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Multibank Holding Companies: Convenience and Needs

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FEATURES:

How well do bank holding companies follow through with the improvements in bank services to the community mentioned in support of their applications to acquire banks? This original study compares planned changes in services with those actually accomplished after acquisition.

Comparing the cost of living from city to city can be tricky. Part I of this two-part analysis explains why the Consumer Price Index should not be used for that purpose but "family budget" estimates can be of help. The living cost advantages of southeastern cities are explored in Part II.

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WHAT THEY SAY AND DO

MULTIBANK HOLDING COMPANIES: CONVENIENCE AND NEEDS

by Joseph E. Rossman* and B. Frank King

Bank holding companies have expanded significantly since World War II. Their growth has caused concern on the part of Federal and state legislatures and resulted in several acts designed to control holding company expansion. On the Federal level, the Bank Holding Company Act of 1956 and its amendments provide the principal basis for such control. The Congress named the Board of Governors of the Federal Reserve System the prime enforcer of the Act and gave the Board sets of criteria for regulating various methods of holding company expansion.

One of the most important means of expansion is the acquisition of additional banks. The Bank Holding Company Act requires the Board to evaluate all bank acquisitions. The Board's decisions to approve or deny an acquisition are to be the result of weighing the effects of several aspects of the acquisition on the public interest. Among these aspects is the effect of the acquisition on the convenience and needs of the community of the acquired bank—the focus of this study.

The Board is directed in Section 3 of the Act not to approve any bank acquisition

> ...whose effect in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade, unless it finds that the anticompetitive effects of the proposed transaction *are clearly outweighed by probable effects of the transaction in meeting the convenience and needs of the community to be served.* (emphasis supplied)[1]

In this statement, the Board is given a balancing test in which adverse effects of an acquisition on competition may be outweighed by the beneficial effects of the acquisition in meeting the convenience

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[1] U.S.C., title 12, section 1843. As amended by Acts of July 1, 1966 (80 Stat. 238) and December 31, 1970 (84 Stat. 1763).

and needs of the community. There is no reference to other factors; however, the Act continues with the instruction:

> *In every case,* the Board shall take into consideration the *financial* and *managerial* resources and *future prospects* of the company or companies and the banks concerned and *the convenience and needs of the community to be served.*
> (emphasis supplied)[2]

This section adds financial and managerial effects to the factors to be considered and reiterates the instruction to consider convenience and needs, this time in every case.

Research on the Board's orders approving or denying holding company applications to acquire banks indicates that the convenience and needs of the community have seldom been pivotal factors in decisions. In a study of the Board's early orders, Jules Bachman concluded that except in cases involving acquisition of newly chartered banks, the Board did not appear to find convenience and needs factors decisive or compelling.[3] More recently, Michael Jessee and Stephen Seelig, after studying the Board's consideration of convenience and needs factors in post-1970 acquisitions, found that the Board mentioned but seldom dwelt on convenience and needs factors where there were no adverse effects on competitive, managerial, or financial factors. They also concluded that "...the Board's treatment of public benefits suggests only a narrow range within which [convenience and needs factors] would sway the Board when important adverse factors are present in a proposal."[4]

Nevertheless, the Board considers convenience and needs factors in connection with every bank acquisition and includes in each approval or denial order a statement about the weight of these factors in its decision. Further, in each application to acquire a bank, the Board requires holding companies to submit an analysis of the banking needs of the bank's community and a statement of how those needs will be better met as a result of the acquisition.

Although other studies have analyzed the Board's weighing of convenience and needs factors, there has been little systematic analysis of what applying companies present to the Board as their intended contributions to communities of banks to be acquired or how much the companies follow up their stated intentions. Do the companies present benefits that are within their capacity? Do they intend to make changes or offer services that the banks being acquired could not provide on their own? Do their plans relate specifically to the needs of the community of the bank to be acquired? Are their intentions stated firmly or ambiguously? After acquisition, do holding companies carry out their stated intentions? Do they do more than they promise? If so, in what areas? When intentions are not realized, can one account for this on the basis of characteristics of the company, the bank, or its market?

An effort to answer these questions is worthwhile for two reasons. Holding company perceptions of their benefits to the public and their actual record in providing benefits give evidence of possible strengths, weaknesses, and overall social benefits of the holding company type of organization. Further, evidence about how often holding companies realize their intentions could help explain why studies comparing performance of banks acquired by multibank holding companies with that of independent banks have found few significant operating differences.[5]

In order to answer some parts of these questions about holding companies and convenience and needs, we analyzed bank acquisition applications filed by multibank companies in the Sixth Federal Reserve District. We recorded stated intentions from each application and conducted a mail survey asking acquiring companies which intentions had been realized. Analyses of applications and survey results

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[2] *Ibid.*

[3] Bachman, J., "The Bank Holding Company Act," **The Bulletin of the C. J. Devine Institute of Finance,** Bulletin 24-25 (April-June 1963), pp. 45-47.

[4] Jessee, M. A. and S. A. Seelig, "Analysis of the Public Benefits Test of the Bank Holding Company Act," **Monthly Review,** Federal Reserve Bank of New York, New York, Vol. 56 (June 1974), pp. 161-162.

[5] A recent summary of this evidence is in "MHBC's: Evidence After Two Decades of Regulation," **Business Conditions,** Federal Reserve Bank of Chicago, Chicago (December 1976), pp. 3-15.

TABLE 1

CHARACTERISTICS OF SURVEYED INSTITUTIONS

A. Location

State	Number of Banks	Holding Companies
Alabama	12	4
in SMSA	4	
not in SMSA	8	
Florida	88	14
in SMSA	77	
not in SMSA	11	
Tennessee	9	3
in SMSA	5	
not in SMSA	4	
Total	109	21

B. Bank Size, Assets at Nearest Semiannual Call Date Prior to Acquisition (Million $)

State	Mean	Largest	Smallest
Alabama	32.2	77.2	6.1
Florida	31.6	173.0	2.8
Tennessee	31.0	78.3	18.1

C. Holding Company, Assets at Nearest Semiannual Call Date Prior to Acquisition (Million $)

State	Mean	Largest	Smallest
Alabama	746.9	1,080.9	616.5
Florida	688.9	2,361.6	111.6
Tennessee	690.8	1,062.7	370.5

D. Lead Bank, Assets at Nearest Semiannual Call Date Prior to Acquisition (Million $)

State	Mean	Largest	Smallest
Alabama	522.6	938.3	302.4
Florida	385.0	1,246.1	45.9
Tennessee	708.7	948.6	297.8

provide the basic data for the following analysis.

