OUR KIND OF TOWN

A Financial Plan that Puts Chicago’s Communities First

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The ReFund America Project
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EXECUTIVE SUMMARY

The major credit rating agencies’ decisions to downgrade the City of Chicago, Chicago Public Schools, and the Chicago Park District have put Chicago’s financial problems under the microscope. These downgrades are baseless because none of Chicago’s governmental units are actually in any danger of defaulting on their debt. Instead, the downgrades appear to be driven by a desire to advance an austerity agenda in Chicago and to slash government workers’ pensions.

Much of the public discourse has already moved in this direction, focusing on the need to fix the budget by enacting painful cuts. This is wrongheaded, because the problem in Chicago is not that the city is spending too much money on community services. The real problem is that there is not enough revenue coming in from the city’s wealthiest residents and its largest, most profitable corporations. The one area in which the city’s governmental units are spending too much is on their financial deals. The City of Chicago and Chicago Public Schools are trapped in a host of predatory municipal finance deals that cost taxpayers tens of millions of dollars every year. Instead of cutting services for residents, the city should look to reduce its financial expenses.

Balancing the budget on the backs of Chicago’s working families will only exacerbate economic inequality in the city and compound the pain felt by communities that are already struggling to get by. The people of Chicago need a new financial plan that puts communities first.

RECOMMENDATIONS

► **Recover losses from predatory municipal finance deals.** Chicago’s governmental units and their pension funds should pursue all legal and economic means at their disposal to recover taxpayer dollars when banks deal unfairly with them on deals like interest rate swaps.

► **Reduce financial fees by 20 percent across the board.** Chicago’s governmental units and their pension funds should press for negotiations demanding 20 percent reductions on all financial fees.

► **Insource pension fund management.** Chicago’s governmental units should bring investment management in-house for a significant portion of their pension funds’ investments.

► **End corporate tax subsidies and tax breaks.** The City of Chicago should end all corporate tax subsidies (including TIF subsidies) and tax breaks to major corporations, and claw back subsidies given to corporations that do not live up to their promises.

► **Collective bargaining with Wall Street.** Chicago’s governmental units and their pension funds should partner with other cities to create a new industry standard for better terms on financial deals and refuse to do business with any bank that does not abide by that standard.

► **Create a public bank.** The City of Chicago should establish a public bank that is owned by taxpayers and can deliver a range of services and provide capital for local economic development and affordable housing.

► **Raise progressive revenue.** The City of Chicago should work to raise progressive revenue by instituting measures like a graduated city income tax, a commuter tax, and the LaSalle Street Tax on financial transactions.
IN FEBRUARY 2015, the City of Chicago’s credit rating was downgraded by Moody’s Investor Service.¹ In March, Moody’s also downgraded the Chicago Park District (CPD), and both Moody’s and Fitch Ratings downgraded Chicago Public Schools.³ This has put the issue of financial management front and center in the political debate in Chicago, and has brought the budgets of the city’s various governmental units under a microscope. These questions about how best to manage the city’s money shine a spotlight on the competing interests of Chicago residents and the powerful Wall Street firms that have been profiting off of the city’s financial problems.

The three major credit rating agencies in the United States – Moody’s, and Fitch, and Standard and Poor’s Ratings Services – are all unreliable institutions, rife with conflicts of interest and a history of missed calls. Moody’s and Fitch are using these downgrades to push an austerity agenda in Chicago. These downgrades will benefit Wall Street firms, because the City of Chicago, CPS, and CPD will be forced to take out more expensive products like credit enhancements and bond insurance to boost investor confidence in their bonds. However, this will come at the expense of community services like education, mental health, and parks programs. All of this is wholly unnecessary because none of Chicago’s governmental units are actually in any danger of defaulting on their bonds. There have been numerous comparisons made between Chicago and the City of Detroit, which filed bankruptcy in 2013, but those comparisons are unfounded and ill-advised.

Many politicians have used the downgrades to call for austerity measures that would take a toll on Chicago’s most vulnerable residents and to justify slashing government workers’ pensions, in violation of the Illinois Constitution. However, this ignores the simple reality that the city is not spending too much on either public services or workers. The real budget problem in Chicago is that the city’s governmental units are hemorrhaging money on predatory financial deals with Wall Street banks and not properly taxing its wealthiest corporations and residents.

Chicago needs a proactive agenda that puts the needs of communities first. In the short term, this includes measures like:

- **Recovering losses from predatory municipal finance deals.** The City of Chicago, its related governmental units, and their pension funds should take all steps to recover taxpayer dollars when banks deal unfairly with them. This includes taking both legal and economic action to try get out of bad deals like interest rate swaps and recoup lost money.

- **Reducing financial fees by 20 percent across the board.** The City of Chicago, its related governmental units, and their pension funds should press for negotiations demanding 20 percent reductions on all financial fees to force Wall Street firms to share in the sacrifices that Chicagoans are being forced to make every day.

- **Insourcing pension fund management.** The City of Chicago and its related governmental units should bring investment management in-house for a significant portion of their pension funds’ investments, by hiring qualified staff with a proven record of effective management instead of paying Wall Street firms tens of millions of dollars each year to accomplish the same goal.
• **Ending corporate tax subsidies and tax breaks.** The City of Chicago should end all corporate tax subsidies and tax breaks to major corporations, and claw back subsidies given to corporations in exchange for job creation if they did not live up to their goals of creating jobs for city residents. This includes tax subsidies from the city’s tax-increment financing (TIF) programs.

