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**ELECTRONICS:
THE KEY TO BREAKING
THE INTERSTATE BANKING BARRIER**

Joanna H. Frodin

... Innovations in electronics pose a serious challenge to bans on interstate banking.

**BUSINESS
REVIEW**

Federal Reserve Bank of Philadelphia
100 North Sixth Street
Philadelphia, Pennsylvania 19106

**DELAWARE VALLEY
DEFENSE INDUSTRY UPDATE**

John J. Mulhern

... Better information on the Defense market could catalyze subcontracting and other forms of regional participation.

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Electronics: The Key to Breaking the Interstate Banking Barrier

*by Joanna H. Frodin**

Legal limits on interstate banking have stood firm for half a century. These geographic restrictions, however, have not prevented the development of certain types of interstate and national banking. Banking institutions have been able to seek profitable opportunities across state lines through a variety of channels. As a result, they have established a substantial interstate presence, primarily in asset services.

The demise of interstate limits is progressing rapidly, and full-service interstate banking appears just around the corner. The reason is that innovations in electronic funds and information transfer have brought about a fundamental change in the economics of banking. Specifically, electronics, which is reducing the cost of many banking functions,

makes deposit taking across state lines economic on a larger scale than it was before. While noneconomic forces—institutional and political—surely will influence the timing and exact form of legal changes, the economic forces for change should prove overriding.

LEGAL BACKGROUND

Geographic restrictions on bank branching stem from the McFadden Act of 1927 and the Banking Act of 1935, which effectively made state boundaries the ultimate limits to bank expansion. Prior to 1927, national banks could not branch—a prohibition based on a 1911 ruling by the Attorney General that the National Bank Act did not empower national banks to branch. State banks could branch if permitted by state regulations. The McFadden Act allowed a national bank to branch in the city of its location, subject to state laws. The Banking Act of 1935 extended such branching statewide, again subject to state laws.

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Although these two Acts liberalized branching regulations for national banks, they set state lines as boundaries and deferred to the states on the issue of location of banks within a state. McFadden defined a branch as “any place of business . . . at which deposits are received, or checks paid, or money lent.”¹ In theory, this definition meant that banks could not pursue opportunities for making loans or taking deposits by physical expansion across state lines.

State lines also limit Bank Holding Companies (BHCs) geographically. The Douglas Amendment of 1956 to the Bank Holding Company Act (BHCA) prohibited BHCs from acquiring a commercial bank in another state unless specifically authorized by that state. However, the BHCA did allow BHCs to operate nonbank subsidiaries in approved bank-related activities without specific geographic limits.

EARLY INROADS TO AN INTERSTATE ROLE

While the McFadden Act and the Douglas Amendment put strict limits on bank branching across state lines and BHC acquisition of out-of-state banks, many banks have pursued profitable opportunities across state lines via other available routes. Banks have crossed state boundaries primarily with asset services, exploiting legal channels available either to banks directly or to BHCs. Many domestic banking institutions have attained an interstate—indeed, even a nationwide—presence as a result. In addition, many foreign banking institutions, initially not subject to the same restrictions, have developed full-service interstate banking operations.

GEOGRAPHIC EXPANSION BY DOMESTIC BANKS . . .

Banks have made use of several avenues to achieve an interstate role, including Edge

Act Corporations, loan production offices, and partial acquisitions.

Edge Act Corporations. For many years, banks have crossed state lines to compete with other banks, U.S. and foreign, for *international* business through Edge Act Corporations. The 1919 Edge Act permitted banks to establish offices in states other than their home state to finance exports of U.S. goods and other international business. It limited deposit taking to deposits of foreign residents and to those incidental to the export business. Over time, many U.S. banks found their ability to compete with foreign banks in this area limited by the small number of Edge corporations they could afford to capitalize at the required \$2 million each.

The International Banking Act (IBA) of 1978 evened out the game with three measures. First, it allowed banks to consolidate these corporations into a single Edge Act Corporation, capitalized at \$2 million, which could operate separate Edge offices as branches. Second, it liberalized the allowable loan-to-capital ratios. Third, it permitted foreign banks to establish Edges. By the end of 1980, 44 domestic banks (or groups of banks) were operating or waiting for approval to operate a total of 123 Edge offices in approximately 15 cities outside their home states.²

Loan Production Offices. National banks and many state-chartered banks have had the opportunity to expand geographically through loan production offices. Banks may make loans through these out-of-state offices, subject to the requirement that the home office approve each loan. Banks have used loan production offices particularly for commercial lending. In fact, many large banks service a national market for business loans through their loan production offices. Banks have also used traveling loan officers to service the interstate commercial market.

²Donald Baer, “Behind Miami’s Surge in International Banking,” *Economic Review*, Federal Reserve Bank of Atlanta, April 1981, p. 12.

¹McFadden Act. PL 639, 69th Congress, p.5.

Acquisition. By law, a bank may purchase up to 4.9 percent of another bank's stock, regardless of the acquired bank's location. Recently, banks have increased such purchases in an attempt to be in position for full-scale interstate acquisitions. Some banks have made still more extensive commitments. For example, in 1980 Citibank bought non-voting preferred stock of Central National of Chicago, the parent of Central National Bank, and received a 15-year option to purchase 27 percent of its common stock in the event that interstate laws change. Chase acquired a similar stake in Equimark Corp. of Pittsburgh.

. . . AND DOMESTIC BANK HOLDING COMPANY EXPANSION . . .

Banks also have tried to break down interstate barriers through their parent bank holding companies in a variety of ways.

Acquisition of Banks. The BHCA actually has provided some leeway for banks to expand geographically, both interstate and intrastate. One route appears in Section 3(d) of the Douglas Amendment which allowed BHCs to acquire out-of-state banks where

the acquired bank's state so authorized. Prior to 1980, only two states exercised that option, and their actions have had little effect on interstate expansion. Since 1956, Iowa has allowed a grandfathered out-of-state BHC to make additional acquisitions; in 1978, Maine permitted out-of-state BHCs to acquire Maine banks if Maine received reciprocal treatment. Since no other states have granted reciprocity, Maine's law has had no real effect (see INDIVIDUAL STATE LAWS). In 1980, South Dakota changed its law to allow limited out-of-state BHC entry. Delaware enacted similar legislation in 1981 (see INTERSTATE BANKING AND THE THIRD DISTRICT overleaf). As of July 1, 1982, Alaska allowed unrestricted entry of out-of-state BHCs.

Grandfathered Institutions. In western and north central states, interstate multibank holding companies, in existence prior to 1956 and "grandfathered" by the Douglas Amendment, have an established and growing presence in full-service banking. Among these regional groups, First Interstate Bancorp, formerly Western Bancshares, is particularly aggressive in interstate banking. It has 22 banks in 11 western states with 900 branches

INDIVIDUAL STATE LAWS

Iowa: This state allows one out-of-state BHC, grandfathered by the Douglas Amendment in 1956, to acquire additional banks in the state, subject to a ceiling of 8 percent of the state's deposits.

Maine: Maine has allowed out-of-state acquisition since 1978 only if there is reciprocity: the home state of the acquiring BHC must give Maine BHCs no less restrictive treatment. Since no other states have enacted reciprocity legislation, no out-of-state BHCs own Maine banks. Maine currently is considering dropping the reciprocity condition to make Maine banks more attractive targets for acquisition.

South Dakota: This state passed legislation in 1980 permitting out-of-state BHC activity, subject to certain restrictions. The BHC could acquire, in a location not likely to draw customers from existing banks, a single *de novo* bank run as a bank and/or a service affiliate. The BHC could not expand beyond a single banking office by merger or acquisition. Citibank moved its credit card operation to Sioux Falls in 1981 to avoid the usury laws and limits on annual fees imposed in New York.

