obvious opportunities for bankers to service merchandise flows through nearby U.S. ports of entry. But besides financing stateside trade, U.S. banks service financial and commercial activity in many distant markets (see MEASURES OF RISK AND RETURN overleaf). U.S. private investment abroad, for example, grew at a compound annual rate of 34.2 percent from 1972 to 1977. And it's no longer just the big corporations that invest abroad. Smaller businesses also are finding attractive investment opportunities on foreign shores.

Many American businesses have established close client relationships with U.S. banks on domestic matters. These firms often find it convenient to continue this relationship when expanding abroad. Foreign operations may involve less familiar currencies, with different economic and political institutions and modes of conduct. Further, tax laws or currency controls multiply the complexity of financial decisions in foreign countries. Familiar banking contacts may be helpful in providing information or overcoming obstacles in foreign markets. So American business in foreign countries continues to depend on American banks, boosting the volume of their international transactions.

Finding Funds. U.S. bank foreign involvement has been encouraged also by require-

[4]This geographical distribution is changed only slightly when external guarantees are taken into account. An external guarantee is a commitment by an entity located in a third country, such as a government or international institution, to protect the lender against default; although the borrower may be physically located in Country A, someone in Country B has agreed to repay should the borrower default. So it can be argued that the risk of a loan should be treated as if the characteristics of Country B are important to assess also.

ments for new sources of funds. These requirements are influenced not only by the volume of trade but also by changes in the regulatory environment.

In the mid-1960s, the Federal government introduced policies designed to curtail outflows of U.S. capital and reduce the balance of payments deficit. The capital controls established at that time included guidelines for bank lending to foreigners, ceilings on foreign direct investment, and taxes on foreign securities. In response to those restrictions on capital flows, U.S. multinational corporations began to seek external sources of funds to finance their foreign operations. And U.S. banks set up networks to tap foreign sources of funds and to place loans.

Later, during the 1969-70 credit crunch, banks were unable to compete effectively for domestic funds because of interest-rate ceilings, and so many turned to their foreign branches to supplement their traditional sources of funds. Although later regulatory changes diminished the incentives for member banks to borrow from their overseas branches, their initial move abroad opened up new horizons.

Activity at the Port. While the growth of trade financing has affected most U.S. international banking centers in roughly similar ways, Philadelphia has felt the impact more strongly than others because its customs region accounts for an increasing share of U.S.

MEASURES OF RISK AND RETURN

One useful way to try to get a grip on the foreign operations of Philadelphia banks is to focus on foreign exposure and financial return. Foreign exposure usually is viewed as the volume of claims subject to a foreign risk, and it can be measured by calculating these claims or assets as a percent of consolidated capital. This measure may indicate potential trouble if the ratio is so high as to suggest that capital would be endangered if defaults were to rise significantly. But it is difficult to establish a critical level that says "any ratio above this percentage is too high."

Another approach along this line is for the bank to measure a group of its most risky claims against total capital. The assumption underlying the use of a subset of claims is that some borrowers are more likely to default than others and the bank certainly does not expect to cover more than a negligible portion of defaults with its capital.

A more direct way of assessing the performance of foreign lending operations is to look at net chargeoffs—loan losses minus recoveries. Whereas exposure ratios attempt to measure the likelihood of default, chargeoffs record loan losses that already have occurred. Foreign net chargeoffs for the representative Philadelphia bank are slightly below the national average of 0.176 percent and compare favorably to their domestic net chargeoffs.*

Foreign-income-to-asset ratios provide another view of the financial side of foreign operations. Essentially, these ratios give a picture of the rate of return on foreign assets—a return which surpasses that on total assets for Philadelphia banks. This result may be caused partly by sluggish domestic loans and unusual domestic loan losses. But the foreign asset picture generally is a bright one. Although foreign income and revenue figures for Philadelphia banks actually peaked around 1974, yearly income figures are on the rise again and soon will reach their former high level.

The importance of foreign earnings to Philadelphia banks probably is captured most accurately by the ratio of foreign income to total income—currently 40 percent. Judged by this or the other ratios, international financial services clearly provide substantial returns to Philadelphia bankers.

*The 0.176 percent comes from a survey of 127 banks by Robert Morris Associates, a Philadelphia-based organization. Their domestic loan loss figure of 0.51 percent measures chargeoffs as a percentage of the average loan portfolio for 751 banks surveyed.

merchandise trade.[5] The nine ports of the Philadelphia area—ranging from Trenton to Wilmington—more than tripled the dollar value of their exports and imports from the 1972 figure of $2.9 billion to over $10 billion in 1977. And they moved into first place nationally in terms of dollar value of general cargo and bulk (Figure 2).

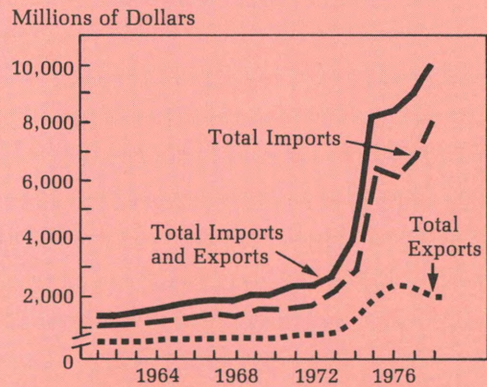
Exports from the area in dollar terms are dominated by machinery, especially transportation equipment. But when both exports and imports are counted, petroleum clearly is the big ticket commodity. In 1977, petroleum products, at $5.2 billion, accounted for two-thirds of the value of imports and were greater in value than all exported cargo. Since the Philadelphia-Delaware River area is known as a major refinery and petrochemical center, this figure is not surprising. And as might be expected from the strength of oil products, several oil exporting nations—Saudi Arabia, Nigeria, and Venezuela—are among the major exporters to this area. But millions of dollars of cargo also go to and from many other countries in the world, especially Japan. As international business of area companies has expanded, it has produced a new wave of demand for financial services.