The Study Methods. In all, our survey covered 109 applications by 21 multibank holding companies. These applications were filed by multibank companies between June 1970 and December 1973. The survey covered only acquisitions that had been approved and consummated; it omitted newly chartered banks and a few corporate reorganizations. About four-fifths of the banks involved were in Florida; the rest were about equally divided between Alabama and Tennessee.[6] The banks ranged in asset size (at time of consummation) from $3 million to $173 million; the average size was $32 million. The acquiring companies ranged in average asset size from $112 million to $2.4 billion. One company had 16 applications covered in the survey; only three companies had one.

We first recorded a list of holding company intentions from the convenience and needs section of each application. Language used in the applications was usually ambiguous and timeless; firm commitments were few and far between. We gave up attempts to judge the relative strength of commitments and assumed that if a company had not intended to do something, it would not have talked about it. Therefore, we treated all matters that companies discussed as intentions.

After reading the applications, we developed a master questionnaire covering all areas of company intentions recorded in the survey of applications. Questions related to specific intentions for each bank were taken from this questionnaire. This selection process resulted in a specific questionnaire for each bank. Each company was sent its packet of questionnaires in July 1976.

The Applicants' Intentions. The bank holding companies' plans concentrated on services that are more often and more extensively provided by the larger lead banks of the companies than by the smaller banks that were acquired. Plans most often included trust services, loan participations, data processing, investment assistance, improved business and real estate loan operations, and management and personnel assistance. In general, companies intended to provide more services to the acquired bank than directly to its customers but classed bank services as public benefits because they would increase the bank's efficiency or responsiveness or reduce the bank's risk.

Convenience and needs discussions in most applications were couched in terms that are subject to a variety of interpretations. We found few firm commitments, and even these were usually vague as to when and for how long the improvements would be implemented. Only about half of the applications discussed specific needs of the bank to be acquired. In such cases, companies described courses of action

[6]The survey does not cover banks and companies in Georgia, Louisiana, and Mississippi because these states did not allow bank acquisitions by multibank companies during the study period.

TABLE 2

INTENTIONS DISCUSSED, BY COMPANY AND BANK

	Holding Companies Discussing the Service		Applications Discussing the Service	
	Number	Percent of Total	Number	Percent of Total
A. Direct Customer Services				
Trust	21	100	87	80
International	14	67	37	34
Credit Card	7	33	13	12
Leasing	6	29	12	11
Industrial Development	5	24	10	9
Factoring	1	5	2	2
B. Services to Bank				
Loan Participations	21	100	96	88
Data Processing	18	86	69	63
Investment Assistance	18	86	69	63
Marketing/Advertising	16	76	57	52
Auditing/Accounting	17	81	49	45
Credit Information	6	29	14	13
C. Management and Personnel				
Management	20	95	85	78
Recruitment	21	100	86	79
Training	19	90	80	73
D. Hours and Facilities				
Build, Remodel, or Expand Bank Building	6	29	9	8
Provide Drive-in Windows	6	29	7	6
Provide Parking	6	29	6	6
Extend Hours	3	14	6	6

	Holding Companies: Expand		Holding Companies: Expand-Improve		Applications: Expand		Applications: Expand-Improve	
	Number	Percent of Total	Number	Percent of Total	Number	Percent of Total	Number	Percent of Total
E. Loan Portfolio Changes								
Total	19	90			71	65		
Business	19	10	21	100	57	52	100	91
Real Estate	14	67	14	67	42	39	44	40
Consumer	12	57	12	57	34	31	34	31
Agricultural	4	19	4	19	6	6	6	6

with more detail and certainty.

For purposes of analysis, we divided the companies' intentions into five major categories: direct customer services, services to the bank, loan portfolio changes, management and personnel assistance, and changes in facilities and hours. These categories overlap, but we attempted to categorize intentions consistently.

In most of the applications reviewed for this study, companies discussed providing services directly to customers of the acquired bank; however, the number of these services was usually quite small—about one and one-half per application on average. Most often, discussions of direct customer services alluded to introduction or improvement of trust and international services.

Four-fifths of the applications covered trust services. Each company mentioned them at least once. When applicants went on to discuss methods of providing trust services, about half indicated plans to establish new departments; the other half planned to offer trust services through another subsidiary of the company.

About one-third of the applications included international services. In most of these cases, the applicant indicated that international services would be making their first appearance at the acquired bank. The companies generally spoke of making these services available through an existing company subsidiary rather than a new department. Letters of credit were the most frequently mentioned specific international service.

Applicants discussed other direct customer services in only a few cases. Except for credit cards, these other services are usually provided by larger banking organizations than those acquired. They include leasing, industrial development assistance, and factoring.

Holding companies planned to offer services to the bank more than twice as often per application as direct customer services. The bank services that companies concentrated on were those that one would expect to be offered by a larger bank: furnishing a buyer of loan participations from the bank, providing data processing, investment assistance, aid in marketing, advertising, auditing, accounting, and credit information.

Expanding lending limits of the acquired bank by introducing or improving procedures for selling loan participations led the list of planned bank services. In contrast, applications seldom mentioned providing an outlet for the bank's excess funds by facilitating the bank's purchase of participations. In all, almost 90 percent of applications discussed loan participations. Business loans received the most attention; they were followed closely by real estate loans.

Companies intended to provide data processing and investment assistance—two other standard correspondent banking services—in almost two-thirds of the applications and to provide assistance in marketing and advertising and in auditing and accounting in about half. Upwards of 10 percent of the applications discussed improving credit information through centralized analysis and use of special expertise.

Each company discussed plans that would be expected to influence loan portfolio distribution and quality. Participations were an important element of these intentions, but companies also looked to specific changes in lending emphasis and to the availability of company or lead bank specialists. In a few cases in which the loan-deposit ratio of the bank was very low, companies specifically committed to increase total loans.

We inferred from almost two-thirds of the applications that total loans would be increased. Applicants discussed improvement or expansion of business loans in upwards of 90 percent of the applications surveyed, real estate loans in four-fifths, consumer loans in one-third, and agricultural loans in only six applications.

Four-fifths of the applications covered intentions to provide general management assistance and recruitment, and three-fourths covered training. Each company stated intentions to provide management and personnel assistance in at least one application. Specific statements of the type of management and personnel assistance to be provided were found only in a few cases in which obvious management succession problems loomed.

