Federal Reserve Bank of Chicago
Third Summit on Regional Competitiveness
October 23, 2015

The Regional Economy,

"Kicking the can - what to do when you run out of road"

GREG HINZ: Thank you for those kind words. I've been trying to figure out kind of why they asked me to do this. I suspect it has something to do with the fact that I'm one of the few journalists in the Chicago area -- there aren't very many of us left -- who actually write about government and the economy and private companies and how they all interact together.

It's not a terribly pretty picture. I had an experience four or five years ago. I was writing about how the CME Group, which owns the Mercantile Exchange and the Board of Trade, was considering moving its headquarters out of Chicago. And I got a tip from a very good source that the State of Indiana had offered them $150 million in tax breaks (inaudible 0:01:09.5) to move the company, at least part of the company, on the other side of the border.

So I wrote the story, and a couple days later I happened to run into Mitch Daniels, who then was the governor of Indiana, and those of you who haven't had the experience of dealing with an angry Mitch Daniels haven't lived. He was screaming and yelling, and "Well, I didn't offer them $150 million," and he was upset that I had left the impression that he was offering $150 million in special breaks as opposed to $150 million in lower taxes available to everybody.

In fact, I had said it was both, but he didn't deny that Indiana was willing them, and he didn't deny that they had put some big money on the table, and that is kind of typical to how life still oftentimes works in the metropolitan Chicago area, which covers three different states.

Some cities and some regions around the country have started to get their act together and realize that, like Chicago, they're not just competing against the county next door, but they are competing against another metropolitan area around the country; we're competing with Atlanta, we're competing with Los Angeles; we're competing with Dallas-Fort Worth; we're competing with Paris and London, most of which have gotten much farther down the road we're talking about today than we have.

But yet the kind of experience I had with Governor Daniels in Indiana is kind of typical, and it continues to this day. Our mayor, Rahm Emanuel, has gotten a lot of credit lately for bringing big companies downtown. Well, most of the big companies he's brought downtown came from the suburbs, and there's pluses and minuses to both of them, but at a certain point at least some of that is a zero-sum game.

The backdrop for this is that the Midwest's economy as a whole has lagged the nation's economy now for quite a while, and Illinois is lagging the Midwest economy. The latest reports out show that we've lost jobs last month. We've gained fewer jobs than any other Midwest state so far this year. It's not a good picture, and the side story -- and we're going to talk about how much they interact with each other -- is that the state itself is, for all practical purposes, broke.

Two credit rating agencies have downgraded the state of Illinois debt this year, this week in fact. We have the lowest credit rating of any of the 50 states. We have the budget crisis of all budget crises. Be careful when you walk out this afternoon; they may have pulled up the street because somebody didn't pay the bill because the state cut off the money. It's not pretty.

Still, there are some good things that are going on. The region came together in a way I've rarely seen to get the regional manufacturing, digital manufacturing center out on Goose Island. That's involved any number of institutions and companies across any number of things. The current effort to rebuild Union Station is drawing an awful lot of support, it certainly crosses the usual city-suburban lines.

Even here in Illinois, if they ever solve the budget -- please, I'm tired of writing about it -- if they ever solve the budget problem, Randy Blankenhorn, who is the head of the Illinois Department of Transportation, is a really good guy who has some really good ideas. He just needs to have his chance on stage.

So with us today to kind of set the scene and talk about all of that in a little more depth; where we are, how we get out of where we are; are two guys who certainly know what they're talking about. Jeremiah Boyle, if you would come up, sir, he is the managing director of economic development for the Federal Reserve Bank here.

I'm sorry. I'm reading the wrong list -- Rich Mattoon -- I'm sorry, Dick. Richard Mattoon, senior economist and economic advisor, here at the Federal Reserve will go first and David Javdan, who is the managing director at Alvarez and Marsal. We have kind of a loosely defined this as the first gentleman is going to define the problem and the second gentleman is going to tell us how we get out of the problem. With that, I will be quiet.

RICHARD MATTOON: Thanks, Greg, and good morning, everyone. It's a pleasure to be here.

As he said, the topic is this "Kicking the can down the road." In particular, what we're going to emphasize is the relationship between physical structure and how our economies are performing. I've been given the task of covering a lot of ground really quickly, so I am going to already tell you that if you blink you're going to miss some of this presentation because I'm going to cover a lot of topics pretty fast.

The first thing I want to talk about is a little bit about is just a stylized way of looking at how our three states have performed over this recent recovery, both relative to each other, and then relative to the U.S. I want to talk about the current fiscal condition in each of the three states and how that affects the region.

I'm going to use Illinois and Chicago as Greg suggested in some ways as a cautionary tale when it comes to fiscal policy. And then I want to conclude with two more philosophical points, which is why should we care about fiscal health of cities and states, what's its implications for economic development, and why should Indiana and Wisconsin care about the fiscal health of Illinois and

Chicago?

So the first thing I want to talk about is how the region has recovered from the great recession. Until recently, this recovery cycle was relatively beneficial to our region, but it’s starting to get a little bit long in the tooth. It was driven by two things. First of all, a rebound in manufacturing particularly auto-related manufacturing, and then also agriculture, which was doing quite well.

Both of those things have shown significant decay recently. If you look at the agricultural sector, farm incomes are going to be down significantly this year from the peak that they were at in 2012, and if you look at the ISM Manufacturing Index, it’s barely above 50, which is indicating barely expansion at this point.

Now, if you look at how this has affected the three states in the region, Indiana has probably been the biggest beneficiary. The first thing is it has more auto-related manufacturing. It has been more beneficial, and when I show you the next figure you’re going to see that. The lagging industries have tended to be finance and business and professional services, and obviously those are the ones that are most concentrated in Chicago so the recovery is taking longer to get going in Chicago. There was some improvement towards the end of last year in these cycles but nothing terribly dramatic.