**In the longer run, Chicago needs structural solutions. This includes:**

• **Collective bargaining with Wall Street.** The City of Chicago, its related governmental units, and their pension funds should identify financial fees that bear no reasonable relationship to the costs of providing the service and join with other cities in the region and across the country to create a new industry standard for fees and refuse to do business with any bank that does not abide by that standard.

• **Creating a public bank.** The City of Chicago should establish a public bank that is owned by taxpayers and can deliver a range of services, including municipal finance, and provide capital for local economic development and affordable housing in Chicago’s neighborhoods.

• **Raising progressive revenue.** The City of Chicago should work to raise progressive revenue by instituting measures like a graduated city income tax to force high-earners to pay their fair share, a commuter tax on suburban residents who work in the city, and the LaSalle Street Tax on financial transactions at the Chicago Board of Trade and the Chicago Board Options Exchange. All of these likely require state approval, so the mayor would have to petition the state for authorization. California and Minnesota have both enacted progressive revenue measures in recent years that have helped solve their respective budget crises.

These steps will allow Chicago to reclaim power in its relationship with Wall Street and create a financial regime in the city that will put the interests of Chicago’s communities first.

**THE DOWNGRADE**

On February 27, 2015, Moody’s Investor Service downgraded the City of Chicago’s credit rating to Baa2, two notches above junk status. A week later, it cut the Chicago Park District’s rating to Baa1 and Chicago Public Schools’ rating to Baa3, just one notch above junk status. It is maintaining a negative outlook on all three governmental units, which means it expects that the ratings could decrease further. On March 20, Fitch Ratings affirmed the earlier move by Moody’s by downgrading Chicago Public Schools’ rating to BBB-, also just one notch above junk. If a borrower’s rating drops to junk level, it can cause the cost of borrowing to skyrocket because many bondholders are not permitted to buy junk bonds. This limits the pool of potential lenders and drives interest rates higher.

However, these downgrades are not rooted in reality. Credit ratings are supposed to be an indicator of the financial health of municipalities in the same way that credit scores are supposed to be
indicators of the financial health of individual people. More specifically, credit ratings are used to predict how likely a municipal borrower is to default on its debt. Bondholders who are considering investing in the debt of any particular city, state, or public agency use the ratings to determine how likely it is that they will get back the money they are lending out. The fact is that there is only one group of creditors that has any reason to worry about the City of Chicago, CPS, or CPD defaulting on their debt to them, and that is their pensioners. There is zero possibility that any of the other creditors will lose any of the money they are owed because the city enjoys a healthy tax base and its debts are backed by an unrestricted ability to raise taxes. According to a report by Moody’s itself, the default rate for municipal issuers that it rates was 0.012 percent between 1970 and 2012. Even though there has been a microscopic uptick following the financial crisis, the likelihood of municipal default is still virtually nonexistent. Chicago’s bondholders have no reason to worry.

Instead, the downgrades are a political ploy by the rating agencies to push the leadership of the city to take a hard line against city workers’ pensions. Moody’s all but calls on the City of Chicago, Chicago Public Schools, and the Chicago Park District to slash pensions. It goes so far as to state that if a court determines that it is unconstitutional to cut pensions, that it could lead to further rating downgrades for the City of Chicago. As mentioned above, this is particularly absurd because pensioners are also creditors. For years, the city government has been using money that pensioners earned and diverting it to other uses to plug budget holes. Pensioners have a valid debt that they would like to collect that is guaranteed by the Illinois Constitution. The fact that Moody’s is threatening the City of Chicago with a downgrade unless it defaults on that debt poses an interesting paradox, since defaulting on debt is supposed to lower a borrower’s credit rating.

This isn’t the first time that rating agencies have used credit ratings for political purposes. In 2011, Standard & Poor’s Ratings Services, another of the three major credit rating agencies,
downgraded the sovereign debt of the United States, citing Congress’s refusal to make drastic cuts to Medicare and other safety net programs as its reason.\textsuperscript{6}

These political ploys come at a cost to taxpayers. If a municipality’s credit rating gets too low, bondholders could demand higher interest rates to protect themselves against the perceived risk of default, which could drive up the cost of borrowing for taxpayers. If bondholders are led to believe their money is unsafe with any particular borrower, they could even refuse to lend to that city altogether. If traditional bondholders refuse to lend to a city, it can be forced into riskier forms of financing, the same way that people with lower, subprime credit scores were forced into riskier mortgages. Municipal borrowers with low credit ratings could also be forced to purchase expensive bond insurance and other credit enhancements on their debt, which is similar to requiring cosigners on loans for low-income families because their credit scores are too low.

A downgrade can also trigger a series of termination penalties and accelerated repayment clauses on some or all of a borrower’s financing deals, which can cost taxpayers hundreds of millions of dollars. In the case of Chicago, the city government’s downgrade has already triggered $58 million in penalties on its interest rate swaps.\textsuperscript{7} The mayor’s office is negotiating with the banks to avoid these costs, but these are Band-Aid solutions.\textsuperscript{8} If the City of Chicago’s credit rating drops another two notches, it could trigger $1.4 billion in payments on the city government’s various financing deals, including its interest rate swaps.\textsuperscript{9} The downgrades by Moody’s and Fitch have also triggered $263 million in penalties on CPS’s interest rate swaps.\textsuperscript{10} Although there are legal options available to the city government and to CPS to end these deals and avoid these penalties, the mayor has thus far refused to pursue those options.

