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California *and* Bust

The smart money says the U.S. economy will splinter, with some states thriving, some states not, and all eyes are on California as the nightmare scenario. After a hair-raising visit with former governor Arnold Schwarzenegger, who explains why the Golden State has cratered, Michael Lewis goes where the buck literally stops—the local level, where the likes of San Jose mayor Chuck Reed and Vallejo fire chief Paige Meyer are trying to avert even worse catastrophes and rethink what it means to be a society.

On August 5, 2011, moments after the U.S. government watched a rating agency lower its credit rating for the first time in American history, the market for U.S. Treasury bonds soared. Four days later, the interest rates paid by the U.S. government on its new 10-year bonds were plummeting on their way to record lows. The price of gold rose right alongside the price of U.S. Treasury bonds, but the prices of virtually all stocks and other bonds in rich Western countries went into a free fall. The net effect of a major U.S. rating agency's saying that the U.S. government was less likely than before to repay its debts was to lower the cost of borrowing for the U.S. government and to raise it for everyone else. This told you a lot of what you needed to know about the ability of the U.S. government to live beyond its means: it had, for the moment, a blank check. The shakier the United States government appeared, up to some faraway point, the more cheaply it would be able to borrow. It wasn't exposed yet to the same vicious cycle that threatened the financial life of European countries: a moment of doubt leads to higher borrowing costs, which leads to greater doubt and even higher borrowing costs, and so on until you become Greece. The fear that the United States might actually not pay back the money it had borrowed was still unreal.

On December 14, 2010, the television news program *60 Minutes* aired a 14-minute piece about U.S. state and local finances. Correspondent Steve Kroft interviewed a private Wall Street analyst named Meredith Whitney, who, back in 2007, had gone from being obscure to famous when she correctly suggested that Citigroup's losses in U.S. subprime bonds were far bigger than anyone imagined, and predicted the bank would be forced to cut its dividend. The *60 Minutes* segment noted that U.S. state and local governments faced a collective annual deficit of roughly half a trillion dollars, adding that another trillion-dollar gap existed between what the governments owed retired workers and the money they had on hand to pay them. Whitney pointed out that even these numbers were unreliable, and probably optimistic, as the states did a poor job of providing information about their finances to the public. New Jersey governor Chris Christie concurred with her and added, "At this point, if it's worse, what's the difference?" The bill owed by American states to retired American workers was so large that it couldn't be paid, whatever the amount. At the end of the piece, Kroft asked Whitney what she thought about the ability and willingness of the American states to repay their debts. She didn't see a real risk that the states would default, because the states had the ability to push their problems down to counties and cities. But at these lower levels of government, where American life was lived, she thought there would be serious problems. "You could see 50 to a hundred sizable defaults, [maybe] more," she said. A minute later Kroft returned to her to ask when people should start worrying about a crisis in local finances. "It'll be something to worry about within the next 12 months," she said.

That prophecy turned out to be self-fulfilling: people started worrying about U.S. municipal finance the minute the words were out of her mouth. The next day the municipal-bond market tanked. It kept falling right through the next month. It fell so far, and her prediction received so much attention, that money managers who had put clients into municipal bonds felt compelled to hire more people to analyze states and cities, to prove her wrong. (One of them called it "the Meredith Whitney Municipal Bond Analyst Full Employment Act.") Inside the financial world a new literature was born, devoted to persuading readers that Meredith Whitney didn't know what she was talking about. She was vulnerable to the charge: up until the moment she appeared on *60 Minutes* she had, so far as anyone knew, no experience at all of U.S. municipal finance. Many of the articles attacking her accused her of making a very specific forecast—as many as a hundred defaults within a year!—that failed to materialize. (Sample

Bloomberg News headline: MEREDITH WHITNEY LOSES CREDIBILITY AS MUNI DEFAULTS FALL 60%.) The whirlwind thrown up by the brief market panic sucked in everyone who was anywhere near municipal finance. The nonpartisan, dispassionate, sober-minded Center on Budget and Policy Priorities, in Washington, D.C., even released a statement saying that there was a "mistaken impression that drastic and immediate measures are needed to avoid an imminent fiscal meltdown." This was treated in news accounts as a response to Meredith Whitney, as she was the only one in sight who could be accused of having made such a prediction.

But that's not at all what she had said: her words were being misrepresented so that her message might be more easily attacked. "She was referring to the complacency of the ratings agencies and investment advisers who say there is nothing to worry about," said a person at *60 Minutes* who reviewed the transcripts of the interview for me, to make sure I had heard what I thought I had heard. "She says there is something to worry about, and it will be apparent to everyone in the next 12 months."

Whatever else she had done, Meredith Whitney had found the pressure point in American finance: the fear that American cities would not pay back the money they had borrowed. The market for municipal bonds, unlike the market for U.S. government bonds, spooked easily. American cities and states were susceptible to the same cycle of doom that had forced Greece to seek help from the International Monetary Fund. All it took to create doubt and raise borrowing costs for states and cities was for a woman with no standing in the municipal-bond market to utter a few sentences on television. That was the amazing thing: she had offered nothing to back up her statement. She'd written a massive, detailed report on state and local finances, but no one except a handful of her clients had any idea what was in it. "If I was a real nasty hedge-fund guy," one hedge-fund manager put it to me, "I'd sit back and say, 'This is a herd of cattle that can be stampeded.' "

What Meredith Whitney was trying to say was more interesting than what she was accused of saying. She didn't actually care all that much about the municipal-bond market, or how many cities were likely to go bankrupt. The municipal-bond market was a dreary backwater. As she put it, "Who cares about the stinking, muni-bond, market?" The only reason she had stumbled into that market was that she had come to view the U.S. national economy as a collection of regional economies. To understand the regional economies, she had to understand how state and local governments were likely to behave, and to understand this she needed to understand their finances. Thus she had spent two unlikely years researching state and local finance. "I didn't have a plan to do this," she said. "Not one of my clients asked for it. I only looked at this because I needed to understand it myself. How it started was with a question: How can G.D.P. [gross domestic product] estimates be so high when the states that outperformed the U.S. economy during the boom were now underperforming the U.S. economy—and they were 22 percent of that economy?" It was a good question.

From 2002 to 2008, the states had piled up debts right alongside their citizens': their level of indebtedness, as a group, had almost doubled, and state spending had grown by two-thirds. In that time they had also systematically underfunded their pension plans and other future liabilities by a total of nearly $1.5 trillion. In response, perhaps, the pension money that they had set aside was invested in ever riskier assets. In 1980 only 23 percent of state pension money had been invested in the stock market; by 2008 the number had risen to 60 percent. To top it off, these pension funds were pretty much all assuming they could earn 8 percent on the money they had to invest, at a time when the Federal Reserve was promising to keep interest rates at zero. Toss in underfunded health-care plans, a reduction in federal dollars available to the states, and the depression in tax revenues caused by a soft economy, and you were looking at multi-trillion-dollar holes that could be dealt with in only one of two ways: massive cutbacks in public services or a default—or both. Whitney thought default unlikely, at least at the state level, because the state could bleed the cities of money to pay off its bonds. The cities were where the pain would be felt most intensely. "The scary thing about state treasurers," she said, "is that they don't know the financial situation in their own municipalities."

"How do you know that?"

"Because, I asked them!"

All states may have been created equal, but they were equal no longer. The states that had enjoyed the biggest boom were now facing the biggest busts. "How does the United States emerge from the credit crisis?" Whitney

asked herself. “I was convinced—because the credit crisis had been so different from region to region—that it would emerge with new regional strengths and weaknesses. Companies are more likely to flourish in the stronger states; the individuals will go to where the jobs are. Ultimately, the people will follow the companies.” The country, she thought, might organize itself increasingly into zones of financial security and zones of financial crisis. And the more clearly people understood which zones were which, the more friction there would be between the two. (“Indiana is going to be like, ‘N.F.W. I’m bailing out New Jersey.’ ”) As more and more people grasped which places had serious financial problems and which did not, the problems would only increase. “Those who have money and can move do so,” Whitney wrote in her report to her Wall Street clients, “those without money and who cannot move do not, and ultimately rely more on state and local assistance. It becomes effectively a ‘tragedy of the commons.’ ”

The point of Meredith Whitney’s investigation, in her mind, was not to predict defaults in the municipal-bond market. It was to compare the states with one another so that they might be ranked. She wanted to get a sense of who in America was likely to play the role of the Greeks, and who the Germans – of who was strong, and who weak. In the process she had, in effect, unearthed America’s scariest financial places.

