

THE CIVIC FEDERATION/FEDERAL RESERVE BANK OF CHICAGO

Chicago Fiscal Future: Growth or Insolvency?

Dealing with and Overcoming Fiscal Distress

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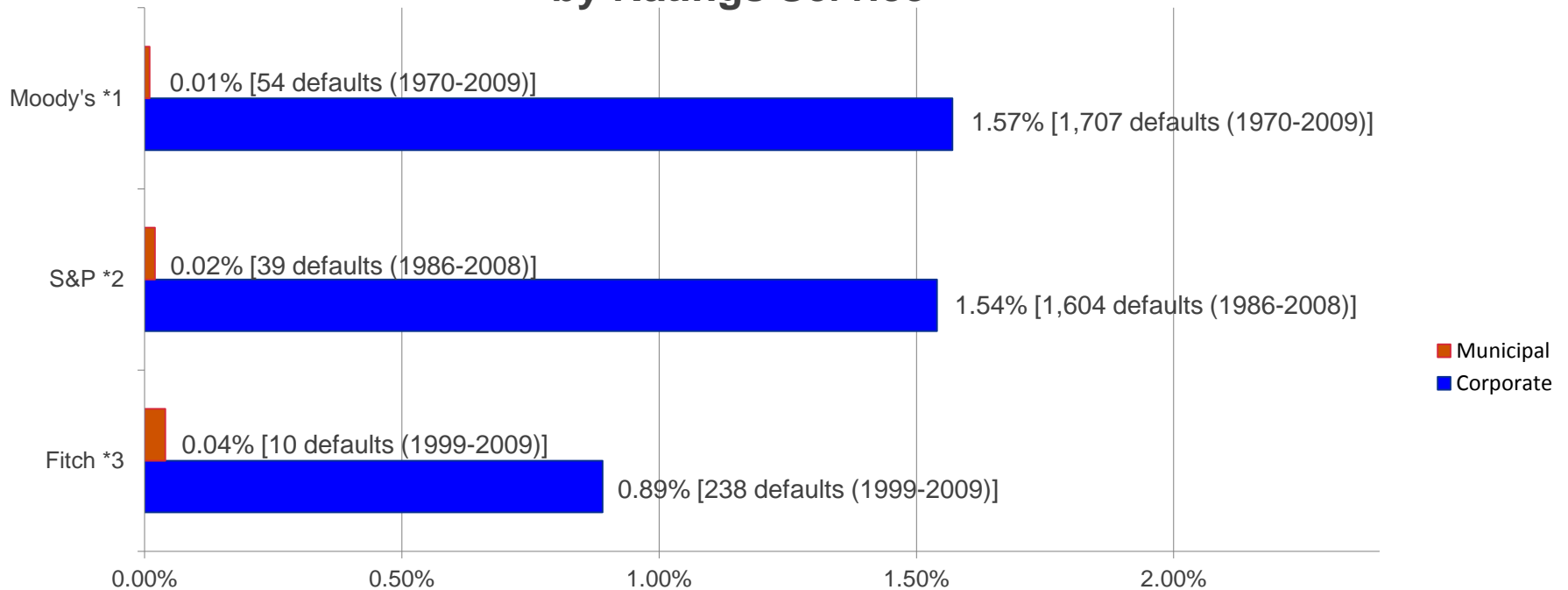
I. THE GATHERING STORM

A. Financial Distress of State and Local Governments is Rare but It Does Occur:

1. The default rate for rated state and local government bond debt is 1/50 to 1/100 (1 or 2%) of that of the rated corporate bond defaults.
2. The rate of Chapter 9 bankruptcies for municipalities is actually .086% of corporate Chapter 11 filings or 8.6/10,000 of that of corporate Chapter 11 per year over the last 36 years.

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Rated Municipal vs. Corporate Default Rates by Ratings Service



1. Moody's Investors Services, U.S. Municipal Bond Defaults and Recoveries, 1970-2009 (February 2010); Moody's Investors ServCorporate Default and Recovery Rates, 1920-2009 (February 2010). Percentages based upon average one-year default rate.
2. Standard & Poor's, 2009 Global Corporate Default Study and Ratings Transitions (March 17, 2010); Standard & Poor's; U.S. Municipal Ratings Transitions and Defaults, 1986-2009 (March 11, 2009). Percentages based on average default rate.
3. Fitch Ratings Inc. U.S. Public Finance Transition and Default Study (1999-2009), March 25, 2010; Fitch Ratings Global Corporate Finance 2009 Transition and Default Study.

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- B. Recent Default Rate: Historically, there is a low default rate for bonds issued by municipalities and states and studies of recent default since 1970 continue the trend:
- The late Dr. John Petersen of George Mason University noted in his paper on “Municipal Defaults: Eighty Years Made a Big Difference” (2011) that, between 1970’s-2000’s, the municipal default for municipalities averaged per decade .10% to .24% (adjusted for WPPSS and Jefferson County, Alabama) not including the fact that over 80% of the defaults were conduit financings and not essential public financings. This is a far cry from the corporate bond default rate on average for investment grade and non-investment grade of about 10%. (Petersen, 2013).
 - States have not defaulted on general obligations bonds since the late 1880’s, with the exception of Arkansas debt in 1933, which was thereafter refinanced.