Thus it appears that the demand for international financial services has come from a broad spectrum of both commercial and noncommercial activity in the region. And new initiatives on both fronts can be expected to expand the role of international banking in Philadelphia. But it has become clear in the

FIGURE 2

WATERBORNE TRADE RISES STEEPLY IN THE EARLY 1970s

Imports and Exports for Philadelphia Area Ports*



SOURCE: Delaware River Port Authority.

*The excess of the dollar value of imports over that of exports in the mid-1970s can be accounted for largely by the quadrupling of oil prices in October 1973. Petroleum products currently make up two-thirds of the total value of imports.

course of this present growth phase that certain adjustments of a legislative and regulatory kind may be required to preserve the efficiency and competitiveness of the international banking environment.

[5]Philadelphia banks finance a substantial portion of trade through the Delaware River ports. Much of the financing is handled by banker's acceptances and letters of credit, both short-term claims. For example, take the case of a local exporter who is selling some machinery to a company located in Germany. The German importer arranges for his banker in Germany to issue a letter of credit in favor of the exporter. This letter gives the terms of the merchandise transaction and states that the U.S. exporter may draw a time draft on the German bank. The exporter then draws the draft on the German bank, negotiates it at his U.S. bank (at a discount), and receives payment. The U.S. bank forwards the draft to the German bank which accepts the obligation to pay the draft, hence the name 'banker's acceptance.'

Thus the accepting bank transfers funds to the exporter and is reimbursed subsequently by the importer. The exporter shifts the burden of assessing the creditworthiness of the importer, and thus the default risk, to the bank that accepts the draft; and the exporter can get his money at a discount without waiting for the importer to pay for the goods. The importer is enabled to defer payment; in effect, he gets a loan, for which he pays a fee. And the U.S. bank gets possession of a marketable, interest-earning asset which provides liquidity, and also receives a fee for guaranteeing the transaction.

AN INTERNATIONAL FUTURE FOR PHILADELPHIA BANKS

Just as the growth of commerce in Philadelphia has spurred the demand for bank services, the banks themselves now are actively involved in attempts to develop inducements for trade, including a major new trade effort—the International City project. Bankers, civic leaders, private organizations, and others are working on a design to make Philadelphia a recognized international city by 1982—the city's Tricentennial year.

International City. Philadelphia needs a strong investment plan and an overall economic strategy to revitalize the city's economy and especially to create jobs. And any city that wants to remain economically viable will find that it must develop sound international business institutions. It's not that Philadelphia is isolated now; this city is far more cosmopolitan than many people realize. The port and its shipping lines, the large pharmaceutical companies, banks, insurance companies, and others all have offices or other connections in other countries. Moreover, the population of the city and surrounding suburbs is highly diverse in ethnic and racial background. These things are a good start, and the International City project emphasizes building upon them to develop the two-way nature of international trade. The game-plan is to seek foreign investment while at the same time strengthening the capability of Philadelphia-based business to compete in foreign markets.[6]

There are several segments to the program, most of which still are in the planning stage. One of these is the Philadelphia Financial Network—a commitment to make Philadelphia a leading regional financial center by offering financial services that might induce foreign companies to locate here. Such services might include loans to foreign companies or precommitments for financing that recognize the special borrowing requirements of firms that are unfamiliar to lenders in this area. Or they might include the development of innovative banking services to identify leads and attract foreign investment, providing information to reduce the uncertainities of locating in Philadelphia or the nearby area.

Other major elements in the project are geared to demonstrate that Philadelphia is equipped to service foreign firms as well as a thriving international business community. One proposal is to centralize business and communications for many international firms in a world trade center at the port. Another proposal that's actually made it off the drawing board is the establishment of a free trade zone for goods on the waterfront. Approved by the Department of Commerce in March 1978, the new zone permits firms to avoid duties on their products until processing or manufacturing is completed. The reduction of tariffs and customs regulations in this zone is expected to create incentives for new firms to locate here, creating jobs and increasing cargo flows.[7]

[6]For further information on the International City project see *News You Should Use*, a newsletter issued periodically by the Greater Philadelphia Partnership.

[7]S.I. Le Saffre, a French yeast firm which plans to occupy a large portion of the free trade zone on the Philadelphia waterfront, provides an example. The firm benefits because the materials it imports won't be taxed in the zone. Nor will the yeast that it exports to other countries. Only yeast that enters the U.S. will be taxed. The local area benefits from the employment and income that the firm generates as it builds its plant and produces its product.

Bankers in Pennsylvania and other states also are watching to see what happens in New York, where a state law allowing a free trade zone for banking was signed in June 1978. This law permits banks to establish international banking facilities to transact foreign business free of state and New York City taxes. Currently, these taxes on loan activities add an appreciable burden over and above the Federal tax of 48 percent. The new facilities are intended to attract loans which now are booked in the Caribbean and elsewhere. Supporters of the free banking zone are hoping to persuade the Federal Reserve to exempt such facilities from Regulation Q ceilings on interest rates and Regulation D reserve requirements.