Perhaps most importantly, credit rating downgrades are too often used to justify an austerity agenda, which can result in draconian cuts to essential community services like education, public health, and infrastructure. This is because credit ratings have no moral compass. If exacting cost-cutting measures would free up cash that a city can use to pay its bondholders, then that is what rating agencies will encourage that city to do. They are not concerned with the health and well-being of the city or its residents, but simply its ability to pay its bondholders.

For example, in downgrading CPS, Moody’s listed some of the key financial challenges facing the school district. It cited as a factor in the downgrade, “reduced cost cutting options following the closure of 50 schools several years ago.”\textsuperscript{11} In other words, the district’s rating was downgraded in part because there are no more schools left to close. Moody’s invoked “a powerful union that may impede, and essentially limit, the district’s ability to reduce costs.”\textsuperscript{12}

Credit rating agencies are neither objective nor independent. They are deeply conflicted because of their close relationship with other Wall Street firms, whom they rely on for a very large portion of their business. The big three rating agencies played a key part in inflating the housing bubble and creating the circumstances that led to the financial crash in 2008 because they gave pristine credit ratings to securitized subprime mortgage debt. They did this because they were being paid by the very banks who were trying to sell the subprime mortgage-backed securities to investors.\textsuperscript{13} In 2011, two California counties filed litigation alleging the rating agencies were colluding with
a monoline bond insurer to create a dual ratings structure that discriminated against municipal borrowers and forced them to take out expensive bond insurance.\textsuperscript{14}

The downgrades of the various Chicago governmental units should be taken with a grain of salt. Rumors of Chicago’s financial demise have been greatly exaggerated in order to push a political agenda. In reality there is no reason to fear that any of these governmental units will default on their bonds or file bankruptcy. There is real reason to worry, however, that these downgrades will be used to push the city and its governmental units to default on their pensions, even though such a move would be unconstitutional. It should be clear, however, that any decision to slash pensions would be rooted in politics, not financial necessity.

\textbf{CHICAGO’S DIRTY DEALS}

The growing dominance of the financial sector in our economy, known as financialization, has distorted our social, economic, and political priorities. Cities and states across the country are forced to cut essential community services because they are trapped in predatory municipal finance deals that cost them millions of dollars every year. Wall Street firms and other big corporations are engaged in a systematic effort to suppress taxes, making it difficult for cities and states to advance progressive revenue solutions to properly fund public services. Banks then take advantage of this crisis, which they helped create, by targeting state and local governments with predatory municipal finance deals, just like they targeted cash-strapped homeowners with predatory mortgages during the housing boom.

\textbf{CHICAGO IS NOT DETROIT}

In the aftermath of the downgrades, there have been numerous comparisons made between the City of Chicago and the City of Detroit, which filed the largest municipal bankruptcy in American history in 2013. These comparisons are baseless. Chicago is not Detroit. The unique set of circumstances that drove Detroit into bankruptcy does not exist in Chicago. First and foremost, Detroit had seen its population shrink more than 60 percent from its peak, and was hit harder by the foreclosure crisis than almost any city in the country.\textsuperscript{15} This combination of circumstances had severely depleted the city’s property tax base. Furthermore, Michigan Governor Rick Snyder and the Michigan Legislature made a calculated political decision to push Detroit into bankruptcy by cutting state revenue sharing with the city while also prohibiting it from raising additional taxes.\textsuperscript{16}

Chicago, on the other hand, still enjoys a healthy tax base that is more than capable of supporting the city’s financial needs. Those who are invoking the specter of a Detroit-like bankruptcy in Chicago are using the downgrade in order to advocate for drastic cuts to essential services and other painful austerity measures in order to reduce the city’s expenses. But in so doing, they are ignoring the other half of the budget – the revenue side. In fact, in its report downgrading the city government, Moody’s pointed out that one of the City of Chicago’s key strengths is its ability to raise new revenue. Unlike Detroit, the City of Chicago has no statutory limitations on its ability to raise local taxes, which virtually guarantees that there is no chance of it defaulting on its debt or going bankrupt.

There are two key similarities between the two cities that are important to note, however. First, there was a dominant narrative in both places that overspending had led to the crisis. This myth of overspending was thoroughly debunked in a 2013 report by Demos called \textit{The Detroit Bankruptcy}, which showed that the city’s operating expenses had actually been cut by nearly 40 percent between fiscal years 2008 and 2013.\textsuperscript{17} The second similarity is that like the City of Chicago, Detroit was also trapped in costly interest rate swap deals that exacerbated the city’s financial distress.\textsuperscript{18}
Predatory financing deals are ones that prey upon the weakness of borrowers. They are characterized by high costs and high risks, are typically overly complex, and are often designed to fail. Because of the high level of risk and complexity in these deals, they can cost taxpayers hundreds of millions more in penalties and losses if they go south. This could force public officials to turn around and go right back to the same banks for even more loans to cover the costs. Chicago’s governmental units have a number of these predatory municipal finance deals.

Just a handful of these dirty deals are highlighted below. These are the expenses that the city should be looking to cut rather than funding for essential services like education and mental health.