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Recorded Defaults, by Type of Local Government Unit 1839-1969

	1839	1850	1860	1870	1880	1890	1900	1910	1920	1930	1940	1950	1960	Total Defaults	Number of Local Governments in 1967 ^a	% of Annual Default Rate Over 130 Yrs. ^b
By Type of Units	-49	-59	-69	-79	-89	-99	-09	-19	-29	-39	-49	-59	-69			
Counties and parishes		7	15	57	30	94	43	7	15	417	6	12	24	727	3,049	.183%
Incorp. munics.	4	4	13	50	30	93	51	17	39	1,434	31	31	114	1911	18,048	.081%
Nunincorp. Munics.		4	9	46	31	50	33	5	10	88	7	4	26	313	17,105	.014%
School districts				4	5	0	11		14	1241	5	23	60	1,272	21,782	.048%
Other districts				2	1	12	11	7	107	1,590	30	42	70	1,872	21,264	.067%
Totals	4	15	37	159	97	258	149	36	185	4,770	79	112	294	6,195	81,248	.058%

a The number of local government units has changed rapidly. For example, in 1932 there were 127,108 school districts, 8,580 other districts, and 175,369 state and local government units.

b The percent of annual default in total defaults by type divided by number of governments divided by 130 (years).

Sources: Default information in *The Daily Bond Buyer*, *The Commercial and Financial Chronicle* and *The Investment Bankers' Associations Bulletin*: default lists from Federal Deposit Insurance Corporation, Life Insurance Commission, and U.S. Courts; and Albert M. Hillhouse, *Defaulted Municipal Bonds* (Chicago: Municipal Financial Officers Association, 1935). Number of local government units from: U.S. Department of Commerce, Bureau of Census, *Census of Governments, 1967*, Vol. 1 "Governmental Organization" (Gov't Printing Office, 1969) and ACIR Report *Bankruptcy, Defaults and Other Local Government Financial Emergencies* U.S. Government 1973.

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- Historically, based on default rate, willingness to pay has not been a real problem but current events may test that premise.
- Essential service debt financing has historically enjoyed a significantly lower default rate than healthcare, housing and conduit state and local governmental financing.
- Unfunded pension obligations and deferred infrastructure costs are a more recent phenomenon – Prior to 1960s, most pension obligations were treated as gratuities and a significant number of big ticket infrastructure costs are only now starting to age such as the interstate highway system, electric grid, waste water treatment facilities, etc.
- We are closer to a tipping point and departure from the historical assurances than we have ever been. The difference may be whether there will be adherence to the Washington-Hamilton principle of honoring the payment of public debts and reinvesting in state and local government going forward.

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D. What Is Chapter 9?

- Exclusive chapter of the Bankruptcy Code that provides a method for municipalities to adjust debt.
- Not a tool for elimination of municipal debt.
- It is voluntary, a municipality cannot be forced into bankruptcy.
- States cannot file a Chapter 9 bankruptcy because they are also co-equal Sovereigns with the federal government and federal courts cannot involuntarily alter states rights under Article X of the U.S. Constitution.
See Written Testimony of James E. Spiotto “The Role of Public Employees Pensions in Contributing to State Insolvency and Possible State Bankruptcy Chapter 9”. Hearing before the U.S. House Subcommittee on County/Commercial and Administrative Law, 112th Cong. 54 (2011) available at http://Judiciary.house.gov/hearings/printers/112th/112-25_64585.pdf

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D. For What Purpose has Chapter 9 Municipal Bankruptcy Been Used?

- To adjust the level of debt obligations of a municipality so the debt is sustainable and affordable.
- To restructure burdensome labor contracts.
- To avoid or restructure legal settlements and judgments.
- To address losses on or poor investment strategies.
- To restructure pension and health care related liabilities.
- To restructure contractual obligations.
- To restructure debt on a failed enterprise or proprietary project.
- To restructure tax-exempt debt.
- To be used as a last resort when all other compromise and restructuring efforts fail to reduce debt obligations of municipalities so that essential governmental services can continue to be provided.

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E. Historically the Use of Chapter 9 Bankruptcy by a Municipality Has Been Rare and a Last Resort, Especially Compared to Corporate Chapter 11 Filings:

- Since 1937 when Chapter 9 municipal debt adjustment was enacted almost 80 years ago there have been only 672 Chapter 9 filings namely by small municipal utilities and special tax districts and by some cities, towns, villages and counties but generally not of any significant size.
- Since 1954, virtually all of those municipalities that filed Chapter 9 were small or not major issuers of bond debt except for Bridgeport, CT in 1991, Orange County in 1994, Vallejo, CA in 2008, Jefferson County, AL in 2011, Stockton and San Bernardino, CA in 2012 and Detroit in 2013. Both Harrisburg, PA and Boise County, ID. cases were dismissed as was Bridgeport in 1991.

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- Of the 303 Chapter 9 filings since 1980 and of the 328 filings since 1954, 178 (193 since 1954) have been municipal utilities and special districts and only 54 (64 since 1954) have been cities, counties, towns and villages. The remaining, 57 (since 1954 and 1980) have been hospitals or healthcare, 8 transportation and 6 school or educational facilities. Less than 70% of the Chapter 9 filings resulted in a confirmed plan of debt adjustment.
- Since 1980 Chapter 11 corporate filings have averaged at least 10,000 per year compared to about 8.6 Chapter 9 filings per year.