“So what’s the scariest state?” I asked her.

She had to think for only about two seconds.

“California.”

California Iron Man

At seven o’clock one summer morning I pedaled a $5,000 titanium-frame mountain bike rented in anxiety the previous evening down the Santa Monica beach road to the corner where Arnold Schwarzenegger had asked me to meet him. He turned up right on time, driving a black Cadillac S.U.V. with a handful of crappy old jalopy bikes racked to the back. I wore the closest I could find to actual bicycle gear; he wore a green fleece, shorts, and soft beige slipper-like shoes that suggested both a surprising indifference to his own appearance and a security in his own manhood. His hair was still vaguely in a shape left by a pillow, and his eyelids drooped, though he swore he’d been up for an hour and a half reading newspapers. After reading the newspapers, this is what the former governor of California often does: rides his bike for cardio, then hits the weight room.

He hauls a bike off the back of the car, hops on, and takes off down an already busy Ocean Avenue. He wears no bike helmet, runs red lights, and rips past DO NOT ENTER signs without seeming to notice them and up one-way streets the wrong way. When he wants to cross three lanes of fast traffic he doesn’t so much as glance over his shoulder but just sticks out his hand and follows it, assuming that whatever is behind him will stop. His bike has at least 10 speeds, but he has just 2: zero and pedaling as fast as he can. Inside half a mile he’s moving fast enough that wind-induced tears course down his cheeks.

He’s got to be one of the world’s most recognizable people, but he doesn’t appear to worry that anyone will recognize him, and no one does. It may be that people who get out of bed at dawn to jog and Rollerblade and race walk are too interested in what they are doing to break their trance. Or it may be that he’s taking them by surprise. He has no entourage, not even a bodyguard. His former economic adviser, David Crane, and his media adviser, Adam Mendelsohn, who came along for the ride just because it sounded fun, are now somewhere far behind him. Anyone paying attention would think, That guy might look like Arnold, but it can’t possibly be Arnold, because Arnold would never be out alone on a bike at seven in the morning, trying to commit suicide. It isn’t until he is forced to stop at a red light that he makes meaningful contact with the public. A woman pushing a baby stroller and talking on a cell phone crosses the street right in front of him and does a double take. “Oh . . . my . . . God,” she gasps into her phone. “It’s Bill Clinton!” She’s not 10 feet away, but she keeps talking to the phone, as if the man were unreal. “I’m here with Bill Clinton.”

“It’s one of those guys who has had a sex scandal,” says Arnold, smiling.

“Wait . . . wait,” says the woman to her phone. “Maybe it’s not Bill Clinton.”

Before she can make a positive identification, the light is green, and we're off.

His life has been a series of carefully staged experiences. He himself has no staged presentation of it, however. He is fresh, alive, and improvisational: I'm not sure even he knows what he will do next. He's not exactly humble, but then, if I had lived the life he's lived, I'm not sure I would be, either, though I might try to fake humility more often than he does, which is roughly never. What saves him from self-absorption, aside from a natural curiosity, is a genuine lack of interest in personal reflection. He lives the same way he rides his bike, paying far more attention to what's ahead than what's behind. In office, he kept no journal of any sort. I find it amazing, but he now says he didn't so much as scribble little notes that might later be used to reconstruct his experience and his feelings about it. "Why would I do that?" he says. "It's kind of like you come home and your wife asks you about your day. I've done it once and I don't want to do it again." What he wanted to do after a long day of being governor, more or less, was to lift weights.

We're just a couple of miles in when he zips around a corner and into a narrow alleyway just off Venice Beach. He's humoring me; I've been pestering him about what it was like for him when he first arrived in America, back in 1968, with little money, less English, really nothing but his lats, pecs, traps, and abs, for which there was no obvious market. He stops beside a tall brick wall. It surrounds what might once have been an impressive stone house that now just looks old and bleak and empty. The wall is what interests him, because he built it 43 years ago, right after he had arrived and started to train on Muscle Beach. "Franco [Columbu, like Schwarzenegger a former Mr. Olympia] and I made money this way. In bodybuilding there was no money. Here we were, world champions of this little subculture, and we did this to eat. Franco ran the business. I mixed the cement and knocked things down with the sledgehammer."

Before he stumbled while running downhill with a refrigerator strapped to his back, Columbu was the front-runner in the 1977 contest for the title of the World's Strongest Man, so there was some distinction in being hired by his operation, as Schwarzenegger was, to be the muscle. They had a routine. Franco would play the unreliable Italian, Arnold the sober German. Before they cut any deal they'd scream at each other in German in front of the customer until the customer would finally ask what was going on. Arnold would turn to the customer and explain, *Oh, he's Italian, and you know how they are. He wants to charge you more, but I think we can do it cheaply.* Schwarzenegger would then name a not so cheap price. "And the customer," he says now, laughing, "he would always say, 'Arnold, you're such a nice guy! So honest!' It was selling, you know."

He surveys his handiwork. "It'll be here for a thousand years," he says, then points out some erosion on the top. "I said to Franco we ought to come back and fix the top. You know, to show it was guaranteed for life."

A poor kid from a small village in Austria, the son of a former Nazi, hops on a plane to America, starts out laying bricks, and winds up running the state and becoming one of America's most prominent political leaders. From post to wire the race takes less than 35 years. I couldn't help but ask the obvious question.

"If someone had told you when you were building this wall that you would wind up governor of California, what would you have said?"

"That would be all right," he said, not exactly catching my drift.

"As a boy," I said, taking another tack, "did you believe you'd lead something other than an ordinary life?"

"Yes." He didn't miss a beat.

"Why?"

"I don't know."

"No one has had this kind of crazy, wild ride," he says as we speed away from the brick wall, but in a tone that suggests the ride was an accident. "I was influenced a lot by America," he said. "The giant six-lane highways, the Empire State Building, the risk taking." He still remembers vividly the America he heard and read about as a boy in

Austria: everything about it was big. The only reason he set out to grow himself some big muscles was that he thought it might be a ticket to America.

If there had not been a popular movement to remove sitting governor Gray Davis and the chance to run for governor without having to endure a party primary, he never would have bothered. “The recall happens and people are asking me, ‘What are you going to do?’” he says, dodging vagrants and joggers along the beach bike path. “I thought about it but decided I wasn’t going to do it. I told Maria I wasn’t running. I told everyone I wasn’t running. I wasn’t running.” Then, in the middle of the recall madness, *Terminator 3: Rise of the Machines* opened. As the movie’s leading machine, he was expected to appear on *The Tonight Show* to promote it. En route he experienced a familiar impulse—the impulse to do something out of the ordinary. “I just thought, this will freak everyone out,” he says. “It’ll be so funny. I’ll announce that I am running. I told Leno I was running. And two months later I was governor.” He looks over at me, pedaling as fast as I can to keep up with him, and laughs. “What the fuck is *that?*”

We’re now off the beach and on the surface roads, and the traffic is already heavy. He veers left, across four lanes, arrives on the other side, and says, “All these people are asking me, ‘What’s your plan? Who’s on your staff?’ I didn’t have a plan. I didn’t have a staff. I wasn’t running until I went on *Jay Leno.*”

His view of his seven years trying to run the state of California can be summarized as follows. He came to power accidentally, but not without ideas about what he wanted to do. At his core he thought government had become more of a problem than solution: an institution run less for the benefit of the people than for the benefit of politicians and other public employees. He behaved pretty much as Americans seem to imagine the ideal politician should behave: he made bold decisions without looking at polls; he didn’t sell favors; he treated his opponents fairly; he was quick to acknowledge his mistakes and to learn from them; and so on. He was the rare elected official who believed, with some reason, that he had nothing to lose, and behaved accordingly. When presented with the chance to pursue an agenda that violated his own narrow political self-interest for the sake of the public interest, he tended to leap at it. “There were a lot of times when we said, ‘You just can’t do that,’ ” says his former chief of staff, Susan Kennedy, a lifelong Democrat, whose hiring was one of those things a Republican governor was not supposed to do. “He was always like, ‘I don’t care.’ Ninety percent of the time it was a good thing.”

