SPECIAL ISSUE
THE FEDERAL RESERVE BANK OF CHICAGO
MARCH 2005
NUMBER 212a

Chicago Fed Letter

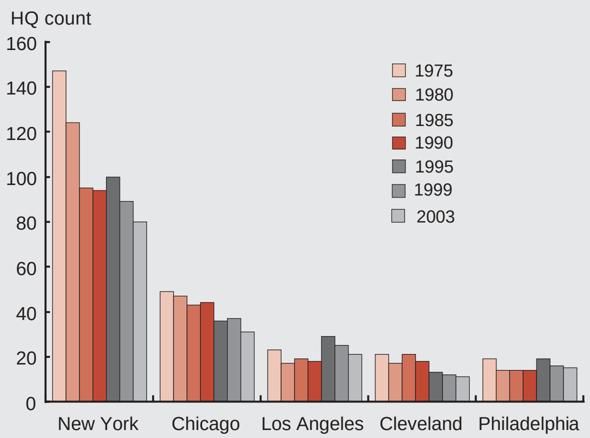
The changing relationship between headquarters and cities

by William Testa, director of regional programs, Thomas Klier, senior economist, and Yukako Ono, economist

A recent Chicago Fed conference looked at the shifting geography of company headquarters, with a public policy focus on headquarters as a much-desired target of economic development efforts.

On October 29, 2004, the Federal Reserve Bank of Chicago held a conference entitled "Headquarters and Cities."[1] The headquarters operations (HQs) of large multi-establishment firms are usually located in cities because of superior transportation and communication infrastructure and, more common of late, because cities are often preferred by high-skilled workers and dual-career households.

1. Fortune 500 headquarters 1975–2003



SOURCE: *Fortune* magazine, various issues.

In his introductory remarks, Bill Testa, vice president and director of regional programs at the Chicago Fed, noted that headquarters are the "prized pelts" of city economic development offices. Why is this? For one, HQs enhance a city's economic strength and image. A city that is the location of big name corporations will find it easier to attract potential investors. For another, HQs often rely on high-level business services—many of which may be purchased locally, thereby creating jobs and income. In addition, the jobs of HQ workers are typically of the highly skilled and highly compensated variety. Thus, from the local community perspective, HQ employees may be corporate leaders who are active in civic and philanthropic affairs.

However, the philanthropic activities of HQs may be changing along with the evolving organizational structure of firms. Most importantly, the size of corporate HQs is said to be shrinking in many firms and industries. As many firms have outsourced services formerly performed at the headquarters, no longer does the headquarters translate into a single "corporate campus," housing everything from payroll to R&D to administration to public relations. Company mergers and acquisitions have increased, along with CEO turnover, often leading to consolidation and relocation of headquarters. Finally, many companies have become more global and knowledge-intensive in scope, with corporate control more broadly dispersed.

In view of these trends, policymakers, planners, and development professionals may need to adjust their development targets, possibly to focus more on achieving a combination or "cluster" of both HQ functions and related business service providers, such as accounting, advertising, banking, insurance, legal, and management consulting. Alternatively, rather than focusing on facilities and companies at all, perhaps cities should be thinking about what public services attract high-income personnel, i.e., professional workers and entrepreneurs who develop and staff headquarters and related finance and business service companies.

The first conference session was moderated by Greg Hinz, weekly columnist for *Crain's Chicago Business*. Hinz has covered the progress of Chicago as the domicile of HQs in recent years as it has lost prominent HQs, such as Amoco and Bank One, while gaining Boeing and recently the North American HQ of HSBC. Observers have been asking whether the recent drop off in business service jobs in the Chicago economy can be attributed to an outflow of large corporate HQs (which may be their customers).

Thomas Klier, senior economist at the Chicago Fed, explained that headquarters of large companies continue to be disproportionately concentrated in large cities. Among these, however, mid-tier cities have been gaining headquarters at the expense of the very largest cities, such as New York and Chicago, for some time (see figure 1).[2] Klier said that Chicago gained headquarters during the 1990s and remained second only to New York as a location for headquarters of publicly traded companies. He reported a considerable amount of volatility in headquarters locations, related to firm births and deaths, as well as growth, decline, and mergers of companies. In Dallas, for example, a disproportionately large share of the volatility is explained by companies relocating to Dallas. In Minneapolis, on the other hand, a larger than average share of headquarters volatility is related to the growth of existing companies. Finally, Klier discussed the results of his statistical model of headquarters location, which combines company- and city-specific data. The model shows that cities with a well-educated work force, good access to international transportation, and a reputation as a global business center were more likely to retain headquarters during the 1990s.

