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Not Just Pensions: The Social Origins of Municipal Bankruptcy in California

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Introduction

Big-city bankruptcies are costly and disruptive no matter where they occur. But the question of how to avoid them is of particular importance to policy makers and the public in California, because they have occurred disproportionately in this state. There are 289 cities in the U.S. with populations greater than 100,000. Of these cities, only four filed for bankruptcy since the last recession began in 2007. The most famous of them is Detroit, Michigan (2013), but the other three—Vallejo (2007), Stockton (2012), and San Bernardino (2012)—were all in California.

The purpose of this brief is to place these bankruptcies in comparative perspective and to highlight some lessons from relevant social science on the roots of big-city fiscal crises. Big-city bankruptcies are sufficiently rare events that we cannot rely on statistical studies of a large sample of cases to determine their causes. We do, however, have a substantial case-study literature on the causes of fiscal strain in California cities.

A lesson of these studies is that the state policy of property tax limitation contributes to the long-term risk of municipal bankruptcy. Rising municipal expenses are part of the story. But rising expenses only become a crisis when something prevents revenues from rising to meet them. In California, that something is political. A crucial factor that our large, bankrupt cities have in common with each other, and one that sets them apart from most other big cities in the United States, is that their revenues have been especially constrained by a state constitution that stringently limits local governments' power to tax real estate.

The Old Property Tax System

For most of the twentieth century, California city governments, like most municipal governments in the United States, raised the greatest share of their revenues from property taxes. Reliance on real property tax made city governments dependent on land owners. In the decades after World War II, that meant especially dependence on single-family homeowners. There was little resistance to rising property taxes in this era. Homeowners were generally content with the rising tax burden because they also received informal and illegal tax breaks from local officials who deliberately underestimated their tax liabilities.

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Local government implicitly subsidized home ownership by ensuring that taxes grew more slowly than the value of property. In return, homeowners more or less willingly paid the greatest share of the expenses of city government.ⁱ

That bargain broke down in the 1960s, when the courts finally began to enforce the law requiring local officials to tax property fairly at its true market value. The result was a sudden increase in the property tax burden. Many Californians saw their taxes double or triple in a year. Some low-income and elderly homeowners worried that rising taxes might force them to sell their homes.

Homeowners rebelled. Protesters around the state of California organized petition drives, demonstrations, and tax strikes. In August 1975, for example, a group of San Bernardino homeowners was arrested in the local office of their state senator, where they were engaged in a sit-in to demand that he support property tax cuts for elderly home owners.ⁱⁱ The protests spread throughout the state. By 1977, protesters in cities throughout California were coordinating several grassroots political campaigns to demand a constitutional amendment that would drastically limit the taxation of homes. The petitioners attracted more support than any previous petition drive in the history of California.ⁱⁱⁱ

The protesters won: their tax limitation proposal became law when voters approved it in 1978. A package of constitutional amendments, called Proposition 13 on the ballot, imposed a maximum rate of property tax. They limited the annual increase in the assessed value of any property until it was sold—thereby providing a substantial tax benefit for owners of real estate that was appreciating in value. Finally, they reduced the authority of local governments to levy new taxes. In most cases, a city government could no longer impose a new tax without first submitting it to a vote of the people.

Property Tax Limitation and the Permanent Fiscal Crisis

The victory of the tax protesters forced California cities to decrease their dependence on real property owners and increase their dependence on holders of other, more mobile assets. They shifted from reliance on property tax to reliance on sales tax, thereby increasing their dependence on local retail establishments and their customers. They imposed other excises—especially hotel taxes, which were popular with local voters because they mainly burdened out-of-town visitors, but which, by the same token, made city revenues dependent on a continued stream of tourists. They imposed new fees for city services. They relied increasingly on federal and state aid, which was reliant on the largesse of federal and state policy makers and funded in large part by economically volatile income tax revenues. They also borrowed heavily.