So what I'm going to do is use the Philadelphia Fed's Coincident Indicator Index, and what it's going to show you is over the last 10 years Indiana has had the best growth followed by Wisconsin with Illinois bringing up the rear; however, all of them are significantly below the U.S. average, so you're looking at still a region as a whole that has been underperforming really throughout this period of time.

So this is the coincident indicator index. Blue, the top line, is Indiana. As you can see, Indiana actually had the biggest contraction during the recession. It has come out the strongest. So if you look at the slope of the line, it has actually had the best recovery.

If you look at Wisconsin, it had actually the shallowest contraction and has come out in a slow and steady pace. If you look at Illinois, again, it has been probably the most problematic as it has had the lowest curve of actual performance.

If you compare that, however, to the U.S., as you can see, all of the states are significantly below the U.S. in terms of recovery although the path is pretty much similar. This has been a recovery that's been really marked by nothing like a sharp snap back but rather a fairly slow and steady recovery coming out.

If you look at current economic conditions, this is something that we put together here at the Chicago Fed, it's the Midwest economic index. And what it shows is essentially if you have a figure at zero, it suggests that you're growing at trend growth. This is the last report that came out, and what it suggests at this point is that all of our states are growing somewhat below trend growth at this point with Wisconsin having the biggest downturn. It also shows you the distribution across four key sectors of the economy to give you a sense of where we are right at this moment.

The next thing I want to do is turn to fiscal conditions. Indiana has clearly the most solid position. The states entering fiscal year '16 with estimated reserves of over $2 billion or 14 percent of state funding. That's well above the national average, which is eight percent of reserves, and the closest Midwestern state is Ohio, which has 5.8 percent reserves. So Indiana is in a very solid fiscal condition.

Wisconsin has been under a lot of budget pressure, but most of it has been due to cutting tax rates. The nonpartisan Legislative Fiscal Bureau had projected earlier that the state would actually start the year with, the biennium in 2017-19, with a structural deficit of $490 million. This week the governor's office actually improved that figure. They said that they actually ended the year with a slight surplus, but Wisconsin has been under pressure again mostly because of reductions in tax rates as it relates to their revenue performance.

Illinois clearly has been the worst. The state still hasn't passed a budget. It's estimated that we have unpaid bills near $9 billion, and we have the worst funded pension system in the nation at this point.

A recent study, this was done by the Mercatus Institute at George Mason University, and what they did was they ranked all of the states in the U.S. on various criteria looking at the various measures of fiscal performance: cash solvency, budgetary solvency, long-run solvency, service-level solvency, trust fund solvency, and then a composite rank.

As you can see, Illinois clearly performs the worse across all of these. In fact, it gives the worst rating in our country at 50 for its composite rank. As you can see, it does pretty poorly across every one of these indicators. Indiana does the best of the group coming in at 16 for a composite rank, and Wisconsin is sort of the middle of the nation at 28. So clearly, again some dispersion in terms of fiscal performance over this period of time.

The next thing I want to show you about fiscal condition is really how the states have performed in terms of general expenditures coming out of this recession. You are going to see essentially a similar picture but also with some significant differences for all of these states.

First of all, there is going to be a big spike in spending in 2010. That's the ARRA federal funding coming into play, so the states all ramped up their expenditures during this period of time. Then there's a drawdown as the ARRA goes away, and then there is some sort of pattern as to what the state is headed for right now.

As you can see for Illinois you have this very flat trajectory and then somewhat of an uptick really going from '12 into '13. If you look at Indiana, it's probably the most stable. As you can see, it had less of a drop-off actually from ARRA, level spending to the down years, and then since then it's been on a slow trajectory up. Again, this is similar to what a lot of states are seeing because they're not seeing that recovery in revenues that is normally associated with this point of a business cycle.

And then if you look at Wisconsin, it's the most outlier. Again, Wisconsin is actively trying to cut state revenues and cut state expenditures, and as you can see, coming out of this period of time it’s actually been reducing its level of expenditures at a pretty good clip coming out of this particular cycle. So a very different fiscal policy across the three different states.

So why should we care about fiscal policy, and why should we care about it particularly at the state and local level? First, in theory, states and local governments must annually balance their budgets while the feds can deficit spend over the business cycle. This is particularly tricky for states because obviously your expenditures don’t necessarily perform across the business cycle.

So in many cases states and localities face greater spending pressure just at the time the economy turns down. So unless you have active federal aid, such as happened with the ARRA or you have larger rainy day funds, it’s a real management challenge for states and localities.

The other thing is states and localities really provide the services that are of the most interest to people; schools, police, fires, courts, healthcare, and infrastructure, so they are really part of the government structure that really affects people most directly.

The other thing is when states get into trouble they don’t have all that many options as to how to get out of trouble. Often what happens is they start to crowd out regular general fund spending, sort of regular programmatic stuff, in favor of trying to pay off debt. So that has its own effects as it plays through the cycle.

So linking economics and growth to public budgets, what's the implications if you get into poor fiscal conditions? Well, the first thing is if your budget doesn't balance you basically have three options. You can either raise taxes, cut expenditures, use budget tricks, or do all of the above. Generally speaking, all of the above tends to be the option.

If you raise taxes, economic research can be really contradictory as to what the impact of high taxes are on state and local growth. That being said, most generally find that taxes are very significant on the margin. If other factors are equal, the low tax vocation is going to win, but what economic research also shows is that what government spends money on also matters a lot.

So research suggests that if higher shares of public expenditures are spent on education, infrastructure, and public safety, businesses generally don't have a problem with paying a higher tax rate. This has always been the argument for what happens in Minnesota. Minnesota is not a low tax state, but the idea is that it provides the range of services that many people think are desirable so they are willing to pay higher taxes for that.