Thus the international banking community in Philadelphia could have a central role in the movement to make Philadelphia more of an international city. But the future role of Philadelphia's banks in this and other international trade efforts will depend in part upon banking legislation and regulation that even now is under study.

The Banking Outlook. Area banks have a solid foothold in international operations upon which to develop their expertise. But international banking is growing and innovating rapidly, and many changes lie ahead.

At the Federal level, changes are occurring both formally, on the legislative front, and informally, through increased cooperation among the central banks. In September 1978, Congress passed the International Banking Act regulating the activities of foreign banks in the U.S. This act is based on the principle of national treatment. In the past, foreign banks operated under the regulations of the home office, giving them what many considered an unfair competitive advantage over U.S. domestic banking institutions in being able to cross state lines. But under the new law, U.S. regulatory controls are broadened to treat foreign banks more like their domestic counterparts. Foreign banks now, for example, must designate a home state and limit deposits at branches outside the home state to those permissible for an Edge Act Corporation.[8] Thus outside branches are limited to less than full-service banking. Further, the law authorizes the Federal Reserve Board to impose mandatory reserve requirements on foreign banks in consultation with state banking authorities.

As the International Banking Act demonstrates, the extent and means of supervision of bank subsidiaries located outside the home country are complex issues. Two basic principles—reciprocity and nondiscrimination—come into play. Reciprocity requires that U.S. banks in foreign countries be afforded regulatory treatment similar to that given foreign banks operating in the U.S. Nondiscrimination ensures that foreign banks are treated like U.S. domestic banks, regardless of how the foreign country treats U.S. banking operations. These principles aren't easy to accommodate, since each country accepts responsibility for home office banks and subsidiaries worldwide and therefore expects some degree of control via adherence to its own laws and regulations.[9] Thus supervision of subsidiaries in foreign countries must be shared with the country in which the subsidiary is located.

Cooperation among central bankers is critical to the resolution of supervisory issues as well as to the overall safety and soundness of the banking institutions. This cooperation can take the form of informational exchange on supervisory responsibilities and analyses of the commercial banks that operate in more than one country. Banking regulations in each country can be reviewed and disseminated, and standards of conduct for foreign banking units can be coordinated. Much of this can be accomplished via informal consultation.[10]

At the state level, banking legislation (Act No. 1977-37) which permits foreign banks to

[8]Foreign banks having operations in more than one state when the bill was passed have a grandfather clause enabling them to continue those branch operations.

[9]See Philip E. Coldwell, Member, Board of Governors of the Federal Reserve System, "International Cooperation for Improved Banking," an address delivered before the Caribbean Basin Conference, Atlanta, August 3, 1978.

[10]Already, new and more comprehensive methods of data collection are being developed to provide regulatory authorities with more information. These authorities—the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation—are coordinating a joint approach to the evaluation, measurement, and analysis of foreign operations. Part of this approach is to evaluate the internal procedures or guidelines of the banks to help ensure a sound U. S. banking system.

establish offices in Pennsylvania was signed in July 1977. Since then, several foreign banks have applied to open offices and five applications have been approved by the state banking authority. These banks plan to locate offices in Pittsburgh and Philadelphia. The Pittsburgh offices will offer wholesale banking services to corporate customers; those in Philadelphia plan to offer retail services. Thus U.S. bankers face growing competition from foreign bankers right here on U.S. turf.

The law states that treatment of U.S. banks in the foreign bank's home country shall be considered in reviewing foreign bank applications. Other provisions require that foreign banks maintain large enough deposits of assets in U.S. banks to protect customer deposits, that they be examined by and report to the state Department of Banking, and that they maintain a level of approved assets equal to 108 percent of liabilities. Thus both Federal and state actions are sure to affect the way Philadelphia banks and their foreign counterparts respond to future demand for international financial services.

IN PROSPECT

International banking can be expected to keep pace with the development of world trade. This outlook signals further commercial and financial growth for Philadelphia, which already is on a sound footing in foreign markets.

For more than a decade, U.S. bankers have viewed international banking as a matter of seeking profits in foreign countries. Now it looks as if foreign banks are ready to reciprocate, entering local markets to compete for the opportunity to provide financial services. While some of the ground rules remain to be worked out, Philadelphia bankers are almost sure to find that, in this new phase, international operations will be bidding for even more of their attention.

A New Job Map for the Philadelphia Region

*By John Gruenstein**

The term 'suburb' used to be synonymous with 'bedroom community' for many people. Suburbanites were pictured as members of a breed who hopped onto trains or into cars in the morning and traveled together to the central city where they worked, returning home at night for board and bed.

Although this simplified picture of the metropolis may have been fairly accurate at one time, it has been made obsolete by the growth of employment in the outlying communities that surround America's largest cities. And the city-suburb stereotype that has replaced it in many people's minds—one of suburban employment spread through rings of diminishing density around the high-density city—also fails to convey a full picture of the current employment landscape. Instead, a job map marked by suburban clusters of activity has emerged, shaped by the interaction of public and private initiatives. Some suburban residents have begun to ask what the future may hold. Will the outward sprawl continue? Will it level off? Or, perhaps, will the central city begin to recover its lost businesses and residents?