Companies seldom discussed changing physical facilities and banking hours. Most intentions to provide facilities seemed to stem from currently perceived needs; they were specifically and firmly stated. Few applications discussed extending banking hours.

No application discussed changing service charges, interest rates charged, or deposit interest rates paid. A rather firm commitment by one company to introduce passbook savings accounts in a small rural bank was the nearest any company came to this type of plan.

Categorizing intentions by bank and company characteristics uncovered general differences only among individual companies and states. Companies varied in several ways: in how closely they related their plans to the needs of the bank to be acquired, in the number of contributions included in their discussions, in the types of services or changes they discussed, and in the apparent strength of their commitments. Company specialties in leasing, industrial development assistance, and mortgage lending appear to have influenced plans for these types of contemplated action.

Companies in Alabama stated their intentions more specifically and intended more changes than companies in Florida or Tennessee. Most Alabama applications related intentions to the needs of the bank to be acquired. These features might have stemmed from the greater competitive problems inherent in several Alabama applications and the companies' attempts to outweigh adverse competitive effects with benefits to the public.

The Acquiring Companies' Actions. How often did acquiring companies follow through on intentions stated in their applications? Responses to our survey indicate that each holding company acted to realize most of its intentions in all banks acquired.

Companies that discussed direct customer services generally reported providing them. Within this class of services, companies realized their intentions to provide trust and industrial development services less often than they followed through on other services. Yet even in the trust category, 83 percent of banks for which services were intended actually offered them as of the survey date. In only two-fifths of these banks did companies report that trust services were provided by an on-site department. Most banks for which trust services were not provided were smaller than average and outside of metropolitan areas, indicating that companies had occasionally overestimated the potential for trust business.

Only one acquired bank had an international department when the survey was made in July 1976, but twenty-five others offered various international services through another subsidiary of their holding company. Six more banks offered international services through referral to a bank not associated with the acquiring company. Thus, most banks offered the intended international services in one way or another.

The companies carried out their plans to provide leasing, credit cards, and factoring in almost every case. On the other hand, they took action on intended industrial development assistance in only six of the ten banks for which it was planned.

Holding companies seem to have been even more effective in following through on services provided to the acquired bank than on direct consumer services. They seldom failed to follow up plans, except those for data processing.

Loan participations, the most popular intention, were acted upon in nearly all cases. Companies reported introducing or expanding participations in 98 percent of cases and improving procedures in 96 percent. Average participation sales per bank rose by 225 percent from acquisition date to December 31, 1975; average purchases by 333 percent. The number of banks engaging in participations doubled. Applicants most often mentioned companywide procedural uniformity, central credit files and analysis, central administration, and documentation review as ways in which participation procedures had been improved.

Intended data processing services were not provided in so large a proportion of banks as were other bank services, but companies followed up their plans to aid in managing investment portfolios in every case. The acquiring organizations most frequently named accounting for deposits, instalment loans, payrolls, commercial loans, general ledger accounting, and investment analysis as the additional data processing applications instituted. The types of investment assistance most often mentioned were advice on credits and portfolio composition, projections of available funds, consolidating of orders and central trading, and safekeeping.

The holding companies made changes in auditing or accounting in every case and changes in marketing and advertising in all but one case. Auditing changes seemed to have been provided more as protection to the company than as a service to the bank, but the companies felt both parties had benefited. Audits by the company were introduced in about three-fourths and other formal procedures of one sort or another in a majority.

The surveyed companies produced a spotty record of realizing intentions to increase total loans or specific loan categories. A majority of banks in which companies planned to expand loans reported increases. However, in the consumer loan category, the majority was

TABLE 3

COMPARISON OF INTENTIONS AND ACTIONS

	Number of Cases		Percent of Cases
	Intentions	Action Taken	Action Taken
A. Direct Customer Services			
Trust	87	72	83
International	37	32	86
Credit Card	13	12	92
Leasing	12	12	100
Industrial Development	10	6	60
Factoring	2	2	100
B. Services to Bank			
Loan Participations	96	94	98
Data Processing	69	53	77
Investment Assistance	69	69	100
Marketing/Advertising	57	56	98
Auditing/Accounting	49	49	100
Credit Information	14	12	86
C. Management and Personnel			
Management	85	85	100
Recruitment	86	71	83
Training	80	77	96
D. Hours and Facilities			
Build, Remodel, or Expand Bank Building	9	9	100
Provide Drive-in Windows	7	6	86
Provide Parking	6	5	83
Extend Hours	6	3	50

	Expand Loans			Expand Loans and/or Improve Service		
	Number of Cases		Percent of Cases	Number of Cases		Percent of Cases
	Intentions	Action Taken	Action Taken	Intentions	Action Taken	Action Taken
E. Loan Portfolio Changes						
Total	71	55	78			
Business	57	38	67	100	100	100
Real Estate	42	35	84	44	43	98
Consumer	34	19	56	34	31	91
Agricultural	6	6	100	6	6	100

slight. Despite a large increase in participations purchased, banks increased business loans in only two-thirds of the intended cases. The companies succeeded in expanding real estate and total loans in about four-fifths of the banks for which such growth was planned, and they expanded agricultural loans in each of the few banks where growth was planned.[7]

When asked to tell what loan changes they had made, the companies that had discussed increasing or improving services on business and real estate loans named larger loan limits as the principal improvement, with addition of specialized expertise a close second. In the consumer category, companies most often pointed to offering new types of loans as the way they had improved service.

Acquiring companies claimed to have provided management assistance to each bank for which it was intended. These banks got regular economic reports, and most received regular analyses of at least some of their internal operations. Nearly all also received some sort of special analyses of certain areas of operations, and most received personnel-related assistance,

[7]We checked action on loan expansion with Call Report data. Success in increasing loans was judged by the change in loans as a percentage of bank assets between the last Call date prior to consummation and the Call date two years after.

such as studies of staffing and of salaries and EEO compliance audits.

Between the acquisition and mail survey dates, holding companies followed through on plans to aid recruiting less often than on plans to assist management. In all but one bank where recruitment aid was given, companies assisted in hiring management; they provided aid in recruiting technical, professional, and clerical personnel much less often.

The surveyed companies provided training in almost all banks for which it was planned. Their programs involved management, technical, and operating personnel in most cases. Companies usually used formal programs prepared by company or lead bank staff.

Generally, in banks for which provision of facilities or changes in hours were planned, holding companies took action. Companies reported action in each case in which new or remodeled banking facilities were intended and in all but one case in which there were plans for new drive-in windows and for parking facilities. In contrast, companies acted in only three of six cases in which they had planned to lengthen banking hours.

