THE FEDERAL RESERVE BANK
OF CHICAGO

ESSAYS ON ISSUES
2017 NUMBER 379

Chicago Fed Letter

Chicago's fiscal future: Growth or insolvency? A conference summary

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The intersection between poor fiscal conditions facing Chicago and the prospects for business development was the subject of a conference cosponsored by the Federal Reserve Bank of Chicago and the Civic Federation on April 19, 2017. Specifically, the program focused on whether municipal bankruptcy is an appropriate mechanism for addressing extreme fiscal stress and the impact such an action might have on key Chicago industries, particularly those characterized by rapid recent growth.

William Testa, Federal Reserve Bank of Chicago, provided balance sheet comparisons of Chicago and other major cities to assess the condition of the city's asset base and its potential ability to generate revenues. He began by suggesting that the idea of fiscal solvency is often understood across two dimensions—the potential for bond default/inability to borrow or the inability to provide necessary government services.

Testa argued that a primary asset on any city's balance sheet is the value of real property within its boundaries. Property values can capitalize changes in other aspects of a city's balance sheet and can provide both current and forward-looking measures of city asset values. Specifically, recent studies have found that fiscal liabilities are reflected (capitalized) in land values.

Conference presentations are available at https://chicagofed.org/events/2017/chicagos-fiscal-future-growth-or-insolvency.

Testa contrasted conditions in Detroit and Chicago to illustrate how property values have reacted to fiscal conditions in both cities. In the run-up to Detroit's 2013 bankruptcy, the run-up city was characterized by exceptionally poor levels of service provision, political gridlock, and the exhaustion of virtually all major local tax bases (including declining intergovernmental support and increasing out-migration). Property measures reflected this as average home selling prices crashed to a low of $14,200 in 2009 and had only recovered to $49,200 by early 2016. In contrast, while Chicago's real estate values declined during the recession, prices have recently shown gains and market values are far above Detroit levels. Testa estimated that Chicago real estate values in 2013 were more than $85,000 per capita, compared with Detroit's value of slightly more than $20,000. Chicago's real estate market value is also higher than those of fast-growing cities, such as Jacksonville, Houston, Phoenix, and San Antonio. Testa concluded that while Chicago's fiscal liabilities are substantial, the asset side of the balance sheet as reflected by real estate appears to be holding up.

Lessons learned from recent municipal bankruptcies

Next, James Spiotto, Civic Federation and Chapman Strategic Advisors, provided a primer on municipal bankruptcy under Chapter 9 of the federal bankruptcy code and in particular its differences from Chapter 11 corporate bankruptcy.

Spiotto emphasized that municipal bankruptcy is expensive, uncertain, and very rare. It is also restrictive in that only debt can be adjusted in the process because the bankruptcy courts do not have the jurisdiction to alter services. Less than half of the states allow their local governments to file bankruptcy and there is no involuntary process whereby a municipality can be pushed into bankruptcy by its creditors, such as exists under Chapter 11 bankruptcy. Chapter 9 bankruptcy is solely voluntary on the part of the government. Spiotto noted that the large governments that have gone into Chapter 9 bankruptcy all have their own stories, but they have generally involved service-level insolvency, revenue insolvency, and/or economic insolvency. If a jurisdiction does not have these extraordinary problems, bankruptcy is probably not the right choice. However, if a municipality does choose bankruptcy, it is prudent to develop a comprehensive long-term recovery plan in concert with the bankruptcy process.

Eric Scorsone, Michigan Department of Treasury, reviewed the City of Detroit's bankruptcy, focusing on the city's recovery. He said that the bankruptcy was only one part of a longer process that had involved the controversial emergency manager program, whereby the State of Michigan took over city government. Detroit was arguably insolvent by all of the measures Spiotto described when it entered the emergency manager program and later bankruptcy. The bankruptcy process and mediation brought together all of the city's communities to develop a credible plan to exit bankruptcy. The bargain required the philanthropic community, the State of Michigan, and the City of Detroit to put up funding to offset significant proposed cuts in public sector pension benefits.