JOBS IN THE REGION: DECENTRALIZED BUT CONCENTRATED

If the proverbial crow flew straight out in almost any direction from Philadelphia's city hall, it initially would find heavy concentrations of jobs and then fewer and fewer jobs per acre of land the further it went. As a first approximation, our aerial observer might think it saw concentric circles of declining employment density. But here and there along the route the astute bird would notice

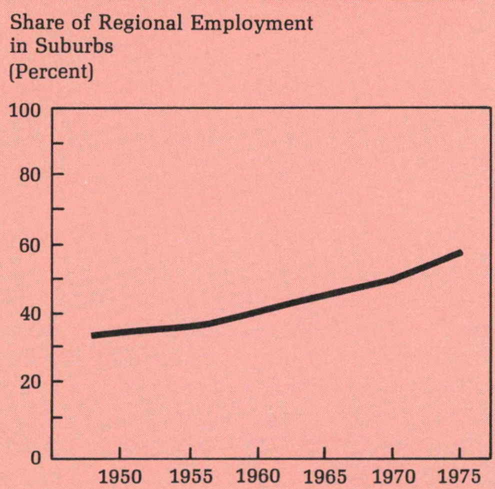
*John Gruenstein joined the Philadelphia Fed's Department of Research in 1977. He specializes in urban and regional economics.

some fairly sizable employment concentrations standing out amidst the greenery, some of them a goodly distance from William Penn's hat.

The ringlike effect has resulted from a long historical spread of jobs outward through the region,[1] and this trend toward decentralization has continued over the past few decades. The suburban share of the region's jobs rose from about 30 percent in 1948 to around 57 percent by 1975 (Figure 1).

FIGURE 1

SUBURBAN EMPLOYMENT SHARE HAS RISEN APPRECIABLY OVER THE PAST THREE DECADES



SOURCE: U. S. Department of Commerce, Bureau of the Census, *County Business Patterns,* 1948, 1956, 1959, 1965, 1970, 1975.

Overlaid on the rings is an uneven scattering of employment in suburban townships, boroughs, and cities—Minor Civil Divisions or MCDs, as the statisticians call them. In 1970, half of all suburban jobs were found in about 30 communities—that is, in fewer than 10 percent of all the 337 MCDs in the Philadelphia region. And since these MCDs comprised less than 10 percent of the suburban land area, most places with a lot of jobs also had a higher density of employment—more jobs per acre—than other areas (Figure 2).

Some of these clusters are in places that grew more or less independently of Philadelphia at first but since have been swept up by metropolitan expansion. Even within the present city limits examples of this process stand out: the once independent towns of Manayunk, Frankford, and Germantown became city neighborhoods when Philadelphia expanded to its current boundaries in 1854. Not far across the city border, Norristown, Chester, and Camden started off somewhat on their own but have been drawn within the orbit of their large neighbor. And some newly developed centers, like King of Prussia and Cherry Hill, have grown up in recent years within Philadelphia's sphere of influence.

Thus jobs have spread out from the central city to the rest of the region and have clustered into semiurban groupings. The result has been a relative loss of jobs and tax base in the central city and corresponding gains in the suburbs. These gains, however, have come at the price of increased congestion, crime, and demand for services in some areas that mimic conditions in the central city itself.

TRANSPORTATION AND TAXES HELP SHAPE THE MAP

Many influences contribute to shifts in employment location. Some are basic forces about which policymakers can do very little. But in other areas government policies have combined with changes in technology, taste, and social behavior to shape the present job map. The prime such area of public-private interaction is transportation, which clearly dominated the region's early development.

[1]The region is the standard metropolitan statistical area (SMSA) comprising Philadelphia, Bucks, Chester, Delaware, and Montgomery counties in Pennsylvania and Burlington, Camden, and Gloucester counties in New Jersey.

FIGURE 2

SUBURBAN EMPLOYMENT AROUND PHILADELPHIA IS CONCENTRATED IN A FEW RELATIVELY LARGE, DENSE CLUSTERS

Number of Employees	Number of Suburban MCDs	Percent of Suburban MCDs	Percent of Suburban Jobs	Percent of Suburban Land Area	Average Employment Density (Employees per Acre)
20,000 or More	7	2.1	21.2	2.8	4.6
10,000 - 19,999	16	4.7	22.9	4.8	3.3
5,000 - 9,999	25	7.4	17.8	6.8	2.6
2,500 - 4,999	50	14.8	18.2	10.2	2.5
1,000 - 2,499	83	24.6	13.5	24.5	1.4
500 - 999	56	16.6	4.2	17.0	1.1
Fewer than 500	100	29.7	2.3	34.0	0.3
All Suburbs	337	100.0	100.0	100.0	0.5
Philadelphia	---	-----	-----	-----	10.9
All SMSA	---	-----	-----	-----	0.9

For each employment range group, density is the average for all MCDs in that group. For All Suburbs, Philadelphia, and All SMSA, density is the total employment divided by the total land area.

The City of Philadelphia had a much higher density than any MCD, with just about twice as many employees per acre as the MCDs in the group with 20,000 or more employees. But the differences among MCDs themselves were just as great. The largest averaged close to twice the economic density of the communities in the middle groups—2,500 to 9,999 jobs—and more than fifteen times the density of the towns with the least employment—those with fewer than 500 jobs.

SOURCE: 1979 Employment Location File and 1970 Land Use File, Delaware Valley Regional Planning Commission.