Two years into his tenure, in mid-2005, he’d tried everything he could think of to persuade individual California state legislators to vote against the short-term desires of their constituents for the greater long-term good of all. “To me there were shocking moments,” he says. Having sped past a DO NOT ENTER sign, we are now flying through intersections without pausing. I can’t help but notice that, if we weren’t breaking the law by going the wrong way down a one-way street, we’d be breaking the law by running stop signs. “When you want to do pension reform for the prison guards,” he says, “and all of a sudden *the Republicans* are all lined up against you. It was really incredible, and it happened over and over: people would say to me, ‘Yes, this is the best idea! I would love to vote for it! But if I vote for it some interest group is going to be angry with me, so I won’t do it.’ I couldn’t believe people could actually say that. You have soldiers dying in Iraq and Afghanistan, and they didn’t want to risk their political lives by doing the right thing.”

He came into office with boundless faith in the American people—after all, they had elected him—and figured he could always appeal directly to them. That was his trump card, and he played it. In November 2005 he called a special election that sought votes on four reforms: limiting state spending, putting an end to the gerrymandering of legislative districts, limiting public-employee-union spending on elections, and lengthening the time it took for public-school teachers to get tenure. All four propositions addressed, directly or indirectly, the state’s large and growing financial mess. All four were defeated; the votes weren’t even close. From then until the end of his time in office he was effectively gelded: the legislators now knew that the people who had elected them to behave exactly the way they were already behaving were not going to undermine them when appealed to directly. The people of California might be irresponsible, but at least they were consistent.

Home of the Free . . . Lunch

A compelling book called *California Crackup* describes this problem more generally. It was written by a pair of journalists and nonpartisan think-tank scholars, Joe Mathews and Mark Paul, and they explain, among other things, why Arnold Schwarzenegger's experience as governor was going to be unlike any other experience in his career: he was never going to win. California had organized itself, not accidentally, into highly partisan legislative districts. It elected highly partisan people to office and then required these people to reach a two-thirds majority to enact any new tax or meddle with big spending decisions. On the off chance that they found some common ground, it could be pulled out from under them by voters through the initiative process. Throw in term limits—no elected official now serves in California government long enough to fully understand it—and you have a recipe for generating maximum contempt for elected officials. Politicians are elected to get things done and are prevented by the system from doing it, leading the people to grow even more disgusted with them. "The vicious cycle of contempt," as Mark Paul calls it. California state government was designed mainly to maximize the likelihood that voters will continue to despise the people they elect.

But when you look below the surface, he adds, the system is actually very good at giving Californians what they want. "What all the polls show," says Paul, "is that people want services and not to pay for them. And that's exactly what they have now got." As much as they claimed to despise their government, the citizens of California shared its defining trait: a need for debt. The average Californian, in 2011, had debts of $78,000 against an income of $43,000. The behavior was unsustainable, but, in its way, for the people, it works brilliantly. For their leaders, even in the short term, it works less well. They ride into office on great false hopes and quickly discover they can do nothing to justify those hopes.

In Paul's view, Arnold Schwarzenegger had been the best test to date of the notion that the problem with California politics was personal, that all the system needed to fix itself was an independent-minded leader willing to rise above petty politics and exert the will of the people. "The recall was, in and of itself, an effort by the people to say that a new governor—a different continued from page 183 person—could solve the problem," says Paul. "He tried every different way of dealing with the crisis in services. He tried to act like a Republican. He tried to act like a Democrat. He tried making nice with the legislature. When that didn't work he called them girlie men. When that didn't work he went directly to the people. And the people voted against his proposals."

The experiment wasn't a complete failure. As governor, Schwarzenegger was able to accomplish a few important things—reforming worker compensation, enabling open primaries, and, at the very end, ensuring that legislative districts would be drawn by an impartial committee rather than by the legislature. But on most issues, and on virtually everything having to do with how the state raised and spent money, he lost. In his first term Schwarzenegger had set out to cut spending and found he could cut only the things that the state actually needed. Near the end of his second term, he managed to pass a slight tax increase, after he talked four Republicans into creating the super-majority necessary for doing so. Every one of them lost his seat in the next election. He'd taken office in 2003 with approval ratings pushing 70 percent and what appeared to be a mandate to fix California's money problems; he left in 2011 with approval ratings below 25 percent, having fixed very little. "I was operating under the commonsense kind of thing," he says now. "It was the voters who recalled Gray Davis. It was the voters who elected me. So it will be the voters who hand me the tools to do the job. But the other side was successful enough for the voters to take the tools away."

David Crane, the former economic adviser—at that moment rapidly receding into the distance—could itemize the result: a long list of depressing government financial statistics. The pensions of state employees ate up twice as much of the budget when Schwarzenegger left office as they had when he arrived, for instance. The officially recognized gap between what the state would owe its workers and what it had on hand to pay them was roughly $105 billion, but that, thanks to accounting gimmicks, was probably only about half the real number. "This year the state will directly spend $32 billion on employee pay and benefits, up 65 percent over the past 10 years," says Crane later. "Compare that to state spending on higher education [down 5 percent], health and human services [up just 5 percent], and parks and recreation [flat], all crowded out in large part by fast-rising employment costs." Crane is a lifelong Democrat with no particular hostility to government. But the more he looked into the details, the more shocking he found them to be. In 2010, for instance, the state spent $6 billion on fewer than 30,000

guards and other prison-system employees. A prison guard who started his career at the age of 45 could retire after five years with a pension that very nearly equaled his former salary. The head parole psychiatrist for the California prison system was the state's highest-paid public employee; in 2010 he'd made $838,706. The same fiscal year that the state spent $6 billion on prisons, it had invested just $4.7 billion in its higher education—that is, 33 campuses with 670,000 students. Over the past 30 years the state's share of the budget for the University of California has fallen from 30 percent to 11 percent, and it is about to fall a lot more. In 1980 a Cal student paid $776 a year in tuition; in 2011 he pays $13,218. Everywhere you turn, the long-term future of the state is being sacrificed.

This same set of facts, and the narrative it suggested, would throw an ordinary man into depression. He might conclude that he lived in a society that was ungovernable. After seven years of trying and mostly failing to run California, Schwarzenegger is persuasively not depressed. "You have to realize the thing was so much fun!" he says. "We had a great time! There were times of frustration. There were times of disappointment. But if you want to live rather than just exist, you want the drama." As we roll to a stop very near the place on the beach where he began his American bodybuilding career, he says, "You have to step back and say, 'I was elected under odd circumstances. And I'm going out in odd circumstances.' You can't have it both ways. You can't be a spoiled brat."

The odd circumstances were the never-ending financial crises. He'd come to power in the bust after the Internet bubble; he'd left in the bust after the housing bubble. Before and after our bike ride, I sat down with him to get his view of this second event. It was in the middle of 2007, he said, when he first noticed something was not quite right in the California economy. He'd been finishing up budget negotiations and arrived at a number, however phony, where the budget could be declared balanced. An aide walked into his office to give him a heads-up: the tax receipts for that month were less than expected. "We were all of a sudden short $300 million in revenue for the month," says Schwarzenegger. "I somehow felt, Uh-oh. Because there was something in the air." Soon after that he visited the George W. Bush White House, where he gave a talk that was, as ever, upbeat. "At the end of it this guy—he was the guy who was in charge of housing, I forgot the name. Great guy. For some reason or other he was very honest with me. I don't know why. He probably didn't think I'd go out and blab, which I didn't. He says, 'That was a great speech you gave, but we're heading to a major problem.' I said, 'What do you mean?' He said, 'I looked at some of the numbers, and it's going to be ugly.' That's all he said. He wouldn't elaborate." A housing-price decline in the United States meant a housing-price collapse in California, and a housing-price collapse in California meant an economic collapse and a decline in tax revenues. "The next month our revenues came in short $600 million. By December we were short a billion."

At some point in our talks I asked Schwarzenegger how much time he had spent, as governor, grappling with the on-the-ground local implications of the big state crisis. The question pretty clearly bored him. "I'm not into the local stuff," he'd said. "I was born for the world."

City of Broken Dreams

About an hour into the weekly meeting of the San Jose City Council, I find myself wishing that I, too, was born for the world. A hundred citizens yawn and text as the council honors National Farmers Market Week; the few people who seem to be paying attention get up and leave after the honor is bestowed. The council commemorates August 7 as Assyrian Martyrs Day, "honoring the massacre of three thousand people in August 1933, and recognizing 2,000 years of persecution of Assyrian Christians." Maybe 30 people turn their attention from their cell phones to the ceremony, but then they, too, rise and exit the chamber. A mere handful of people are left to hear the San Jose city manager offer the latest bleak financial news: the state of California was clawing back tens of millions of dollars more, and "140 employees have been separated from the city." (New times call for new euphemisms.) A pollster presents his finding that, no matter how the question is phrased, the citizens of San Jose are unlikely to approve any ballot measure that raises taxes. A numbers guy gets to his feet and explains that the investment returns in the city's pension plan are not likely to be anything near as high as was assumed. In addition to there not being enough money in this particular pot to begin with, the pot is failing to expand as fast as everyone had hoped,

and so the gap between what the city's employees are entitled to and what will exist is even greater than previously imagined. The council then votes to postpone, for six weeks, a vote on whether to declare the city's budget a "public emergency," and thus to give to the mayor, Chuck Reed, new powers.