Scorsone said strong financial leadership and a flexible and comprehensive long-term plan have significantly improved the City of Detroit's finances to the point where it is on track for the oversight board, the Financial Review Commission (FRC), to go dormant in 2018. He said that Detroit's economic recovery since bankruptcy has been extraordinary and much better than could have been imagined five years ago. The city now has a budget surplus, basic services are being provided again, and people and businesses are returning.

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Harrison J. Goldin, Goldin Associates, focused his remarks on the near-bankruptcy of New York City in the 1970s, which represents a unique case, he argued, but with useful lessons for other cities. Goldin was chief financial officer of New York City as it went through its financial turmoil and vividly described the city's disarray in managing and tracking its finances and expenditures prior to his arrival as CFO. The financial crisis forced the city to live within its means and become more transparent in its budgeting, but it also forced difficult cuts to services with significant social consequences. New York had to close municipal hospitals and firehouses and reduce pensions; the city also had to raise revenues by requiring tuition at the previously free City University of New York system and increasing bus and subway fares. The upside was a stable financial environment that allowed New York's economy to grow. Goldin said the lesson of all of the municipal bankruptcies and near-bankruptcies he has consulted on is that a coalition of public officials, unions, and civic leaders must come together to implement the four steps necessary for financial recovery: 1) documenting the magnitude of the problem; 2) developing a credible multiyear remediation plan; 3) formulating credible independent mechanisms for monitoring compliance; and 4) establishing consensus on service priorities.

Mary Murphy, Pew Charitable Trusts, provided a broad overview of the role of states in preventing and managing local government fiscal distress. She emphasized the great diversity among states in whether they monitor local fiscal conditions, whether they offer technical assistance to distressed communities, how they respond to a fiscal emergency, and even how they define distress. States also vary in their legal requirements to access bankruptcy, with only 12 allowing unconditional access to bankruptcy procedures and 12 allowing conditional access. She noted that states often try to keep specific municipalities out of bankruptcy in order to avoid credit effects on other local governments. However, it has been established by the courts that states cannot interfere with a municipality filing for bankruptcy. Finally, Murphy emphasized that the market response to state financial monitoring systems has generally been positive, with Moody's in 2013 saying such programs are beneficial to credit ratings.

City of the big brains? Chicago's future economic growth

Panel moderator David Snyder, Create Your Economic Destiny, said he sees the following five significant changes in Chicago's economic landscape:

- The era of large publicly held companies driving local growth is over.
- Business concentration will continue to favor the central city at the expense of neighborhoods and possibly the suburbs.
- Chicago's economy will continue to benefit from diversification. Currently no single industry represents more than 13% of the economy.
- Privately held, middle-market companies will be increasingly important to growth.
- The economy will be driven by reviving entrepreneurial culture and building necessary infrastructure.

One industry that is seen as key to Chicago's growth is the exchange-based financial service industry. John Lothian, John Lothian & Co., described the significant consolidation, technological change, and market position of Chicago's futures industry. Since the 1980s, the industry has moved from an open-out-cry trading structure to a largely electronic trading platform. At the same time, the exchanges have undertaken several significant mergers and acquisitions, including the merger of the CME and CBOT, which created the world's largest and most diverse exchange, the acquisition by CME of the NYMEX, and the integration of the CBOE and BATS exchanges. As a result, the CME Group markets are now home to 97% of the U.S. futures trade.

The challenge for the industry is primarily reflected through technology and staffing. Lothian noted that 50% of the industry's new employees today need to have a background in STEM (science, technology, engineering, and math) disciplines. To ensure that these workers will be available, Lothian proposed that Chicago should create a financial services education center focused on STEM disciplines, serving 10 to 17 year olds. This would help create a pipeline of elementary and secondary students who will be ready to study STEM disciplines in college and will have access to futures market jobs upon graduation.