To see if companies did more than they intended, we asked them to name actions taken but not discussed in their applications. We had hoped from this to get information both on company response to specific bank problems and on company development; however, the casual responses of several companies make comparisons among companies and banks difficult to interpret. Even so, these questions provide a few interesting insights. Two services that were never discussed but often later provided—single-fee consumer packages and IRA and Keogh plans—became widespread in banking only after most applications were filed. Audit improvements were often made when no intention had been stated; so, to a lesser extent, was provision of data processing and legal services. Companies listed few additional changes in loans but often added companywide employee benefit and salary administration programs.

When Intentions Were Not Realized. Although they generally followed up their plans, the applicants' records were not perfect. Each company and a large minority of acquired banks had some plans that did not bear fruit. These situations bring up several questions: Did the applying companies overestimate their capacity? Did they fail to monitor their intentions carefully? Did they discuss actions that they had no intention of taking? Were the companies inaccurate in estimating the feasibility of certain actions at the time of application? Did market supply or demand changes make some actions infeasible between application and consummation?

Our results shed some light on those questions. Judging from the profile of company intentions that we developed from the analysis of applications, companies seldom discussed actions that moderately sized lead banks cannot perform; therefore, most inaction seems unlikely to have resulted from company incapacity. Companies also fulfilled intentions in most cases, leading us to discount the idea that companies might generally have stated plans they had no intention of carrying out.

This study lends some support to the hypothesis that some companies do not closely monitor convenience and needs intentions or their fulfillment. However, this does not seem to be a serious problem. Several companies presented standard packages of intentions, whatever the characteristics of acquired banks. This may be taken as evidence of inattention to special problems of banks to be acquired. Further, several companies sent their survey questionnaires to individual banks rather than answering them at a central location—not a likely move for a company with a monitoring system. Even so, comparison of intentions and actions for companies with standard benefits packages and without apparent monitoring systems revealed that these companies had no worse records in acting on intentions than others.

The study also yields some evidence that inaction may often be associated with inaccurate estimation of market conditions by the applying companies. The major categories with lowest action rates were, with two exceptions, those in which market conditions are difficult to project and are important determinants of feasibility. The lowest action rates were recorded in services that were offered directly to customers—trust and industrial development services and several categories of loans. (Data processing and recruitment categories were exceptions to this pattern.) Most failures to carry out plans for trust services were in small rural banks where demand for new or improved trust services may not have been great. In addition, a disproportionately large number of failures to achieve intentions to expand loans occurred in Florida—an area in which the economy and bank lending deteriorated sharply during the study period. Company realization of the possibility of poor market evaluation may also have played a part in the generally ambiguous nature of their convenience and needs discussions.

An Overview of the Results. Before summing up our results, we should point out that the method of study used in our survey has at least three basic limitations. First, in the study itself, we performed no analysis of whether the intended actions would actually benefit the public. In addition, except in limited cases where cross-checks were convenient, we took the companies' word about what they had done. Finally, no control group of independent banks was used to see if changes might have been made even in the absence of holding company acquisition.

Subject to these limitations, our study indicates that companies proposed convenience and needs benefits that paralleled services of large banks. The dominant service offered directly to consumers was trust service. Companies discussed services to the acquired bank more often than direct customer services. High on the list of the bank services were loan participations, data processing, and assistance with investments, marketing, and auditing. The companies' most popular categories for loan expansion and improvement were business and real estate loans—both closely related by the applicants to loan participations. Companies also planned special management, recruiting, and training assistance quite often.

For the most part, one would expect the holding company lead banks to be able to handle intended actions. Banks of the size generally acquired do not often offer these services as extensively as the generally larger lead banks of the companies surveyed.

Applications contained few firm statements of intentions. Discussions were usually hedged at best and nebulous at worst. They approached only the most obvious needs with relatively specific and firm commitments.

Companies varied widely in the extent, firmness, and specificness of their intentions. The only other bank or company characteristic that seemed to be related to intentions was the state where the bank was located. Alabama companies' intentions were more extensive, firmer, and more specifically related to the bank than those of Florida or Tennessee companies. This may have been because more of the Alabama companies' applications raised competitive problems.

Most significantly, companies took action in the vast majority of cases in which it was intended. Lowest rates of realization of intentions were in extending hours and providing industrial development assistance—two plans that were seldom presented. In categories of plans most often discussed, trust and data processing services, recruitment, and loan expansion received action in a somewhat smaller proportion of cases than did other changes.

The study did not uncover any application in which no action was taken. Indeed, in all acquired banks studied, most matters on which action was intended were reportedly given attention. We found no evidence that holding companies discussed plans that they did not intend to carry out or that they lacked capacity to carry out. On the other hand, there was some evidence that some companies were less than careful in choosing intentions and monitoring follow-up, but these did not seem to be serious problems. Failure of markets to support company actions appears to have played a part when companies did not follow through, but the evidence is not sufficient to support conclusive statements. ■

COST-OF-LIVING COMPARISONS: OASIS OR MIRAGE?

Congratulations! You've just been offered a promotion and a big raise. But the new job will involve a transfer to another city, rumored to be an expensive place to live, and you are concerned that the extra money in your paycheck might not cover the higher bills you would be paying. A prudent decision in your situation and in many other personal, business, and public affairs necessitates a comparison of living costs between cities or regions. But what information can be used for such a comparison?

The idea that first comes to mind is to look at Consumer Price Indexes (CPIs). Though CPIs give sound measurements of inflation *within* areas, they are not designed to permit comparison of living costs *between* areas. Publications of the Bureau of Labor Statistics clearly warn against such applications of the CPI. For example, "The Consumer Price Index: A Short Description" (1971) contains this explicit warning: "The Consumer Price Index (CPI) . . . measures changes in prices, which are the most important cause of changes in the cost of living, but it does not indicate how much families actually spend to defray their living expenses."

Part I of this analysis describes the characteristics that a cost-of-living measure must possess to be adequate for geographical comparisons and points out the shortcomings of using the CPI in that role. A more suitable alternative measure, the Bureau of Labor Statistics "family budget" data, is then examined. Part II utilizes the budget data to compare living costs in southeastern cities with those in urban areas in other parts of the United States.

Note: Condensed for publication by Patricia Faulkinberry from a staff study written by James T. Fergus.