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The largest cities, towns, villages and counties to have filed Chapter 9 bankruptcy in the last 60 years (including Detroit):

	Approximate Population	Approximate Debt in Millions
Orange County (filed 1994)	3,000,000	\$1,974
Vallejo, California (filed 2008)	115,942	\$175 (2008)
Jefferson County (filed 2011)	658,931 (2011)	\$4,200
Stockton, California (filed 2012)	291,707 (2010)	\$1,032 (2011)
San Bernardino (filed 2012)	213,012 (2011)	\$492.3 (2011)
Detroit, Michigan (filed 2013)	701,475 (2012)	\$18,500 (2013)

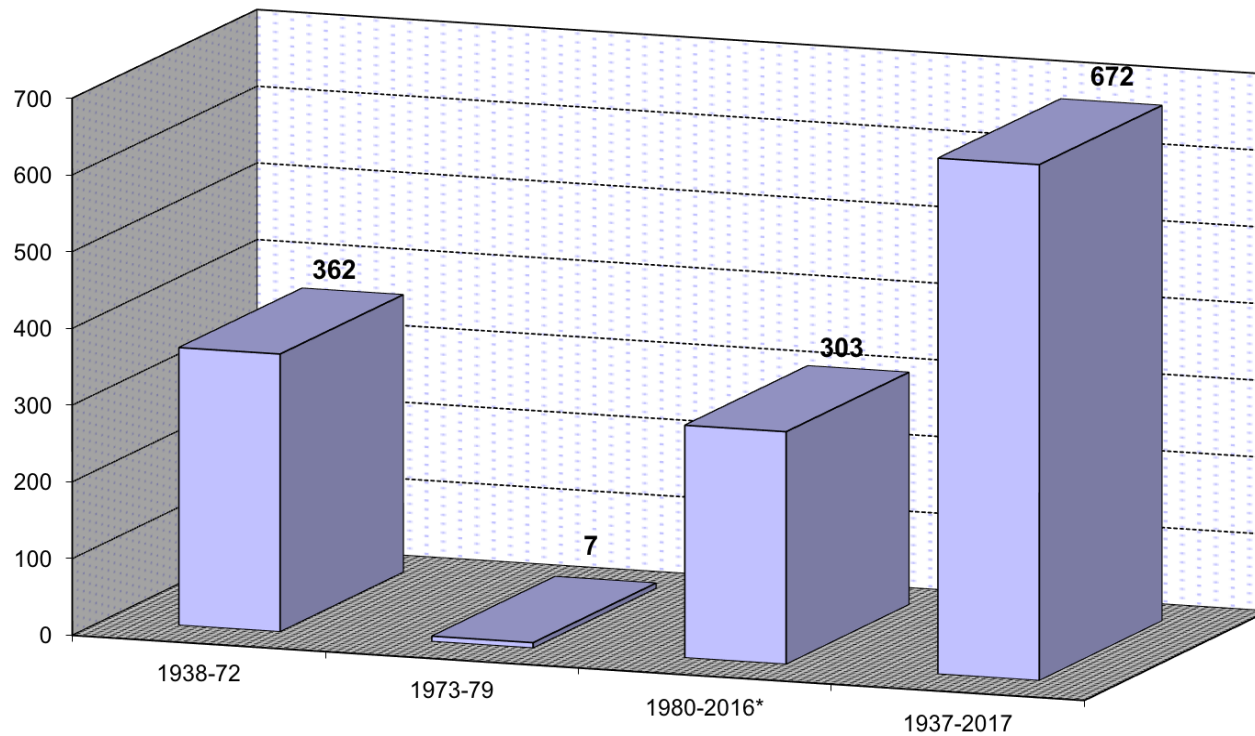
I. THE GATHERING STORM

F. Current Use of Chapter 9:

- No Tsunami of Chapter 9 filings in 2012, 2013, 2014, 2015 and 2016.
- Only 13 Chapter 9 filings in 2011, 12 in 2012, 8 in 2013, 10 in 2014, 3 in 2015, 6 in 2016 and 2 so far in 2017.
- Only 4 cities, towns, counties or villages filed Chapter 9 (municipal bankruptcy) in 2011, namely Jefferson County, Central Falls, Boise County and Harrisburg, PA (Boise County and Harrisburg were dismissed), 3 in 2012, namely Stockton, San Bernardino and Mammoth Lakes (which was dismissed that year) and only 1 in July, 2013 – namely Detroit. Since the Detroit Chapter 9 was filed in 2013, 2014, 2015, 2016 and, so far in 2017, only one city, Hillview, KY in August 2015, filed and that was dismissed in April, 2016 without filing a plan of debt adjustment.
- Total Chapter 9 filings since 1937 – 672. States cannot file Chapter 9 – Co-Sovereign with Federal Government and 10th Amendment Issues.
- Still RARE and mainly small special tax districts, municipal utilities.
- In the last 60 years, only 64 cities, towns, counties and villages have filed out of 328 Chapter 9 filings that have been made. Twenty-nine of the 64 (44%) were Chapter 9 cases dismissed before any plan of debt adjustment was confirmed with purportedly the city, town, village or county finding a better resolution or was not authorized to file under state laws.