Next, Yukako Ono, economist at the Chicago Fed, discussed the turnover and geographical distribution patterns of headquarters. Looking at management offices in general (including corporate, subsidiary, and regional headquarters), Ono said that there is quite high turnover of headquarters (see figure 2). Headquarters appear and disappear at a locality due to firms' separating management offices from their production facilities, relocating existing headquarters, or shutting down some subsidiary or regional headquarters. However, the high turnover does not imply that relocating or opening headquarters is easy for any firm. Ono showed that firms have to reach a certain size to have stand-alone management offices—as opposed to management offices side by side with production facilities. In addition, she argued that, particularly in manufacturing, even after a firm separates its management from its production facilities, proximity to production activities may still be important for the purposes of monitoring, evaluating, and coordinating these activities. This helps explain why, unlike business services that are disproportionately concentrated in more populated areas, manufacturing headquarters are located in small and mid-size cities.

The same is certainly not true of service and finance industries. In a comparison between Manhattan and Chicago's Cook County, Ono showed that one-quarter of stand-alone headquarters in the finance, insurance, and real estate (FIRE) sector are located in Manhattan. Given that some business services and FIRE as a whole are concentrated in Manhattan, the concentration of headquarters might reflect a desire to locate production and management in the same area. On the other hand, a high concentration of a specific sector's headquarters might also reflect the benefits of information exchange among firms within the sector.

Offering the site location practitioners' viewpoint, Jerry Szatan, an experienced principal of a site location company, observed that HQs typically move for one of two reasons or, often, a combination of these two. First, as companies experience significant growth in their operations, a headquarters relocation may make strategic sense for the administration of the new (and expanded) geography of the firm. Second, when a company's size and markets have shifted and expanded, it may seek to change its image to align with these new realities for customers and investors. Szatan cited two significant costs often associated with an HQ move. First, there are the high costs of moving HQ executives and other skilled workers. Increasingly, key personnel are lost to the firm because of the growing prevalence of dual-career households, where both wage-earners must consider the new locale suitable. Second, there are transitory but high costs of disrupting business operations during the move and its aftermath.

2. Turnover among stand-alone HQs

	Opening rate	Closing rate
1977–82	0.54	0.48
1982–87	0.61	0.52
1987–92	0.56	0.48
1992–97	0.58	0.58

NOTE: Opening and closing rates are calculated as ratio of new or closed headquarters to number of existing headquarters at beginning of period.
SOURCE: K. Aarland, J. Davis, J. V. Henderson, and Y. Ono, 2003, "Spatial organization of firms: Decision to split production and administration," Federal Reserve Bank of Chicago, working paper, No. 2003-30.

Lyssa Jenkens, chief economist and vice president with the Greater Dallas Chamber of Commerce, discussed HQ recruitment. To date, because Dallas is a young and rapidly growing area, the Chamber has focused on recruitment rather than retention. For more mature cities, however, retention may be the more effective public policy. Recruitment success can be modeled as a two-stage process in the typical firm's decision-making. First, large scale fundamentals must put you on the final list of candidate cities. For Dallas, the growth of new markets and market opportunities in the region, together with significant cost savings and work force quality, have brought it to the attention of many HQ operations in recent decades. To succeed in the second stage of the process, Jenkens said, the city needs a well-informed and aggressive sales pitch and the ability to create a high comfort level among senior HQ execs with the local quality of life and business climate.

The second panel was introduced by Richard Longworth, executive director of the Global Chicago Center at The Chicago Council on Foreign Relations. Longworth suggested that as companies have become both more global and knowledge-intensive, the attractions of large "global cities" for major headquarters may be changing. Transportation and communication needs may be more pressing for such companies, but the related infrastucture may also be becoming more common among cities. Instead, what may tip the balance toward global cities (such as Chicago) is that an organization's leader can interact there with other corporate leaders during the course of the day. Cities are "learning places," where both new ideas and important business information can be "snatched from the air," so to speak, and this may be critical to globally dispersed, knowledge-intensive firms.

Next, Stuart Rosenthal presented empirical evidence showing that headquarters tend to cluster together in order to take advantage of information-exchange benefits. In particular, he looked at exporters. Exporting requires specialized knowledge of foreign markets. Information exchange is especially important for firms that export to countries with "difficult" trading environments. Rosenthal's research measures, for each country, the degree of difficulty in the trading environment based on the degree to which a country is integrated into the world economy, the level of political freedom, GATT membership, whether the country is subject to U.S. trade sanctions, and the country's credit rating. He reported that the U.S. headquarters of firms that do business in more "difficult" trading environments are more geographically concentrated, indicating that they rely more heavily on local information exchange.

Then, Saskia Sassen, professor of sociology at the University of Chicago and visiting professor at the London School of Economics, discussed the role of digitization in finance. She suggested that finance companies are intense consumers of new technologies and that they use technology to meet the seemingly conflicting goals of decentralization of the product to meet consumer needs while maintaining system integration and control. She argued that centralization/agglomeration is still necessary at the point of product generation, and this tends to affect the location of HQ operations and their functions. Administrative HQs can be located anywhere, since they perform routine functions that don't benefit from the service network found in global cities. In contrast, strategic HQs' operations often require a global city.