PART I: MEASURING GEOGRAPHICAL DIFFERENCES IN THE COST OF LIVING

Criteria For An Adequate Cost-of-Living Measure. What is the "cost of living?" When we seek to compare the cost of living in different locations, we are looking for estimates of the income required to maintain *equal* states of satisfaction, comfort, and well-being in each location. To provide a basis for meaningful geographical comparisons, a cost-of-living measure should reflect not only differences in prices of goods and services but also differences in the amounts and kinds of goods and services required to sustain *a given standard of living.* Thus, our requirements of an adequate cost-of-living measure are two: It must include geographically determined (location-specific) influences on living expenses while excluding all demographically determined (consumer-specific) variations.

A measurement of the cost of living is the product of two components—the amount of goods and services purchased and the prices paid for them. And, if we want to monitor living cost differences over time, changes in quantities and prices become significant. To help us evaluate the thoroughness with which available cost-of-living measures detect geographically determined variations, we can classify the numerous sources of living cost differences according to whether they affect the price level, price change, quantity mix, or quantity change components of living expenses.

Examples of price variations abound. Locally produced commodities usually carry lower price tags than goods which must be transported over long distances and undergo extensive handling. The efficiency and adequacy of various means of transport into an area affect price levels in a similar way. Differences in local regulations, such as building codes, zoning ordinances, and licensing practices, may create variations in the costs of regulated goods and services. State and local property, income, and sales taxes represent the cost of public services provided to residents and vary according to the quantity and quality of services offered at each location.

The most obvious influence on quantity levels or consumption mix that we do want a living cost measure to reflect is climate. Larger expenditures for heating, home insulation, and clothing are required to maintain a particular comfort level in colder areas; air conditioning outlays are greater in warmer climates. Water treatment costs vary with local environmental conditions.

A living cost measure must also detect any changes that occur in the prices and quantities required to sustain a given standard of living if geographical comparisons are to be realistic. Prolonged discrepancies in the rate of inflation for various goods and services foster substitution of cheaper products for more expensive items, altering budget composition. If substitutions are not uniform among regions, distortions creep into geographical comparisons.

Evaluating Available Measures of the Cost of Living. How well do available measures of the cost of living meet the tests of adequacy we have established? Here we will consider two: the Consumer Price Index, frequently referred to as the "cost-of-living index," and a less well-known measure, family budget estimates.[1]

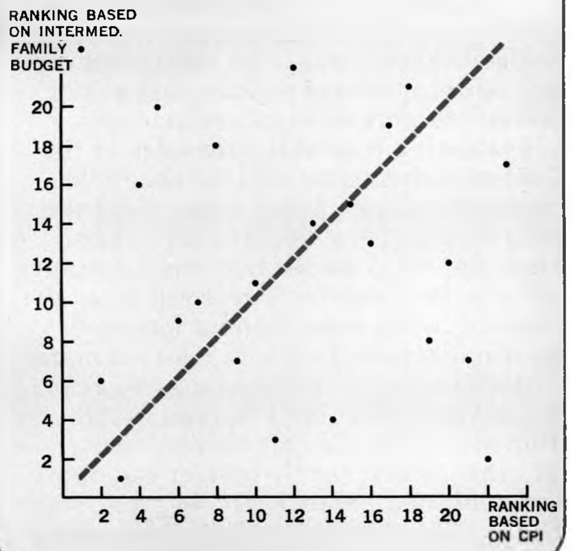
Both measures are produced by the U. S. Department of Labor's Bureau of Labor Statistics. CPIs are calculated quarterly for 23 urban areas; family budget estimates are published annually for 44 areas, including 40 standard metropolitan statistical areas. Price information that goes into an area's CPI is standardized for "urban wage earners and clerical workers," weighted according to a preselected "market basket" of consumer items, and converted to an index based on the average price of the identical basket in 1967. (So, 1967 = 100.) Dollar estimates of family budgets are prepared for three distinct standards of living—lower, intermediate, and higher; the family is specified as a 38-year-old husband working full time, his nonworking wife, a boy of 13, and a girl of 8. The intermediate-level family budget is the basis for all comparisons made in this article.

Are there any major differences in results if one uses the CPI rather than budget estimates to calculate relative living costs in U. S. cities? Chart 1 answers this question with a resounding "yes." To compare the CPI (in index form) with the budget estimates (in dollars), living cost estimates have been ranked from highest

[1] A third measure, the "Inter-City Cost-of-Living Index," is produced quarterly by the American Chamber of Commerce Researchers Association. Its advantage of coverage of a large number of cities (varying from 160 to 180) is offset by the small number of items sampled (43), the informality of its data collection methods (the data are collected by personnel of participating Chambers of Commerce), and the relatively high income level for which the budget is defined (a middle-management executive family of four with an annual income of $18,000 to $20,000).

CHART 1

Ranking of Cost of Living In Late 1975, of Urban Areas Based On CPI and Family Budget Data



to lowest for the 23 urban areas for which both measures were available for autumn 1975. Living cost rank according to the budget data forms the vertical axis of the chart; the horizontal axis indicates rank according to CPIs, with 1 representing the highest cost of living on both scales. Each point represents a city; its rank according to each measure can thus be easily read.

A close correspondence between the rankings would produce a cluster of points around the dashed line. The wide scatter of points illustrates the divergence of the two measures. This is not surprising because the CPI measures price changes while the budgets track living cost levels. Note that the city which ranked highest in living costs according to family budgets fell lowest in the CPI ranking. Since the data show virtually no association of the two measures, we must conclude that despite its frequent use, the CPI is not a reliable indicator of the relative costs of living in U. S. cities.

Lack of agreement between the measures raises the question of where the strengths and weaknesses of each lie. The CPI and budget measures are evaluated as cost-of-living measures in the next two parts of this discussion.

An Appraisal of the Consumer Price Index as a Cost-of-Living Measure. The Consumer Price Index is the most familiar measure of price trends. Despite its common designation as the "cost-of-living index," it is not designed and was not intended for geographical comparisons of the cost of living as we have defined it. Its primary function is to measure price change within particular geographical areas; the following evaluation of the CPI against the criteria we have established suggests that it has many shortcomings when used for comparing living costs in one area with those in another.

The greatest drawback in comparing CPIs from city to city is that they give *no* indication of differences in price levels. Since each area's price index is based on the 1967 price level, equal index values for different cities tell us only that prices have risen at equal percentage rates since 1967, not that price levels are identical. If prices in two cities rose by 25 percent between 1967 and 1975, the 1975 CPI for both of them would be 125. This would be true even though the price level in one city were substantially greater.