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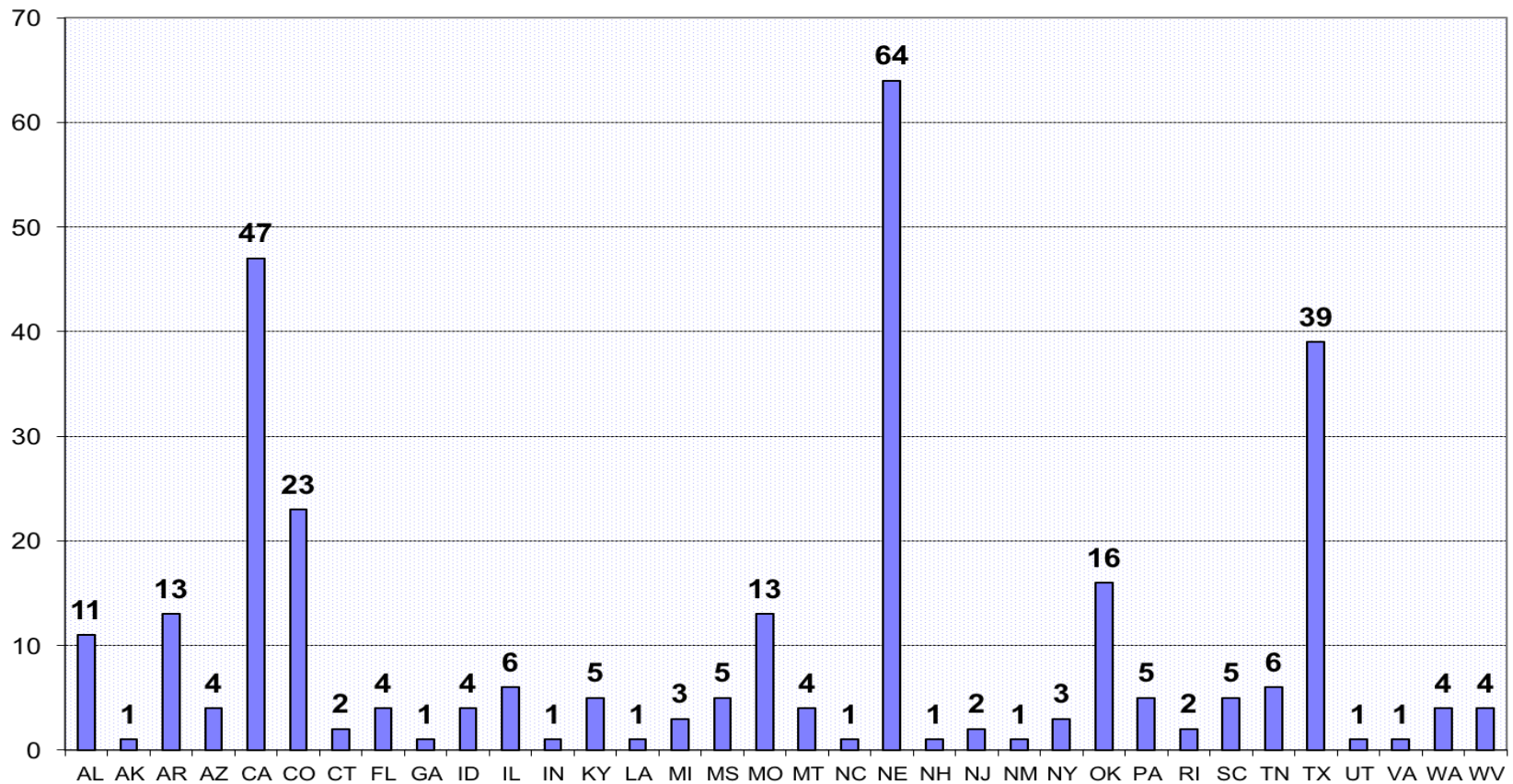
FREQUENCY OF MUNICIPAL BANKRUPTCIES • 1937-2017
(as of 2/07/2017)



* Since passage of the Bankruptcy Code.