Alaska: The Alaskan legislature recently passed a bill authorizing out-of-state BHCs to acquire and to operate full-service banks in Alaska without requiring reciprocity. As of July 1, when this bill went into effect, Alaska's policy became the most liberal to date.

and several hundred automatic teller machines (ATMs). Recently, it started the formation of a nationwide ATM network and announced plans to franchise its name and to sell services nationwide. The first bank to acquire the franchise was the First National Bank in Golden, Colorado, since renamed the First Interstate Bank of Golden.

Bank-Related Activities. Considerable expansion, particularly since 1970, has occurred via the second possible route—bank-related activities. The BHCA allowed holding companies to engage in certain nonbank activities approved by the Federal Reserve Board. While the Act contained no explicit geographic restrictions, two things militated

INTERSTATE BANKING AND THE THIRD DISTRICT

How does the Third Federal Reserve District, comprising eastern Pennsylvania, southern New Jersey, and Delaware, fit into the interstate banking picture? Has its experience been typical? Two things differentiate the Third District from other districts: location and the banking laws of Delaware.

Location. The location of the Third District decidedly has influenced the way interstate pressures have developed. All three states, perhaps with an eye on New York banks, prohibit out-of-state banks from operating loan production offices within their states. However, that restriction does not guard against traveling loan officers. It also does not apply to out-of-state BHC subsidiaries, which are very active in consumer and mortgage finance.

With New York the preferred location, only two foreign banks have offices in Philadelphia and only two out-of-state companies have Edges in the Third District.* Two Philadelphia banks, Fidelity and Girard, have Edges in New York. There is no grandfathered interstate banking activity in the Third District, so no pressure comes from that source. Activity of Third District institutions in ATM network development contributes additional, but not unusual, pressure.

In general, many banks have faced considerable interstate competition because of their location. The nearness of New Jersey and eastern Pennsylvania banks to New York and of southern New Jersey banks to Philadelphia has produced more interstate competition than in many areas. Specifically, Third District banks probably have faced more interstate competition from money-market funds than banks in many other areas. The proximity of New York, where many of the major funds are located, presents consumers with extensive radio, TV, and newspaper advertising. Within the district, there is interstate pressure from the sizable Delaware Fund in Philadelphia.

The presence of Philadelphia, the fourth largest city in the U.S., in the Third District places it in a strategic position vis-à-vis potential interstate competitor. A Philadelphia bank, Industrial Valley Bank & Trust Co. (IVB), Pennsylvania's twelfth largest bank, was the target of one of the more extensive recent bank stock acquisitions deals. Marine Midland of Buffalo, N.Y. gave IVB a capital infusion of \$24.7 million in exchange for 4.9 percent of its outstanding stock plus the future sale of \$22 million of nonvoting preferred stock and warrants to buy another 20 percent of common stock if interstate law changes.

Many large Philadelphia banks view themselves as potential takeover targets of New York banks and are planning to fight for survival as independent regional banks or to merge, depending on the assessment of their chances. The reactions of banks to actual or potential interstate competition have differed and will differ reflecting their location and their respective state laws. For instance, both New Jersey and Delaware have statewide branching, while Pennsylvania, in part reacting to

*The two foreign banks are Bank Leumi Le Israel and Bank Hapoalim. The two out-of-state institutions with Edge Act Corporations in the Third District are First Maryland International Banking Corporation with an Edge in York and Continental Bank International, a subsidiary of Illinois National Bank & Trust Co. of Chicago, with an Edge in Philadelphia.

interstate pressures, recently changed its law to allow banks to branch two counties away from their home office (instead of one) and to branch into Philadelphia and Pittsburgh. The new law also authorizes limited BHC expansion statewide. The first major development based on this change was the merger of the holding companies of Pittsburgh National Bank and Provident National Bank of Philadelphia into PNC.

Delaware. What differentiates the Third from other districts to date is Delaware's new banking legislation, passed in 1981. Since 1956, under the Douglas Amendment to the BHCA, a BHC has been able to acquire a commercial bank in another state only if specifically authorized to do so by the other state's laws. The Financial Center Development Act in Delaware now allows such acquisition subject to certain conditions. The amended section 803 of the Delaware code states that "an out-of-state bank holding company or any subsidiary thereof may acquire and hold all or substantially all of the voting shares of a single bank located in this State" if the acquired institution: is a *de novo* bank with a single office open to the public; has a minimum capital stock and paid-in surplus of \$10 million when it opens and \$25 million within one year; employs not less than 100 employees within one year; and "is operated in a manner and at a location that is not likely to attract customers from the general public in this State to the substantial detriment of existing banking institutions located in this State."[†]

While the new law did limit the scope of out-of-state BHC activities, it represented the most liberal state legislation prior to July 1982. In addition, Delaware abolished its usury ceilings and permitted annual fees for credit card users. Since these changes occurred, Girard Bank of Philadelphia has purchased Farmers Bank of Wilmington, owned by the State of Delaware and the FDIC, and has renamed it Girard Bank Delaware.[‡] Out-of-state BHCs which have acquired *de novo* offices directly or via a subsidiary are J.P. Morgan, Philadelphia National Bank, Provident National Corp., First Maryland Bancorp, Chase, and Chemical. The Teachers Service Organization, a consumer finance organization in Pennsylvania, has acquired control of the Colonial National Bank of Wilmington to expand into electronic funds transfer.

Delaware has been forward looking on two counts. First, the influx of out-of-state banks and the probable entry of foreign banks will bring additional employment yet minimum short-run competition under the strict provisions of the Act. Second, if interstate laws are changed, Delaware will be in an excellent position to benefit from the expansion of those banks, as well as its own. Delaware's move may well have added another to the growing list of pressures on geographic restrictions.

[†]Amendment to Title 5, Delaware Code, House Bill No. 28, House of Representatives, 131st General Assembly, p. 2.

[‡]This specific arrangement depended on additional legislation.

against expansion in the period from 1956 to 1970. First, the short list of activities allowed by the Board did not include many with the potential of a large market area. Second, in administering the Act, the Board often deferred to the spirit of McFadden and put geographic limits on holding companies similar to those on banks.³

The 1970 amendment to the BHCA paved

³The *Supervision and Regulation of Bank Holding Companies: An Assessment of Objectives and Implementation* (Washington: Association of Bank Holding Companies, 1978), p. 140.

the way for a substantial increase in interstate operations. The Fed expanded the number of permissible BHC activities and specifically stated that the Act contained no *geographic limits* to these activities.⁴ BHCs

⁴Activities permitted by the Federal Reserve for Bank Holding Companies under Section 4(c)(8) include:

1. management consulting for nonaffiliated banks and nonbank depository institutions under certain conditions.
2. full payout leasing of personal and certain real property.
3. mortgage banking and servicing loans.
4. consumer credit, industrial bank operation.

subsequently achieved a sizable interstate presence with offices dealing in consumer finance, mortgage banking, leasing, investment advising, management consulting, trust, and reinsurance services. For instance, by 1980 Citicorp had 229 consumer and mortgage finance offices in 55 cities.⁵ The Fed also allowed interstate expansion of BHCs through acquisition of industrial banks and similar institutions deemed "near-banks." Only limited expansion has taken place via this route, however, since not all states have such near-banks, which usually tend to be small and few in number even where they do exist.

... ALONG WITH FOREIGN BANKING INSTITUTIONS ...