There are weaknesses in CPI coverage of quantity factors as well. Though the market basket of items whose prices are included in the CPI includes an exhaustive array of products and services,[2] it omits income and personal property taxes. And, since the aim of the CPI is to measure price changes, the market basket of goods and services in each area is purposely held constant over several years. Thus, it is only when infrequent revisions of market basket contents and price weights occur[3] that changes in consumption patterns are detected. In the meantime, substitutions of other products for increasingly expensive goods can undermine the reliability of the market basket quantities.

CPI market baskets are not identical for all U. S. cities. Each city's basket is based on the actual consumption patterns of wage earners and clerical workers in the

[2]The following number of items is priced: 105 food items, 81 housing items, 77 apparel and upkeep items, 34 transportation items, 99 health and recreation items, and 3 other goods and services items

[3]Such a revision is now under way and is scheduled for implementation in late 1977 The revised expenditure weights and market basket will be based on a consumer expenditure survey conducted in 1972-73. The present set of weight was implemented in 1966, based on a 1960-61 expenditure survey

area. To that extent, CPIs do detect geographically determined differences in the quantity mix of goods and services purchased. But this approach to establishing expenditure weights allows the demographic characteristics of each area to affect the composition of its market basket. Factors such as the average age or income of the population are reflected in the life styles and consumption patterns of the area. Thus, because these demographic influences are not held constant, consumer-specific influences are transmitted to CPI market baskets. The CPIs of different cities, therefore, may reflect demographic differences in addition to whatever geographic differences exist in costs of living.

Thus, the CPI adequately meets only one of the four requirements for geographical comparisons of the cost of living, the monitoring of price changes. Its "scorecard" summarizes its performance.

CONSUMER PRICE INDEX

	LEVEL	CHANGE
PRICE	−	+
QUANTITY	−	−

+indicates adequate representation
−indicates inadequate representation

Urban Family Budgets: A Better Tool for Living Cost Comparisons. Family budget estimates are designed to reveal "how much it costs, at current price levels, to purchase the specified lists of goods and services drawn up to represent different levels of living."[4] This definition itself tells us that budget estimates incorporate both price levels and price changes. The prices that are collected for the CPI and some supplementary data provide the raw material for the estimates.

The quantities of goods and services needed to satisfy a given standard of living are represented more fully in family budget data than in the CPIs. The measurement of living expenses for a standardized family unit minimizes the influence of variations in the demographic characteristics of cities. But, the lack of adequate measurement of changes in the quantity mix over time plagues the family budget data as well as the CPIs. The most recent revision of family budget "shopping lists" occurred in the mid-1960s; plans for another update of expenditure weights await completion of a full review of the procedure for budget estimation.

Examining the "scoreboard" for the family budgets, note that they provide an adequate basis for geographical comparisons of living costs for three out of four influences. Comparing the family budget score with that of the CPI suggests that the budgets offer a conceptually superior means of measuring living cost differentials.

FAMILY BUDGET ESTIMATES

	LEVEL	CHANGE
PRICE	+	+
QUANTITY	+	−

+indicates adequate representation
−indicates inadequate representation

Guideposts for Users of Cost-of-Living Data. Despite their conceptual superiority, potential users of family budget estimates should be aware of several considerations which limit the applicability of the data and cause some distortions in geographic comparisons. Perhaps chief among these is the specific definition of the characteristics of the family unit whose budget is calculated. The Bureau of Labor Statistics has developed equivalence factors that may be used to adjust the data so that they pertain to users whose family size and characteristics differ from the standard four persons described earlier, but the resulting alterations sometimes appear unreasonable.

Even a family whose characteristics closely approximate the budget family's features will probably deviate from the average expenditure pattern in at least some respects. Unique family needs and

[4]U. S. Bureau of Labor Statistics, "Three Budgets for an Urban Family of Four Persons, 1969-70" (Supplement to Bulletin 1570-5, 1972), p. 1.

tastes require that particular attention be paid to relative costs of items demanded in greater- or lower-than-average quantities if the living cost comparison is to be useful.

Value judgments have crept into the budget specifications so that measurements are based on desirable rather than actual consumption patterns. The exclusion of all tobacco products from the list of items priced is one example; another is that the cost of medical insurance premiums is included at all budget levels, when, in fact, many low-income families spend very little for medical care or take advantage of clinic treatments provided at public expense. The Department of Agriculture's specifications for a "nutritional diet" are used as the definition of the amounts and kinds of food items included in the family budgets. The sampling of rents and home prices excludes dwellings that do not meet standards for adequate housing. Of course, acceptance of the food and housing standards is based on the budget-compiler's judgment. Similarly, income ranges that delimit the lower, intermediate, and higher level living standards have been somewhat arbitrarily chosen and cover only a limited segment of the wide spectrum of possible living conditions.

Other problems arise from revisions of budget data. Users making long-term comparisons of living cost estimates should be aware that occasional changes in living standard definitions have interrupted the continuity of the data series and impaired its comparability over time. Infrequent revisions of the quantities of goods and services specified by the budgets have caused the living cost estimates to lose touch with basic changes in consumption patterns (such as increased patronage of fast-food restaurants and changes in energy usage). As a result, living costs tend to be overstated because the substitution effects caused by sustained differences in inflation rates for various items go undetected.

Some of the assumptions made to simplify data collection and calculations also undermine the realism of budget estimates. The cost of housing as defined for the budgets includes home mortgage payments in total. It can be argued that only the interest expense should be counted, as the equity investment is eventually returned to the owner when the house is sold. The tax bill included in budget estimates is calculated using the standard deduction; it is probably overstated in areas where the percentage of homeownership is relatively high and more families reduce their taxes by itemizing deductions.

PART II: COST-OF-LIVING COMPARISONS: SOUTHEASTERN VS. OTHER METROPOLITAN AREAS

How do living costs in cities of the Southeast[5] compare with those in urban areas of other parts of the nation? Have expenses risen more or less rapidly in the Southeast in recent years? If there are differences, what kinds of expenditures help explain them? The urban family budget estimates described and appraised in Part I can be put to work in answering such questions.

Southeastern Living Costs Are Low but Gaining. The cost of living in southeastern cities has been and remains low compared to the majority of urban areas in other sections of the U. S. The four southeastern cities of Atlanta, Nashville, Baton Rouge, and Orlando ranked in the bottom quarter of the 44 areas included in the intermediate level family budget surveys of 1970 and 1975 despite greater increases in living costs relative to other areas in the first two during that time period (see Chart 2). Table 1 compares regional average inflation rates to those experienced by the southeastern cities. The four-city average rate slightly exceeded rates of broader regions, including the South; Atlanta's 7.5-percent advance in the cost of living was outpaced only by Boston's 7.7 percent. Recent rapid price increases have not been sharp or prolonged enough to erase the living cost advantages enjoyed by southeastern city dwellers, however.