All of these changes made local governments in California more vulnerable to fiscal strain. Some have operated on the verge of insolvency for decades and have avoided default only by resorting to illegitimate financial manipulation to obscure their budgetary difficulties. Orange County, for example, tried to make up a chronic revenue shortfall by speculating in exotic financial instruments, and was forced to declare bankruptcy when the bond market declined in 1994; at the time, this was the single largest local government bankruptcy in American history.^{iv} The city of San Diego manipulated accounts to meet its municipal pension obligations without raising taxes, and almost had to declare bankruptcy in 2003.^v Bond rating agencies continue to

warn investors that California municipal bonds are a particularly risky investment. In the words of Eric Hoffman, Senior Vice President of Moody's Investors Service, for example, "California cities operate under more rigid revenue raising constraints than cities in many other parts of the country.... Since the adoption of Proposition 13 in the late 1970s, the cities' inability to access their local property tax bases for increased operating funds led to diversification into even more economically sensitive revenue sources, such as sales, business, and hotel taxes."^{vi} California's legacy of property tax protest meant that its cities were especially vulnerable in the event of an economic downturn.

That downturn came in 2007, and it, too, was exacerbated by California's legacy of property tax limitation. The housing investment bubble may have been especially inflated in California in part because of Proposition 13. The policy of property tax limitation probably contributed to rising home prices in California by stimulating demand: California's constitutional commitment to keep property taxes low in perpetuity made real property appear to be an especially advantageous investment.^{vii} Property tax limitation also increased home prices by constraining the supply of existing housing: the tax benefits provided by Proposition 13 were so lucrative that most long-time California homeowners were reluctant to sell.^{viii} California thus saw a particularly large influx of investment in new housing construction in the boom years. Vallejo, Stockton, and San Bernardino were especially appealing sites for speculative housing construction because they are all located just outside an hour's drive from larger, more densely settled, and more expensive metropolitan areas. Investors gambled that commuters would demand housing in these communities. All three cities enjoyed a glut of speculative housing construction and a windfall increase in tax revenues during the boom years. All three cities suffered from an especially severe slump in the real estate and construction industries--and in municipal tax revenues--after the investment bubble burst in 2006.^{ix}

It's Not Just the Pensions

The role of property tax limitation in preparing the ground for this crisis is illuminated by comparing Stockton, Vallejo, and San Bernardino to cities that faced similar challenges without being constrained by a rigid property tax limitation. A good comparison group is the three cities of Rochester, Buffalo, and Syracuse, New York. These cities are roughly similar in population to their California counterparts. They also have similar levels of public and private sector union density. On the eve of the global financial crisis, in fiscal year 2007, their annual pension costs were a similar percentage of the total expenditures (see table). These cities make for a particularly useful comparison because New York and California have many political and institutional similarities. They are both large states with a reputation for political liberalism. They are also both "home rule" states whose laws explicitly permit most local governments to file for bankruptcy. Until 1978, they also relied on approximately the same mix of state and local taxes.^x

Table.

Selected characteristics of Stockton, San Bernardino, and Vallejo in comparison to Rochester, Buffalo and Syracuse

	Population, 2013	Annual pension cost, FY 2007, in \$000s	Total governmental expenditures, FY 2007, in \$000s	Ratio of annual pension cost to total governmental spending	Public sector union density in MSA, 2013	Total union density in MSA, 2013	Median real estate tax paid by county residents as % median home value, 2005-07
Stockton, CA	298,118	24,162	354,596	6.8%	72.9%	16.8%	0.49%
San Bernardino, CA	213,708	11,614	200,065	5.8%	62.1%	23.5%	0.48%
Vallejo, CA	118,837	11,734	169,804	6.9%	54.9%	25.4%	0.53%
Rochester, NY	210,358	46,313	496,573	9.3%	70.7%	18.1%	2.84%
Buffalo, NY	258,959	45,571	497,985	9.2%	66.8%	22.4%	2.56%
Syracuse, NY	144,669	31,606	590,351	5.4%	71.6%	23.1%	2.56%
Source	(a)	(b)	(b)	(b)	(c)	(c)	(d)