Foreign banks and BHCs form one banking group with an interstate presence in both asset and liability services. As of March 1982, there were 164 foreign banks in the U.S.; half were operating in more than one state.⁶ In recent years, they have expanded dramatically, with assets rising from \$20 billion in 1972 and \$40 billion in 1976 to over

\$160 billion in 1981.⁷ Such multistate, full-service bank expansion created an anomaly in the U.S. banking structure. Foreign banks could branch across state lines where domestic banks could not.

The International Banking Act, directed at this inequity, forced foreign banks to choose a home state (where they could branch if allowed) for full-service banking, although it did grandfather existing operations. It also limited deposit taking in other states to international trade activity—the same restriction applicable to an Edge corporation. Foreign banks have followed domestic banks in circumventing branching restrictions by expanding the number of their Edges. Seven of the sixteen new Edges set up in 1981 belong to foreign banks.⁸

The IBA notwithstanding, foreign bank development has led to another structural inequity. Foreign banks have been able to acquire banks in desirable locations which interstate and antitrust restrictions put out of reach of domestic banks. One example is the purchase of Marine Midland Bank of New York by the Hong Kong & Shanghai Banking Co. in 1980. Another is the merger of Crocker National Bank of California with Midland Banks of England. In both cases, the foreign parent has obtained an excellent foothold for expansion in the event of a collapse of interstate barriers, and the domestic bank has received a capital infusion to strengthen its competitive position with other U.S. banks.

... MEAN A SUBSTANTIAL INTERSTATE PRESENCE

Taken together, the inroads on interstate and national markets made by banks directly or through BHCs constitute a sizable end run around the geographic boundaries imposed on banking by McFadden and Douglas. Most of this circumvention has occurred through

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5. commercial finance and factoring.
 6. providing trust services/company (fiduciary).
 7. investment advisory.
 8. investing in community welfare projects.
 9. data processing and bookkeeping services.
 10. acting as insurance agent or broker where insurance is connected with the extension of credit in community of less than 5,000 people.
 11. underwriting credit insurance (reinsurance).
 12. armored car and courier services on explicit fee basis.
 13. operating credit card company.
 14. economic information and advisory.
 15. selling traveler's checks, U.S. savings bonds, and money orders.
 16. check verification service—on a case-by-case basis.
 17. real estate appraisal.

See Carter H. Golembe and David S. Holland, *Federal Regulation of Banking* (Washington: Golembe Associates, 1981), p. 117, on geographic limits.

⁵ *Federal Reserve Bulletin*, January 1980, p. 3.

⁶ *American Banker*, March 26, 1982, p. 60.

⁷ *Treasury Bulletin*, Capital Movements, Table CM-I-1, March 1982.

⁸ *American Banker*, May 24, 1982, p. 1.

expansion of asset services since the law has provided more such opportunities than for liability services. In fact, interstate banking on the asset side of the balance sheet is already here. Traveling officers, loan production offices, Edges, and BHC subsidiaries all represent ways banks have pursued profit in asset holdings across state lines. Additionally, some banking institutions—foreign banks and grandfathered interstate BHCs—have significant interstate operations in both asset and liability services.

These successful efforts to get around geographic limits have not brought about any Federal changes in interstate banking laws so far. Despite many banks' desire to go interstate, the pressure for change has not been sufficient to outweigh that for the status quo and to cause the demise of McFadden and Douglas. Having stood intact for many years, is there any reason why these laws should soon fall? The recent spate of out-of-state acquisitions by banks gives a clue to the answer. Why would banks take these steps unless they perceive high odds that the laws will change? Why should that change occur today or tomorrow rather than yesterday?

CROSSING THE LAST BOUNDARY: TAKING DEPOSITS

Modifications of the laws are likely because a fundamental change in the economics of banking is underway. The catalysts for this change have been developments in electronic funds transfer and related computer services which have dramatically improved efficiency and lowered costs. The high opportunity cost of money has spurred more efficient use of funds and adoption of lower cost, electronic media.

Electronic developments have enabled the traditional suppliers of financial services—commercial banks—to lower the costs of existing services and to offer new ones. Electronics also has spurred nonbank suppliers of financial services to move into retail banking markets with substitutes for some bank services. The eventual demise of current geo-

graphic restrictions will occur because electronic transfer is rendering state lines even more meaningless for many bank services, particularly deposit taking.

ELECTRONICS AND COMMERCIAL BANKS

The greatest challenge to McFadden came in the form of the automatic teller machine (ATM) in the early 1970s. ATMs made deposit taking across state lines possible without new banking offices. Court interpretation of ATMs as equivalent to brick-and-mortar branches, however, upheld the theory of McFadden and stymied immediate development of ATMs in interstate activity. Nevertheless, banks increased their use of ATMs. Facing large investment costs for computer equipment and uncertain demand for retail electronic services, banks either joined forces with other institutions in sharing facilities, sold services to other institutions, or bought them from a nonbank vendor. X-press of Baybanks, Massachusetts is an example of a shared ATM system, while Mac, operated by Philadelphia National Bank, is one of many proprietary networks formed by a bank that sells services to other banks. Tyme, operated by A.O. Smith, Inc., is a network run by a computer service company. Network formation has enabled small and medium institutions to reap the benefits of economies of scale from large computer systems and to offer the latest in efficient service.

Although no deposit taking across state lines is allowed, many networks serve institutions in several states (see ATM NETWORKS IN THE THIRD DISTRICT overleaf). A direct challenge to McFadden currently is developing with the formation of nationwide ATM systems. At least three different groups are considering the linkage of existing networks into a nationwide network. Eleven multi-billion-dollar banks have formed a shared network named Cirrus which will link more than 4,000 ATMs nationwide. Another, the Regional Interchange Association (RIA), represents a cooperative effort of sev-

eral networks to provide internetwork, national switching for more than 2,500 ATMs. These networks would provide 24-hour banking services on a nationwide basis at a minimal cost to the customer.

With existing interstate networks and the potential of national ones, the stage is set for interstate and nationwide deposit taking. Interstate banking on the liability side is a technical reality. With the innovation of electronics in ATMs and related computer services has come a drastic reduction in the cost of transferring funds and information. The economics of deposit taking across state lines has changed from high-cost brick-and-mortar branches to low-cost ATM facilities. Such low-cost, electronic funds services and the geographic restrictions of state lines are incompatible. These economic forces should prove too strong for the legal barriers to withstand.

ELECTRONICS AND NONBANKS

Inexpensive computer services and funds

transfer have enabled nonbank institutions to move into some traditional retail banking services to take advantage of the current high interest rate environment. The variability of interest rates has created a desire for liquid investments. Money-market mutual funds have met this demand with a variety of innovative products, among them highly liquid accounts with check writing facilities that pay a market rate. Banks, subject to Regulations Q and D and unable to pay market interest rates, have experienced a considerable outflow of dollars to money funds.⁹ While banks have regained many of these dollars through deposits by money-market funds, they are legitimately concerned at losing direct contact with the retail customer who can now bypass the local commercial bank to a large degree.

For the issue of interstate banking, the

⁹Regulation Q limits the interest rates banks may pay on deposits; Regulation D covers reserve requirements.

ATM NETWORKS IN THE THIRD DISTRICT

Two Philadelphia banks have developed extensive ATM systems. Girard Bank, via Girard Services, operates a network of 200 ATMs named George and sells complete data processing services to other financial institutions outside its immediate area. The network includes institutions in Pennsylvania, New Jersey, and Delaware. Recently, it received permission from Banking Commissions in Pennsylvania and Delaware for customers of Girard (Pa.) and Girard (Del.) to withdraw cash from George in either state, although they cannot make deposits. New Jersey does not allow such cross-state interchange.