Following each motion an obese man not so much dressed as enshrouded in blue-jean overalls maximizes his right to be heard for five minutes on every subject: over and again he rises from the front row of the audience, waddles to the podium, and delivers sophisticated-sounding but incomprehensible critiques of everything. "*The absolute reduction in competence of government is predicated on what happened today . . .* "

The relationship between the people and their money in California is such that you can pluck almost any city at random and enter a crisis. San Jose has the highest per capita income of any city in the United States, after New York. It has the highest credit rating of any city in California with a population over 250,000. It is one of the few cities in America with a triple-A rating from Moody's and Standard & Poor's, but only because its bondholders have the power to compel the city to levy a tax on property owners to pay off the bonds. The city itself is not all that far from being bankrupt.

It is late afternoon when I meet Mayor Chuck Reed in his office at the top of the city-hall tower. The crowd below has just begun to chant. The public employees, as usual, are protesting him. Reed is so used to it that he hardly notices. He's a former air-force officer and Vietnam-era veteran with an intellectual bent and the clipped manner of a mid-western farmer. He has a master's degree from Princeton, a law degree from Stanford, and a lifelong interest in public policy. Still, he presents less as the mayor of a big city in California than as a hard-bitten, upstanding sheriff of a small town who doesn't want any trouble. Elected to the city council in 2000, he became mayor six years later; in 2010 he was re-elected with 77 percent of the vote. He's a Democrat, but at this point it doesn't much matter which party he belongs to, or what his ideological leanings are, or for that matter how popular he is with the people of San Jose. He's got a problem so big that it overwhelms ordinary politics: the city owes so much more money to its employees than it can afford to pay that it could cut its debts in half and still wind up broke. "I did a calculation of cost per public employee," he says as we settle in. "We're not as bad as Greece, I don't think."

The problem, he explains, pre-dates the most recent financial crisis. "Hell, I was here. I know how it started. It started in the 1990s with the Internet boom. We live near rich people, so we thought we were rich." San Jose's budget, like the budget of any city, turns on the pay of public-safety workers: the police and firefighters now eat 75 percent of all discretionary spending. The Internet boom created both great expectations for public employees and tax revenues to meet them. In its negotiations with unions the city was required to submit to binding arbitration, which works for police officers and firefighters just as it does for Major League Baseball players. Each side of any pay dispute makes its best offer, and a putatively neutral judge picks one of them. There is no meeting in the middle: the judge simply rules for one side or the other. Each side thus has an incentive to be reasonable, for the less reasonable they are, the less likely it is that the judge will favor their proposal. The problem with binding arbitration for police officers and firefighters, says Reed, is that the judges are not neutral. "They tend to be labor lawyers who favor the unions," he says, "and so the city does anything it can to avoid the process." And what politician wants to spat publicly with police officers and firefighters?

Over the past decade the city of San Jose had repeatedly caved to the demands of its public-safety unions. In practice this meant that when the police or fire department of any neighboring city struck a better deal for itself, it became a fresh argument for improving the pay of San Jose police and fire. The effect was to make the sweetest deal cut by public-safety workers with any city in Northern California the starting point for the next round of negotiations for every other city. The departments also used each other to score debating points. For instance, back in 2002, the San Jose police union cut a three-year deal that raised police officers' pay by 18 percent over the contract. Soon afterward, the San Jose firefighters cut a better deal for themselves, including a pay raise of more than 23 percent. The police felt robbed and complained mightily until the city council crafted a deal that handed them 5 percent more premium pay in exchange for training to fight terrorists. "We got famous for our anti-terrorist-training pay," explains one city official. Eventually the anti-terrorist-training premium pay stopped; the

police just kept the extra pay, with benefits. “Our police and firefighters will earn more in retirement than they did when they were working,” says Reed. “There used to be an argument that you have to give us money or we can’t afford to live in the city. Now the more you pay them the less likely they are to live in the city, because they can afford to leave. It’s staggering. When did we go from giving people sick leave to letting them accumulate it and cash it in for hundreds of thousands of dollars when they are done working? There’s a corruption here. It’s not just a financial corruption. It’s a corruption of the attitude of public service.”

When he was elected to the city council, Reed says, “I hadn’t even thought about pensions. I can’t say I said, ‘Here is my plan.’ I never thought about this stuff. It never came up.” It wasn’t until San Diego flirted with bankruptcy, in 2002, that he wondered about San Jose’s finances. He began to investigate the matter. “That’s when I realized there were big problems,” he says. “That’s when I started paying attention. That’s when I started asking questions: Could it happen here? It’s like the housing bubble and the Internet bubble. There were people around who were writing about it. It’s not that there aren’t people telling us that this is crazy. It’s that you refuse to believe that you are crazy.”

He hands me a chart. It shows that the city’s pension costs when he first became interested in the subject were projected to run $73 million a year. This year they would be $245 million: pension and health-care costs of retired workers now are more than half the budget. In three years’ time pension costs alone would come to $400 million, though “if you were to adjust for real life expectancy it is more like $650 million.” Legally obliged to meet these costs, the city can respond only by cutting elsewhere. As a result, San Jose, once run by 7,450 city workers, was now being run by 5,400 city workers. The city was back to staffing levels of 1988, when it had a quarter of a million fewer residents. The remaining workers had taken a 10 percent pay cut; yet even that was not enough to offset the increase in the city’s pension liability. The city had closed its libraries three days a week. It had cut back servicing its parks. It had refrained from opening a brand-new community center, built before the housing bust, because it couldn’t pay to staff the place. For the first time in history it had laid off police officers and firefighters.

By 2014, Reed had calculated, a city of a million people, the 10th-largest city in the United States, would be serviced by 1,600 public workers. “There is no way to run a city with that level of staffing,” he said. “You start to ask: What is a city? Why do we bother to live together? But that’s just the start.” The problem was going to grow worse until, as he put it, you get to one. “A single employee to serve the entire city, presumably with a focus on paying pensions.” I don’t know how far out you have to go until you get to one,” said Reed, “but it isn’t all that far.” At that point, if not before, the city would be nothing more than a vehicle to pay the retirement costs of its former workers. The only clear solution was if former city workers up and died, soon. But former city workers were, blessedly, living longer than ever.

This wasn’t a hypothetical scary situation, said Reed. “It’s a mathematical inevitability.” In spirit it reminded me of Bernard Madoff’s investment business. Anyone who looked at Madoff’s returns and understood them could see he was running a Ponzi scheme; only one person who had understood them bothered to blow the whistle, and no one listened to him. (See No One Would Listen: A True *Financial Thriller,* by Harry Markopolos.)

In his negotiations with the unions, the mayor has gotten nowhere. “I understand the police and firefighters,” he says. “They think, we’re the most important, and everyone else goes [gets fired] first.” The police union recently suggested to the mayor that he close the libraries for the other four days. “We looked into that,” Reed says. “If you close the libraries an extra day you pay for 20 or 30 cops.” Adding 20 more police officers for a year wouldn’t solve anything. The cops who were spared this year would be axed next, in response to the soaring costs of the pensions of city workers who already had retired. On the other side of the inequality is the taxpayer of San Jose, who has no interest in paying more than he already does. “It’s not that we’re insolvent and can’t pay our bills,” says Reed. “It’s about willingness.”

I ask him what the chances are that, in this pinch, he could raise taxes. He holds up a thumb and index finger: zero. He’s recently coined a phrase, he says: “service-level insolvency.” Service-level insolvency means that the expensive community center that has been built and named cannot be opened. It means closing libraries three days a week. It isn’t financial bankruptcy; it’s cultural bankruptcy.

“How on earth did this happen?” I ask him.

“The only way I can explain it,” he says, “is that they got the money because it was there.” But he has another way to explain it, and in a moment he offers it up.

“I think we’ve suffered from a series of mass delusions,” he says.

I didn’t completely understand what he meant, and said so.

“We’re all going to be rich,” he says. “We’re all going to live forever. All the forces in the state are lined up to preserve the status quo. To preserve the delusion. And here—this place—is where the reality hits.”