Sources:

- (a) Census Bureau, Population Estimates Program, table PEPANNRSIP - Annual Estimates of the Resident Population for Incorporated Places of 50,000 or More, Ranked by July 1, 2013
Population: April 1, 2010 to July 1, 2013 - United States -- Places of 50,000+ Population
- (b) Author's calculations from city financial statements, including:
City of San Bernardino Comprehensive Annual Financial Report, year ended June 30, 2007
City of Rochester, New York, Comprehensive Annual Financial Report, year ended June 30, 2007
City of Buffalo, New York, Comprehensive Annual Financial Report for the fiscal year ended June 30, 2007
City of Vallejo, California, Comprehensive Annual Financial Report for the fiscal year ended June 30, 2007
City of Syracuse, New York, Basic Financial Statements for the fiscal year ended June 30, 2007
- (c) Barry T. Hirsch and David A. Macpherson, Union Membership and Coverage Database from the Current Population Survey, www.unionstats.com
- (d) American Community Survey, computations by Tax Foundation
<<http://interactive.taxfoundation.org/propertytax/>>

After 1978, however, California municipal governments were constrained by Proposition 13, while most municipal governments in New York remained free to raise property taxes for another three decades. The result has been a lasting difference in reliance on property taxes. In 2007, the median property tax paid to local governments in San Joaquin, Solano, and San Bernardino Counties—where Stockton, Vallejo, and San Bernardino are located—was about 0.5% of the value of the median single-family home. By contrast, the median property tax paid to all local governments in Monroe, Erie, and Onondaga counties—where Rochester, Buffalo,

and Syracuse are located—was between 2.5% and 3% of the median value of a single-family home (see table).