Employers Are Attracted by Transportation. . . The convergence of rivers and rail lines in Philadelphia strongly stimulated the concentration of employment in the city. Prior to the twentieth century, water routes and railroads were the cheapest means of moving both freight and passengers. Thus firms which relied on deliveries of heavy materials tended to concentrate in areas near ports and railroad terminals like downtown Philadelphia. Downtown was the ideal spot for retail stores, too, because more people could get to them there, and also for banks, insurance companies, law firms, and other businesses which relied heavily on face-to-face contact and quick access to current information.

When everyone wants to be in the same place, however, competition dictates that some will be crowded out. So outlying locations along rivers and railroads also were favored by businesses, and even current maps of the area show fingers of high employment density reaching out along the Schuylkill and Delaware Rivers and along railroad lines to the North and West, reflecting the persistence of much older patterns (Figure 3).

Transportation to outlying areas became cheaper and faster with the advent of electrified street cars in the late 1800s, trucks and cars in the first half of the twentieth century, and the Federally subsidized Interstate Highway Program after World War II. As a result, areas that once were too far out to have strong ties to the city or hadn't the good fortune to be located on a river became more easily accessible. Heavy trucks rumbling along tax-supported highways began to offer firms the option to develop away from rail lines and waterways. Movement to locations where land cost less, because there was more of it and competition for it wasn't as heated, now became possible. Firms were trading cheaper land for a greater separation from the center; transportation costs were higher, but not so much higher as they would have been without highway subsidies. And improvements in communications technology made it possible to transmit most kinds of information without physical movement, thereby further freeing many types of businesses—nonmanufacturing as well as industrial—from having to remain downtown.

. . . And Tax Advantages. In more recent years, tax and service packages seem to have become more important influences on industry location choices, as the constraints imposed by transportation routes have weakened. Many suburban centers offer relatively high levels of services such as police and fire protection at relatively low cost. And they may spend less on such services as welfare and health care, which probably carry little direct benefit to business. New firms coming into the area or old firms seeking a new location probably shop around to some extent for the combination of taxes and services that will suit their requirements most closely. So a favorable tax and service package can have a direct effect on business location decisions and the topography of the job market.[2]

And So Are Employees. Many of the considerations that draw employers into the suburbs bring their workforces out, too. By the end of World War II, more and more people already were living in the suburbs, partly because of easier and cheaper transportation over subsidized roads and partly because of rising incomes which increased the demand for spacious yards and newer houses. Government tax and housing policies encouraged this trend. The new suburbanites represented both a market for products and a labor force of skilled workers, providing another reason for the decentralization of firms of all sorts.[3] Thus the conditions that influenced residential patterns had an indirect effect on employment location as well.

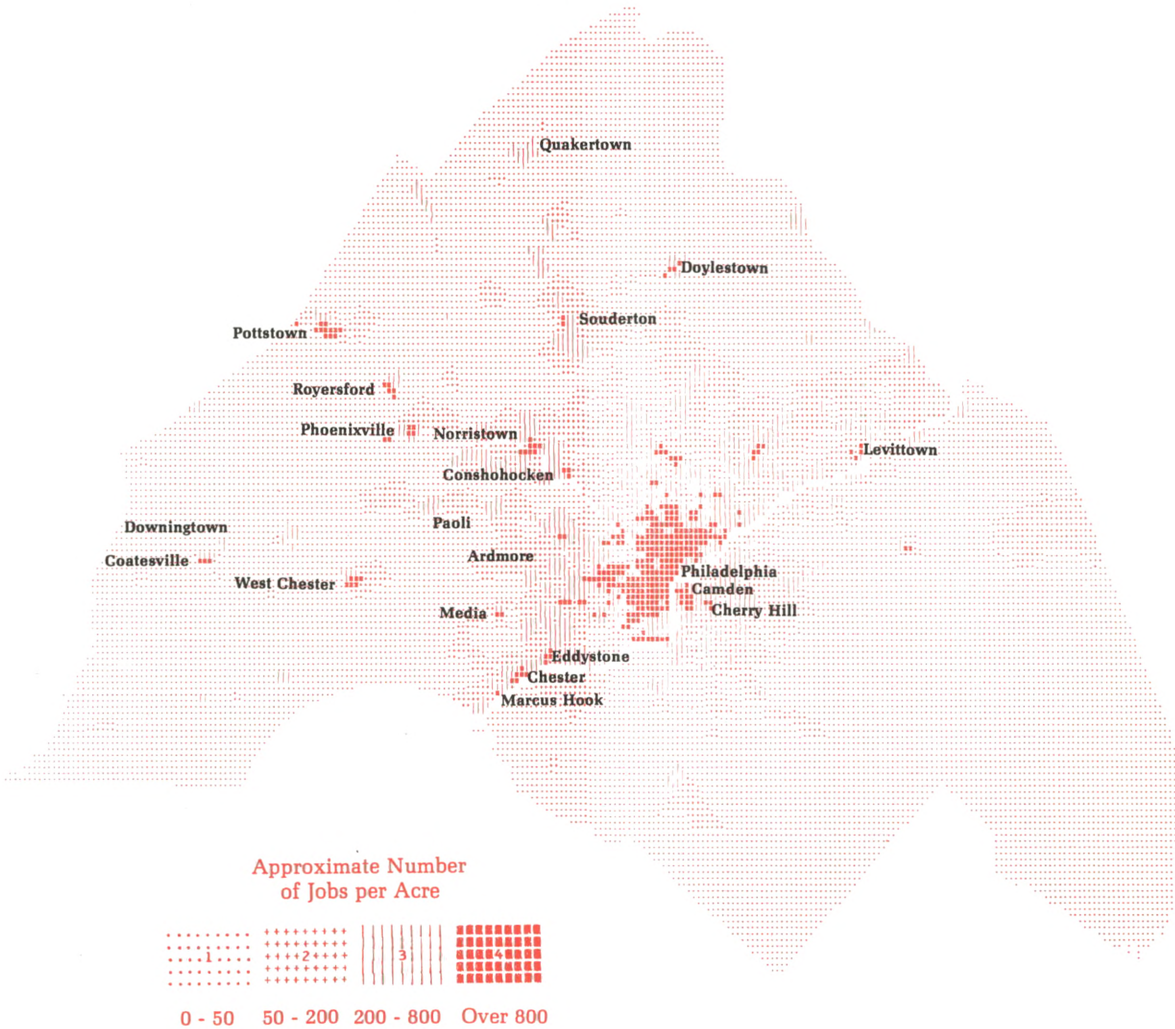
Although the movement of population out of the central city started earlier and proceeded at a faster pace than the movement of jobs, both trends have been operating since