Philadelphia National Bank operates the other large network—Mac (Money Access Center)—for all types of financial institutions. The number of participating institutions recently expanded to 85, 66 of which are in eastern Pennsylvania and 19 in New Jersey. They will operate 400 ATMs, up from 244 in March 1982. Currently, there is no cross-state access, although the capability exists.

Three New Jersey institutions, Fidelity Union Bank, The Summit Bancorporation, and First Jersey National Corporation, jointly operate The Treasurer, a smaller network of 60 ATMs. Six banks in Pennsylvania and Delaware agreed in March to join this network of about a dozen institutions in anticipation of changes in interstate banking laws.

Following the trend of large banks in joining recently formed nationwide networks, Philadelphia National Bank has joined Mac with Plus Systems, Inc. which will provide switching services for a national network. Members of Plus will share some or all of their ATMs with other members' customers. Other large Philadelphia banks probably will join different nationwide groups, given the existing trend for large competing institutions not to belong to the same network.

importance of the money-market funds lies in their checkable accounts. It is through this channel that interstate deposit taking is occurring and will expand. While ATMs currently do not figure in these services, the possibility of access to money funds through ATMs or home and business computers is not remote. Thus, interstate deposit taking by money-market funds could occur electronically as well as by mail and telephone. Several funds already provide something very close to one-stop financial service. A link with ATMs will help close the gap.

Low-cost electronic transfer also is prompting the newest threat to interstate barriers. With an enormous nationwide marketing structure and experience in selling insurance, Sears, a national retailer, plans to sell a variety of financial services. One of its first offerings was a money-market fund based on government securities. Although this fund currently does not offer transactions accounts, the potential exists. Sears made an additional step in mid-June. It opened its 851 customer service counters to check cashing for the clients of Dean Witter, the brokerage house it merged with in 1981. In the context of interstate banking, the possibility that Sears might have a "bank" in all its locations with systemwide access challenges the limits of state lines and implies considerable potential competition for many banks. The technology Sears is using will enable other corporations also to go nationwide with marketing of financial services.

Interstate banking is a reality whose time has come. If the legal barriers do not fall as the economic ones have, interstate banking will move on a large scale into the nonregulated, nonbank sector, leaving commercial banking to perform a narrower set of services than consumers desire.

CONCLUSION

Over the years, many banking institutions have taken advantage of the leeway in the law to pursue business opportunities across state lines. They have used Edge Act Corpo-

rations, loan production offices, traveling officers, and subsidiaries in bank-related activities to create interstate or nationwide markets for their services. While this expansion has occurred primarily in asset services, foreign banks and grandfathered interstate BHCs have an established and growing interstate presence in full-service banking. Despite a buildup of considerable interstate competition and pressure on legal geographic limitations, the McFadden Act and the Douglas Amendment remain unaltered. Why should changes occur now?

The economics of interstate banking has changed dramatically. Electronic transfer of data and funds not only makes interstate asset services cheaper but also renders interstate deposit taking economically feasible for banks on a larger scale. Previously, the cost of brick-and-mortar branching posed an economic barrier to expansion alongside the legal one. Banks now can cross state lines to take deposits at a relatively low cost. Electronic developments also have enabled other financial institutions to offer a wide variety of financial services, including deposits, on an interstate and nationwide basis.

Small and medium-sized banking institutions recently have accompanied large banks in a scramble for an interstate presence. These banks have joined or formed ATM networks with an interstate market area, while large banks are joining or organizing nationwide networks. Many medium-sized banks have bought shares of banks in neighboring states, and some of the nation's largest banks have made long-run acquisition deals dependent on changes in interstate banking laws.

Why would banks take these steps without the ability to take deposits across state lines? Some banks are challenging the law because technological change has made electronic funds transfer a low-cost, viable vehicle for banking services. Electronic funds transfer defies geographic boundaries. The economic argument for interstate banking is irrefutable. Can the legal changes not follow suit?



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SERVICES OF TOMORROW, TODAY

Delaware Valley Defense Industry Update: Is Better Information the Way to Greater Growth?

by John J. Mulhern*

Like many another area of the Northeast, the Delaware Valley continued to be plagued by a sluggish economy overall in 1981. With Defense spending projected to achieve year-over-year real increases, some observers looked to Defense business as a source of economic relief.

During the 1970s, when Defense spending was flat or declining, many areas of the country, including Philadelphia, were more concerned with employment at local Defense installations than with Defense contracts. In fact, just about the only game in town was to hang on to the Defense infrastructure—bases, stations, forts, centers, and offices—in anticipation of a Defense revival later on. Now, though, the situation is different. A contract boom has arrived, and a shift in focus is called for.

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One approach to winning more contract dollars would be to try to increase the number of Defense prime contractors in the region. Attention to numbers of prospective prime contractors is warranted, certainly, especially in the case of those small businesses that typically foster technical innovation. But there are other routes as well. One such approach is to concentrate on bringing more dollars into the region by capturing very large awards. While dependence on too few large contracts may produce undesirable risks, landing the big contracts also may bring economic benefits to a variety of firms, and small businesses may have opportunities as subcontractors that they would lack as prime contractors to profit from Defense business.

The areas of the country that are most successful with Defense business in the years ahead are likely to be those that concentrate not only on increasing the dollar value of their Defense prime contracts, including very large ones, but also on developing the subcontractors and suppliers that will keep Defense dollars in the area for an extended period. Using information to link

prime contractors with nearby subcontractors can be good for the country at large as well as for the region if it promotes production efficiencies and restrains costs.

1981: A YEAR OF PROMISE

Widespread concern with U.S. national security, which had broken the surface in 1979, made itself felt in contract awards and other measures of Defense Department activity in fiscal 1981. Increases in the Defense budgets for 1981 and 1982 had been shaped by the Carter Administration before it left office, and the Reagan Administration moved swiftly to enlarge those increases. Amendments submitted to Congress in March 1981 were a signal of what might follow in the 1983 budget. This signal was confirmed by subsequent Administration proposals. Vendors who were attuned to developments in the Defense market responded rapidly to meet new requirements, and in doing so they positioned themselves to compete effectively for Defense business.

How well has the Delaware Valley responded to growth in the Defense market? So far as employment at Defense Department installations is concerned, the number of people employed locally was up somewhat in 1981, and it probably will stay up for the next two years. Contract activity was higher as well. The region showed a small gain in market share of Defense prime contract awards. These awards opened up new opportunities for firms that wanted to participate in Defense business by subcontracting and providing supplies to major Defense prime contractors.

DESPITE DOD EMPLOYMENT GROWTH, CONTRACT AWARDS DOMINATE

The Philadelphia area houses a large concentration of Defense installations. Some of these installations do the kind of buying that is reported in contract awards, while others are engaged in such functions as manufacturing, research, training, and administration. Many are inside the city.

Together they affect the local economy by employing thousands of people (mostly civilians) directly. And the number of jobs at installations in the Philadelphia area did grow as Defense tried to speed up its activity in fiscal year 1981.

Defense Hires More People . . . The experience of the Defense Logistics Agency's Defense Contract Administration Service (DCAS) provides one example of the kind of growth that occurred. DCAS, which maintains both a regional headquarters and a management area office in Philadelphia, is responsible for production surveillance, quality assurance, financial services, disbursements, and other services connected with contracts awarded by Defense Logistics Agency purchasing activities, military departments, civilian agencies, and foreign governments. The Philadelphia offices saw personnel growth of 5 percent in fiscal 1981, raising their employment from 793 to 835. This increase can be attributed in part to the number of contracts being administered and in part to their degree of complexity.¹

Another source of continued high levels of employment was the Philadelphia Naval Shipyard. The Yard's permanent workforce, which had shrunk to around 7,000 in 1979,

¹The Defense Logistics Agency provides a variety of logistics support services and supplies that the Armed Services use in common. The Philadelphia DCAS region includes management area offices in Baltimore, Pittsburgh, and Reading as well as in Philadelphia. Employment in all regional DCAS offices grew from 1,497 in 1980 to 1,559 in 1981, or about 4 percent. So far in 1982 the numbers appear to be higher—up 9 percent in Philadelphia and 7 percent in the DCAS region overall. (Here as elsewhere in this article, all references to years are to Federal fiscal years.) The numbers given here are authorization numbers, but they do not differ appreciably from actuals.