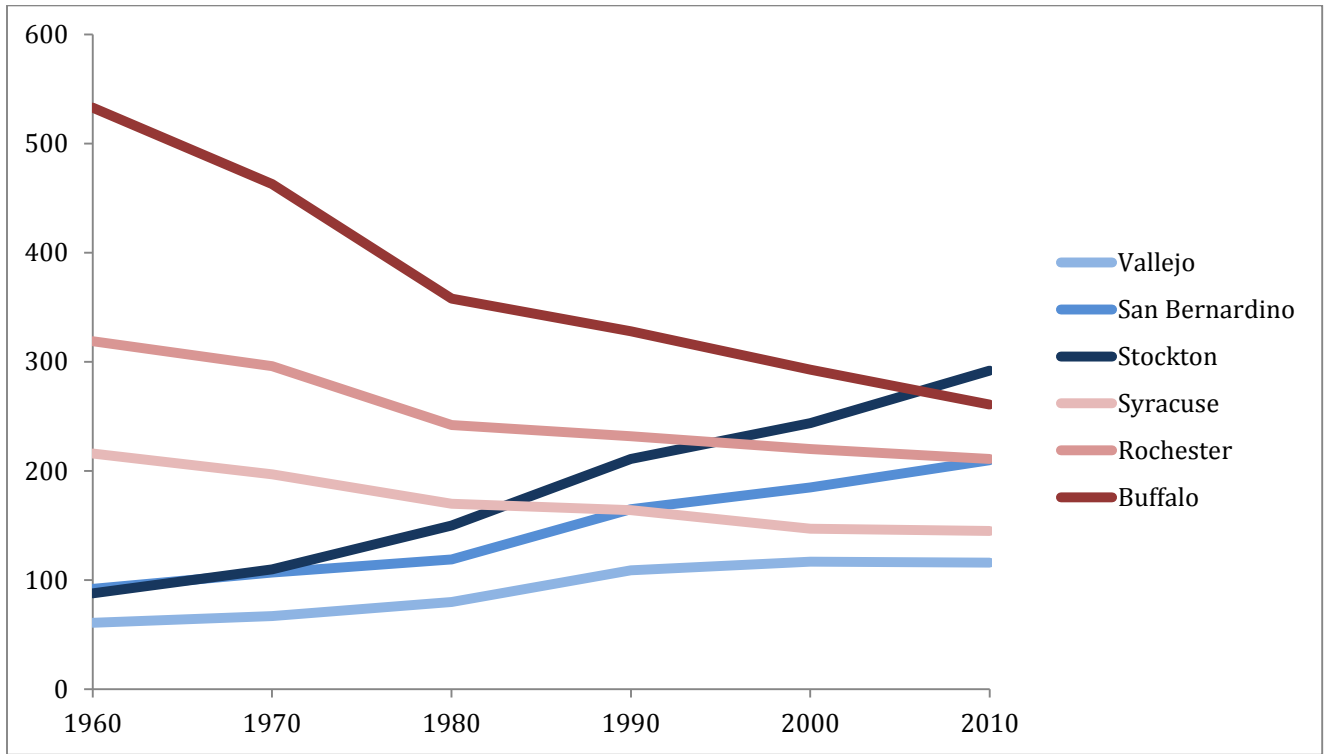
These New York cities have all confronted severe fiscal challenges, but their reliance on the property tax—and the ability to raise property taxes further—has allowed them to weather the storm better than their California counterparts. Syracuse, faced with the prospect of a fiscal crisis, raised property taxes in 2011. Rochester followed suit the next year.^{xi} Buffalo has faced especially severe budgetary strain. After decades of population decline, falling revenues and rising expenses drove the city to seek state assistance even before the housing market crashed; in response, the State of New York passed the “Buffalo Fiscal Stability Authority Act” in 2003, which created an appointed board with emergency powers to oversee collective bargaining agreements, to borrow on the city’s behalf, and to file for municipal bankruptcy if necessary. The authority has coped with Buffalo’s fiscal difficulties in part by freezing wages and benefits. The city has resisted pressure to increase the property tax, and a Proposition-13-style property tax limit adopted by New York State in 2012 means that future tax increases are probably off the table. But Buffalo has resisted pressure to reduce property taxes to California levels, and it weathered the period of its most acute fiscal emergency in part by retaining a relatively high property tax rate.^{xii}

The role of property tax limitation has been obscured in much of the commentary on the municipal fiscal crisis, which has focused on the rising costs of public pensions.^{xiii} It is true that Stockton, Vallejo, and San Bernardino failed to adjust their expenditures downward in part because they had made long-term commitments to fund pensions and health care for city retirees. It is also true that these benefits were secured by collective bargaining agreements. These cities are all in urban labor markets that have comparatively high rates of unionization, and public employee unions in all three cities resisted cuts to pension expenditures. But rising pension expenditures alone do not explain the turn to bankruptcy. Most American cities face rising pension costs. And cities such as Syracuse, with similar rates of public sector union membership, whose budgets were similarly burdened by pensions, were not pushed into bankruptcy by the financial crisis.

Many commentators have been too quick to blame the fiscal troubles of American cities on the long-term decline of American manufacturing. This story is popular because it seems to fit the most famous big-city bankruptcy: the city of Detroit. For example, Michigan Governor Rick Snyder, in approving the bankruptcy petition for the City of Detroit, described it as the outcome of “60 years of decline.”^{xiv} But this explanation does not fit the comparative pattern of facts. America’s other declining industrial cities in the Rust Belt have not declared bankruptcy, and Vallejo, Stockton, and San Bernardino are all Sun Belt cities that underwent rapid economic growth and urban population growth in the decades after the Second World War. Despite their recent economic troubles, none of these cities has experienced anything like Detroit’s population decline. The population of Vallejo has stagnated in the last decade, but Stockton and San Bernardino continue to attract new residents (see graph). Recent big-city bankruptcies in California followed 50 years of publicly subsidized growth.