**INTEREST RATE SWAPS**

Interest rate swaps are a type of derivative instrument that was often pitched to municipal borrowers as a way to protect against rising interest rates on variable-rate bonds. However, these deals were laden with a whole host of risks. Perhaps the biggest risk was posed by the egregious termination clauses embedded in the swap agreements. Because these clauses are typically triggered when cities and states fall under financial distress, they serve to compound financial woes by hitting municipalities with stiff penalties when they can least afford them. For example, the City of Chicago’s credit rating downgrade triggered $58 million in termination penalties, and if its rating falls to junk status, the city government could have to cough up another $133 million in penalties just on its swaps. CPS’s downgrades have similarly triggered $263 million in termination penalties on the school district’s swap deals.

Cities and states that entered into swaps unwittingly took on other risks as well. For example, swaps were supposed to protect against spikes in interest rates, but they backfired when the Federal Reserve slashed interest rates in the fall of 2008 in response to the financial crisis. Not only did the net payments on the swaps rise, but many cities and states were unable to take advantage of the low interest rate environment to refinance because they could not get out of their 20- or 30-year interest rate swaps without paying penalties. For example, the City of Chicago was forced to pay a $36 million penalty in September 2014 in order to terminate a swap so that it could refinance the underlying debt at a lower fixed rate.19

Furthermore, the sharp decline in variable interest rates actually caused the termination penalties on these deals to balloon, so at precisely the time that it would have been most advantageous for cities and states to refinance their bonds, the penalties to get out of the corresponding swap deals were higher than ever before.

The federal “fair dealing” rule prohibits financial institutions from misrepresenting or omitting “facts, risks, potential benefits, or other material information” when doing business with municipal clients. It is likely that the banks that pitched interest rate swaps to the City of Chicago and CPS violated this rule. For example, some of the banks that sold swaps to the city government and school district have admitted to manipulating the interest rates that the swaps were linked to,
which cost taxpayers millions of dollars. Unless they told public officials in advance that they had planned to illegally rig interest rates, this constitutes a violation of the fair dealing rule.

The city government and school board should petition the Securities and Exchange Commission (SEC) to bring an enforcement action against the banks to disgorge them of their ill-gotten profits and undo these deals. These violations also give rise to state-based legal claims. The City of Chicago and CPS should also sue the banks under state law to try to get back their past payments on these deals and get out of future termination fees, which could save taxpayers up to $1.2 billion.

**AUCTION RATE SECURITIES**

Auction rate securities (ARS) are variable-rate bonds whose interest rates typically reset every seven, 28, or 35 days (there are also other, less common reset periods). At the end of every reset period, bondholders who want to sell their ARS may auction them off. At the auctions, potential investors bid the lowest interest rate they are willing to accept for the bond. The interest rate therefore resets at every auction. Banks collect exorbitant fees for conducting these auctions. However, if no investors submit bids at the auctions, then the state and local governments that issued the debt could be forced to pay double-digit penalty interest rates to the bondholders that are unable to sell. That is precisely what happened in 2008 during the financial crisis. Furthermore, because ARS are often linked to interest rate swaps, the collapse of the ARS market in 2008 caused related swaps to go haywire.

Table 1 illustrates the costs of these bad deals to the City of Chicago and CPS.

<table>
<thead>
<tr>
<th>Entity</th>
<th>Estimated Net Payments thru Aug 2014</th>
<th>Potential Penalties for Termination</th>
<th>Total Net Payments And Term Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>City of Chicago</td>
<td>$534 million</td>
<td>$191 million</td>
<td>$725 million</td>
</tr>
<tr>
<td>Chicago Public Schools</td>
<td>$237 million</td>
<td>$263 million</td>
<td>$500 million</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$771 million</strong></td>
<td><strong>$454 million</strong></td>
<td><strong>$1.2 billion</strong></td>
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</tbody>
</table>
Chicago Public Schools had a number of ARS that were linked to swaps that blew up in 2008. A *Chicago Tribune* investigation into these deals estimates that just four of these deals will cost CPS $100 million more than an equivalent fixed-rate bond would have.\(^{22}\) Moreover, the *Tribune*’s expose showed that officials at Bank of America, one of the underwriters on CPS’s ARS, were aware that the ARS market was headed for a “meltdown” but did not warn CPS, in violation of the federal fair dealing rule.\(^{23}\)

In fact, ARS were packed with many hidden risks that banks typically did not adequately disclose, that were not widely understood by municipal borrowers, and that ended up costing taxpayers millions of dollars. As with swaps, CPS can also petition the SEC to bring an enforcement action try to recover losses from ARS, as well as file a lawsuit under state law.

**CAPITAL APPRECIATION BONDS**

A capital appreciation bond (CAB) is a long-term bond with compounding interest on which the borrower is unable to make any principal or interest payments for the first several years, and, in some cases, until the final maturity of the bond. In this way, it is similar to a negative amortization mortgage, in which the outstanding principal actually grows over time because the unpaid interest gets tacked on to the amount owed and compounds. Because of this structure, borrowers often end up paying extraordinarily high interest rates over the life of the bonds. California State Treasurer Bill Lockyer has likened CABs to payday loans.

The City of Chicago has several CABs. Table 2 details the costs of just a handful of these.