There's also two X factors that I would like to identify. The first is, do fiscal conditions create uncertainty? And that's clearly a case for Illinois at this point. The problem is if you're looking at a firm that's trying to make a decision as to whether they make a long-term investment in a place, the only thing you can tell them right now is, "We don't know what the tax rate's going to be, we don't know what public services are going to be, but they're going to be different," and so that becomes hard for companies that are trying to make decisions with some certainty.

The other thing that happens in a case like Illinois where you really get behind is you start having to raise taxes for services that have already been consumed. So in most cases, this isn't going to be services, new services or new public benefits, this is going to be stuff that had actually occurred five, 10, 15 years ago, so that's kind of a worst-case scenario in terms of where these things are going to go.

So real quickly, anatomy of a fiscal crisis, Illinois and Chicago. The first thing that should be recognized is both Illinois and Chicago were running structural budget deficits before the Great Recession occurred. This isn't a new phenomenon. The recession only exposed the depth of the problem.

Common to both is that they have been borrowing from the future to pay for current services. Most of this shows up in the form of unfunded pension liabilities, and it hasn't gone unnoticed. As Greg mentioned, we have the worst bond ratings in the country, and it seems like every day we get downgraded once again.

So starting with Illinois, where are we? On paper, Illinois has not been a traditionally high-tax state, so if you do something which my colleague, Bill Testa, did is he measured taxes relative to GDP in our neighboring states and in Illinois. What it shows is that Illinois has actually historically tried to keep tax rates fairly low, but the way it's been doing this is basically we've been borrowing from the future to keep these rates low and to provide services.

So if you look at this, these are tax revenues as a percentage of gross domestic products, so it's the economy of each of these states, and as you can see Illinois really runs pretty much with the range of all the other states within the area with Wisconsin actually being the highest, and so you wouldn't, from this, suggest that Illinois is necessarily overtaxed; however, if you start factoring in these unpaid liabilities the picture changes pretty dramatically.

This first one adds in the $9 billion in bills that we haven't been paying; sort of a backlog of unpaid bills, and you can see Illinois, if you fill this projected budget gap that the state currently has, moves up pretty significantly in terms of where it would be in terms of the tax burden relative to the size of the economy.

And then if you add the unfunded pension liability on a 30-year basis it moves up even higher. So this would suggest what Illinois would have to do. The red part is essentially, again, paying for past services to get you up to that point of view. You're not adding anything new when you're doing that, so that's difficult to look at.

So what might help in terms of these situations? Well, David is going to talk a lot more about this, but quickly I think independent financial institutions, research we've done suggests that financial control boards can be a real asset, much better accounting rules, more transparency, stronger rules that are easier for people to understand and be able to act on.

Reserve fund balances that are tied to revenue volatility; essentially, if you have very volatile revenue sources you should start to put together reserves that reflect that volatility so that you are able to protect yourself across different periods.

And lastly, state oversight. North Carolina has a particularly good model for when it comes to local governments for oversight that helps them keep out of trouble and allows the state to intervene before the localities get into trouble, so all of those things might help.

So finally, why should I care about fiscal imbalance in the neighboring states? I'm from Indiana and Wisconsin; things look pretty good. At the first glance it seems like it's an opportunity. Businesses want to have the same in general geographic location. I can offer them a better fiscal outlook. I can poach the business. That's clearly a short-term way to look at it.

However, the net gains really might not be all that great, and that's because of work that looks at how integrated this region is from a trade perspective. Geoff Hewings at the University of Illinois has done a lot of work on this on input/output models, and what he suggests is that this is a very highly-integrated region, the Midwest, and we trade heavily with each other.

So whenever you make a key part of the region less attractive, particularly Chicago is a key part for an investment, it really is going to have upflows into the rest of the region, so you are not necessarily going to have benefit from having a weak central pull for where investment is going to occur.

So the idea here is that you really want to look at increasing investment from outside, and if what you're doing is simply a zero-sum game of shuffling firms within the region, you're not really going to get growth in the aggregate going forward.

This is the last item going to show you, and it's what Geoff has come up with. This was several years ago, but we looked at what flows from Illinois, as you can see internationally, which are much smaller than probably most people would think, but within the region they are very, very high. So Illinois' growth has a direct benefit on Ohio, Wisconsin, Indiana, Michigan. It's actually much larger than the benefit that we get from our foreign trades, so these intraregional trade flows really matter, and they're the things that are really going to have a big effect on whether or not we can help our position going forward, and it's why Wisconsin and Indiana should care about how Illinois manages its way out of this problem.

With that, I'll turn it over to David. Thanks very much.

GREG HINZ: Rich Mattoon, I'm sorry, Dick. Richard Mattoon, Senior Economist and Economic Advisor here at the Federal Reserve who will go first. And David Javdan who's the managing director at Alvarez & Marsal. We've kind of loosely defined this as, the first gentleman is going to define the problem and the second gentleman is going to tell us how we get out of the problem. And with that I will be quiet.

RICHARD H. MATTOON: Thanks, Greg. And good morning everyone. It's a pleasure to be here. So as you said, the topic is this kicking the can down the road. In particularly what we're going to emphasize is the relationship between fiscal structure and how our economies are performing. And I've been given the task of covering a lot of ground really quickly. So, I'm going to already tell you that if you blink you're going to miss some of this presentation because I'm going to cover a lot of topics pretty fast.

The first thing I want to talk about is a little bit about a stylized way of looking at how our three states have performed over this recent recovery both relative to each other and then relative to the U.S. I want to talk about the current fiscal condition in each of the three states and how that effects the region. I'm going to use Illinois and Chicago, as Greg suggested, in some ways as a cautionary tale when it comes to fiscal policy.