Sources of Differences in the Cost of Living. To isolate the expenditure categories that account for the relatively low cost of an intermediate standard of living in the Southeast, Table 2 presents each

[5] The Southeast here refers to those states entirely or partially within the Sixth Federal Reserve District–Alabama, Florida, Georgia, Louisiana, Mississippi, and Tennessee

CHART 2

Annual Cost of An Intermediate Budget For A Four-Person Family In Urban Areas of the U.S., 1970 and 1975

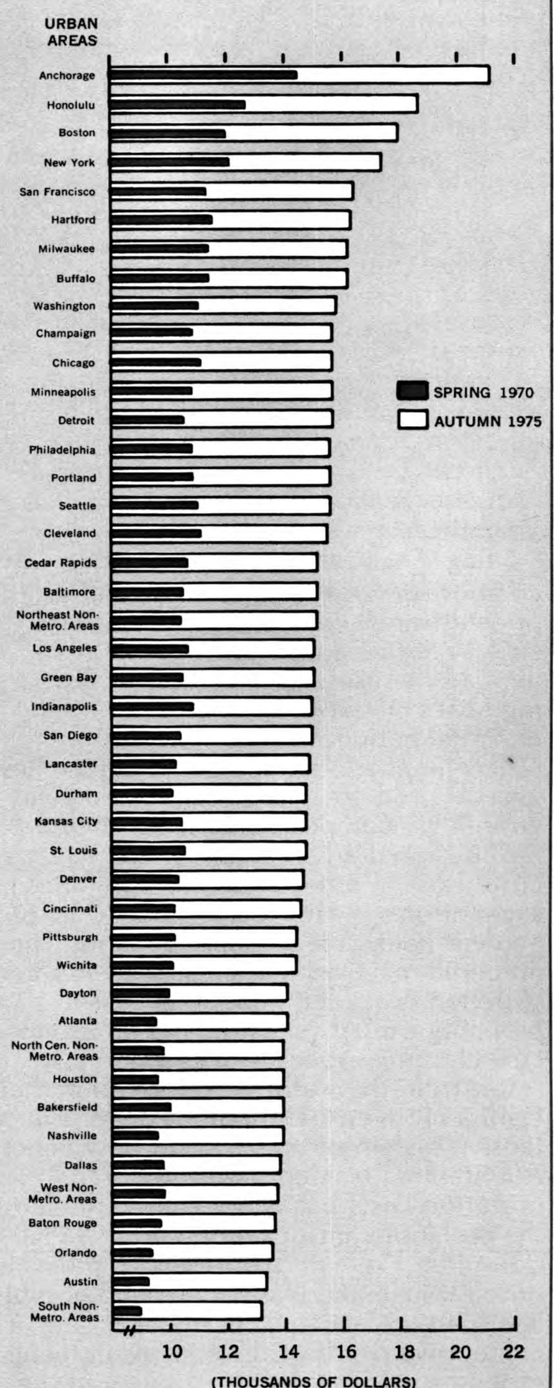


TABLE 1

ANNUAL RATE OF CHANGE IN THE COST OF AN INTERMEDIATE STANDARD OF LIVING SPRING 1970 TO AUTUMN 1975

(Percent Change at an Annual Rate)[1]

Geographic Area	Percent Increase
United States	6.8
Northeast	6.9
North Central	6.6
West	6.8
South	6.9
Southeast	7.0
Atlanta, Georgia	7.5
Baton Rouge, Louisiana	6.6
Nashville, Tennessee	7.0
Orlando, Florida	6.9

Source: Computed from data contained in U. S. Bureau of Labor Statistics, "3 Budgets for an Urban Family of Four Persons, 1969-70" (1972), and "BLS Revises Estimates for Urban Family Budgets and Comparative Indexes for Selected Urban Areas, Autumn 1975" (May 5, 1976).

[1] Regional percent changes are simple averages of urban metropolitan area percent changes.

type of living expense in the southeastern cities as a percentage of average expenses in urban areas of the entire country. Examination of these percentages reveals that personal income taxes and outlays for housing expenses were much lower in all four southeastern cities in the fall of 1975. Families in at least one of the southeastern cities spent less than the norm in every expense category.

Personal income taxes show the most striking differences. Since tax liabilities are based on total budget requirements, which are lower in southeastern cities, smaller tax bills result from applying lower tax rates to lower income levels. The absence or relatively low rate of state and local income taxation also holds down tax outlays in southeastern budgets. Moreover, the estimates of income tax payments included in southeastern budgets are probably overstated. A relatively large share of families in the South own homes and probably benefit from itemized deductions, which are not reflected in budget tax estimates.

The lower grocery bills indicated by budget estimates for southeastern cities are suspect on conceptual grounds. The list of food items priced in calculating family budgets of various areas has been

TABLE 2

COST OF INTERMEDIATE BUDGET ITEMS IN SOUTHEASTERN CITIES AS A PERCENTAGE OF URBAN U. S. AVERAGE, AUTUMN 1975

	Urban U. S. Average	Atlanta, Georgia	Nashville, Tennessee	Orlando, Florida	Baton Rouge, Louisiana
Total	100.00	92.5	91.4	89.3	89.9
Consumption	100.00	93.6	94.5	92.4	92.2
Food	100.00	97.9	93.2	89.1	99.2
Housing	100.00	82.9	90.1	89.3	79.1
Transportation	100.00	97.0	101.0	100.0	99.1
Clothing and Personal Care	100.00	98.8	102.2	90.5	101.2
Medical Care	100.00	96.7	87.3	103.4	82.7
Other Consumption	100.00	101.7	102.0	101.9	99.0
Other Costs[1]	100.00	96.3	96.9	95.6	95.4
Social Security and Disability	100.00	98.9	98.2	96.0	96.8
Personal Income Taxes	100.00	82.4	69.4	66.7	72.3

Source: Computed from data contained in U. S. Bureau of Labor Statistics, "BLS Revises Estimates for Urban Family Budgets and Comparative Indexes for Selected Urban Areas, Autumn 1975" (May 5, 1976).