Graph.

Population of Stockton, San Bernardino, and Vallejo in comparison to Syracuse, Rochester, and Buffalo



Source: Census Bureau

It is hard to identify any common factor in the industrial base of these cities that pushed them into bankruptcy. Vallejo and Stockton are port cities. Stockton and San Bernardino were historically centers of agricultural processing, and also seats of county government. The Second World War transformed the economies of San Bernardino and Vallejo by bringing an influx of military installations (a naval shipyard in Vallejo and an air force base in San Bernardino). It also brought military contracts that stimulated industry—including a major steel plant near San Bernardino, and shipbuilding in Vallejo. For forty years after the war the economies of these cities were more sheltered from recessions than those of many other cities because they were home to large concentrations of federal, state, and county employees whose salaries came from taxes raised outside the city limits. The changing fortunes of these cities had less to do with the global market pressures that undermined Detroit's auto industry than with the shifting patterns of public sector investment—especially the withdrawal of military contracts and the closure of military installations in Vallejo and San Bernardino in the 1990s.

The common factor may simply be a legacy of property tax limitation that rendered city budgets vulnerable when times got tough. This explanation fits Detroit, too. In mid-twentieth-century Detroit, as in California municipalities, local government implicitly subsidized owner-occupied homes by under-taxing them. This bargain fell apart when the state of Michigan began enforcing reforms to property assessment in the 1970s, and homeowners responded by protesting against

local property taxes, just as they did in California. In 1978, Michigan voters approved a tax limitation amendment that was directly copied from California's Proposition 13. This tax limitation constrained Detroit's ability to raise revenue. It was directly implicated in Detroit's bankruptcy: the city's emergency financial manager argued that bankruptcy was the only remaining option because the city was already taxing at the legal limit.^{xv}

The Price We Pay for Low Property Taxes

The resolution of a bankruptcy does not always resolve the underlying social conflict. Vallejo was the first big California city to emerge from bankruptcy, and its experience is instructive. Budgeting remains very difficult. Vallejo city officials inaugurated a participatory budgeting process in hopes that involving neighborhood associations directly would defuse conflict over the allocation of the necessary cuts.^{xvi} The city still has not reconciled its commitment to provide salaries and pension benefits for public employees with its commitment to homeowners who insist on keeping tax revenues low. Its pension expenses are still high. Its public services are still inadequate. Roads are ill maintained. The police department is understaffed.^{xvii} City voters approved a \$.005 sales tax increase in the fall of 2011 by the barest of margins, indicating that further tax increases are unlikely; but current revenues are still inadequate to the city's existing programs, and city officials still struggle to fill a structural budget deficit every year. They are still unable to borrow in municipal bond markets. In 2014, bond rating agencies warned that the city appeared to be headed toward a second bankruptcy.^{xviii}

Big cities can get in big fiscal trouble today because of political choices that voters made long ago to limit the growth of property taxes. The problem is not only, and not even primarily, the high cost of public pensions. The truth is that pension costs have never yet pushed a big city into bankruptcy unless that city was also especially constrained in its ability to raise revenues. Without the legacy of a limitation on local tax increases, there would be no municipal fiscal crisis as we know it today.