[2]This shopping behavior probably works among individual suburban communities as well as between city and suburb. Just how large this effect is compared to other factors is a matter of debate. Some observers view the effect as marginal when compared to more basic forces. Others disagree. In addition, as the suburbs become more urbanized they need to deliver more city-like services and consequently taxes may tend to rise. Finally, other local government policies, like zoning and other land-use restrictions and incentives such as tax abatements and land acquisition programs, can affect location decisions.

[3]Just as the overall movement of the population to the suburbs seems to have drawn jobs along with it, so, too, the pattern of employment location among different suburban towns appears to be sensitive to residential patterns. This effect works both ways, of course; jobs draw people as well as the other way around. For an example of a location model which demonstrates the simultaneous interaction of jobs and people, see Walter D. Fisher and Marjorie C. L. Fisher, "The Spatial Allocation of Employment and Residence within a Metropolitan Area," *Journal of Regional Science*, December 1975, pp. 261-276.

FIGURE 3
EMPLOYMENT REACHES OUT ALONG RIVERS AND RAIL LINES

Philadelphia and Surrounding Counties
(Standard Metropolitan Statistical Area)



SOURCE: Data compiled and plotted by Federal Reserve Bank of Philadelphia at least as far back as the middle of the nineteenth century and probably even earlier for most cities, including Philadelphia. The trend toward employment decentralization has been the result of a long process of change in transportation and government tax policy as well as in production technology and other areas (see NATURE AND TECHNOLOGY . . .). The role of transportation has been that of a constraint: firms need to be in accessible locations. As the accessibility of many noncentral areas has increased, partly as a result of highway subsidies, the grip of the central city has been loosened and other factors have come to play a greater role in setting employment patterns in the region.[4] How will these factors affect the future of employment location patterns? And how will changes in these patterns affect the framework for policy decisions?

THE FUTURE PATTERN

It seems most likely that suburban job growth will continue to outpace the city's. Still, urbanologists find plenty of room to disagree about the shape of cities to come. At least three scenarios seem possible—suburban sprawl, downtown redevelopment, and the many-centered metropolis.

Sprawl. Some observers favor the big bang theory of urban growth, which says that factories, offices, shops, and houses will spread explosively over a larger and larger area. They stress that continuing improvements in transportation and communication will reduce the importance of physical proximity as a factor influencing location decisions. Thus, they argue, further suburban sprawl—low-density, patchwork development—is the likeliest end result, at least in the absence of strong government intervention to change it. In this scenario, jobs and people eventually wind up spread thinly and evenly throughout a greatly expanded metropolitan area.

Recentralization. Other watchers of the urban scene sense the winds of change starting to blow in a different direction—inward and back to the city. One source of this implosive movement is the rise in the cost of fuel, which encourages businesses and residents to cut transportation costs. Another source is changing demographics. The shift

[4] An excellent discussion of the long-term nature of the trends toward employment and population suburbanization can be found in Edwin S. Mills, *Studies in the Structure of the Urban Economy* (Baltimore: Johns Hopkins Press, 1972), chapters 2 and 3. For the impact of Federal policies on the process see Roger J. Vaughan, *The Urban Impacts of Federal Policies: Volume 2, Economic Development* (Santa Monica: RAND Corporation, 1977).

NATURE AND TECHNOLOGY AFFECT LOCATION CHOICES

There are some location factors that governments can do little to change.

Sometimes *natural advantages* have been the lure. The iron and steel industry was attracted to Pottstown and Phoenixville along the Schuylkill River, for example, by deposits of iron ore located near forests which could be used as a source of charcoal for smelting. Fast-flowing streams, even when not navigable, once turned mill wheels to make flour, paper, gunpowder, and other products throughout the Delaware Valley.

Changes in *production technology* and the consequent obsolescence of old structures and equipment also have had an effect. The trend toward decentralization has been reinforced by the desire to locate in single-story plants spread out over large land areas which facilitate modern methods of materials handling and processing. Such plants are cheaper to build in outlying areas, where large lots can be acquired at relatively low cost. Thus, with the passage of time, many multistory buildings which were crowded together to conserve scarce downtown land have lost out as manufacturing sites.

toward smaller households could result in lower demand for single-family houses on large lots and higher demand for more compact living accommodations. Further, as the two-worker family becomes more common, husbands and wives may place a higher value on the time they both spend traveling to work, shops, and entertainment. And they may be more interested in the amenities traditionally associated with downtown living. Changes in some Federal government policies which reduce the incentives for low-density suburban development also have been cited as helping to strengthen a back-to-the-city movement.