Then I want to conclude with two more philosophical points. Which is, why should we care about fiscal health of cities and states? What's its implications for economic development? And why should Indiana and Wisconsin care about the fiscal health of Illinois and Chicago?

So the first thing I want to talk about is how the region has recovered from the Great Recession. So, until recently this recovery cycle was relatively beneficial to our region. But it's starting to get a little bit long in the tooth. It was driven by two things. First of all, a rebound in manufacturing, particularly auto-related manufacturing. And then also agriculture which was doing quite well.

Both those things have shown significant decay recently. If you look at the agricultural sector farm incomes are going to be down significantly this year from the peak that they were at in 2012. And if you look at the ISM Manufacturing index it's barely above 50, which is indicating just barely expansion at this point.

Now if you look at how this has affected the three states in the region, Indiana has probably been the biggest beneficiary. The first thing is it has more auto-related manufacturing which has been more beneficial. And when I show you the next figure you're going to see that. The lagging industries have tended to be finance, and business, and professional services. And obviously those are the ones that are most concentrated in Chicago. So the recovery has taken longer to get going in Chicago. There was some improvement towards the end of last year in these cycles but nothing terribly dramatic.

So one could use the Philadelphia Fed Coincident Indicators Index. And what it's going to show you is over the last ten years Indiana has had the best growth followed by Wisconsin, with Illinois bringing up the rear. However all of them are significantly below the U.S. average. So you're looking at still a region as a whole that has been underperforming really throughout this period of time.

So this is a Coincident Indicator Index. Blue, the top line, is Indiana. As you can see Indiana actually had the biggest contraction during the recession and has come out the strongest. So if you look at the scope of the line it's actually had the best recovery. If you look at Wisconsin it had actually the shallowest contraction. It has come out of it at a slow and steady pace. And if you look at Illinois, again it's been probably the most problematic as it’s had the lowest curve in actual performance.

If you compare that however to the U.S., as you can see all the states are significantly below the U.S. in terms of its recovery, although the path is pretty much similar. This has been a recovery that’s been really marked by nothing like a sharp snap back but rather a fairly slow and steady recovery coming out.

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The next thing I want to do is turn to fiscal conditions. So Indiana has clearly the most solid position. The state’s entering fiscal year ’16 with estimated reserves of over $2 billion, or 14 percent of state funding. That’s well above the national average which is eight percent of reserves. And the closest

Midwestern state is Ohio, which has 5.8 percent reserves. So Indiana is in very solid fiscal condition.

Wisconsin's been under a lot of budget pressure but most of it has been due to cutting tax rates. The non-partisan Legislative Fiscal Bureau had projected earlier that the state would actually start the year with the biennium in 2017-19 with a structural deficit of $490 million. This week the Governor's office improved that figure. They said that they actually ended the year with a slight surplus. But Wisconsin has been under pressure again mostly because of reductions in tax rates as it relates to their revenue performance.

And Illinois clearly has been the worst. The state still hasn't passed a budget. It's estimated that we have unpaid bills near $9 billion and we have the worst funded pension system in the nation at this point.

A recent study, this was done by the Mercatus Institute at George Mason University. And what they did was they ranked all the states in the U.S. on various criteria, looking at various measures of fiscal performance so cash, solvency, budgetary solvency, long run solvency, service level solvency, trust fund solvency and then a composite rank. And as you can see Illinois clearly performs the worst across all these. In fact, it gets the worst rating in the country at 50 for its composite rank. As you can see it does pretty poorly across every one of these indicators.

Indiana does the best of the group, coming in at 16 for a composite rank and Wisconsin sort of middle of the nation at 28. So clearly again some dispersion in terms of fiscal performance over this period of time.

The next thing I want to show you about fiscal condition is really is how the states have performed in terms of general expenditures coming out of this recession. And you're going to see essentially a similar picture but also with some significant differences for all these states. First of all there's going to be a big spite in spending in 2010, that's the ARRA federal funding coming into play. So the states all ramped up their expenditures during this period of time. Then there's a draw down as the ARRA goes away. And then there's some pattern as to what the state is headed for right now.

As you can see for Illinois you had this very flat trajectory and then somewhat of an uptick, really going from '12 into '13. If you look at Indiana it's probably the most stable. As you can see it had less of a drop off actually from ARRA level spending to the down years. And then since then it's been on a slow trajectory up. And again this is similar to what a lot of states are seeing because they're seeing the recovery in revenues that is normally associated with this point of a business cycle.

And then if you look at Wisconsin it's the most outlier. Again, Wisconsin is actively trying to cut state revenues and cut state expenditures. And as you can see coming out of this period of time, it's actually been reducing its level of expenditures at a pretty good clip coming out of this particular cycle. So a very different fiscal policy across the three different states.

So why should we care about fiscal policy? And why should be care about particularly at the state and local level? Well, first in theory, states and local governments must annually balance their budgets while the feds can deficit-spend over the business cycle. This is particularly tricky for states because obviously your expenditures don't necessarily perform across the business cycle. So often in many cases states and localities face greater spending pressure just at the time the economy turns down.

So unless you have active federal aid such as happened with the ARRA or you have large rainy day funds, it's a real management challenge for states and localities. The other thing is states and localities really provide the services that are of most interest to people, schools, police, fires, courts, healthcare and infrastructure. So they're really the part of the government structure that really affects people really most directly.

And the other thing is when states get into trouble they don't have all that many options as to how they get out of trouble. And often what happens is they start to crowd out regular general fund spending, regular programmatic stuff in favor of trying to pay off debt. And so that has its own effects as it plays through the cycle.

So linking economics and growth to public budgets -- so what's the implications if you get in to poor fiscal condition? Well, first thing is if your budget doesn't balance you basically have three options. You can either raise taxes, cut expenditures, use budget tricks or do all of the above. Generally speaking, all of the above tends to be the option.