On the way back to the elevators I chat with two of Mayor Reed’s aides. He’d mentioned to me that, as bad as they might think they have it in San Jose, a lot of other American cities have it worse. “I count my blessings when I talk to the mayors of other cities,” he’d said.

“Which city do you pity most?” I ask just before the elevator doors close.

They laugh and in unison say, “Vallejo!”

Living on the Default Line

Welcome to Vallejo, city of opportunity, reads the sign on the way in, but the shops that remain open display signs that say, we accept food stamps. Weeds surround abandoned businesses, and all traffic lights are set to permanently blink, which is a formality, as there are no longer any cops to police the streets. Vallejo is the one city in the Bay Area where you can park anywhere and not worry about getting a ticket, because there are no meter maids either. The windows of city hall are dark, but its front porch is a hive of activity. A young man in a backward baseball cap, sunglasses, and a new pair of Nike sneakers stands on a low wall and calls out an address: “Nine hundred Cambridge Drive,” he says, “in Benicia.”

The people in the crowd below instantly begin bidding. From 2006 to 2010 the value of Vallejo real estate fell 66 percent. One in 16 homes in the city is in foreclosure. This is apparently the fire sale, but the characters involved are so shady and furtive that I can hardly believe it. I stop to ask what’s going on, but the bidders don’t want to talk. “Why would I tell you anything?” says a guy sitting in a Coleman folding chair. He obviously thinks he’s shrewd, and perhaps he is.

The lobby of city hall is completely empty. There’s a receptionist’s desk but no receptionist. Instead, there’s a sign: TO FORECLOSURE AUCTIONEERS AND FORECLOSURE BIDDERS: PLEASE DO NOT CONDUCT BUSINESS IN THE CITY HALL LOBBY.

On the third floor I find the offices of the new city manager, Phil Batchelor, but when I walk in, there is no one in sight. It’s just a collection of empty cubicles. At length a woman appears and leads me to Batchelor himself. He’s in his 60s and, oddly enough, a published author. He’s written one book on how to raise children and another on how to face death. Both deliver an overtly Christian message, but he doesn’t come across as Evangelical; he comes across as sensible, and a little weary. His day job, before he retired, was running cities with financial difficulties. He came out of retirement to take this job, but only after the city council had asked him a few times. “The more you say no, the more determined they are to get you,” he says. His chief demand was not financial but social: he’d take the job only if the people on the city council ceased being nasty to one another and behaved civilly. He actually got that in writing, and they’ve kept their end of the bargain. “I’ve been in a lot of places that have been in a lot of trouble, but I’ve never seen anything like this,” he says. He then lays out what he finds unusual, beginning with the staffing levels. He’s now running the city, and he has a staff of one: I just met her. “When she goes out to the bathroom, she has to lock the [office] door,” he says, “because I’m in meetings, and we have no one else.”

Back in 2008, unable to come to terms with its many creditors, Vallejo declared bankruptcy. Eighty percent of the city’s budget—and the lion’s share of the claims that had thrown it into bankruptcy—were wrapped up in the pay and benefits of public-safety workers. Relations between the police and the firefighters, on the one hand, and the citizens, on the other, were at historic lows. The public-safety workers thought that the city was out to screw them

on their contracts; the citizenry thought that the public-safety workers were using fear as a tool to extort money from them. The local joke was that "P.D." stands for "Pay or Die." The city-council meetings had become exercises in outrage: at one, a citizen arrived with a severed pig's head on a barbecue grill. "There's no good reason why Vallejo is as fucked up as it is," says longtime resident Marc Garman, who created a Web site to catalogue the civil war. "It's a boat ride to San Francisco. You throw a stone and you hit Napa." Since the bankruptcy, the police and fire departments have been cut in half; some number of the citizens who came to Phil Batchelor's office did so to say they no longer felt safe in their own homes. All other city services had been reduced effectively to zero. "Do you know that some cities actually pave their streets?" says Batchelor. "That's not here."

I notice on his shelf a copy of *Fortune* magazine, with Meredith Whitney on the cover. And as he talked about the bankrupting of Vallejo, I realized that I had heard this story before, or a private-sector version of it. The people who had power in the society, and were charged with saving it from itself, had instead bled the society to death. The problem with police officers and firefighters isn't a public-sector problem; it isn't a problem with government; it's a problem with the entire society. It's what happened on Wall Street in the run-up to the subprime crisis. It's a problem of people taking what they can, just because they can, without regard to the larger social consequences. It's not just a coincidence that the debts of cities and states spun out of control at the same time as the debts of individual Americans. Alone in a dark room with a pile of money, Americans knew exactly what they wanted to do, from the top of the society to the bottom. They'd been conditioned to grab as much as they could, without thinking about the long-term consequences. Afterward, the people on Wall Street would privately bemoan the low morals of the American people who walked away from their subprime loans, and the American people would express outrage at the Wall Street people who paid themselves a fortune to design the bad loans.

Having failed to convince its public-safety workers that it could not afford to make them rich, the city of Vallejo, California, had hit bottom: it could fall no lower. "My approach has been I don't care who is to blame," Batchelor said. "We needed to change." When I met him, a few months after he had taken the job, he was still trying to resolve a narrow financial dispute: the city had 1,013 claimants with half a billion dollars in claims but only $6 million to dole out to them. They were survivors of a shipwreck on a life raft with limited provisions. His job, as he saw it, was to convince them that the only chance of survival was to work together. He didn't view the city's main problem as financial: the financial problems were the symptom. The disease was the culture. Just a few weeks earlier, he had sent a memo to the remaining city staff—the city council, the mayor, the public-safety workers. The central message was that if you want to fix this place you need to change how you behave, each and every one of you. "It's got to be about the people," he said. "Teach them respect for each other, integrity and how to strive for excellence. Cultures change. But people need to want to change. People convinced against their will are of the same opinion still."

"How do you change the culture of an entire city?" I asked him.

"First of all we look internally," he said.

Too Fat to Fly

The road out of Vallejo passes directly through the office of Dr. Peter Whybrow, a British neuroscientist at U.C.L.A. with a theory about American life. He thinks the dysfunction in America's society is a by-product of America's success. In academic papers and a popular book, *American Mania,* Whybrow argues, in effect, that human beings are neurologically ill-designed to be modern Americans. The human brain evolved over hundreds of thousands of years in an environment defined by scarcity. It was not designed, at least originally, for an environment of extreme abundance. "Human beings are wandering around with brains that are fabulously limited," he says cheerfully. "We've got the core of the average lizard." Wrapped around this reptilian core, he explains, is a mammalian layer (associated with maternal concern and social interaction), and around that is wrapped a third layer, which enables feats of memory and the capacity for abstract thought. "The only problem," he says, "is our passions are still driven by the lizard core. We are set up to acquire as much as we can of things we

perceive as scarce, particularly sex, safety, and food." Even a person on a diet who sensibly avoids coming face-to-face with a piece of chocolate cake will find it hard to control himself if the chocolate cake somehow finds him. Every pastry chef in America understands this, and now neuroscience does, too. "When faced with abundance, the brain's ancient reward pathways are difficult to suppress," says Whybrow. "In that moment the value of eating the chocolate cake exceeds the value of the diet. We cannot think down the road when we are faced with the chocolate cake."

The richest society the world has ever seen has grown rich by devising better and better ways to give people what they want. The effect on the brain of lots of instant gratification is something like the effect on the right hand of cutting off the left: the more the lizard core is used the more dominant it becomes. "What we're doing is minimizing the use of the part of the brain that lizards don't have," says Whybrow. "We've created physiological dysfunction. We have lost the ability to self-regulate, at all levels of the society. The $5 million you get paid at Goldman Sachs if you do whatever they ask you to do—that is the chocolate cake upgraded."

The succession of financial bubbles and the amassing of personal and public debt, Whybrow views as simply an expression of the lizard-brained way of life. A color-coded map of American personal indebtedness could be laid on top of the Centers for Disease Control's color-coded map that illustrates the fantastic rise in rates of obesity across the United States since 1985 without disturbing the general pattern. The boom in trading activity in individual stock portfolios; the spread of legalized gambling; the rise of drug and alcohol addiction—it is all of a piece. Everywhere you turn you see Americans sacrifice their long-term interests for short-term rewards.