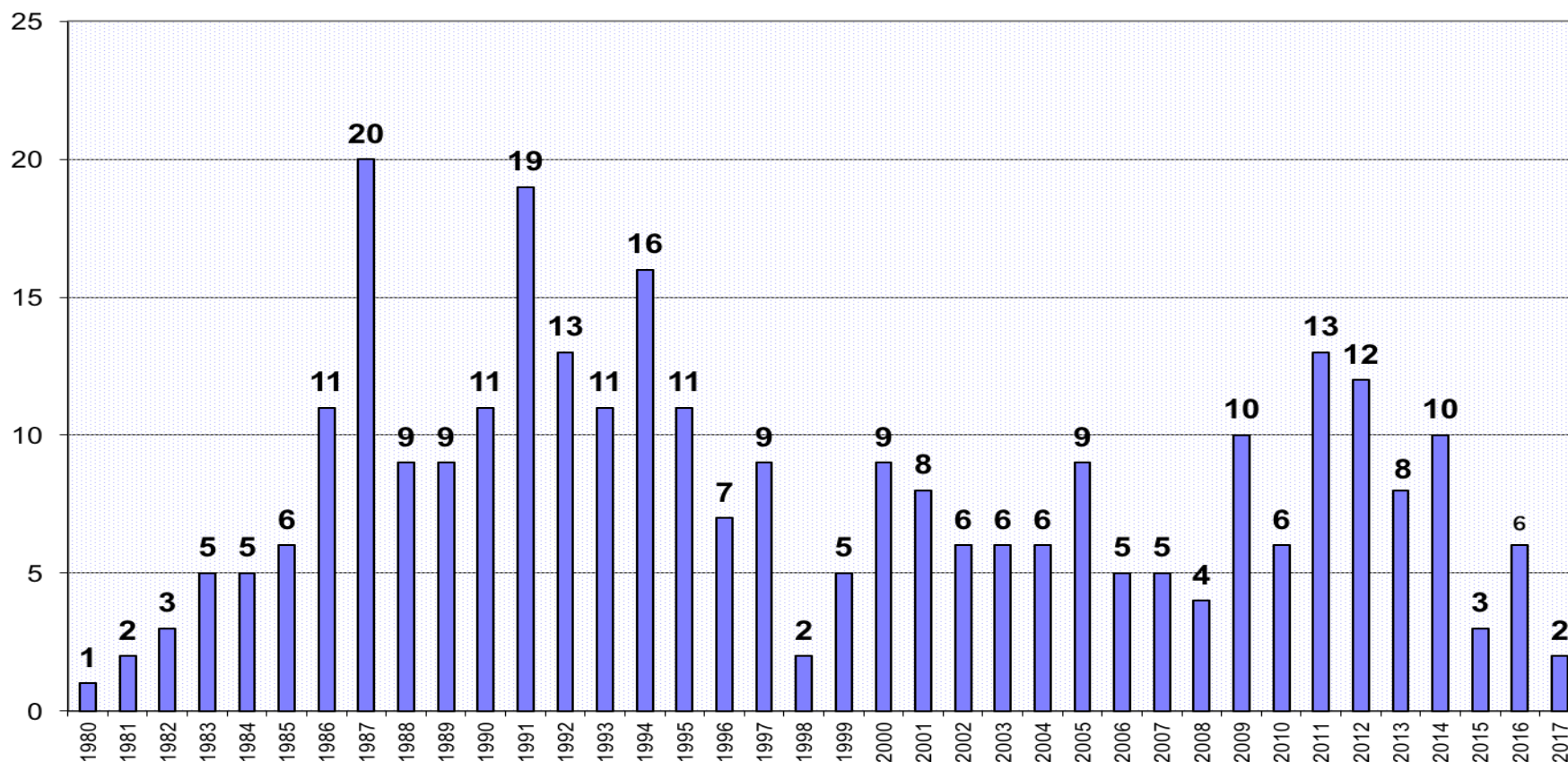
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CHAPTER 9 FILINGS BY STATE • 1980-2017
(as of 2/07/2017)



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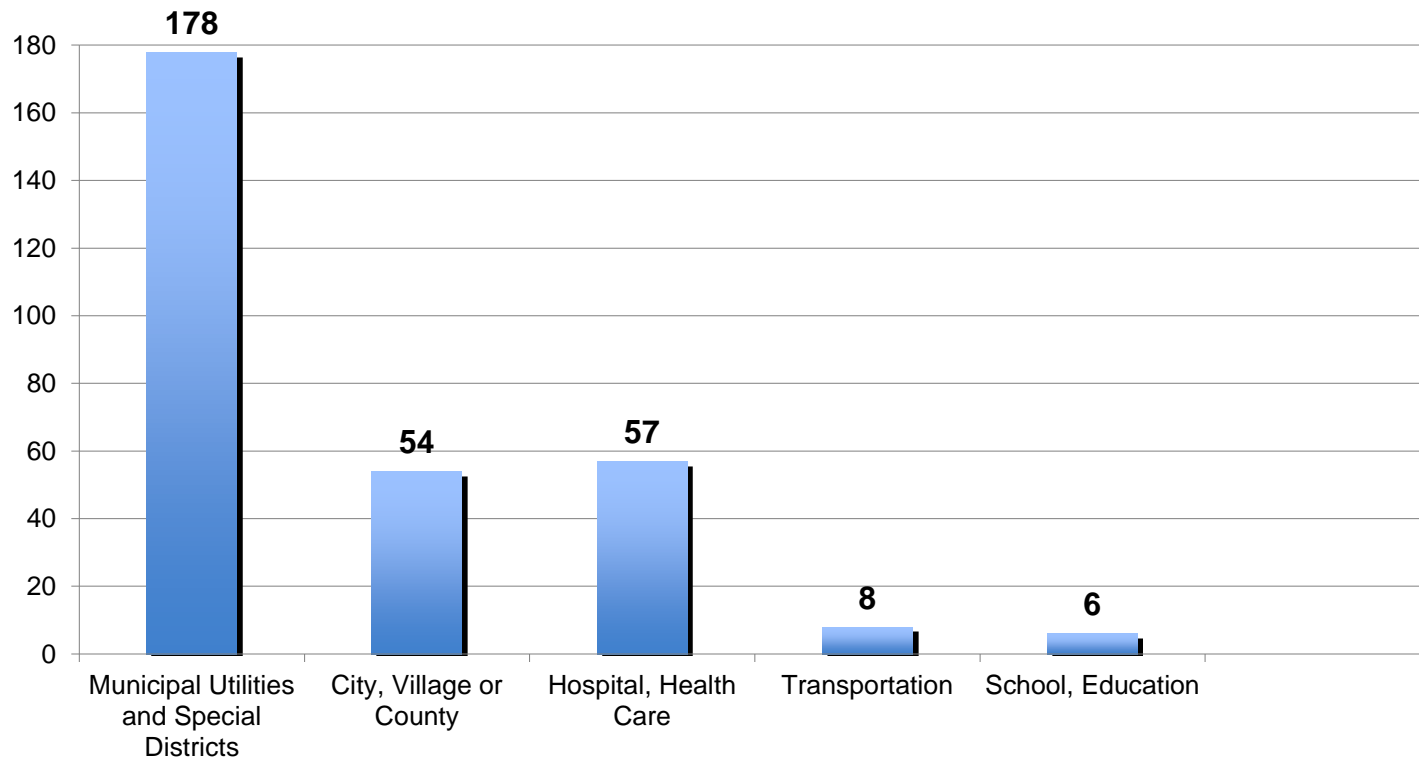
CHAPTER 9 FILINGS BY YEAR • 1980-2017
(as of 2/07/2017)