Caralynn Nowinski Collens, UI Labs, discussed opportunities associated with technology firms, particularly as they interact with Chicago's legacy industrial base. Collens said that a goal of UI Labs is to pull industries forward into the digital age and to build an infrastructure that supports innovation. Significant progress has been made, she said, and today Chicago has more than 100 incubators, 300 corporate research and development centers, and is launching, on average, 275 new digital start-ups every year. In 2015, $1.7 billion was invested in start-ups in Chicago; and the city now has four so-called unicorn companies with market values over $1 billion.

Collens suggested that what will set Chicago apart is its focus on marrying digital processes to industrial firms. The goal is not to be Silicon Valley but to leverage the existing industrial base and move it toward advanced manufacturing. According to Collens, this "fourth" industrial revolution has the potential to leverage each new advanced manufacturing job and create 16 others in the broader economy.

Collens concluded with two challenges facing the manufacturing sector. First, the image of manufacturing as a dead-end career needs to change, so firms can attract more young workers. Second, a strategy to address potential job loss through increasing automation needs to be developed. While automation will reduce the need for some production jobs, it will increase the need for roles requiring advanced skills. Finally, Collens suggested that in addition to manufacturing, Chicago has digital industrial potential in infrastructure, health care, water technology, and cybersecurity.

Jerry Szatan, Szatan & Associates, provided the perspective of a site-location consultant. Szatan asked why the risk of higher future taxes/reduced government services has not deterred the recent wave of investment in Chicago? Szatan suggested that site selection is all about weighing trade-offs. Companies looking to expand, relocate, or reorganize are typically risk averse and focused on minimizing operating costs, accessing the best labor supply, and accessing the markets for their products. Only after these firm-specific criteria are met, do government incentives come into play, he said. While it is difficult to identify the most important factor driving this process, talent is usually at the top of the list, and Chicago offers a broad, deep, and well-educated labor force. Additional competitive factors in Chicago's favor are connectivity (particularly O'Hare Airport), a vibrant urban environment, and opportunities to collaborate with other firms and institutions.

Szatan argued it is not true to say Chicago's fiscal stress does not matter but that other advantages and the ability to mitigate fiscal risks might make the trade-off worthwhile. However, in some cases the potential for reduced services may pose a significant concern.

The future of corporate investment in Chicago

Chicago Tribune business columnist Robert Reed led a discussion of Chicago's attraction as a location for corporate headquarters and corporate investment. Jennifer Rodriguez, Motorola Solutions, described her company's reasoning for moving its headquarters from suburban Schaumburg to downtown Chicago. She emphasized that the company hopes to attract the young, well-educated workers who prefer to live in the city. Additionally, the company hopes, through the inviting design of its headquarters and ease of access through public transportation, to entice its employees to come into the office more often to interact and exchange ideas and creativity.

Kent Swanson, Civic Federation and Riverside Investment and Development, shared his views on the advantages Chicago has in attracting both domestic and foreign investment. First, Chicago has the infrastructure assets, educated work force, and international appeal of a global city, but not the high cost of a New York or a San Francisco. Office space costs are much more competitive, and therefore attractive to start-ups and smaller businesses. Additionally, Swanson said he viewed the recent movement of headquarters to Chicago as a microcosm of what is happening across the world.

David Reifman, City of Chicago, pointed out that despite the financial challenges of the State of Illinois, the city has worked to improve its pension funding and financial practices. He also underscored the amenities that Chicago offers to corporations, particularly amenities in near proximity to downtown, such as expanded O'Hare Airport services, new train stations and enhanced public transportation service, and programs that leverage high-density investments in the downtown area to generate funding for underdeveloped areas.

Conclusion

Conference presenters agreed that poor fiscal conditions are clearly a drag on Chicago's economy and discussed important concerns about future development and services in the area. To date, the city's existing assets have been sufficient to overcome this fiscal drag and encourage continued investment. It is unclear how long this balance can be maintained.

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ISSN 0895-0164