**TABLE 2: PARTIAL SAMPLING OF THE CITY OF CHICAGO’S CAPITAL APPRECIATION BONDS\(^{24}\)**

<table>
<thead>
<tr>
<th>Bond</th>
<th>Principal Amount Borrowed</th>
<th>Total Cost to Repay</th>
<th>Interest Rate over the Life of the Bond</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995 General Obligation Bonds</td>
<td>$22.1 million</td>
<td>$123.6 million</td>
<td>459%</td>
</tr>
<tr>
<td>2000A General Obligation Bonds</td>
<td>$7.4 million</td>
<td>$39.5 million</td>
<td>434%</td>
</tr>
<tr>
<td>2009C Sales Tax Bonds</td>
<td>$20.0 million</td>
<td>$81.0 million</td>
<td>304%</td>
</tr>
</tbody>
</table>
These CABs are similar to the City of Chicago’s parking meter deals, in that they allow public officials to access cash upfront to fill their budget holes, but come at a very high cost to future generations of taxpayers. Municipal borrowers are typically not allowed to pay down the debt ahead of schedule unless they pay steep prepayment penalties.

**CREDIT ENHANCEMENTS**

Getting a credit enhancement is similar to getting a cosigner on a loan. Though there are some variations between different types of credit enhancements (e.g., letters of credit, standby purchase agreements, liquidity facilities, etc.), the basic idea is that a city or state that has a lower credit rating can pay a financial firm with a higher credit rating to cosign its loan. Through this, the city or state effectively uses the higher credit rating of the financial firm and is able to get a lower interest rate on its debt.

This is a ruse since municipal borrowers in the United States have such extremely low rates of default. In many cases the higher-rated financial firms actually have a riskier credit profile than the lower-rated municipal borrowers whose debt they are insuring. For example, during the financial crisis, the two biggest monoline bond insurers in the country, Ambac and MBIA, sustained significant losses because they had insured large volumes of subprime mortgage-backed securities that they had to pay out in the wake of the foreclosure crisis. This caused their credit ratings to tumble, and any municipal borrower that had purchased insurance from either of them discovered that their insurance was worthless.26 For many municipalities, this caused their interest rates to skyrocket, and it triggered termination clauses on deals like interest rate swaps.27

Furthermore, the credit enhancements protect the lenders, not the borrowers. For example, if a city defaults on a bond payment, the city’s bond insurer will pay the bondholders to make sure they get their money back, but the city will now be on the hook for paying back the bond insurer. Furthermore, the city will likely have to pay back the entire outstanding bond principal at once, which is not always feasible.

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**TABLE 3: CHICAGO PUBLIC SCHOOLS’ CAPITAL APPRECIATION BONDS**

<table>
<thead>
<tr>
<th>Bond</th>
<th>Principal Amount Borrowed</th>
<th>Total Cost to Repay</th>
<th>Interest Rate over the Life of the Bond</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997A Bonds</td>
<td>$38.0 million</td>
<td>$91.5 million</td>
<td>141%</td>
</tr>
<tr>
<td>1998B-1 Bonds</td>
<td>$328.7 million</td>
<td>$1.1 billion</td>
<td>248%</td>
</tr>
<tr>
<td>1999A Bonds</td>
<td>$299.5 million</td>
<td>$916.8 million</td>
<td>206%</td>
</tr>
</tbody>
</table>

CPS has three CABs. Table 3 details the costs of these deals.
forcing it to come up with millions of dollars it simply does not have. Borrowers pay for these credit enhancements because they help lower interest rates, but in reality they protect bondholders from losses, not borrowers.

For example, the City of Chicago has approximately 40 different deals with credit enhancements, including many letters of credit. All of the city government’s letters of credit include provisions that treat a ratings downgrade to junk level as a default event. This means that if Moody’s drops the City of Chicago’s rating two more notches, it could trigger $1.2 billion in accelerated payments because the city government will have to pay back the entire outstanding principal on the debt underlying its letters of credit.

Credit enhancement providers, which are typically either investment banks or insurance companies, can charge high fees for this service, which are typically a percentage of the amount of the total debt issuance. They justify these fees because presumably they are assuming the risk if the city or state is unable to pay back the debt. However, the risk of default is so low that it is virtually nonexistent.

Chicago Public Schools has a letter of credit with Wells Fargo in connection with its 2000B bonds. When CPS’s credit rating was downgraded in 2013, Wells Fargo spiked the fees on this letter of credit by 0.1 percent, or nearly $100,000 annually. According to its 2013 financial statements, CPS now pays $903,450 in annual fees to Wells Fargo for this letter of credit, even though Wells Fargo bears no cost and virtually zero risk for providing this service. This letter of credit is up for renewal again on March 27, 2015. In its downgrade report, Moody’s listed “Potential refinancing risks associated with the March 27 expiration of the district’s letter of credit agreement” as a challenge facing CPS.

PUTTING CHICAGO’S FINANCES BACK ON TRACK

There are two sides to every budget – a revenue side and an expense side. To get Chicago back on a solid financial footing, city leadership needs to look at both sides of the budget – it needs to figure out how to raise new revenue and how to cut expenses. But it needs to do both surgically to be sure not to exacerbate the financial distress in working class communities that are already bearing the brunt of the impact of the city’s financial problems. This means new revenue should not take money out of the pockets of working families through fees and fines, but should instead draw on the vast resources of the wealthiest residents and corporations in the city. It means that spending cuts should not be aimed at mental health clinics or other safety net programs, but should instead look to Chicago governmental units’ expensive financial deals with Wall Street banks.