Some indications of such a movement already have been seen in many cities, including Philadelphia, where recent years have brought the development of the Gallery shopping mall, the revitalization of downtown neighborhoods like Society Hill, and the first reversal of the loss of jobs in about a decade. But although in *absolute* terms Philadelphia's employment decline may have bottomed out, few, if any, would argue that the *relative* standings of city and suburban growth patterns are likelv to change.

The Many-Centered Metropolis. A third group, including such scholars as Werner Hirsch of UCLA and Peter Muller of Temple University, contends that the likeliest course of events is neither total explosion nor total implosion but the advent of another kind of urban form—the multicentered metropolis. Centers in outlying areas would function as suburban downtowns and would attain a sufficient size, density, and variety of activities to rival the central city in economic and political clout. Such relatively high density arrangements already have begun to coalesce. Industrial parks, regional shopping malls, and office parks have been drawn almost invariably to locations adjoining highway interchanges. As time has passed, the prestige of such locations has grown, and the increased availability of business services and conveniences for workers, executives, and shoppers has reinforced previous growth. Finally, the same higher energy prices and changes in family structure that have stimulated some movement back to the city may be even more important in promoting higher densities and increased clustering of activities in *suburban* areas.[5]

It isn't easy to tell whose crystal ball is the clearest, and all three viewpoints probably contain a grain of truth. In some ways the multicentered scenario seems the most likely to succeed, since clear suburban employment concentrations already are in place and have been for some time. But these have a long way to grow to approach Philadelphia's order of magnitude.

Some evidence which may shed light on future growth patterns is available in Federal and state census tabulations. These figures show suburban MCDs of large and medium employment size growing faster than the city of Philadelphia in population and retail employment and losing jobs in manufacturing at a slower rate (Figure 4 overleaf). And although not doing as well in manufacturing and population as smaller suburban places on average, the medium-sized MCDs have had the largest percentage gains in retail employment (except for the under-500 employment group, which started from a very small base). Furthermore, one group of medium-sized MCDs—the one with 5,000 to 9,999 employees—has had a very high average population growth rate. This evidence suggests that even if extremely large centers don't emerge, concentrations should persist in the Philadelphia region and complete sprawl is unlikely.

Looking behind the averages, it's clear that

[5]The possibilities for future multicentered metropolitan development are outlined in Werner Z. Hirsch, "Energy and America's Changing Urban Settlement Pattern" (Los Angeles: RAND Corporation, 1976); Peter O. Muller, *The Outer City: Geographical Consequences of the Urbanization of the Suburbs* (Washington: Association of American Geographers, 1976); and "The Suburbs are Winning, Professor Claims," *Philadelphia Inquirer*, August 17, 1978.

suburban development continues to be uneven. While some centers have been growing quickly, others have been losing employment and population. In recent years, many of the older centers like Chester, Camden, and Norristown have suffered from the same problems as larger central cities—loss of manufacturing and retail jobs followed by relatively high unemployment and a shrinking tax base, outmigration of the relatively affluent while the poor stayed behind, and decay of residential, commercial, and industrial structures.

Thus the same social, economic, and technological shifts that have led to decentralization have produced mixed results in the suburbs. Some MCDs have prospered because of these shifts and with the aid of government-sponsored initiatives in transportation and other areas. But others, especially those with older or decaying infrastructures, have failed to keep up. Recognizing this unevenness is a prerequisite for promoting efficient and equitable development in the future.[6]

[6]Four different patterns ranging from sprawl to recentralization are discussed in *Alternative Futures for the Delaware Valley,* Year 2000 report no. 4 (Philadelphia: Delaware Valley Regional Planning Commission, September 1976).

FIGURE 4

PHILADELPHIA SUBURBAN EMPLOYMENT AND POPULATION SHOW UNEVEN GROWTH PATTERNS

Clusters by Number of Employees 1970	Average Annual Percent Change: Manufacturing Employment 1970-1975*	Retail Employment 1967-1972†	Population 1970-1975‡
20,000 or More	-1.1	3.0	-0.7
10,000 - 19,999	-2.5	9.1	0.7
5,000 - 9,999	-2.9	9.5	12.4
2,500 - 4,999	-1.7	6.6	1.3
1,000 - 2,499	-0.4	6.8	1.7
500 - 999	-0.4	7.2	1.9
Fewer than 500	-0.6	2.4	2.7
All Suburbs	-2.3	2.1	0.6
Philadelphia	-6.7	-1.3	-1.3
All SMSA	-4.1	4.6	-0.1

*Includes all MCDs in the Pennsylvania portion of the SMSA as listed in Pennsylvania Department of Commerce, *County Industry Reports,* 1970 and 1975.

† Includes all MCDs with more than 2,500 inhabitants as listed in U.S. Census of Business, *Retail Trade,* 1972.

‡ Includes all MCDs in the SMSA, except Philadelphia, as listed in U.S. Census Bureau, *Current Population Reports,* 1977.

POLICY SHIFTS IN THE OFFING?