The number of contracts in hand in the DCAS region at the end of 1981 was up by over 8 percent over the previous year and approached 44,000, with face value of nearly \$13 billion. The number of separate invoices processed increased to almost 142,000, up from 114,000. (These figures were supplied by the office of the Commander, Defense Contract Administration Services Region Philadelphia.)

was up above 9,500 through much of fiscal 1981, right around its Congressionally authorized ceiling, because of work in progress on the Saratoga and on other ships. These numbers were increased by the addition of about 1,000 temporary workers. Thus the Naval Shipyard has been a sizable employer of skilled labor (see NAVAL SHIPYARD JOBS: WHO GOT THEM?).

Looked at in aggregate terms, employment at Defense installations in the Philadelphia area has grown faster than the national rate. According to recent information, DOD employment nationwide (military and civilian) was up 1.2 percent in 1981 to 2,300,000.² The percentage increase in Philadelphia County alone

was considerably higher, at 5.7 percent for civilians and 6.1 percent for the total—enough to keep Philadelphia in ninth place among concentrations of Defense direct-hire employees. Although some other places in the region took losses in DOD personnel, Philadelphia showed a solid increase in direct-hire employment (see PHILADELPHIA LED THE REGION . . . overleaf).

Over the longer haul, though, it could be

²Department of Defense, Washington Headquarters Services, Directorate of Information, Operations, and Reports, DIOR Report MO2, "Distribution of Personnel by State and by Selected Locations," Fiscal Year 1980, p.3, and Fiscal Year 1981, p. 5.

NAVAL SHIPYARD JOBS: WHO GOT THEM?

Defense installations provide fairly large numbers of jobs, but how effective are they at spreading those jobs around to members of different socio-economic groups? If the Philadelphia Naval Shipyard is representative, they have been very effective.

The Yard hires people for all sorts of positions, from work-study trainee to senior executive. At the end of September 1981, 22 percent were general schedule (mainly white collar) employees while 77 percent were craftsmen; laborers made up the remaining one percent. Thus skilled jobs predominate. Overall full-time employment stood at 10,040 — an 11 percent change from a year before.* Adding in part-time workers would raise the total over 11,000.

Members of minority groups made up a significant and increasing portion of the work force. In October 1980, minorities made up 23 percent of the work force. By August 1981, their numbers had risen to 31 percent.† Further, the Yard continues to operate an aggressive recruitment program to identify minority prospects.

The current regulatory authority for the Yard's effort along these lines is the Department of the Navy FY 1982-86 *Affirmative Action Program Plan and Federal Equal Opportunity Recruitment Program Plan* issued by Navy Secretary Lehman in February 1982. This document includes: a profile of the Navy civilian workforce (about 300,000 employees) by occupation, level, race, ethnicity, and gender; a report of underrepresentation calculations by civilian labor force and relevant labor force; five-year goals; and, perhaps most interesting, an analysis of the barriers to employment with strategies for overcoming those barriers.

The barrier analysis lists 15 internal barriers (for example, "lack of societal encouragement for women and minorities to pursue professional occupations") and 16 external barriers ("minimal availability of underrepresented group members in applicant pools"). Recruitment strategies — say, "encourage women to apply for positions which have been traditionally held by males only" — are suggested by the Navy to overcome barriers to employment at different levels in different skill groups.

*Based on *Department of the Navy Minority Census*, Date 110380, p. 439 and Date 110781, p. 3149.

†*Command Profile*, p. 9.

disappointing to bank on DOD employment as a source of growth for the region. The reason is that the Defense establishment, in tune with the rest of the Federal government, plans to reduce personnel ceilings in the years ahead. While the number of direct-hire civilian employees nationally is scheduled to stand at 936,000 in fiscal years 1982 and 1983, it will drop by 6,000 per year thereafter through 1986, falling close to its 1980 level. Part of this reduction is expected to be made up by internal productivity improvements, part of it by contracting out to private firms work of the kind that used to be done by government employees. Overall Federal employment already is declining both in absolute numbers and as a percent of the population.³ For these reasons, private-sector contracting probably offers greater

opportunities for growth in the longer term.

. . . But Contracts Show Larger Gains. Military prime contract awards over \$10,000 in the area stood at \$2.1 billion in fiscal year 1981, up from about \$1.5 billion in 1980 (awards under \$10,000 would amount to about another \$170 million if the national ratio holds).⁴ Even in inflation-adjusted terms, the increases were considerable—about 25 per-

³James W. Abellera and Roger P. Labrie, "The Five-Year Spending Plan," *AEI Foreign Policy and Defense Review* 3 (4,5), p. 17, Table 13. See also *The Budget of the United States Government, 1983, Special Analysis I: Civilian Employment in the Executive Branch, February 1982*, p. 13, Table 1-4.

⁴DIOR Report P12, "Prime Contract Awards Over \$10,000 by State, County, Contractor, and Place," Fiscal Years 1980 and 1981. The region or area is defined as the Philadelphia Standard Metropolitan Statistical Area—three counties in New Jersey (Burlington, Camden, Gloucester) and five in Pennsylvania (Bucks, Chester, Delaware, Montgomery, Philadelphia). While many of the numbers in this article apply to the SMSA and its counties, the thrust of the article applies to the region more widely conceived—to the 11-county area of the PENJERDEL Council, to the Third Federal Reserve District, and to the Middle Atlantic census division (New Jersey, New York, and Pennsylvania). The Defense budget's three main buying categories—procurement, research, and construction—are reflected in contract awards. Procurement is the largest, at about \$65 billion of total obligation authority in FY 1982. Procurement dollars go for a wide range of supplies and services including both systems (airplanes, tanks, radars) and commodities (construction materials such as plywood and concrete, industrial materials such as wire rope and bar stock). Research—actually research, development, test, and evaluation—is the next largest buy at about \$20 billion. Construction comes next, at around \$7 billion of total obligation authority in FY 1982.

While small (under \$10,000) purchases are not reported by region, their impact can be considerable. In FY 1981, for example, the Defense Industrial Supply Center in Northeast Philadelphia spent 55 percent of its \$510-million budget for industrial hardware through small purchases. As a result of the DOD Acquisition Improvement Program, the limit on the use of simplified purchase procedures has been raised from \$10,000 to \$25,000, and many actions under simplified procedures have a fast pay provision. On these actions, contractors may be paid based on an invoice certifying that shipment has been made, even if the shipment has not arrived at its destination. Fast pay can have a strong positive effect on the cash flow of small businesses.