If you raise taxes, economic research can be really contradictory as to what the impact of high taxes are on state and local growth. That being said, most generally we find that taxes are very significant on the margin. If other factors are equal, the low tax location is going to win. But what economic research also shows is that what government spends money on also matters a lot.

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There’s also two x-factors I’d like to identify. The first is, do fiscal conditions create uncertainty? And that’s clearly a case for Illinois at this point. The problem is if you’re looking at a firm that’s trying to make a decision as to whether they make a long term investment in a place, the only thing you can tell them right now is, we don’t know what the tax rates going to be. We don’t know what public services are going to be. But they’re going to be different. And so that becomes hard for companies that are trying to make decisions with some certainty.

The other thing that happens in a case like Illinois where you really get behind is you start having to raise taxes for services that have already been consumed. So in most cases this is isn’t going to be services, new services or new public benefits. This is going to be stuff that actually occurred five, ten, fifteen years ago. And so that's kind of a worst-case scenario in terms of where these things are going to go.

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So this first one adds in the $9 billion in bills that we haven't been paying, this backlog of unpaid bills. And you can see how Illinois, if you fill this projected budget gap that the state currently has, moves up pretty significantly in terms of where it would be in terms of the tax burden relative to the size of the economy. And then if you add the unfunded pension liability on a 30-year basis, it moves up even higher.

So this would suggest what Illinois would have to do. The red part is essentially again paying for past services to get you up to that point of view. You're not adding anything new when you're doing that. So that's difficult to look at.

So what might help in terms of these situations? Well David's going to talk a lot more about this. But quickly I think independent financial institutions, research we've done, suggests that financial control boards can be a real asset. Much better accounting rules, more transparency, stronger rules that are easier for people to understand and be able to act on. Reserve fund balances that are tied to revenue volatility. Essentially if you have very volatile revenue sources you should start to put together reserves that reflect that volatility so that you're able to protect yourself across different periods.

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So finally, why should I care about fiscal imbalance in a neighboring state? So I'm from Indiana and Wisconsin. Things look pretty good. At the first glance it seems like it's an opportunity. Businesses want to have the same general geographic location. I can offer them a better fiscal outlook. I can poach the business, right? So that's clearly a short term way to look at it.

However, the net gains really might not be all that great. And that's because of work that looks at how integrated this region is from a trade perspective. And

Jeff Hewings at the University of Illinois has done a lot of work on this on input/output models. And what he suggests is that this is a very highly integrated region, the Midwest, and we trade heavily with each other. So whenever you make a key part of the region less attractive, particularly Chicago as a key part for an investment, it really is going to have flows into the rest of the region.

So you're not necessarily going to benefit from having a weak central pole for where investment is going to occur. So the idea here is that you really want to look at increasing investment from outside. And if what you're doing is simply a zero-sum game of shuffling firms within the region you're not really going to get growth in the aggregate going forward.

So this is the last slide I'm going to show you and it's what Jeff has come up with. Now this was several years ago. What we looked at was what flows from Illinois as you can see internationally, which are much smaller than probably most people would think. But within the region they are very, very high.

So Illinois' growth has a direct benefit on Ohio, Wisconsin, Indiana, Michigan. It's actually much larger than the benefit that we get from our foreign trades. So these intra-regional trade flows really matter. And they are the things that are really going to have a big effect on whether or not we can help our position going forward. That’s why Wisconsin and Indiana should care about how Illinois manages its way out of this problem.

So with that I’ll turn it over to David. Thanks very much.

DAVID A. JAVDAN: Well, thank you so much for having me here. And you’ve certainly laid out the problems. I will try and be solution-oriented. I don’t know if that always works. And also, do my best to try and keep everyone awake and engaged at this point in time. So what I’m going to is I’m very quickly going to discuss why you might consider listening to me. Then I’ll discuss why, be it in the private sector or in the public sector you can’t cut your way to nirvana.

Maybe if the first interactive piece -- how many people here have an Apple product with them? Look at this room. Most of you probably figured not the lowest cost provider, right? Not the cheapest product but you can be the most expense product and people will stand in line for hours to get your product. And much is the same with businesses and with governments.

Finally, as the former general counsel of one of the largest federal government economic development agencies, I'll focus on the most important thing that you can do to maintain and develop your economy, and that's to make your government function. I've heard a lot of conversations about higher taxes, lower taxes and all that stuff. But it's really about what you get for your money, and what works, and how you do it.

People talk about spending more or less. I could stand to lose maybe 40 or 50 pounds. There are two ways you could do it. I could go to the gym and lose a lot of weight and eat proper food, and I would probably function better, be more awake, live longer. Or you hack off my arms and legs, and that wouldn't be good at least for me anyway. But we laugh, but that's how it tends to be done in government. When we do cuts we tend to hack off peoples' arms and legs. We go for the most drastic and painful things as opposed to doing some things.

We've gone into government agencies where as a result of the cuts, they've actually worked better because you've gotten rid of layers of bureaucracy. And you've empowered the career people who work on the ground to do their job. But it's counterintuitive because you've cut. But you've empowered them on the line levels to do what they need.

So to step back, why would you listen to me? Alvarez and Marsal, we're the world's largest restructuring firm.

We’ve been brought in by bankruptcy courts, U.S. trustees, private equity forums, boards of directors to save, not to liquidate, but to save companies. Lehman Brothers, Washington Mutual, the nationalized banks of Iceland, Ireland, Spain and Greece. Here in Chicago, the Tribune Companies and a number of other entities.

Our people are operational not financial. If we were bankers I’d be wearing a much better suit. But our people tend to be not consultants, but former CFOs, CEOs. We do a lot of blocking and tackling, and getting to the ground. And that is where we feel governments get into a lot of challenges. We’re the only traditional restructuring firm to have a specific group focus on the public sector. Most of our friendly competitors have been too smart to get into the business.

