Why Are California Cities in Financial Trouble?

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MarketWatch Blog by Alicia H. Munnell

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Dysfunctional government, the financial crisis, and generous pensions are all contributing factors

We are beginning a project to figure out why some localities are facing serious financial problems. Instead of reviewing the finances of the 2,400 cities and towns in the *U.S. Census of Governments*, we decided to search newspapers, magazines, wire services and other sources for cities or towns that have been cited in the press as financially troubled. Our search turned up 34 localities. Nine of those were tiny towns that had lost a major lawsuit. The other 25 localities had more pervasive problems, and included the expected larger suspects such as Chicago, Detroit, Philadelphia, and Providence. Others were small, like Pritchard Alabama and Central Falls, Rhode Island. What I found astounding was that 10 of the 25 financially troubled cities were in California. I guess the bright side is that, excluding California, American cities are not about to topple over like dominoes. On the other hand, what is going on in California?

According to the *Economist*, California's underlying problems rest with its brand of democracy. Essentially, Californians have adopted a direct and participatory democracy rather than the representative democracy favored by James Madison and other founders. The California approach opened the way for a major role for voter initiatives. These initiatives were used sparingly for much of the 20th century, but then in 1978, Californians passed Proposition 13. It was an anti-tax measure but had vast implications both for taxes and the power of the legislature to respond to economic shocks, such as the financial crisis and Great Recession.

Proposition 13 was a reaction to a doubling of property tax bills, as assessments soared in the early 1970s. The initiative cut the property-tax rate from an average of 2.6 percent to 1 percent in every county. It also capped the annual increase in assessed values at 2 percent. To make sure that the tax cut was not offset by tax increases elsewhere, Proposition 13 required a two-thirds super majority in the legislature for any tax hike.

With a huge revenue hole, local services faced enormous cuts. Instead, the state government, which had a large surplus, bailed the localities out. That one-time transfer became a permanent financing mechanism. And even the remaining property tax revenues were allocated by the state legislature. California now transfers 60 to 70 percent of its state revenues to localities.

In the wake of Proposition 13, two things have happened. First, of the hundreds of new initiatives that have passed, many have promised a tax cut or an expanded service without compensating financing, so much of the budget was allocated before the legislature even had a chance to negotiate. Second, the requirement for a super majority for any revenue increase made it almost impossible to raise taxes. The consensus appears to be that California has become unmanageable.

On the pension front, I know the story. California is in trouble because a retroactive expansion of benefits in the late 1990s made the state one of the most generous in the nation. Although unlike Illinois and New Jersey, it is not guilty of deliberately underfunding its plans, some degree of underfunding and the sheer magnitude of the pension commitments are putting enormous pressure on both state and local budgets in California. It is also a state where it is particularly difficult to modify public pensions by changing future benefits for current employees.

Finally, California was particularly hard hit by the financial crisis and ensuing recession. Even today, California has higher foreclosure and unemployment rates than most states. And local government revenue in California grew between 2007 and 2010 by only 3 percent compared to 9 percent for the rest of the nation. Part of the low growth can be explained by an actual decline in state transfers, which increased elsewhere by 10 percent over the 2007-10 period.

Combine a dysfunctional state government, which cannot raise revenues and cuts back just when localities need help, with very generous pension promises and the devastating impact of the 2008 financial collapse, and California is batting three for three. No wonder 10 of the nation’s 25 financially troubled cities are located in California.