PHILADELPHIA LED THE REGION IN DEFENSE PERSONNEL GAINS

Fiscal Years 1980-1981

| | 1980 Personnel | 1981 Personnel | Percent Change |
|---------------------------|-------------------|-------------------|-------------------|
| Philadelphia | 25,694 | 27,268 | +6.1% |
| Fort Dix | 11,918 | 11,863 | -.5 |
| McGuire AFB | 6,862 | 6,747 | -1.7 |
| Dover AFB | 6,239 | 5,995 | -3.9 |
| Warminster | 2,376 | 2,350 | -1.1 |
| Horsham & Willow Grove | 1,793 | 1,843 | +2.8 |
| Total | 54,882 | 56,066 | +2.2 |

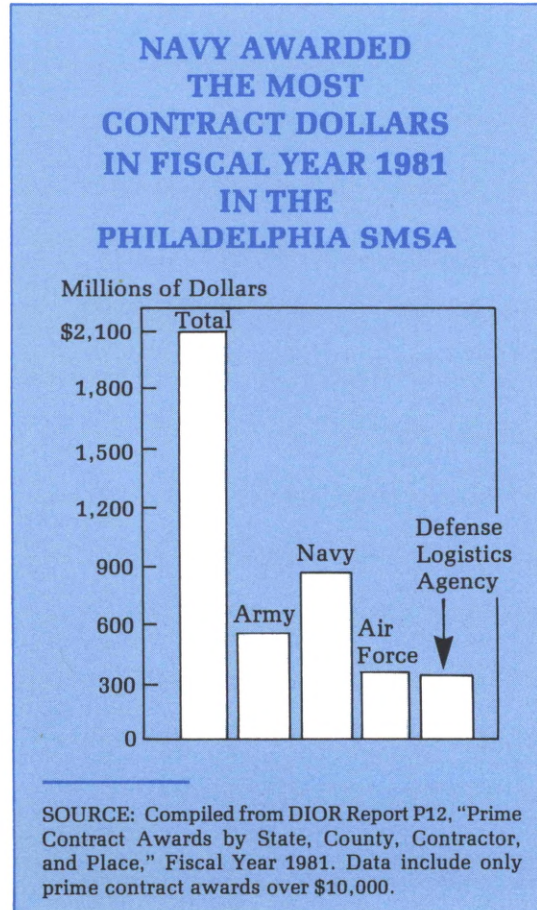
SOURCE: DIOR Report M02, "Distribution of Personnel by State and by Selected Locations," Fiscal Years 1980 and 1981. Figures are totals for military and civilian personnel for all services and Defense agencies.

cent for large prime contract awards.⁵ Thus they signal a real positive effect on regional wealth (see NAVY AWARDED THE MOST CONTRACT DOLLARS.)

In comparison to the nation overall, though, this area's growth was less spectacular. In fiscal year 1980 the national total for large (over \$10,000) prime contracts awarded to business firms stood at \$68 billion, of which the area had 2.2 percent.⁶

⁵Based on a change in the Philadelphia CPI of 10.8 percent.

⁶DIOR Report P06, "Prime Contract Awards by Region and State, Fiscal Years 1979, 1980, 1981," p. 5, Table A, Awards Distributed to Regions and States. This



With the national total at \$88 billion in 1981, the region had about 2.4 percent.⁷ This percentage is larger than the region's share of the national population (4.7 million out of 226.6 million, or 2.1 percent according to 1980 census data), but while it shows some growth in market share, that growth is small.⁸

Within the region, the greatest percentage growth in contract award dollars occurred in Pennsylvania's Chester County and Delaware County and in New Jersey's Burlington County. One part of the explanation for higher growth in these counties may be the presence there of some of the area's largest Defense manufacturing firms.⁹ Very large

figure is used because it is consistent with the county figures for prime contract awards in DIOR Report P12, "Prime Contract Awards Over \$10,000 by State, County, Contractor, and Place"—the source used here for local contract award figures. Awards Distributed to Regions and States equals Total Prime Contract Awards minus: Work Performed Outside the United States; Actions of \$10,000 or less; and Awards Not Assigned to a State for some other reason (about 3 percent of the total).

⁷DIOR Report P06, 1979, 1980, 1981.

⁸U.S. Department of Commerce, Bureau of the Census, *1980 Census of Population and Housing, Standard Metropolitan Statistical Areas and Standard Consolidated Statistical Areas: 1980, April 1981, PC80-S1-5, p. 1, Table A, and p. 34, Table 1.*

⁹Through fiscal year 1980, the Community Services Administration compiled county data on DOD outlays under five classes of large prime contracts: civil functions; military construction; military research, development, test, and evaluation; military services; and military supplies. It compiled county data also on DOD small contracts (those worth less than \$10,000). For fiscal year 1981, prime contracts have been reclassified into three groups for reporting purposes: small military and civil; large civil functions; and large military functions. Further, these numbers are available only as statewide aggregates. Thus the 1980 county data are the latest that permit even a gross sectoral analysis.

In preparing this article, the series consulted most frequently were total obligation authority and prime contract awards. In John J. Mulhern, "The Defense Sector: A Source of Strength for Philadelphia's Economy" (*Business Review*, Federal Reserve Bank of Philadelphia, July/August 1981), the focus was on outlays and, to a lesser extent, shipments—two series well adapted to a retrospective analysis. *Business Conditions Digest* pro-

hardware contracts require very large firms—firms that are broad and deep financially, managerially, and technically. The industrially developed outer counties (all but Gloucester) have such firms. Lower land values and taxes along with changes in production technology and improved transportation facilities have operated over a long period of time to make the outer counties more attractive to large manufacturing operations. Burlington, Camden, Delaware, and Montgomery all have firms that compete successfully for major weapon systems contracts, and in the aggregate they handle far more in such contracts than Philadelphia does. Since the big money goes to systems contracts, it goes to the suburban counties.

The flow of money to the outer counties doesn't come to rest, of course, in the treasuries of the large prime contractors. Through their subcontracting and supply purchasing, this money is spread around to a myriad of other firms, both large and small, in central city and suburban locations. Rather than being competitors for smaller firms, these large outfits offer a sizable secondary market over and above the part of the direct market in which smaller firms can be responsive as prime contractors.

In short, the outer counties did quite well with Defense contracts in 1981. Six of the seven enlarged their winnings of prime contracts at a nominal rate faster than the national average of 29 percent.¹⁰ Although Philadelphia County pulled the area's average down, with a nominal growth rate of only 2.6 percent, it probably could improve its

vides a useful set of leading, intermediate, and final indicators, though these classes have some overlap. For a discussion of the indicators see Glenn H. Miller, Jr. and Stephen L. Able, "Defense Spending and Economic Activity," *Economic Review*, Federal Reserve Bank of Kansas City, July/August 1980, pp. 3-14. For a discussion of the use of shipment data see Lynn E. Browne and Sarah Gavian, "The Importance of Defense to New England," *New England Economic Indicators*, Federal Reserve Bank of Boston, October 1981, pp. A4-A5.

¹⁰DIOR Report P06, 1979, 1980, 1981, p.2.

performance by focusing on industrial sectors where demand is strong, perhaps looking to the manufacture of components for the large contracting operations in the outlying suburban areas. Thanks to the advent of automated information systems, it has become possible to isolate the pertinent demand information at both national and regional levels.

ASSESSING THE DEMAND

The Department of Defense issues contract award reports which give information about past demand. It also generates forecasts of expected demand by industrial sector. This information can help put the experience of the last year into perspective.

In 1981, as in the two years prior, the lion's share of prime contract award dollars nationwide went to purchase aircraft, electronics, and missile and space systems. These and four other kinds of hard goods made up more than two-thirds of the dollar value of all large prime contract awards. Indications are that these items will continue to generate the highest dollar value of demand through 1987.

Overall, the Middle Atlantic census division, which includes New York as well as Pennsylvania and New Jersey, ranked fourth of nine in value of large prime contract awards in 1981, a step down from third in 1980. Middle Atlantic's strengths in both dollars and market share lay in aircraft and in electronics and communication equipment. Both of these sectors showed healthy dollar increases, at 26 percent and 16 percent; but again, the changes in market share weren't all that impressive. In aircraft there was a modest gain of a tenth of a percentage point, in electronics and communications equipment a loss of seven-tenths of a point. The other hard goods lines showed mixed results (see DEFENSE HARD GOODS . . .).