We’ve been involved in the restructuring of seven bankrupt municipalities on both the debtor and the creditor side. We think it’s very important if you want to do this right that you can see the perspective of both sides. And similarly we’ve begun to work with a lot of states. We are currently serving as the CFO for four state Medicaid agencies. And three weeks ago I spent -- you know, standing up here is nice. It’s not interactive. But it was maybe too interactive three weeks ago.

I got to spend three hours testifying in front of the Kansas legislature as part of an RFP process where we've been hired to review the finances and operations of the entire state. There too, the governor and the legislature though both of the same party got into a very big budget impasse and a very big fight. And the way they decided to break the impasse was to bring in an independent firm to go and review spending and operations.

To make the deal happen though, the governor had to concede and allow the legislature to hire the firm that would do this. So I've never had to go through a RFP process where I was actually testifying with reporters standing there and taking notes and all that stuff. So it was very interesting.

MR. HINZ: Piece of cake.

MR. JAVDAN: Piece of cake, very good. No questions, no one pushed hard, oh my.

And we've done a lot of work with the municipalities. Our first sort of signature public sector job, Mayor Bloomberg, a businessman, he came in. He said, "Let me take over the New York City schools. I'll make them run better." He came in. The first thing he did was hire us. Everyone said, "Hey, I thought you were a business person. You would know how to do this." And he goes, "Yeah, if I had a company that had an underperforming division or if I bought an underperforming division, I wouldn't try and micromanage and do everything myself. I'd bring in a turnaround firm."

A lot of that work was donated, by the way, by foundations, the Gates Foundation, The Broad Foundation and a lot of others, to do it. We were able to cut $300 million a year out of overhead, put it into the classroom. Teacher's union originally very opposed to it. We sat with them, talked it through and then all of a sudden they realized, oh, wait more money to hire more teachers. Pay us a little bit better? Okay, we're with you. We may not like everything else that Mayor Bloomberg is doing, but we're with you.

Now I also want to raise something. Many people will say, "Oh, the use of private sector methods, be it restructuring, turnaround, consulting, all that stuff, they don't apply to the public sector. The public sector's different." And indeed the public sector's different but it's not as unique as you would think. But I'm not making the argument that oh, we should be cold and heartless in the public sector.

Quite the opposite, it's because that's not how you restructure businesses in the private sector. You do not save companies by cutting costs alone. We always tell our people, if all you want to do is cut the cost just shut the doors. You shut your doors. You fire everyone. You close. You go out of business. You've got no recurring expenses. But you also have no company and you have nothing going forward.

So of course minimizing costs can be important and all that stuff. But just like you don't save a company by killing it, you don't save a government by making things so miserable that people flee. Because when that happens you end up in a death spiral. And you can never catch up because you have an infrastructure that's built for a whole lot more and you're really paying for the old infrastructure. You're not even paying, as was mentioned earlier, for new services.

So you need to make a government that works well for people and if it works for people, just like people want to spend money for the Apple products, the iPhones and all that stuff, people are happy to give more money to you. But we talk a lot about okay, more money as if it's a cypher for supporting government and all that stuff. But that is often not true. The key is really building capacity. People are what are key. We focus on reorganizing and helping to transform things, but recruit people in.

One of the challenges that government have is that we don't pay people anymore. And not only that, we don't empower the people in government to do what they want to do. There's a lot of focus -- are the people on the left correct? Are the people on the right correct? I'll give you a hint, on 95 percent of the things the people even near the extremes on the left and near on the extremes on the right, they're going to do the same thing. But what will happen is, it's not that bad people are in charge, it's that no one's in charge. Even when you agree, you can't get anything done.

And what happens is, in the old days you'd have people -- we served as the interim CFO of the Detroit Public Schools under the receivership done by Governor Granholm for many years. We know the schools never went bankrupt though the city did. We were the interim CFO for almost three years, four years, not because we were so good but because no one would take the job. The job didn't pay a lot of money. But there were lots people who if they felt they could fix it they wanted -- they would be willing to make the sacrifice and do something in their career, but they felt they couldn't fix it.

The older people didn't want the headache and to ruin their reputation from taking it. The junior people said, all right, not only am I not going to make money I'm going to be seen as overseeing a failure because I'm not set up to succeed here. So you couldn't get anyone to take the job. People -- no one viewed it as a way to make their career. No one viewed it as a way to actually succeed and serve. And that's what we have to be able to do. That is the key focus for a lot of this economic development is to be able to empower the people who are on the ground to do what they need to do.

And again when we talk about money, more money could obviously be helpful. But pouring more money into a broken system will just lead you to failure. Look at the D.C. schools which we had been brought in by the Gates Foundation and other local foundations to turnaround. They were spending 30K a head for results. Worse than Mississippi and Alabama were getting at seven to 10 thousand a head. So just adding more money into that system wasn't going to work. You have to transform the way it worked.

And it was both why Mayor Fenty became very popular and why he became very unpopular. Though if anyone was ever worried about losing the election, he lost an election, stopped being mayor, and now is dating Steve

Job's widow, speaking of Apple products. So I guess he did okay. I guess he didn't get punished that badly for becoming a leader in education reform because that's how the two of them met through education reform.

I live in Bethesda, Maryland. A fact that irritates my wife to no end. She lived at One West Superior Street over here in Chicago until I dragged her into what she terms "exile." Also, Bethesda is not the lowest tax area in the region by a long shot. I can move ten minutes across the border into Virginia. It would be very easy. I don't. We're urban folks. I'm from New York. My wife is from here in Chicago. We wanted to live D.C. We had a place at 12th and U. We would have been more than happy to pay higher taxes and to stay in D.C. How much would most of you pay not to have a longer commute?