[1] "Other Costs" include allowances for gifts, contributions, life insurance premiums, and occupational expenses.

standardized for nutrition content, but some variations have been retained to allow for regional differences in food preferences. The Agriculture Department Food Consumption Survey that has been used to establish regional tastes found that consumption of certain low-cost food products was relatively high in the South. If the greater quantities of these foods on the grocery lists for southern cities reflect the lower income levels rather than the tastes of the region, family food budget estimates do not pertain to comparable standards of living in all regions.

Other measurements of food costs cast further suspicion on the low food budget estimates for southern cities. When a uniform market basket of food products was priced in each region of the U. S. in 1966, the South's food prices exactly equaled the national average; family budget data for 1966 estimated food costs in the South at 5 percent below the national average.[6] This sketchy evidence, viewed in light of the dubious allowance for taste differences, suggests that variations in the composition of the food basket rather than price differences account for southern cities' relative advantage in food costs, limiting the usefulness of the data in regional comparisons. The differences from the national norm shown by Nashville and Orlando food budgets, however, are too great to be explained away entirely by compositional differences.

Substantial advantages for southeastern cities exist in other areas, notably housing expenditures, which range from 10 to 20 percent below the national average. The milder climate, which reduces shelter construction costs and heating expenses, probably explains most of the differences. Low clothing expenses in Orlando also result from the warm weather and perhaps from a more casual mode of dress. An extensive system of mass transit now benefits Atlanta area residents with low transportation costs but is not fully reflected in the budget quantities based on the 1960-61 Consumer Expenditure Survey. Families in Baton Rouge and Nashville spend notably less than the average for medical care. The cumulative result of differences in living expenses is that the cost of living in the four southeastern cities ranged from 7.5 to

[6] J. Peter Mattila, "Metropolitan Living Costs, Labor Costs, and Regional Variation: Comment," **Southern Economic Journal**, Vol. 42, No. 4 (April 1976), pp. 744-746

TABLE 3

PROPORTION OF METROPOLITAN AREAS EXHIBITING RATES OF COST INCREASE GREATER THAN THE U.S. URBAN AVERAGE, 1970-1975, BY BUDGET CATEGORY AND REGION

	Region			
Budget Category[1]	Northeast	North Central	South	West
Food	3/8	6/14	6/10	3/8
Housing	3/8	2/14	8/10	5/8
Transportation	2/8	6/14	6/10	4/8
Clothing and Personal Care	5/8	6/14	5/10	4/8
Medical Care	2/8	5/14	5/10	2/8
Other Family Consumption	6/8	7/14	5/10	3/8
Other Costs	3/8	2/14	6/10	4/8
Personal Income Taxes	6/8	6/14	4/10	4/8

[1]Social Security and disability payments have been excluded because the percentage change varied so little between metropolitan areas to be inconsequential.

TABLE 4

RANKING OF PERCENTAGE CHANGE IN LIVING EXPENSES, 1970-1975, FOR AN INTERMEDIATE BUDGET, BY BUDGET CATEGORY, FOR FOUR SOUTHEASTERN METROPOLITAN AREAS

	Metropolitan Areas			
Budget Category	Atlanta	Baton Rouge	Nashville	Orlando
Food	1	11*	7*	23*
Housing	5*	30*	12*	7
Transportation	17*	31*	13*	1
Clothing and Personal Care	14*	8*	3*	25*
Medical Care	3*	38*	20*	6
Other Family Consumption	19*	17*	19*	13*
Other Items	3*	21*	8*	8*
Personal Income Taxes	11*	31*	34	35*

*One or more additional U. S. urban areas experienced an identical increase and has the same ranking (e.g., the identical ranking of Nashville and Orlando for "Other Items").

Note: Of the 40 urban areas ranked, the most rapid increase in living expenses is ranked first; the next most rapid is ranked second, etc.

10.7 percent below the national average.

Sources of Cost-of-Living Increases. We now know which types of expenses explain the Southeast's relatively low cost of living. Pinpointing the costs which have risen the most rapidly in recent years will tell us if those relative advantages are broadening or dwindling and if new advantages are developing. As we saw in Table 1, annual rates of change in total budgets varied little from region to region between 1970 and 1975 because there were offsetting changes in individual components. Analysis of changes in the budget components tells a more interesting tale.

The ratios in Table 3 give a rough overview of regional inflation of living costs by expenditure categories. Each fraction indicates the proportion of the region's cities which experienced greater-than-average increases in that particular type of living expense between 1970 and 1975. The upper number (numerator) shows how many metropolitan areas in a particular region have cost increases of a specific type greater than the U. S. urban average. This number is divided by the total number of metropolitan areas within each region for which budget data are available: 8 in the Northeast, 14 in the North Central, 10 in the South, and 8 in the West.[7]

The more rapid overall inflation of living costs in the South stands out. Only in the tax category did less than half of southern cities experience above-average inflation. In four expenditure classes, including the key food, housing, and transportation categories, greater-than-average cost gains appeared in over half of the southern cities sampled.

The prevalence of above-average increases in southern living costs contrasts sharply with the experience of the North Central states. For that region, in every expenditure category, half or more of the metropolitan areas had below-average cost increases. Cost increases in the northeastern region also are below average; and the larger gains are concentrated in expenditure categories of secondary importance. The West has experienced cost

[7]The proportions shown in Table 3 assign an equal weight to each city regardless of population. Furthermore, they show only whether price increases in an area fall above or below the U. S. urban average without reference to the magnitude or the statistical significance of the divergence from this level

increases at approximately the average rate for the nation.

Table 4 extends the examination of relative rates of change in various living costs to the four southeastern cities. Each number denotes where that city fell in a ranking of the rate of increase in family budgets in metropolitan areas for each type of living expense, 1970-75. The city which ranked first had the most rapid cost advances of any of the 40 cities ranked, as did Atlanta in the food category and Orlando in transportation costs. One immediately notices the relative rapidity of Atlanta's price changes in all categories; Baton Rouge appears to have experienced unusual stability of living costs. In general, price increases have been chipping away the cost advantages of southeastern cities in food and housing; the relatively slow climb in personal income tax payments has maintained or improved the Southeast's advantage in tax outlays.

Geographic comparisons of family budget data thus bear out the common belief that the cost of living in southeastern cities is significantly lower than in the metropolitan areas of other regions. Relative living cost advantages have persisted despite comparatively large increases in living expenses, particularly in food and housing expenditures, which have been major sources of the Southeast's benefits. The area's cities are holding on to their edge in personal income tax outlays. One southeastern city—Atlanta—has experienced unusually rapid inflation of living costs. ■

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