What about the future? While an exact call of anything in the future is a chancey business, the Department of Defense has projected its requirements in a document

known as the Five-Year Defense Program, and these requirements have been analyzed by industrial sector in the Defense Economic Impact Modeling System (DEIMS). Advance procurement commitments for items in the DEIMS forecast will tend to lock in future purchases.¹¹ Further, DOD has become very sensitive to the potentially disruptive effects of unexpected changes in purchase levels and over the last two years has sought to make buying activity more stable as part of its Acquisition Improvement Program. Thus it appears that the DEIMS model should be a useful predictor of demand for Defense

products and services.

The February 1982 DEIMS projections indicate that Defense spending on electronics and communication equipment will show an average annual growth of around 13 percent through 1987 and that Defense production in this sector will come to over \$26 billion (1981 dollars) in the last year of the period. Spending on aircraft and missile systems will be growing at a comparable rate, and 1987 dollar value for the two together will total \$22 billion. Further, Defense demand in these sectors will grow faster than commercial demand.¹²

¹¹The effect is to raise the cost of cancelling these commitments. According to Alan Greenspan as quoted in the *New York Times*, June 27, 1982: "Once the growth in obligations starts to accelerate, it becomes very difficult to control or slow the growth in total outlays. You cannot reverse commitments without heavy costs. That's one reason why the proposed cuts in defense have been so minuscule."

¹²See David L. Blond, "The Defense Economic Impact Modeling System," Office of the Secretary of Defense, January 1982. Sectoral tables from which these figures are drawn include 322 (radio and TV communication equipment), 45 (complete guided missiles), and 335 (aircraft). DEIMS tables are available to industry from the Defense Industrial Resources Support Office, Suite 1406, Two Skyline Place, 5203 Leesburg Pike, Falls Church, VA 22041.

DEFENSE HARD GOODS SHOW MIXED ACTIVITY IN MIDDLE ATLANTIC DIVISION

(Millions of Dollars)

| | Fiscal Year 1980 | | Fiscal Year 1981 | |
|---|---------------------|--|---------------------|--|
| | Divisional Value | Divisional Share of National Market | Divisional Value | Divisional Share of National Market |
| Aircraft | \$2,241 | 14.8% | \$2,825 | 14.9% |
| Missile and Space Systems | 596 | 6.4 | 768 | 6.7 |
| Ships | 917 | 14.7 | 1,363 | 17.5 |
| Tank-Automotive | 134 | 4.8 | 229 | 5.3 |
| Weapons | 348 | 26.1 | 145 | 8.6 |
| Ammunition | 194 | 9.5 | 267 | 11.5 |
| Electronics and Communication Equipment | 1,936 | 18.2 | 2,255 | 17.5 |

SOURCE: DIOR Report P06, "Prime Contract Awards by Region and State," Fiscal Years 1979, 1980, 1981, pp. 15-16. Data include only prime contract awards over \$10,000.

If these forecasts are anywhere near the mark, the lines of Defense business that currently show the most strength in the region could continue to show considerable vigor nationally. Whether the prime contract dollars come to this region and stay here, however, will depend at least in part on what kind of an economic development effort the region is willing to make. Use of demand information and of information on the industrial structure of the region both will be prominent parts of a successful development effort.

INFORMATION CAN SPUR LOCAL SUPPLY ACTIVITY

In the Defense market as in other markets, buyers must be matched to sellers if business is to be transacted, and this matching depends on information. Many observers believe that improving the information available to potential Defense contractors and local policymakers could help distribute the benefits of Defense prime contracts more widely in the region and provide a focus for job training efforts.

Concentration and Subcontracting. Defense prime contracting is highly concentrated in the Philadelphia area. Of the \$2.1 billion of 1981 large prime contract awards that was divided among over 1,700 area contractors, for example, over 50 percent of the contract value went to just three hard goods contractors and another 10 percent to an oil company; a little less than 40 percent or roughly \$800 million was left for the other 1,700-plus prime contractors (see DEFENSE BUSINESS IN THE THIRD FEDERAL RESERVE DISTRICT).

Much of the value of Defense prime contracts, however, may be subcontracted; the rule of thumb is one-half the value for hard goods awards. If local subcontractors are forthcoming, a high percentage of the subcontract dollars can be kept in the region. Thus subcontracting is a key issue.

Subcontracting is good business, especially for small concerns. In 1980, for ex-

ample, small businesses nationwide received about \$14 billion in Defense prime contract awards, and in 1981, about \$18 billion.¹³ In those same years, military subcontract commitments to small businesses from just the 1,100 firms that were required to report (because they held very large prime contracts) totaled about \$11 billion and \$13 billion; and no one knows how much else was subcontracted to small businesses.¹⁴ Even by a conservative estimate, small businesses did more than two-thirds as much business in subcontracting as they did in prime contracting.

For firms in the city of Philadelphia, emphasis on local subcontracting may be particularly attractive. Most of the local major primes are outside the city limits. In the first nine months of fiscal 1981, for example, fifteen of the seventeen local prime contractors that were required to participate in the DOD subcontracting program were based outside Philadelphia. They committed about \$287 million of the area's \$327-million subcontract program total, a third of which went to small business.¹⁵ The city has firms that can perform competitively as subcontractors and suppliers to these majors. The task is to get local primes and subs together.

Indeed, regional cooperation could play a crucial role in cutting the cost of doing Defense business, because on-site inspection is a feature of many Defense contracts. Quality control and quality assurance programs are used by Defense contracting offices to come as close as possible to a zero

¹³DIOR Report P03, "Prime Contract Awards," Fiscal Year 1981, p. 2-2.

¹⁴DIOR Report P03, Fiscal Year 1981, pp. 8-1, 8-2. Firms are required to report in the subcontracting program mandated by Public Law 95-507 only on contracts which individually are expected to exceed \$500,000 (\$1 million for construction). Thus a great deal of subcontracting is not reported under this program.

¹⁵DIOR Report P14, "Companies Participating in the Department of Defense Subcontracting Program," first nine months, FY 1981.

defects rate. In order to meet their own contract commitments, prime contractors often require inspections of their subcontractors' products or processes down to the lowest tiers. Prime contractors stand to benefit from buying their production inputs locally, since transportation and coordination costs drop sharply as distances between industrial plants become shorter. The contractor that can avoid frequent and costly inspection trips to distant plants may find himself at a competitive advantage.

The opportunities for gains from local subcontracting have been illustrated over the past two years by the Ocean Systems Division of Gould, Inc., which was the eighty-fifth largest Defense prime contractor in 1981. This Cleveland-based firm, which manufactures torpedoes and other underwater devices, developed a program to increase its subcontractor base in its own eight-county

area. As a result of the program, subcontracts were issued to 63 new firms in the first six months, approximately doubling local subcontract commitments from \$12 million to \$25 million. Gould estimates that the initial cost savings simply from increased competition in procurement, not to mention overhead savings related to control of the subcontracts, amounted to an average of 27 percent across the board.¹⁶ But building up the local subcontractor networks required cooperation and information.

Regional Information Initiatives. There are signs that regional awareness of infor-

¹⁶Gould, Inc., Ocean Systems Division, "Make It in Cleveland: A Program of Greater Cleveland Small Business Procurement Conducted by Gould's Ocean Systems Division," August 1980. Gould personnel indicate that the number of new subcontractors participating has doubled since the 1980 report.