Whether suburban employment clusters end up as large cities or as something more modest, the new job map will affect the way local suburban governments provide services, raise revenues, and interact with higher levels of government. As the suburbs become more like the cities they surround, suburban officials increasingly will find themselves dealing with questions of transportation policy, tax policy, and Federal assistance that once were faced mainly by their big-city counterparts.

Mass Transit. As they become more dense, suburban employment centers could increase traffic congestion on some roads and highways. One possible policy response is to build more highways. Another is to try to disperse employment. But a better approach may be to upgrade mass transit—an option often favored by large cities. For suburban areas, upgrading probably would mean improving bus service, perhaps through more express bus lanes, and developing other forms of highway-oriented mass transit, like jitneys. For while the clustering of suburban employment by itself would make the development of mass transportation more efficient, so too the emergence of transit systems to link suburban employment centers would encourage an efficient pattern of growth.

Further, such systems could produce significant social benefits such as reduced congestion on highways, less pollution from automobiles, and better transportation for those who have no access to cars—the elderly, children, and the poor. Also, greater use of mass transportation and shorter automobile trips because of higher densities could promote the achievement of national energy conservation goals. Thus a policy decision to improve suburban mass transit could enhance the attractiveness of the multicentered metropolis as a format for regional growth.

Local Taxes. As suburban employment centers grow, legislators who represent them may come under heavier pressure to shift more of the tax burden to commuters and other travelers between suburbs by means of a variety of taxes. In the past, the tax issue has been looked at mainly from the city-vs.-suburb point of view. It has been asked, for example, whether the Philadelphia wage tax should be lower for commuters than for people who both work and live in the city. But the growth of suburban employment centers now poses a similar question for groups of outlying sites.[7]

The question is a complicated one. Benefits and taxes can flow back and forth among a large number of suburban communities, as well as between the central city and the suburbs, and to and from places outside the region. With more and more people living in one suburban municipality, working in another, and shopping and seeking recreation in yet others, the quantity of public services provided to nonresidents—services such as street maintenance and police protection—will increase. But although benefits spill over to outsiders, taxes do, too. Direct taxes, like a wage tax, are the most straightforward examples, but taxes can be exported indirectly as well. Business property taxes, for example, ultimately must be paid by consumers, employees, stockholders, and landlords in the form of higher product prices and lower wages, profits, and rents.

[7] New or increased taxes which are intended to shift resources from one municipality to another could be justified on the basis of economic efficiency to the extent that they would allocate costs of services to the users of those services. Some proposals have been made with this aim for Pennsylvania, where currently, for all communities outside Philadelphia, an earned income tax paid to one's place of residence is credited against a tax of the same kind levied by one's place of employment. Senate Bill 943, for example, which was introduced into the Pennsylvania Senate in 1977 and still is pending, would allow municipalities to levy a maximum $25 municipal services tax on all employed persons. Another proposal, advocated in 1969 by the Pennsylvania Economy League, would allow a 50-50 split between place of employment and place of residence in the earned income tax. Both Senate Bill 943 and the Pennsylvania Economy League envisage property tax relief as one of the goals of the proposed changes.

So in response to the changing job map, suburban policymakers may well try to charge users, through taxes, for the local public services they use, regardless of where they reside. But such a program must be carried out carefully, with full regard to the way in which costs already are being shared through both direct and indirect taxes.

Federal Aid. Just as changes in local tax policy need to be made with a clear view of emerging employment patterns, Federal policies also should attempt to accommodate themselves to uneven suburban development. In the past, medium-sized cities in decline have suffered from relative neglect by the Federal government, which has focused mainly on the difficulties of the big cities. But recently enacted and proposed programs for urban areas, such as the Urban Development Action Grants program, passed in 1977, and a number of other urban policy initiatives currently under consideration, use guidelines for allocating funds which are intended to include medium-sized cities as well as large ones, in order to assist disadvantaged people wherever they reside. Political pressure from increasingly powerful suburban legislators has helped to bring about this shift. But so has the more widespread realization that people, not places or jurisdictions, should be the beneficiaries of Federal aid.

Furthermore, the Federal government has proposed to reevaluate programs which have worked against older cities, such as subsidies for water and sewer systems in newly developing areas. The rationale is to take advantage of in-place facilities as much as possible. Action along these lines could rescue public capital, like sewer and water lines, and private capital, such as abandoned factories and houses, which may have been undervalued by the market or slighted by past tax policies. This proposal has been interpreted by some observers as a program for large cities only, but it is likely to benefit some older high-density areas outside the central city as well.

So Federal, state, and local policy can interact in complex ways to affect patterns of employment growth. In turn, coordination of these policies can best be done with a clear understanding of how all forces acting together have created the present pattern and have set the stage for a new one.

LOOKING FORWARD

Thus the job map isn't what it used to be. The sharp urban-suburban split of employment from residential location is a thing of the past, replaced by a patchwork of job concentrations scattered unevenly across the region. Transportation and tax policy, along with natural conditions and technological developments, helped shape this realignment, and policymakers, along with other interested parties, will continue to watch for their influence. For it's fairly clear that continued suburban employment gains are more likely than a full-scale revitalization of the old downtown districts. And a reinforcement of suburban clustering is a surer bet than overall job sprawl. But whether suburban employment clusters end up as cities in the country or as something smaller—that remains to be seen.

The Fed in Print

Business Review Topics, First Half 1978

Selected by Barbara Turnbull

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