I. THE GATHERING STORM

CHAPTER 9 FILINGS BY TYPE • 1980-2017

(as of 2/07/2017)



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G. Chapter 9 Is Not a Tool for Elimination of Municipal Debt:

- Since a municipal unit is intended to continue to provide governmental services in perpetuity and is not intended to liquidate its assets to satisfy creditors but rather continue to function as a municipality, the primary purpose of Chapter 9 is to allow the municipality to continue operating and keep creditors away while it adjusts or refinances creditor claims.
- Adjustment of the debts of a municipality is typically accomplished either by extending debt maturities, reducing the amount of principal or interest, or refinancing the debt by obtaining a new loan.
- More appropriate to refer to Chapter 9 as municipal debt adjustment rather than municipal bankruptcy.

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- It is voluntary, a municipality cannot be forced into bankruptcy. Chapter 9 has a stigma in the capital markets. Chapter 9 is viewed as the last resort when all else fails.
- Chapter 9 is time consuming, prolonged, uncertain, expensive and generally all parties are not happy with the outcome.
- Chapter 9 municipal debt adjustment process provides no new revenue sources, does not foster an image that attracts new businesses or tax payers and can motivate, both business and individual presently in the municipality, to leave.

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H. Limitations on the Chapter 9 Bankruptcy Court's Jurisdiction:

- The Bankruptcy Court in a Chapter 9 proceeding cannot interfere with the government property, revenues and affairs of the municipality without the municipalities consent and cannot impair, limit or interfere with any mandated actions under state law (§§ 903 and 904 of the Bankruptcy Code).
- Other than the lack of revenues to pay creditors, municipal services are determined as to whether they will be provided by the governmental body, not by the Bankruptcy Judge. (See e.g., Bankruptcy Court's refusal to overturn the "Water Shut Off" ruling by the Detroit utility for nonpayment.)
- Unlike Chapter 11, the municipality can sell its assets, incur debt and engage in governmental affairs without necessarily having to obtain the approval of the Bankruptcy Court.

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I. Labor Issues in Chapter 9:

- Burdensome labor contracts can be rejected for cause (City of Vallejo, Detroit and San Bernardino) unlike the Chapter 11 (Corporate Reorganization) § 1113 there is no time consuming detailed process of proposals, information sharing, negotiation prior to any rejection motion can be filed.
- Unfunded pension liabilities are unsecured obligations and no priority for wages, vacation, pension or healthcare in Chapter 9 unlike Chapter 11.

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J. Who Can File Chapter 9?

- No Chapter 9 for states: States can not file for Chapter 9 bankruptcy because they are co-sovereigns with the Federal Government under the U.S. Constitution (10th Amendment). States have the right as sovereigns to permit their respective sub-sovereigns (municipalities) to file.
- Who can be a Chapter 9 debtor?: Not every municipality can be a debtor in Chapter 9. Only municipalities in states that specifically authorize their municipalities to file can use Chapter 9. To be a debtor in a Chapter 9, an entity must be:
 - A municipality.

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- Special authorized under state law to be a Chapter 9 debtor. Twelve states have statutory provisions in which the state specifically authorizes filing Chapter 9 by a municipality (AL, AZ, AR, ID, MN, MO, MT, NE, OK, SC, TX, WA), another twelve states authorize a filing of Chapter 9 by a municipality conditioned on a further act of the state, an elected official or state entity (CA, CT, FL, KY, LA, MI, NJ, NC, NY, OH, PA, RI). Three states (CO, OR and IL) grant limited authorization, two states prohibit filing of Chapter 9 (GA) but one of them (IA) has an exception to the prohibition. The remaining 21 are either unclear or do not have specific authorization for their municipalities to file Chapter 9.
- Insolvent (unable to pay its debt as they mature).
- Willing to effectuate a plan.
- Either has obtained the agreement of creditors holding majority amount of the claim of each class that the municipality intends to impair or has attempted to negotiate in good faith, but was unable to do so or it was impractical to negotiate with creditors or a creditor is attempting to obtain a preference.

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K. Chapter 9 – (Municipal Debt Adjustment) Is Unlike Chapter 11 (Corporate Reorganization):

IN A CHAPTER 9

- Only the municipality can initiate a Chapter 9 if authorized by state law.
- Only the municipality can file a Plan of Debt Adjustment.

IN A CHAPTER 11

- The corporation (voluntary) or its creditors (involuntary) can initiate a Chapter 11 case if the corporation is a moneyed entity (not a non-for-profit) and insolvent.
- The corporate debtor (during the exclusive period) or any creditor (after the exclusive period) may file a Plan of Reorganization or Liquidation.