DEFENSE BUSINESS IN THE THIRD FEDERAL RESERVE DISTRICT

The states of the Third Federal Reserve District showed mixed results in Defense prime contracting in fiscal year 1981.

In New Jersey, 4 of the 7 military hard goods lines showed 1981 awards at a level above \$100 million, with electronics and communication equipment leading the pack, followed by missile and space systems, and ships. All these programs showed solid growth in market share, as did the fourth-place program—aircraft. In Pennsylvania, aircraft led the way in awards and showed growth in market share; and five other hard goods programs exceeded the \$100-million mark.

In Delaware, which immediately adjoins the Middle Atlantic census division, Defense industry takes a somewhat different form. Delaware's strengths are in petroleum, textiles, and construction rather than in hard goods. With hard goods getting more attention than other items in fiscal 1981, Delaware actually suffered a nominal-dollar loss in value of large prime contract awards in the range of 2 percent, and the number of participating firms dropped a little. But Delaware firms have the capacity to and actually do supply Defense prime contractors with a wide range of products.

The divisional and state figures for prime contract awards are reflected clearly in those for the counties of the Philadelphia area. The largest firms were those that specialized in electronics and communication equipment, aircraft, missile and space systems, and oil—Philadelphia's biggest product in terms of value of shipments.* Further, they all showed healthy year-over-year growth, and all but petroleum showed a rising market share. Though not the only centers of Defense-related economic power in the region, these firms and their industries clearly stand out as the major ones at present.

*Shipments from Philadelphia's petroleum refining industry exceeded \$2 billion in 1980 according to the 1981 "Survey of Industrial Purchasing Power," *Sales and Marketing Management*, April 27, 1981, p. 84.

mation requirements already may be growing in the Delaware Valley—awareness that includes the public and private sectors. Late in 1981, for example, the Mayor of Wilmington initiated a Jobs Through Defense Task Force made up of Delaware industry and government leaders to “help Delaware firms determine their potential for beginning or increasing Defense-related work.” After a series of discussion meetings, the Task Force sponsored a procurement conference in February 1982 at which some 250 participants had the opportunity to speak directly with government buyers and advisers.

At about the time the Wilmington conference was being held, the City of Philadelphia began its operational planning with the Greater Philadelphia Chamber of Commerce, the PENJERDEL Council, and the American Defense Preparedness Association—an industry group—for a conference in May with the theme “Selling to Defense in the 1980s.” This conference differed from many previous ones in giving prime contractors equal billing with DOD representatives as buyers of goods and services in an attempt to foster interindustry awareness.

While these and other conferences have achieved their immediate goals, many observers believe that some ongoing organization to collect, digest, and disseminate information on the Defense economy—a research institute and clearinghouse for national security resources—ought to be part of the regional economic development agenda. They reason that the pace of Defense acquisition of goods and services has picked up so sharply that the requirement for better data on projected spending and on industry opportunities has become critical to the region’s Defense industry participation. As Charles L. Schultze has noted: “an 80-percent increase in the real volume of military procurement and R&D in the short space of four years will give rise to shortages of skilled labor and specialized components within the Defense industries themselves. Capacity will be strained and managerial oversight stretched

thin.”¹⁷

Unquestionably, skilled labor is a critical link in the Defense industry chain, and the skills in question are intellectual as well as manual. A recent report of a Defense Science Board task force focused on requirements for professionals with high-level skills in 17 occupations ranging from aero-astronautic engineers to statisticians and actuaries. According to the report, Defense-related requirements are projected to increase by 38 percent over the period of the forecast (1981-1987), from 229,000 to 316,000 people.¹⁸ The task force leader expressed concern in forwarding the report that there would be “definite short-falls in certain disciplines,” but indicated that Defense needs could be met “if market forces work and the growing numbers of students enrolled in the nation’s engineering programs are properly trained and employed.”¹⁹ Shortfalls are in the forecasts also for skilled operators in traditional blue-collar trades.

For market forces to overcome these shortfalls, information must be available to those who will provide and train the manpower as well as to those who want to acquire it. A regional clearinghouse could play a very valuable role in maintaining information on Defense industry manpower demand and in monitoring attempts to meet it, especially in areas of high unemployment such as Philadelphia.

A Clearinghouse To Improve Information. Better information also could strengthen the critical subcontracting link. According to interviews by *Aviation Week and Space*

¹⁷Charles L. Schultze, “Economic Effects of the Defense Budget,” *The Brookings Bulletin* 182 (Fall 1981), p. 4. How acute these shortfalls turn out to be will depend in part on levels of activity in the civilian economy.

¹⁸“Report of the Defense Science Board Task Force on University Responsiveness to National Security Requirements,” Office of the Under Secretary of Defense for Research and Engineering, January 1982, pp. 3-1, 3-2, 3-3.

¹⁹“Report,” p. v.

Technology, many aerospace firms that worked for Defense prime contractors either failed or were bought up by other firms during the 1970s. As business volume dropped off at the prime contractors, they took subcontract work back into their own plants to use up their excess capacity. Now many of those old subcontract plants are gone or are doing other work,²⁰ and some analysts believe that, in their absence, serious production bottlenecks could occur.

Although firms that have gone through the trauma of losing Defense subcontract business or that are familiar with the history may be reluctant to tool up for Defense work, better market information about both the government sector and the commercial sector could help them improve their planning and reduce their risk. That risk could be reduced further by modernized and more adaptable manufacturing equipment. It has been suggested, for example, that more modern equipment and machinery could be immediately or more quickly converted to meeting the civilian economy's needs or to entering world competition.²¹ Other stabilizing factors such as multi-year procurement authority could make it easier for subcontractors to enter Defense business at an acceptable level of risk. Again, improved information as well as management and technical assistance may be required to make the

most of these developments, which would help make firms less vulnerable to fluctuations in Defense business volume. A clearinghouse could be helpful here as well.

In short, an organization that would take on the responsibility for managing Defense marketing information could catalyze regional participation in Defense business, especially if it could intensify prime contractor interactions with local subcontractors. Strengthening of buyer-seller interactions among local prime contractors and subcontractors not only could perk up the regional economy but also could achieve efficiency gains in providing national security—a public good—to the nation at large. And in the process, the diverse industrial base of the region could be modernized and made more competitive in both national and international markets.

Other things are important, too. Good transportation systems, attractive living conditions, and all the other features that link jobs to places make a difference for Defense business as well as for other business. But, all other things being equal, regional cooperation in providing market information may well be the key to increased Defense industry participation.

RECAP

The region appears just to have held its own in Defense business in fiscal year 1981. Work allocated to the Naval Shipyard and other large installations has put more people on the payroll, but the gains in share of Defense prime contract awards have been slight. Systematic efforts to improve market information are just beginning.

Local leaders in the private sector and the public sector, though, are far more aware than they were of the role Defense business plays in the region's economy. With just a little push, they could make a noticeable change in how well the region does with Defense business.

²⁰"Subcontractors: Shrinking Base of Industry," *Aviation Week and Space Technology*, July 20, 1981, pp. 14-15.

²¹"The Industrial Base: Government Must Take the Calculated Risks," interview with Rep. James J. Blanchard (D-Mich), *Government Executive*, March-April 1982, p. 50. For a discussion of DOD's Manufacturing Technology and Technology Modernization programs, see "The FY 1983 Department of Defense Program for Research, Development, and Acquisition," Statement by the Honorable Richard D. DeLauer, Under Secretary of Defense, Research and Engineering, to the 97th Congress, Second Session, March 2, 1982, pp. IV-5, IV-6.

**BUSINESS
REVIEW**

Federal Reserve Bank of Philadelphia

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