What happens when a society loses its ability to self-regulate, and insists on sacrificing its long-term interest for short-term rewards? How does the story end? "We could regulate ourselves if we chose to think about it," Whybrow says. "But it does not appear that is what we are going to do." Apart from that remote possibility, Whybrow imagines two outcomes. The first he illustrates with a true story, which might be called the parable of the pheasant. Last spring, on sabbatical from the University of Oxford, he was surprised to discover that he was able to rent an apartment inside Blenheim Palace, the Churchill family home. The previous winter at Blenheim had been harsh, and the pheasant hunters had been efficient; as a result, just a single pheasant had survived in the palace gardens. This bird had gained total control of a newly seeded field. Its intake of food, normally regulated by its environment, was now entirely unregulated: it could eat all it wanted, and it did. The pheasant grew so large that, when other birds challenged it for seed, it would simply frighten them away. The fat pheasant became a tourist attraction and even acquired a name: Henry. "Henry was the biggest pheasant anyone had ever seen," says Whybrow. "Even after he got fat, he just ate and ate." It didn't take long before Henry was obese. He could still eat as much as he wanted, but he could no longer fly. Then one day he was gone: a fox ate him.

The other possible outcome was only slightly more hopeful: to hit bottom. To realize what has happened to us—because we have no other choice. "If we refuse to regulate ourselves, the only regulators are our environment," says Whybrow, "and the way that environment deprives us." For meaningful change to occur, in other words, we need the environment to administer the necessary level of pain.

In August 2011, the same week that Standard & Poor's downgraded the debt of the United States government, a judge approved the bankruptcy plan for Vallejo, California. Vallejo's creditors ended up with 5 cents on the dollar, public employees with something like 20 and 30 cents on the dollar. The city no longer received any rating at all from Moody's and Standard & Poor's. It would take years to build the track record needed to obtain a decent rating. The absence of a rating mattered little, as the last thing the city needed to do was to go out and borrow money from strangers.

More out of idle curiosity than with any clear purpose, I drove up again to Vallejo and paid a call on the fire department. In the decay of our sense of common purpose, the firefighters are a telling sign that we are approaching a new bottom. It isn't hard to imagine how a police department might wind up in conflict with the community it's hired to protect. A person who becomes a police officer enjoys the authority. He wants to stop the bad guys. He doesn't necessarily need to care for the people he polices. A person who becomes a firefighter wants to be a good guy. He wants to be *loved.*

The Vallejo firefighter I met with that morning was named Paige Meyer. He was 41 years old. He had short salt-and-pepper hair and olive skin, with traces of burn marks on his cheeks. His natural expression was a smile. He wasn't particularly religious or political. ("I'm not necessarily a God guy.") The closest thing he had to a religion, apart from his family, was his job. He was extremely proud of it, and of his colleagues. "I don't want this to sound arrogant at all," he said, "but many departments in nicer communities, they get a serious fire maybe once a year. We get them all the time." The Vallejo population is older and poorer than in many surrounding cities, and older still are the buildings it lives in. The typical Vallejo house is a charming, highly flammable wooden Victorian. "In this town we fight fires," says Meyer. "This town *rips.*" The department was shaped by its environment: they were extremely aggressive firefighters. "When I came to this department you *rolled* to a fire," he said. "You were not going to see an exterior water stream from this department. We're going in. You have some knucklehead calling in with a sore throat—your giddyup is not so fast. But I'll tell you something about this department. They get a call that there's a baby choking or a 10-year-old not breathing, you better get out of the way or you're going to get run over."

As a young man, to pay his way through college, Meyer had worked as a state-beach lifeguard at lakes in central California. He assumed that there would be little drama in the work but people would turn up, get drunk, and attempt to drown. A few of the times he pulled people from the water, they were in bad enough shape that they needed paramedics; the fire department was there on the spot. He started talking to firefighters and found that "they all absolutely loved what they did. You get to go and *live* and create a second family. How can you not like that?" He came to Vallejo in 1998, at the age of 28. He had left a cushy job in Sunnyvale, outside San Jose, where there aren't many fires, precisely because he wanted to fight fires. "In other departments," he says, "I wasn't a firefighter. The first six months of the job here, I was out at two in the morning at a fire every other week. I couldn't believe it." The houses of Vallejo are mainly balloon-frame construction. The interior walls have no firebreaks: from bottom to top, all four walls carry fire as efficiently as a chimney. One of the rookie mistakes in Vallejo is to put the fire out on the ground floor, only to look up and see it roaring out of the roof. "When we get to a fire we say, 'Boom! Send someone up to the attic.'" Because the fire is going right to the attic.

Meyer actually had made that rookie mistake. One day not long after he'd arrived, he jumped off the truck already breathing air from a tank and raced into what appeared to be a burning one-bedroom apartment. He knocked down the door and put the attack line on the fire and then wondered why the fire wasn't going out. "It should have been getting cooler, but it was getting hotter and hotter." Right in front of his face, on his plastic mask, lines trickled down, like rain on a windshield. The old-school firefighters left their ears exposed so they could feel the heat: the heat contained the critical information. Meyer could only see the heat: his helmet was melting. "If your helmet starts to shrivel up and melt, that's not cool," he says. A melting helmet, among the other problems it presents, is an indication that a room is about to flash. "Flashing," he explains, "is when all combustible materials simultaneously ignite. You're a baked potato after that." He needed more water, or to get out, but his ego was invested in staying inside, and so he stayed inside. Moments later a backup arrived, with another, bigger hose.

Afterward, he understood his mistake: the building was three stories, built on a slope that disguised its size, and the fire had reached the attic. "I'm not saying that if the backup hadn't come when it did I'd be dead," he says, but that's exactly what he is saying. The scar on his face is from that fire. "I needed to learn to control my environment," he said. "I'd had this false sense of security."

When you take care of something, you become attached to it, and he'd become attached to Vallejo. He was extremely uncomfortable with conflict between his union and the citizens, and had found himself in screaming matches with the union's negotiator. Meyer thought firefighters, who tended to be idealistic and trusting, were easily duped. He further thought the rank and file had been deceived both by the city, which lied to them repeatedly in negotiations, and by their own leadership, which harnessed the firefighters' outrage to make unreasonable demands in the union-negotiated contract with the city. What was lost at the bargaining table was the reason they did what they did for a living. "I'm telling you," Meyer says, "when I started, I didn't know what I was getting paid. I didn't care what I was getting paid. I didn't know about benefits. A lot of things that we're politicizing today were not even in my mind. I was just thinking of my dream job. Let me tell you something else:

nobody cared in 2007 how much I made. If I made six figures they said, 'Shit, man, you deserve it. You ran into a burning building.' Because everyone had a job. All they knew about our job is that it was dangerous. The minute the economy started to collapse, people started looking at each other."

Today the backup that may or may not have saved him is far less likely to arrive. When Vallejo entered bankruptcy, the fire department was cut from 121 to 67, for a city of 112,000 people. The department handles roughly 13,000 calls a year, extremely high for the population. When people feel threatened or worried by anything except other people, they call the fire department. Most of these calls are of the cat-in-the-tree variety—pointless. ("You never see the skeleton of a cat in a tree.") They get calls from people who have headaches. They get calls from people who have itches where they can't scratch. They have to answer every call. ("The best call I ever had was phantom-leg pain in a guy with no legs.") To deal with these huge numbers of calls, they once had eight stations, eight three-person engine companies, a four-man truck company (used only for actual fires and rescue calls), one fireboat, one confined-space rescue team, and a team to deal with hazardous materials. They now are down to four stations, four engines, and a truck.

This is particularly relevant to Paige Meyer because, two months ago, he became Vallejo's new fire chief. It surprised him: he hadn't even applied for the job. The city manager, Phil Batchelor, just called him to his office one day. "He didn't ever really ask me if I wanted the job," says Meyer. "He just asked how's the family, told me he was giving me the job, and asked if I had any problem with that."

He didn't, actually. He sat down and made a list of ways to improve the department. He faced a fresh challenge: How to deliver service that was the same as before, or even better than before, with half the resources -- how to cope with an environment of scarcity. He began to measure things that hadn't been measured. The No. 1 cause of death in firefighting was heart attacks. No. 2 was truck crashes. He was now in charge of a department that would be both overworked and in a hurry. Fewer people doing twice the work probably meant twice the number of injuries per firefighter. He'd decided to tailor fitness regimes to fit the job. With fewer fire stations and fewer firefighters in them, the response times were going to be slower. He'd need to find new ways to speed things up. A longer response time meant less room for error; a longer response time meant the fires they'd be fighting would be bigger. He had some thoughts about the most efficient way to fight these bigger fires. He began, in short, to rethink firefighting.