I. THE GATHERING STORM

IN A CHAPTER 9

- The Plan of Debt Adjustment can only adjust debt. It cannot liquidate the municipality.
- A Labor Agreement can be rejected in a Chapter 9 if the Labor Agreement burdens the municipality and the equities balance in favor of rejection. This is a lower standard than a Chapter 11.

IN A CHAPTER 11

- A corporate plan can be for reorganization or liquidation.
- Section 1113 of the Bankruptcy Code sets forth the requirements for sharing information with employee representatives and workers and the process of information sharing, and the proposal by the debtor prior to the rejection of the Labor Agreement. It is a higher standard than Chapter 9.

I. THE GATHERING STORM

IN A CHAPTER 9

- There is no limitation on damages on real estate leases held by a Trustee or Municipal Building Authority for a lease financing and the lease financing will be treated as a secured debt financing.
- Payments to defease or pay current interest or principal on bonds or notes within the 90 day preference period before a Chapter 9 filing are not capable of being voided or deemed a preference.

IN A CHAPTER 11

- There is a limitation of the greater of one year's rent or 15% of the remaining terms of the lease not to exceed three years for lease damages in a corporate Chapter 11. It is not treated as secured debt of the corporate debtor if it is a true lease.
- Payment of principal or interest not secured by collateral could be voided or deemed a preference during the 90 day period prior to filing a Chapter 11 if the holder would receive more than what it would be entitled to in a Chapter 7 liquidation.

I. THE GATHERING STORM

IN A CHAPTER 9

- There are no priorities ahead of unsecured claims for prepetition claims due to employee wages, pensions, accrued vacations, healthcare and other employment benefits.
- “Special Revenues” and “Statutory Liens” are not limited or terminated by a Chapter 9 filing and are intended to continue to be paid to secured creditor and are unimpaired by the Chapter 9 filing (there is no Chapter 11 provisions comparable).

IN A CHAPTER 11

- There is a priority ahead of unsecured claims of up to \$12,475 per employee for pre-petition wages, benefits, accrued vacation and healthcare benefits.
- Accounts receivable and inventory created post petition are not covered by the pre-petition lien of a secured lender and the pre-petition lien is terminated except for “proceeds” of the pre-petition lien.

I. THE GATHERING STORM

IN A CHAPTER 9

- A Bankruptcy Court cannot interfere with any restrictions or requirements of state law regarding a municipality's exercise of its governmental powers (including payment of statutory liens). The Bankruptcy Court cannot interfere with the property, revenue and affairs of the municipality.
- The municipality can sell its assets, incur debt, borrow money and engage in governmental affairs without the necessity of having to obtain the approval of the Bankruptcy Court.

IN A CHAPTER 11

- The corporate debtor cannot take any action outside the ordinary course of business without Bankruptcy Court approval.
- The corporate debtor cannot borrow money, sell assets or expand or contract its business without Bankruptcy Court approval.

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L. Illinois and Its Municipalities Have Faced Some Challenging Financial Developments Due to the Great Recession, 2010 Reduction in Income Tax Rates and Income, Increased Unfunded Pension Obligations and Loss of Manufacturing Jobs Among Other Reasons:

1. Illinois and Chicago Metropolitan Statistical Area (“MSA”) had A bittersweet economic climate since 2000.

The Sweet!

- Illinois is the 5th largest state by population and GDP but the 15th by per capita GDP
- Chicago MSA in 2015 is the 8th, 6th or 5th largest metropolitan area by GDP in the world (it was 4th in 2008).
- In the Midwest, Illinois has the highest GDP per capita but also the highest public debt per capita and the highest percentage of public debt to GDP

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The Not So Sweet and Bitter!

- From 1985 to 2000, Illinois and Chicago MSA were competitive with the increase in percentage of personal income and jobs compared to that for the U.S.A. average and the Los Angeles and New York City MSAs.
- After 2000, Illinois and Chicago MSA lagged in the percentage increase in personal income and jobs in comparison to the average for the U.S.A. and New York City and Los Angeles MSAs.
- This could be due to the adverse effects of NAFTA, China joining the World Trade Organization or the economic downturns of 2001 and 2008 and the combined loss of over 75% in value of the Dow from the beginning to the end of the 2001 and 2008 economic downturns.

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Since 2000:

- Illinois' increase in jobs was 17% slower than U.S.A. average.
- Illinois and Chicago MSA had 22-24% less GDP growth than U.S.A. average and higher unemployment rates.
- Due to a sunset of a tax increase in 2015, Illinois income tax collections were reduced by \$4 billion in FY2016 compared to 2014.
- Illinois' unpaid bills were estimated to be \$14 billion by the end of FY2017.
- Illinois' five pension systems unfunded liabilities have increased over 650% since 1995 to about \$129 billion by the end of FY2016.
- The Chicago Public Schools purportedly had no unfunded pension liabilities in 2000 and now have as of FY2014 over \$9.4 billion unfunded pension liabilities.

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- Illinois and Chicago MSA are one of the largest manufacturing areas in the U.S.A. Chicago MSA is the second largest manufacturing area in the U.S.A. Since 2000, Illinois and Chicago MSA lost about 18% more manufacturing jobs than the U.S.A. average. However, the City of Chicago in 2015 added a net 80,000 jobs and a net 60,000 additional jobs in 2016 with an average annual salary of about \$72,000 mainly due to company headquarter relocations to Chicago.
- The following charts provide additional detail on the financial distress suffered by Illinois and the Chicago MSA over the last 16 years.