The City of Chicago’s refusal to raise progressive revenue in the past has led it to take out record levels of debt and resort to various financial shenanigans and gimmicks to balance its budget, like the parking meter privatization deal. This is exactly the kind of situation that lends itself to financial
abuse and can create a cycle of indebtedness if it isn’t brought under control. As a result, the City of Chicago is getting squeezed on both ends by Wall Street. It does not have enough revenue coming in because the finance industry and other major corporations do not pay their fair share in taxes, and it is forced to spend millions each year on predatory financial deals to fill the hole, driving up expenses.

The City of Chicago, its related governmental units, and their pension funds need to be more sophisticated in their approach to the financial sector and put forth a proactive agenda that puts the needs of Chicago’s communities first. The path to recovery is long. The city cannot change its fortunes overnight, but instead needs to build toward long-term structural solutions that will take time to plan and execute. But there are also immediate steps that the city can take in the meantime to get the process started and address the crisis facing Chicagoans now.

SHORT-TERM SOLUTIONS

RECOVERING LOSSES FROM PREDATORY MUNICIPAL FINANCE DEALS

On Wall Street, fraud and deception pay. Banks routinely get away with unethical and even unlawful behavior. On the rare occasions that they are caught they typically pay a paltry fine and go on with business as usual, often without even admitting wrongdoing. In fact, even in cases where banks admit that they broke the law and illegally profited on the backs of taxpayers, they typically get a slap on the wrist and have to pay a fine that is a fraction of the amount of money that they stole. As a result, these fines simply become the cost of doing business.

The City of Chicago, its governmental units, and their pension funds should investigate all of their deals with Wall Street for unethical and/or illegal behavior, and they should explore all legal and economic options for getting their money back. This includes taking legal action to recover up to $1.2 billion in interest rate swap payments for the City of Chicago and CPS, as well as CPS’s losses from its auction rate securities, by petitioning the SEC to bring enforcement actions and filing lawsuits under state law. It also includes using the full economic leverage of the city – $78 billion – to force the banks to renegotiate bad deals, and threatening to withhold future business from them if they refuse. It is important to note that simply filing a lawsuit would give the city’s governmental units tremendous leverage to force the banks to renegotiate the deals.
REDUCING FINANCIAL FEES BY 20 PERCENT ACROSS THE BOARD

The City of Chicago, its related governmental units, and their pension funds should press for negotiations demanding 20 percent reductions on all financial fees. Banks charge cities tens, if not hundreds, of millions of dollars each year on fees for debt management, investment management, and cash management. A study in Los Angeles found that the city paid more than $300 million in publicly disclosed fees for financial services in fiscal year 2013. That amount does not include any payments of principal or interest, or the millions in fees that the city’s pension funds paid that are not publicly disclosed.33 To date, no comparable study has been done in Chicago.

Like overdraft fees and ATM fees that individual consumers pay, these fees often bear no reasonable relationship to the actual cost of providing services, but rather are completely arbitrary. Banks charge the fees that they do in order to guarantee themselves a hefty profit margin. However, city officials have been asking Chicagoans to make sacrifices for years — schools have been closed, mental health clinics have been shuttered, and bus routes have been cut, just to name a few. Even though the financial industry caused the economic crisis that has devastated Chicago’s communities, Wall Street banks have not been asked to share in the sacrifice. On the contrary, they were rewarded with trillions in taxpayer bailouts and backstops. It is time to make banks do their part by taking a 20 percent reduction in fees.

INSOURCING PENSION FUND MANAGEMENT

The best way to reduce fees to Wall Street banks is to avoid doing business with them when possible. One area where is it certainly possible to cut Wall Street out of the picture is pension fund management. Chicago’s various pension funds could save millions in fees if they hired in-house staff to manage their investments. Investment managers charge high management fees that are based on a percentage of the amount of money that they are managing, and they often also charge performance fees that are based on a percentage of the pension fund’s return on investment. These fees add up very quickly, especially when pension funds invest with private equity firms or hedge funds.

Instead, the pension funds of the City of Chicago and its related governmental units could hire in-house investment staff to manage a significant portion of their investments. Even if they had to offer seven-figure salaries to hire top-tier financial talent, paying a small handful of employees a couple million dollars each would still be significantly cheaper than sending tens, or even hundreds, of millions of dollars to Wall Street every year, which is what currently happens.

ENDING CORPORATE TAX SUBSIDIES AND TAX BREAKS

The City of Chicago has a long history of giving tax subsidies and tax breaks to major corporations located in the Downtown area, especially through its use of tax-increment financing (TIF) districts.
In fact, according to one study, the city government spent $1.2 billion from TIF funds in Downtown between 2004 and 2008.\(^{34}\) Even though the justification for these subsidies was that it would create new jobs, a study by the Grassroots Collaborative shows that, in fact, there has been a net loss in jobs held by Chicago residents. Even though Downtown added more than 52,000 jobs between 2002 and 2011, only a quarter of those jobs went to Chicago residents, who actually experienced a net loss of nearly 54,000 jobs during this time period.\(^{35}\)

The City of Chicago should end all corporate tax subsidies and tax breaks, including TIF subsidies, to major corporations located in Downtown and other prosperous parts of the city. It should also claw back subsidies given to corporations in exchange for job creation if they do not create good, living-wage jobs for city residents that contribute to the city’s economy and grow the tax base. Furthermore, the city government should use revenues generated by TIF districts in prosperous neighborhoods like Downtown to help the city’s struggling neighborhoods elsewhere in the city.