As an example, Sassen cited the location and relocation of various financial service functions in the New York area after September 11. Partly arising from the initial impetus of enhanced security concerns, administrative functions (and the build-up of system redundancy) moved out of Manhattan. However, specialized functions, such as the trading floor at Goldman Sachs, remained behind. She suggested that a shared culture existed in the trading world and that informal interaction was essential to success—both work-site and cross-firm communication. Even though complex software could be designed to guide traders, Sassen argued that non-digital tools are still needed. These may include unique cultural attributes to create trust, an ever-evolving dialect for interpretation of information, and the services and interaction between traders and several connected professions. More generally, she concluded, each city's headquarters may reflect its own deep economic history.

Matt Krentz, Chicago-based partner of the Boston Consulting Group (BCG), commented on the locational strategy of his management consulting firm and some of its clients. With 60 offices around the world, BCG functions more as a neural network than as a hierarchy. Its current CEO, for example, is located in Frankfurt, Germany, while the former CEO was in Chicago. The primary function of all of its offices is to provide expertise and strategic advice to its customers. To some extent, the size and location of offices are determined by access to customers. Loss of headquarters and other key customers in a region can be seen to diminish the presence of a management consulting company there. So too, the depth and breadth of air travel connections to serve customers are key. However, another determinant of BCG office size is the ability to attract and retain the very highest level of skilled consultants. This requires cities that are large and diverse enough to provide career opportunities for dual-career households, have a world-class quality of life, and provide rich educational opportunities. From his observations of other industries, Krentz pointed out that the nature of headquarters has been changing, with many back-office operations now being outsourced to other locations or other companies. Today's headquarters are noticeably smaller than they used to be. They still matter, but in a different way. While the actual headquarters staff may be small in numbers, it interacts with companies that provide support services. Often that contact needs to be face to face. That's why many of the high-end business services are located in metropolitan areas that are home to headquarters.

Next, Rae Rosen, vice president and economist at the Federal Reserve Bank of New York, described New York's experience as a truly "global headquarters" city. Even as New York has lost headquarters in recent decades, its economy has moved upward in the skill composition and wages of its employees. The share of those workers employed in business services, finance, engineering and management, and computer-related industries continued to expand during the 1990s. Total employment has remained largely flat over the past 40 years, but personal income has approximately

Chicago Fed Letter is published monthly by the Research Department of the Federal Reserve Bank of Chicago. The views expressed are the authors' and are not necessarily those of the Federal Reserve Bank of Chicago or the Federal Reserve System.

ISSN 0895-0164

doubled. As evidenced by the behavior of the securities industry, the city has continued to shed back office and less-skilled occupations. The New Jersey side of the metropolitan area now hosts 40,000 jobs in the lucrative securities industry. However, the higher paying jobs have tended to remain and expand in Manhattan. How has NYC continued to reinvent itself as a highly specialized financial center? The process has occurred more through serendipity than planning, said Rosen. Much like other cities, New York is trying to understand how to help build and renew the networks and agglomerations of firms and functions that will create wealth and income in the coming years.

Paul O'Connor, executive director of World Business Chicago, delivered a keynote address on bringing headquarters to Chicago. His organization, a public–private partnership between the Chicago area business community and the City of Chicago, was successful in winning Boeing's global headquarters from Seattle in 2000. In this effort, O'Connor cited such success factors as O'Hare airport's modernization and broad scope in offering nonstop flights, a culturally diverse and high-quality-of-life city where Boeing can be comfortable recruiting the world's best talent (and their families), and the presence of other business leaders with whom to confer on global business strategy and information. O'Connor announced that a major petrochemical operation will make Chicago its global headquarters in the near future.

Reflecting on the importance of headquarters to cities, O'Connor said that large headquarters matter greatly for city morale and for philanthropic/civic leadership. However, he noted that the public and press often hold a distorted or incomplete view of the actual job impact of a nameplate HQ arrival or departure. For example, he cited PepsiCo's acquisition of Chicago-based Quaker Oats in 2000, whereby the city lost a major headquarters but subsequently gained many high level jobs in PepsiCo's strategic reorganization.

Conclusion

Many cities have experienced a similar wave of mergers and acquisitions and with it have lost familiar headquarters' names and prestige. Yet, underneath the upheaval, successful cities continue to grow their own companies in several ways, so that the occasional loss of a headquarters through a merger or acquisition is often not that significant. Consequently, in their public policy and business strategy, cities should emphasize such fundamentals as transportation and communication infrastructure and providing those high-quality public services that serve to create and retain global businesses and their employees.

[1] View the agenda and presentations at www.chicagofed.org/news_and_ conferences/conferences_and_events/2004_ headquarters_and_cities_agenda.cfm.

[2] The headquarters of large banking companies, however, strongly favored larger cities during the 1990s. See Robert DeYoung and Thomas Klier, 2004, "Why Bank One left Chicago: One piece in a bigger puzzle," *Chicago Fed Letter*, Federal Reserve Bank of Chicago, No. 201, April.