II. ALTERNATIVES AVAILABLE TO THE STATE OF ILLINOIS AND ITS MUNICIPALITIES TO MONITOR AND PROVIDE OVERSIGHT AND ASSISTANCE TO FINANCIALLY TROUBLED MUNICIPALITIES

Development of a Local Government Protection Authority (“LGPA”) as a Quasi-Judicial Entity to Determine What Costs Are Sustainable and Affordable and Which Are Not, Including Labor Costs and Benefits and Whether Taxes Should Be Raised or Costs Reduced. (Illinois H.B. 2575 modeled after a Civic Federation Proposal):

- Evolution of Past Mechanisms that Worked. Under consideration by some states is the use of a local government protection authority utilizing some of the best aspects from the mediation process of the neutral evaluator and the oversight and supervision of financial control boards and a receiver.
- State-Created Quasi Judicial Function. Under this municipal debt resolution mechanism, the state would establish an entity that would have a quasi-judicial function and power similar to a commission or special master appointed by a state supreme court or other objective nonpolitical process. The members of the authority would be independent, experienced experts in governmental operation or finance as well as in mediation and debt resolution techniques, including bankruptcy.

Part of the Solution for Illinois and Chicago —

VIII. UPSIDE CHICAGO — CREATION OF 10-18 INDUSTRIAL PARKS IN THE CHICAGO AREA CREATING 20,000 NEW GOOD JOBS FOR ABOUT 100-140 NEW OR RELOCATED COMPANIES

A. The Natural Attributes of Chicago for Business Development.

1. Nation's Transportation Center. Chicago is the center of commerce especially as far as Transportation (major rail, land and air as well as water).
2. Major Manufacturing Center. Chicago USA is the second largest manufacturing metropolitan area in the U.S.A. and has a long history in manufacturing given its central location and ease of transportation.
3. Educated Workforce. Chicago has an educated workforce and the ability to educate and train new workers for the new manufacturing models of the future.

B. Development of Upside Chicago.

1. Business Lead Innovation. The Concept was created by local business professionals on a pro bono basis who had experience with operations, manufacturing, finance, insurance and Special Economic Zones, both domestically and internationally.
2. Use of Special Economic Zone Experience. The factors that produced lower cost for production and distribution of goods that led to the development of the Maquiladora in Mexico and Special Economic Zones in China and elsewhere are now present in Chicago.

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3. Significant Cost Saving. For Labor and Freight Intensive Manufacturing the cost of shipping can be 8-16% or more of Sales Price while labor can be 15-22% of Sales Price. A savings of 3-6% or more of sale costs is the equivalent of reducing employment cost by about 25% or more.
4. Project Costs. Chicago's unique transportation facilities could reduce shipping and handling costs by 4-6% or more of Sale Price depending on the comparative shipping locations.
5. Benefit of Managing Agent and Shared Services. Establishing a non for profit special purpose entity that would be the Industrial Parks Coordinating and Supervising Managing Agent ("Park Agent") that would offer manufacturing site with cost efficiencies for smaller manufacturing companies, 100-250 employees by shared services (similar to condominiums for manufacturing) where building outside maintenance, public safety, freight services, public safety inspection, insurance (worker compensation and other general liability) etc. are shared costs with the leverage in negotiation of the mega manufacturer with 20,000 workers. In addition all available financing assistance through local government economic development incentives, site improvement assistance and financing structures would be pursued to the extent appropriate.

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6. Target Manufacturing Businesses. The main focus would be the lower skilled jobs with the higher shipping and handling costs such as auto reclamation, parts remanufacturing (roughly 2,100 companies in U.S.A.), recyclers (about 3,000 companies in USA, 103,000 employees), return processing (or on-line sales return processing), data storage and processing center etc. Given the projected savings (from reduced shipping costs and shared services savings as well as possible governmental incentives), it would be very attractive to these companies to move to Upside Chicago.
7. Sufficient Workforce. More than sufficient supply of high quantity low skilled and semi-skilled workers in Chicago area — the commutable area has at least 1.4 million workers.
8. Attraction of Industrial Park. Companies can envision themselves in a clean, modern, safe, digitally wired, next generation industrial park opposed to being attracted to disparate (perhaps) degraded individual site. Park companies will bond with each other for the benefit of all. They will learn from each other with regard to workers, safety, security, environmental compliance, security etc. The bundled economics benefits of Upside Chicago gives small companies the benefit of a larger enterprise and increased free time by reducing or eliminating time which would have been spent negotiating individually on shared services provided by the Park Manager.

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VIII. UPSIDE CHICAGO — CREATION OF 10-18 INDUSTRIAL PARKS IN THE CHICAGO AREA CREATING 20,000 NEW GOOD JOBS FOR ABOUT 100-140 NEW OR RELOCATED COMPANIES

C. Projected Economic Benefits of Upside Chicago Concept.

Upside Chicago and the goal of creating 20,000 new manufacturing jobs (with additional indirect and induced jobs) should over the long run:

- Create 44,000 jobs more or less (direct, indirect and induced job multiplier).
- Increase state and local taxes by \$426 million or more.
- Help improve infrastructure and government services with increase tax revenues in addition to the Industrial Park site improvements and infrastructures.
- Produce an estimated economic benefit of the Industrial Park Program of over \$8 billion.

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