**LONG-TERM SOLUTIONS**

**COLLECTIVE BARGAINING WITH WALL STREET**

As mentioned earlier, the fees that banks charge cities and states for municipal finance and investment management services are often arbitrary – they bear no reasonable relationship to the actual cost of providing those services. However, because financial institutions all tend to charge comparable rates for any given service, they are able to keep the market prices high. The City of Chicago, its related governmental units, and their pension funds should identify these arbitrary financial fees and use their bargaining power as Wall Street customers to negotiate lower fees for taxpayers that are significantly below the “market rate” as it is defined by banks.

Currently, financial contracts are either awarded through competitive bidding or negotiated sales. In a competitive bidding process where the bids are not rigged (unfortunately, they often are rigged in the financial sector), different financial institutions submit blind bids to the client, who then awards the contract to the lowest bidder. In such a system, the banks’ goal is to be the lowest bidder, but not by much. This means some banks may bid slightly below the market rate, but they will not drastically deviate from it.

In a competitive bidding system, the most effective way to significantly alter fees is to simply cap bids above a certain rate. Public officials in Chicago should determine the actual cost of providing the service, add a modest premium above that figure, and refuse to take bids above that total. Because the City of Chicago and its governmental units together are major customers and the bank will still make money off the transaction even with the cap – in other words, if the highest price that the officials are willing to accept is still higher than the bank’s cost of providing the service – then eventually bidders will come around.
In negotiated sales, public officials already bargain over fees with banks. Typically, officials agree to negotiated sales because they believe they can get better terms by guaranteeing a bank the contract rather than leaving it to chance and putting the contract out to bid. This is not actually true, since studies have shown that fees have gone up as negotiated bond sales have become more prevalent. Even in these negotiated sales, public officials end up settling for high fees because they may believe that it is not possible to get a price that is substantially below the market rate. However, it is important to remember that the market is not preordained. Especially when it comes to finance, the market is not free. Market rates are arbitrarily set by the banks to guarantee a large profit margin. Cities need to drive a harder bargain that is based on their desire to save money, not the banks’ desire to make money. Even in negotiated sales, Chicago finance officials should again cap fees and refuse to do any and all business with banks that do not abide by their caps. For example, any bank that refuses to abide by the city’s cap on bond underwriting fees should be barred from any business at all with the city. This would use the full $78 billion of economic leverage of the city to secure lower fees for each service for each of its governmental units.

Of course, being a lone crusader against “market rate” fees can feel risky, because banks could threaten not to do business with Chicago any more rather than risk starting a new trend of lower fees. Although it is not likely that banks could effectively sustain a boycott of a major city like Chicago for any significant period of time, the threat would nevertheless be scary.

In the workplace, workers are able to win higher wages from employers by forming a union and collectively bargaining with their boss. Although the boss could fire one worker who asks for a raise, it is significantly more difficult to fire all workers if they band together and act collectively. Public officials from different cities and states could likewise win lower fees from Wall Street if they banded together and collectively bargained for lower fees and fairer fee structures.

The market rate is what it is because a small number of large financial institutions dominate the municipal finance landscape and, over time, they have established industry norms that are driven by their profit motive. Cities and states need to do the same by establishing norms that are driven by their desire to save taxpayer money. Chicago could work with other cities and states to adopt guidelines for an efficient municipal finance system with caps on fees and interest rates, prohibitions on predatory practices, transparency and disclosure requirements, and requirements that bankers exercise a fiduciary responsibility to taxpayers. Together, public officials from the various state and local governments could collectively refuse to do any business at all with any bank that refuses to abide by those guidelines. In this way participating cities and states would be able to use their collective economic leverage to negotiate fairer terms with Wall Street.

The different cities and states could formalize this approach by founding either a nonprofit or a public organization and empowering it to develop guidelines that all participating cities and states agree to abide by. The organization should have a fiduciary duty to the state and local governments that it serves and it should be funded by those governments in a way that incentivizes taxpayer protection. Notably, funding of the organization should not be contingent on the number or dollar amount of the transactions that take place under its guidelines. The organization should also serve as a clearinghouse for data on pricing and fees for participating cities and states, to allow for greater market transparency.
If cities and states refused to do business with banks that did not meet the organization’s guidelines, then it would effectively be empowered to negotiate with Wall Street on behalf of all of those state and local governments and set a new market rate that was based on taxpayers’ interests. This mechanism would allow cities and states across the country to collectively bargain with Wall Street without any new federal legislation. Collective action would also disarm any potential threats of retaliation from Wall Street.

The City of Chicago, its related governmental units, and their pension funds control $78 billion of potential Wall Street business. As one of the largest cities in the United States, Chicago is well-positioned to play a convening role in setting up a vehicle for municipalities to bargain together with Wall Street. It could partner with other municipalities in the region, including Cook County and the suburbs, to help rein in financial costs throughout Chicagoland. It could also partner with other large cities like New York, Los Angeles, Minneapolis, Baltimore, and Oakland that have a history of standing up to Wall Street to create a new national standard. Together, New York City, Los Angeles, and Chicago, and the related governmental units and pension funds of these three cities have nearly $600 billion worth of financial leverage. That is more than the gross domestic product of Sweden.37

<table>
<thead>
<tr>
<th>City</th>
<th>Economic Leverage of City, Related Gov’t Units, and Pension Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>New York</td>
<td>$409 billion</td>
</tr>
<tr>
<td>Los Angeles</td>
<td>$106 billion</td>
</tr>
<tr>
<td>Chicago</td>
<td>$78 billion</td>
</tr>
<tr>
<td>Total</td>
<td>$593 billion</td>
</tr>
</tbody>
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**TABLE 4: FINANCIAL BARGAINING POWER OF THREE LARGEST U.S. CITIES**

ESTABLISHING PUBLIC BANKS

The City of Chicago should establish a publicly-owned municipal bank. A public bank could provide a range of services to the city, its governmental units and other municipalities in Illinois. It could also provide capital that could be used for local economic stimulus, to invest in the local community, or to plug budget deficits. Revenue from the bank could be used to bolster affordable housing developments, early childhood education programs, infrastructure upgrades, green energy retrofitting programs, and other capital-intensive projects.