When people pile up debts they will find difficult and perhaps even impossible to repay, they are saying several things at once. They are obviously saying that they want more than they can immediately afford. They are saying, less obviously, that their present wants are so important that, to satisfy them, it is worth some future difficulty. But in making that bargain they are implying that, when the future difficulty arrives, they'll figure it out. They don't always do that. But you can never rule out the possibility that they will. As idiotic as optimism can sometimes seem, it has a weird habit of paying off.

The smart money says the U.S. economy will splinter, with some states thriving, some states not, and all eyes are on California as the nightmare scenario. After a hair-raising visit with former governor Arnold Schwarzenegger, who explains why the Golden State has cratered, Michael Lewis goes where the buck literally stops—the local level, where the likes of San Jose mayor Chuck Reed and Vallejo fire chief Paige Meyer are trying to avert even worse catastrophes and rethink what it means to be a society.

FEATURES

The Kids Are Actually Sort of Alright

My screwed, coddled, self-absorbed, mocked, surprisingly resilient generation.

By Noreen Malone Published Oct 16, 2011 ShareThis

Every generation finds, eventually, a mode of expression that suits it. Cavemen drew lines on their cave walls. Sixties kids marched. My generation, we Gchat, a million tiny windows blinking orange with hopes and dreams and YouTube links, with five-year plans and lunch plans. So as I began to search for a single phrase that could, preposterously, describe our entire cohort, post-crash, I did what I always do in moments of crisis. I Gchatted my 24-year-old sister Clare, who happens to be living back at home with our parents while she looks for a job:

(10:24 p.m.) CLARE: how about they just call us SAA
self-absorbed assholes
ME: booo
CLARE: we need a D
to make it really good
SAD—self-absorbed delusionals
ps
(10:26) can i send you a cover letter right quick?
ME: sure
(10:28) CLARE:
our generation is:
delayed
afraid
immature
(10:29) independent
fame and glory hungry
(ambitious?)
weirdly apathetic when it comes to things outside of the internet
(10:32) ME: delayed is not our fault
CLARE: ok, you know what i always think about when i think of our generation? i read the david brooks

book, “the social animal” and while it was only mediocre, he had this one really great bit that really stuck with me—the Greek ideal of “thumos”, which is the lust not for money or success (in the conventional sense) but the lust for glory
we want glory through our ideas-we want to know we matter
(10:33) the cold truth is that not all of us are brilliant
we are not all big thinkers. Not everyone’s TED talks will change the world
some of us will just dissipate into the ether
(10:34) but it is the digital connectivity, that proximity to these people, that makes us think that perhaps we will succeed as well
(10:35) ok, i’m done
(10:36) no i’m not
here’s why the recession is so devastating to us
we grew up, all the way through college, with everything seeming so ripe and possible
(10:37) we had a PC education—people tried to hide from us as long as possible that not everyone is equal
we were told we all have a fair chance of making it
that’s just not so
and we’re starting to realize that
(10:39) are you even listening to me anymore?
(10:41) ME: hi sorry
(10:42) i was writing an email
i am filing your comments
in my file.
(10:43) i think
your cover letter is good!
CLARE: i thought it was ok
(10:47) but I am, to be honest, expecting a rejection.

I know this might read as very woe-is-us, but these are the facts: Nearly 14 percent of college graduates from the classes of 2006 through 2010 can’t find full-time work, and overall just 55.3 percent of people ages 16 to 29 have jobs. That’s the lowest percentage since World War II, as you might have heard an Occupy Wall Street protester point out. (Not coincidentally, one in five young adults now lives below the poverty line.) Almost a quarter more people ages 25 to 34—in other words, people who should be a few years into their independent lives—are living with their parents than at the beginning of the recession.

Being young is supposed to mean you have the luxury of time. But in hard times, a few fallow years can become a lifetime drag on what you earn, sort of the opposite of compound interest. Because the average person grabs 70 percent of their total pay bumps during their first ten years in the workforce, according to a paper from the National Bureau of Economic Research, having stagnant or nonexistent wages during that period means you hit that springboard at a crawl. Economist Lisa Kahn explained to *The Atlantic* in 2010 that those who graduate into a recession are still earning an average of 10 percent less nearly two decades into their careers. In hard, paycheck-shrinking numbers, the salary lost over that stretch totals around $100,000. That works out to $490 or so less a month, money that could go, say, toward repaying student loans, which for the class of 2009 average $24,000. Those student loans (the responsible borrowing option!) have reportedly passed credit cards as the nation’s largest source of debt.

This is not just a rotten moment to be young. It's a putrid, stinking, several-months-old-stringy-goat-meat moment to be young.

Earlier generations have weathered recessions, of course; this stall we're in has the look of something nastier. Social Security and Medicare are going to be diminished, at best. Hours worked are up even as hiring staggers along: Blood from a stone looks to be the normal order of things "going forward," to borrow the business-speak. Economists are warning that even when the economy recuperates, full employment will be lower and growth will be slower—a sad little rhyme that adds up to something decidedly unpoetic. A majority of Americans say, for the first time ever, that this generation will not be better off than its parents.

Next: The two long-term soc

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The Surety of Fools

It afflicts us all. Because confidence in our own judgments is part of being human.

By DANIEL KAHNEMAN

Many decades ago I spent what seemed like a great deal of time under a scorching sun, watching groups of sweaty soldiers as they solved a problem. I was doing my national service in the Israeli Army at the time. I had completed an undergraduate degree in psychology, and after a year as an infantry officer, I was assigned to the army's Psychology Branch, where one of my occasional duties was to help evaluate candidates for officer training. We used methods that were developed by the British Army in World War II.

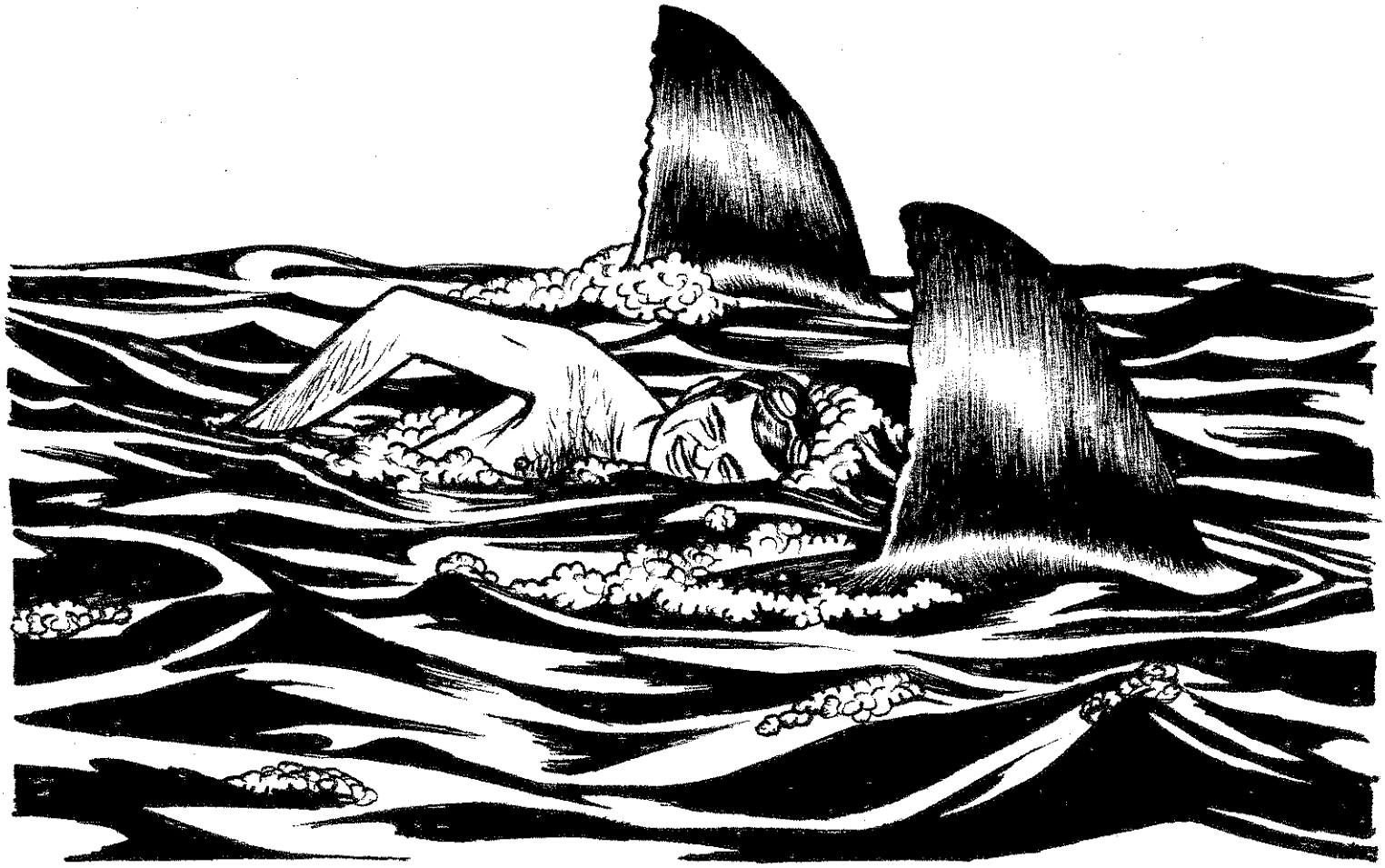
One test, called the leaderless group challenge, was conducted on an obstacle field. Eight candidates, strangers to one another, with all insignia of rank removed and only numbered tags to identify them, were instructed to lift a long log from the ground and haul it to a wall about six feet high. There, they were told that the entire group had to get to the other side of the wall without the log touching either the ground or the wall, and without anyone touching the wall. If any of these things happened, they were to acknowledge it and start again.

