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How Stockton Went Bust:
A California City's Decade of Policies and the Financial Crisis that Followed

Executive Summary

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In February 2012, Stockton, California voted to enter bankruptcy mediation. Stockton is one of California's 20 largest cities, and it would be the nation's largest city to go bankrupt in history. Its story highlights the pressures on local governments in the aftermath of the 2008 recession and the looming threat of further bankruptcies. This report strives to understand the causes behind Stockton's present financial crisis and to explain some of the more esoteric financial details in plain language.

Our study evaluates the main strains on the Stockton's budget and their origins through an examination of the city's annual budgets, audit reports, employment agreements and other documents from the past decade. Although a number of accounts in the popular press attribute Stockton's financial straits to the 2008 recession, the real story is considerably more convoluted. This report largely attributes Stockton's financial problems to three distinct but related factors:

1. **The housing and financial collapses.** The post-2001 economy grew quickly, fueled largely by the growth of the real estate market. The city's higher revenue fueled an unbounded optimism about Stockton's potential growth. In the aftermath of the market collapses, the city experienced general fund budget deficits every year. These annual deficits quickly depleted the city's scant reserves and pushed it towards insolvency.

2. **Excessive optimism and unsustainable compensation promises.** The optimism of the first half of the decade contributed to the city's willingness to sign several generous employment agreements during the mid-2000's. These agreements locked in increasing expenditures on salaries, pensions, and other benefits, which together comprise the bulk of the city's budget. The city now faces more than $800 million in unfunded liabilities for pensions and other retirement benefits.

3. **An ill-timed bond offering.** In 2007, to help lower the city's high pension costs, Stockton undertook a bond offering that would lower its interest payments on roughly $125 million of its pension obligation. Due to CalPERS's investment performance, today that investment is worth less than $100 million, but will ultimately cost the city $248 million to pay back.

We focus on the portion of the General Fund that was most affected by this series of events: Employee Services, which include all benefits and compensation that an employee receives. Employee compensation and benefits comprise the bulk of Stockton's General Fund budget. Additionally, healthcare costs are increasing rapidly for current and retired employees. If Stockton intends to remain solvent and continue providing effective services to its citizens, then addressing these costs will be essential.

We compare Stockton to Vallejo, California, which exited bankruptcy proceedings in 2011. We conclude the report with a summary of arguments for and against proceeding with bankruptcy, a choice the city will need to make in the coming weeks.