Public banks could better equip cities and states to manage the economic impact of boom-and-bust cycles in the economy. During an economic downturn, they could provide wholesale loans to local community banks to encourage them to increase small business lending to spur local job creation. Thus, public banks could effectively enable a city to implement countercyclical monetary policy at the local level.40
Notably, a public bank could also provide municipal finance services to Chicago’s governmental units and other municipalities in the state. City pension funds’ in-house investment managers could be based in a public bank. It could also house bond underwriters that would serve all municipal borrowers in Illinois. A public bank could also provide credit enhancements and other debt management services to Illinois municipalities. Chicago’s governmental units and other cities and counties could house their deposits in a Chicago public bank. Depending on how it is set up, the public bank may also be able to take out short-term loans from the Federal Reserve’s discount window at extremely low interest rates and pass those savings on to taxpayers.

North Dakota already has a thriving state-owned bank that returns an annual profit and helped the state weather the Great Recession relatively unscathed. A Chicago public bank would not have to be confined to the Bank of North Dakota model, but could be designed to meet the economic and financial needs of local communities.

RAISING PROGRESSIVE REVENUE

In addition to finding ways to cut its hefty payments to Wall Street, the City of Chicago also needs to find ways to implement progressive revenue measures. Several options are outlined below:

- **Graduated Income Tax:** The City of Chicago should implement a graduated income tax at the city level that would shift the tax structure to ensure that high-earners pay their fair share. It has been estimated that even a modest graduated income tax of 0.5 percent to 1.5 percent could generate more than $600 million in annual revenue. Many cities like New York, Baltimore, Pittsburgh, and St. Louis already have city income taxes, but Chicago does not.

- **Commuter Tax:** The City of Chicago should institute a commuter tax on suburban residents who work in the city and use the city’s resources to ensure that they pay their fair share. Suburban commuters rely heavily on city services for their employment, but do not have to contribute significantly to the city infrastructure that supports them. A commuter tax would fix that. The 620,000 suburban commuters who work in Chicago have an estimated combined income of $30 billion. Even a 1 percent commuter tax could bring in $300 million per year to Chicago. The Chicago Teachers Union estimated that a graduated commuter tax of 0.5 percent to 1.5 percent could generate approximately $350 million a year. A commuter tax could also be structured to exempt low-wage workers. Philadelphia currently has a commuter tax and New York used to have one.

- **LaSalle Street Tax:** The City of Chicago should work with the Illinois Legislature to impose a tax on the financial transactions at the Chicago Board of Trade and Chicago Board Options Exchange in the city’s Financial District on LaSalle Street. While the amount of revenue that could be generated would vary depending on the size of the tax, one proposal put forward by State Representative Mary Flowers during the 2014 Illinois legislative session could generate $10-12 billion per year for the State of Illinois at current trading levels, according to estimates by the Chicago Political Economy Group. Chicago’s share of this would depend on the allocation formula, but since Chicago accounts for roughly 20 percent of the population of the state, it would not be unreasonable to allot 20 percent of the revenues, or $2.0 to $2.4 billion, to the City of Chicago.
All three of these proposals would likely require state approval, so the mayor would need to petition the state for authorization and fight aggressively to win these measures.

These progressive revenue solutions would force wealthy people and large, profitable corporations in Chicago to contribute their fair share so that there can be shared prosperity in the city instead of addressing the city’s budget woes on the backs of working class communities. Elsewhere in the country, progressive revenue measures have helped governments close large budget deficits without exacerbating economic inequality by enacting painful cuts that disparately impact those who can least afford it. Voters in California passed Proposition 30 in 2012, which instituted a high-earners tax that has eliminated the state’s budget deficit, which used to be the largest in the country. In 2013, Minnesota also passed a high-earners tax and other revenue measures that helped fix the state’s budget crisis and allowed for the reversal of cuts to education and other programs.

CONCLUSION

The credit rating agencies’ downgrades of the City of Chicago, Chicago Public Schools, and the Chicago Park District have put a spotlight on the city’s budget problems. Many are using this as an opportunity to go after workers’ pensions and advance an austerity agenda. However, the real budget problem in Chicago is not that the city’s governmental units are spending too much on workers and public services like education and public health, but rather that they are hemorrhaging money on predatory financial deals and not bringing in enough revenue from the city’s wealthiest corporations and residents. The city needs to institute progressive revenue measures like implementing a tax on the financial transactions on LaSalle Street’s exchanges, and it needs to take steps to reclaim the power in its relationship with Wall Street and avoid predatory financial deals in the future. This will allow Chicago to create a financial regime that will put the interests of the city’s communities first.
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