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- ⁱ Isaac William Martin, *The Permanent Tax Revolt: How the Property Tax Transformed American Politics* (Stanford University Press, 2008), 48.
- ⁱⁱ Americans Nonpartisan for Tax Equity, “ ‘Arrestees’ Update – Ayala Files Charges!” *Taxation*, vol. 2, no. 11 (Nov. 1975), Wisconsin Historical Society, Movement for Economic Justice Records (Mss. 766), Box 18, Folder 1.
- ⁱⁱⁱ John Allswang, *The Initiative and Referendum in California, 1898-1998* (Stanford University Press, 2000), 105.
- ^{iv} Mark Baldassare, *When Government Fails: The Orange County Bankruptcy* (University of California Press, 1998).
- ^v Steven P. Erie, Vladimir Kogan, and Scott A. MacKenzie, *Paradise Plundered: Fiscal Crisis and Governance in San Diego* (Stanford University Press, 2011).
- ^{vi} Quoted in Moody’s Investors Service, *Rating Action: Moody’s Reviews Ratings of 32 California Cities; Nine Pension Bonds Downgraded*, Press release, 9 October 2012; see also Moody’s Investors Service, *Special Comment: Why Some California Cities are Choosing Bankruptcy*, 17 August 2012.
- ^{vii} For evidence that property tax limitation increased housing prices in the boom years, see William H. Hoyt, Paul A. Coomes, and Amelia M. Biehl, “Tax Limits and Housing Markets: Some Evidence at the State Level,” *Real Estate Economics*, vol. 39, no. 1 (2011), 97–132.
- ^{viii} On residential mobility, see Fernando Ferreira, “You Can Take It With You: Proposition 13 Tax Benefits, Residential Mobility, and Willingness to Pay for Housing Amenities,” *Journal of Public Economics*, vol. 94, 661-73.
- ^{ix} Moody’s Investors Service, *Special Comment*, 17 August 2012, 5. See Alex Schafran, “Origins of an Urban Crisis: The Restructuring of the San Francisco Bay Area and the Geography of Foreclosure,” *International Journal of Urban and Regional Research*, vol. 37, no. 2 (2013): 663-88, 674-5.
- ^x See Colin H. McCubbins and Matthew D. McCubbins, “Proposition 13 and the California Fiscal Shell Game,” *California Journal of Politics and Policy*, vol. 2, no. 2, 14, 16, 18.
- ^{xi} Tim Knauss, “With Fiscal Crisis Looming, Syracuse Officials Want Workers, Retirees to Pay More for Health Care,” *Syracuse Post-Standard*, 19 March 2012; Brian Sharp, “City Budget Raises Taxes Slightly,” *Rochester Democrat and Chronicle*, 16 May 2014.
- ^{xii} Jill Terreri, “Buffalo’s Property Taxes are Still Frozen, but Reserves are Dwindling,” *Buffalo News*, 19 January 2013; cf. Steve H. Hanke and Stephen J. K. Walters, “A Property Tax Cut Could Help Save Buffalo,” *Wall Street Journal*, 6 December 2008.
- ^{xiii} See, e.g., Steven Malanga, “The Pension Fund that Ate California,” *City Journal* (winter 2013); Michael Barone, “The Tales of Three Bankrupt Cities,” *National Review Online*, 13 August 2013. For a more general overview of some of this commentary, and of the interest groups that are promoting this view, see Jamie Peck, “Pushing Austerity: State Failure, Municipal Bankruptcy and the Crises of Fiscal Federalism in the U.S.A.” *Cambridge Journal of Regions, Economy, and Society*, vol. 7, no. 1, 17-44.
- ^{xiv} Rick Snyder to Kevyn D. Orr and Andrew Dillon, 18 July 2013, Re: Authorization to Commence Chapter 9 Bankruptcy Proceeding.
- ^{xv} Kevyn D. Orr to Richard D. Snyder and Andrew Dillon, 16 July 2013, p. 5. On the Michigan property tax revolt, see Martin, *Permanent Tax Revolt*, 115-8.
- ^{xvi} See Brandon Kent Chapin, “From the Ashes of Bankruptcy: An Assessment of the Collaborative Nature of the City of Vallejo’s Participatory Budgeting Process,” M.A. Thesis, Department of Public Policy and Administration, California State University, Sacramento.
- ^{xvii} On police staffing levels, see Alex Emslie, “Questions Surround Surge in Vallejo Police Shootings,” KQED News, 20 May 2014.
- ^{xviii} Moody’s Investors Service, *Moody’s: Bankrupt California Cities Face Steep Climb to Solvency without Pension Relief*, 20 February 2014.