But I couldn't pay higher and pay for private school tuition, and pay for a private generator because my power went off once or twice a month. And to pay for water because when my wife was pregnant and we went to the doctor they said, "No matter what you do, do not drink the D.C. water even if you filter it." That's a very comforting thing in our nation's capital, right? If I explained all those things oh, you have to have your own private source. You can't send the people to school. You'd have to have a generator. You couldn't drink -- they'd think it was like the capital of Rwanda, not the United States. But that's the world we live in.

My neighbors in Bethesda are D.C.'s tax base. These aren't people who are seeking the lowest tax jurisdiction, but they couldn't -- and trust me, it is not a conservative group of people. It is probably among the most liberal people you'll find in the country, progressive. But there's a point where they have to take care of their own.

So what do you do when you run out of road? First of all, stop kicking. Making difficult choices now prevents unbearable choices later. Start fresh, don't try to do what you're already doing and cut 10 percent. It's a huge mistake. We see people do it all the time. Okay, well we don't have enough money so everyone just take a haircut just to share the pain equally. But the reality is some things should be cut 100 percent. They should be eliminated. Somethings should be cut 90 percent. Other things you should spend incredibly more money.

We've told a few -- we've restructured a large number of hospital systems. It's a classic example. They're like, we love our doctors. We love our nurses. We don't want to lay any of them off. They're the line staff. And by the way, we've never recommended firing doctors and nurses. So what do they do? They say, all right well let's cut overhead. Let's get rid of all this administrative staff.

Well what happened? For every $50,000-$60,000 job you save, you probably lose about $2 million in insurance revenue. There weren't people to do the paperwork and get it. And even if you get your money from insurance or Medicaid or anything like that, instead of getting it in 60 days, you get it in 120 days, your cash flow situation. And we constantly see this with jurisdictions or with public entities that they cut their way into bankruptcy. The more they cut, the worse their financial situation is.

So above all, don't do any harm. Don't do something that's going to actually put you in a worse position to try and do it. Again I'll say, stop looking at money as a rough approximation for quality. It's not. Focus on what counts. People love their children. If they can't educate their kids, they're going to move. Focus on what drives people away.

I'm always nervous to talk about parking meters or anything when I'm in Chicago because of all the history. But notice the most successful retailers. What do they do? Their stuff might be successful but they've got free parking. If you go to Beverly Hills, not one of the lower cost jurisdictions in the country, like every two blocks there is like a seven-level free parking lot. All the stores have -- I mean public parking by the jurisdiction. All the stores in the centers, they have free parking. Why? It would seem crazy that that little bit of cost would drive people away. But it does and it’s not just the cost.

Most of our neighbors in Bethesda, we’re ten minutes away from the D.C. border. As you can tell, I’m kind of foodie, right. Great food in D.C. We won’t go. Between my wife and I, we’ve got two law degrees. She has a 4.0. I can’t say what mine was. We’re about as educated as you can be. I have yet to be able to get the parking correct in D.C. I can’t figure it out. If I can’t figure it out how can anyone figure it out? And it’s not the cost of it, it’s just you know, you’ll go. You’ll get a ticket. You’ll get in trouble. And these things sound small but they drive people away. And that’s what works.

And then, I would stop talking about cuts. Focus on what you want to provide. If you talk to the people and you say, “I’m going to cut this from you. I’m going to cut that from you.” Of course, they’re not going to want you to cut that. But if you focus on what you want to provide. Hey we want to give you more teachers. We want to give this. We want to give that. And you start talking about all the things you're going to provide. And you what? In order to pay for it we're going to have to make these changes.

People aren't dumb. I think we make a real mistake in underestimating the public and underestimating the people. And if we talk to them and let them hear and be transparent about the choices that are being made and why you're doing things, they'll back you up, and bring in everything.

And then I'd say finally, it's important to understand the value of certainty and don't demonize and disrespect the other people. We've done a lot of work in Puerto Rico. We were reviewing statewide, the finances and operations of all of Puerto Rico a few years back. We're still doing their highway authority. We're reviewed the finances and operations mentioned in Kansas, in Louisiana and all that. I can tell you there are number of creditors of Puerto Rico who would be happy to make a deal today with no bankruptcy code, with nothing like that. Their concern is they're going to make a deal today for some sort of haircut. And then they're going to make a deal again in two and a half years or three years.

So to your point about you can't say what the tax rate is; can't say what things are, certainty even it's not the best answer, the worst answer is no answer.

So anyway I've gone on and no, I'm -- Apple's not a client. I'm not paid by them or anything like that. But I would be certainly happy if you have any questions or want to chat a little bit.

MR. HINZ: The worst answer is no answer. I'd love to hear what Bruce Rauner has to say about that. But, maybe we'll get to that. We don't have -- we have a lot to talk about and about ten minutes to do it. I was struck that both of you have kind of the same bottom line. And the bottom line is that cost, for government purpose is taxes, are not as important as delivery and performance, except maybe on the margins.

I'm struck at that because one of the things that I have written about a lot in the metropolitan area of Chicago is that the central area economy, downtown, where costs are highest is doing fabulous. I did an article last year about how employment in the central area is apparently at the highest level it's ever been at least since they started counting in the way they are 30 years ago. There's probably going to be a new record when the numbers come out later next month.

There's been all kinds of headlines about companies like ConAgra and Archer Daniels Midland, whatever movement that had put us here. But yet the rest of the city and the rest of the metropolitan area, which are much more dependent on manufacturing where price is a factor, are doing not nearly as well. Illinois has lost manufacturing jobs. Well, most of them I'd say scammed them. Maybe that's our mix of industries or maybe it's something else.

So I want each of you to comment on, is price -- cost of taxes really not a significant factor that we need worry about very much? And, to the extent that's true, how do you make that argument in a political milieu in which one of our major political parties constantly talks about, "Taxes are evil. Taxes are bad. We have to cut taxes."

MR. MATTOON: I'll take that first dragon and as a good economist, I'm going to complicate the question rather than answer it. First of all, I would say that you have to look at which specific taxes you're talking about because the incidence that certain taxes matter more to certain firms. So one of the other things that has to be considered is the economics of whether it's the sales tax base, the property tax base, the income tax base.

Where are you making the adjustment because that's going to have different profiles for different kinds of operations? And incidence really, at least in my experience, is the only thing that tends to matter to people. It's not what the tax level is, it's what the incidence is for me individually.

So I think one of the things you also have to discuss is having a comprehensive solution that also considers the economics. And one of the things I know Dave and I talked about is a concern right now at least in Illinois is you have a beggar-thy-neighbor kind of strategy when it comes to solving tax problems. Which is a government just simply says, I'm going to take this tax base. Not necessarily in the context of, is it most efficient for that level of government to take that tax base? Should we share it across the state and the local government, and the county government? How do you relate these things to what services are being provided?

So I think you have to have actually a much more sophisticated analysis though to suggest what tax you're going to raise. What's the incidence of that tax and what's the economic effect of it? And then you can come up with better and maybe hopefully more optimal solutions as to how you provide these services in the long run.

MR. JAVDAN: Well, I want to be very careful to say I'm not like, "Oh yeah, higher taxes, not a problem." They certainly are and everything else being equal, you want lower taxes. And what is fatal is high taxes and crummy services, and that's the death spiral that a lot of jurisdictions find themselves in. Or when you take money and you waste money. So I do want to be clear we believe that the most important thing is to make government work.

If you don't make it work then you do need to make it cheaper because sometimes people will move to very low cost areas. I think it does very much vary by industry. I think there is case to be made that if you're manufacturing you need those tax breaks and all that stuff because you're not just competing regionally. You're competing internationally. If you're doing something where you need a more skilled workforce and all that, then it's very different. There are different paths to nirvana.

This -- I've heard some conversation about the beggar-thy-neighbor as it's being called. I'm not sure that that's always, I want to be nuanced also. We're big on getting things done but I want to be nuanced. Beggar-thy-neighbor could be bad but competition -- you know I was on the New York Banking Board for seven years and we always had this thing, constructive competition and destructive competition.

If you're forcing everyone. If you're taking jobs from the suburban Chicago and bringing them downtown when those jobs otherwise might have gone to another country or another region, that's a good thing for everyone. If you're doing it and no one is really changing the way they do business. If you're doing this as a way to keep each other honest, it's great. How do you make the changes and how do you make the cases? I think it's more conversations. I think it's more real conversations.

We're the only -- maybe one way that we've had success is 90 percent of time -- when we've had success 90 percent of time, everyone else drops out because we'll testify in front of the legislature 30 times, 40 times. You know, a traditional accounting firm and all that, you'll write a very particularized report and you stand on that. You don't want to get sued for anything you said that's off. And if you want to get things done, it's a lot of engagement and it's a lot of blocking and tackling. And it's a lot of empowering your senior leadership and getting them in there.

We found that -- there's an old saying in Washington, "the shorter the title, the greater the power." President, Vice President, Secretary of State, you know. We saw in a lot of agencies we had an administrator, general counsel, okay, pretty good, assistant deputy administrator for government contract and business development. Yet that person was one of the most important procurement people in the entire country. Incredibly powerful and for both sides of the aisle. You couldn't get great people for that job. Literally, arguably the most powerful procurement person in there. A number of them can be found in the federal penitentiary right now.

But because of the titling and there's not clarity in what people do. So I mean, I think getting good people back in the government and getting them in a position where people understand what their job is. It's not just that the title's long --

MR. HINZ: Let me -- what I pick up on that a little bit are, what's -- are the interests of the City of Chicago, what the City of Chicago needs now to prosper and grow synonymous with those of the state and the region?

MR. JAVDAN: Absolutely.

MR. HINZ: And if they're not, how do you get them on the same page?

MR. JAVDAN: They're absolutely synonymous.

MR. HINZ: Totally?

MR. JAVDAN: Totally, it's -- I mean, look it's the same -- a lot of the same people. It's not like, "Oh, I'm a citizen of the imperium of Chicago and not of Illinois." One can't survive without the other. Look, I -- I'm from New York City, right? You know, I'm originally from upstate New York where Republicans and Democrats were bound by a mutual hatred of New York City. But you just can't make anything work without it being together.

Now the solutions that people want might be different, but you've got to respect each other. I think a lot of people are very critical of Governor Rauner right now. But the can's been kicked a very long time and the situation is very difficult. I understand, you've got to work both ways.

MR. HINZ: All right, so each of you from a turnaround perspective and from a good economics perspective, if Mike Madigan and Bruce Rauner were to walk in here right now and sit down, what would you tell them as to how they get past this ideological war in which each seems to be unable to give the other what the other needs?

MR. JAVDAN: I would start by not characterizing it as an ideological war. I think the minute you try and say it's ideological, you know sometimes things are -- sometimes we say things in this country are ideological and they're really practical. I think they're both very practical people. And what I would probably do is the solutions, talk about very much public. But I wouldn't -- they're not in public to tell either of them what they should do. They were chosen, the governor by the people at large and Madigan by another Democratic body. They do need to work together, but they do need to respect each other.

MR. HINZ: Richard?

MR. MATTOON: Yeah, I mean I think I would just try and make a good economics recommendation. Again, I would talk about the inner relationship of how the state grows. I'd give them a growth model and try to explain to them that subtracting growth isn't going to help either constituency over any period of time.

MR. HINZ: Yeah, but is that going to get me re-elected? I wish we had more time. But we're out for this time. Thank you gentlemen. I appreciate your two perspectives.

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