A common solution was for several men to reach the other side by crawling along the log as the other men held it up at an angle, like a giant fishing rod. Then one man would climb onto another's shoulder and tip the log to the far side. The last two men would then have to jump up at the log, now suspended from the other side by those who had made it over, shinny their way along its length and then leap down safely once they crossed the wall. Failure was common at this point, which required starting over.

As a colleague and I monitored the exercise, we made note of who took charge, who tried to lead but was rebuffed, how much each soldier contributed to the group effort. We saw who seemed to be stubborn, submissive, arrogant, patient, hot-tempered, persistent or a quitter. We sometimes saw competitive spite when someone whose idea had been rejected by the group no longer worked very hard. And we saw reactions to crisis: who berated a comrade whose mistake caused the whole group to fail, who stepped forward to lead when the exhausted team had to start over. Under the stress of the event, we felt, each man's true nature revealed itself in sharp relief.

After watching the candidates go through several such tests, we had to summarize our impres-

ILLUSTRATION BY TIM ENTHOVEN



sions of the soldiers' leadership abilities with a grade and determine who would be eligible for officer training. We spent some time discussing each case and reviewing our impressions. The task was not difficult, because we had already seen each of these soldiers' leadership skills. Some of the men looked like strong leaders, others seemed like wimps or arrogant fools, others mediocre but not hopeless. Quite a few appeared to be so weak that we ruled them out as officer candidates. When our multiple observations of each candidate converged on a coherent picture, we were completely confident in our evaluations and believed that what we saw pointed directly to the future. The soldier who took over when the group was in trouble and led the team over the wall was a leader at that moment. The obvious best guess about how he would do in training, or in combat, was that he would be as effective as he had been at the wall. Any other prediction seemed inconsistent with what we saw.

Because our impressions of how well each soldier performed were generally coherent and clear, our formal predictions were just as definite. We rarely experienced doubt or conflicting impressions. We were quite willing to declare: "This one will never make it," "That fellow is rather mediocre, but should do O.K." or "He will be a star." We felt no need to question our forecasts, moderate them or equivocate. If challenged, however, we were fully prepared to admit, "But of course anything could happen."

We were willing to make that admission because, as it turned out, despite our certainty about the potential of individual candidates, our forecasts were largely useless. The evidence was overwhelming. Every few months we had a feedback session in which we could compare our evaluations of future cadets with the judgments of their commanders at the officer-training school. The story was always the same: our ability to predict performance at the school was negligible. Our forecasts were better than blind guesses, but not by much.

We were downcast for a while after receiving the discouraging news. But this was the army. Useful or not, there was a routine to be followed, and there were orders to be obeyed. Another batch of candidates would arrive the next day. We took them to the obstacle field, we faced them with the wall, they lifted the log and within

a few minutes we saw their true natures revealed, as clearly as ever. The dismal truth about the quality of our predictions had no effect whatsoever on how we evaluated new candidates and very little effect on the confidence we had in our judgments and predictions.

I thought that what was happening to us was remarkable. The statistical evidence of our failure should have shaken our confidence in our judgments of particular candidates, but it did not. It should also have caused us to moderate our predictions, but it did not. We knew as a general fact that our predictions were little better than random guesses, but we continued to feel and act as if each particular prediction was valid. I was reminded of visual illusions, which remain compelling even when you know that what you see is false. I was so struck by the analogy that I coined a term for our experience: the illusion of validity.

I had discovered my first cognitive fallacy.

Decades later, I can see many of the central themes of my thinking about judgment in that old experience. One of these themes is that people who face a difficult question often answer an easier one instead, without realizing it. We were required to predict a soldier's performance in officer training and in combat, but we did so by evaluating his behavior over one hour in an artificial situation. This was a perfect instance of a general rule that I call WYSIATI, "What you see is all there is." We had made up a story from the little we knew but had no way to allow for what we did not know about the individual's future, which was almost everything that would actually matter. When you know as little as we did, you should not make extreme predictions like "He will be a star." The stars we saw on the obstacle field were most likely accidental flickers, in which a coincidence of random events — like who was near the wall — largely determined who became a leader. Other events — some of them also random — would determine later success in training and combat.

You may be surprised by our failure: it is natural to expect the same leadership ability to manifest itself in various situations. But the exaggerated expectation of consistency is a common error. We are prone to think that the world is more regular and predictable than it really is, because our memory automatically and continuously maintains a story about what is going on, and because the rules of memory tend to make that story as coherent as possible and to suppress alternatives. Fast thinking is not prone to doubt.

The confidence we experience as we make a judgment is not a reasoned evaluation of the probability that it is right. Confidence is a feeling, one determined mostly by the coherence of the story and by the ease with which it comes to mind, even when the evidence for the story is sparse and unreliable. The bias toward coherence favors overconfidence. An individual who expresses high confidence probably has a good story, which may or may not be true.

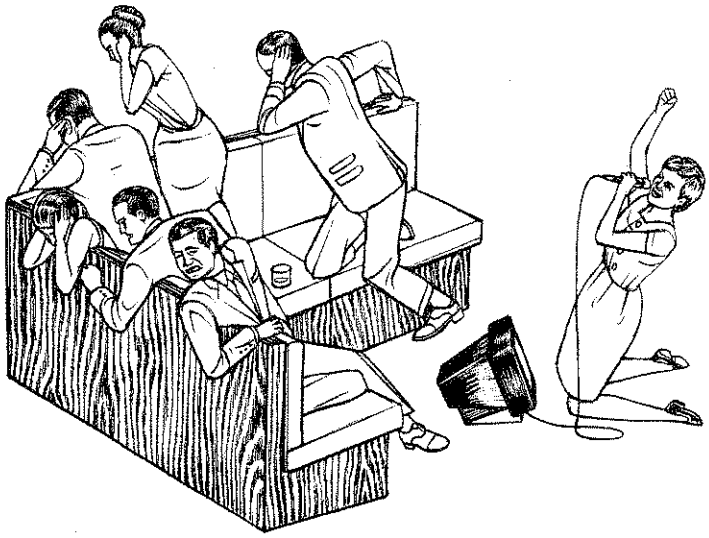
I coined the term "illusion of validity" because the confidence we had in judgments about individual soldiers was not affected by a statistical fact we knew to be true — that our predictions were unrelated to the truth. This is not an isolated observation. When a compelling impression of a particular event clashes with general knowledge, the impression commonly prevails. And this goes for you, too. The confidence you will experience in your future judgments will not be diminished by what you just read, even if you believe every word.

I first visited a Wall Street firm in 1984. I was there with my longtime collaborator Amos Tversky, who died in 1996, and our friend Richard Thaler, now a guru of behavioral economics. Our host, a senior investment manager, had invited us to discuss the role of judgment biases in investing. I knew so little about finance at the time that I had no idea what to ask him, but I remember one exchange. "When you sell a stock," I asked him, "who buys it?" He answered with a wave in the vague direction of the window, indicating that he expected the buyer to be someone else very much like him. That was odd: because most buyers and sellers know that they have the same information as one another, what made one person buy and the other sell? Buyers think the price is too low and likely to rise; sellers think the price is high and likely to drop. The puzzle is why buyers and sellers alike think that the current price is wrong.

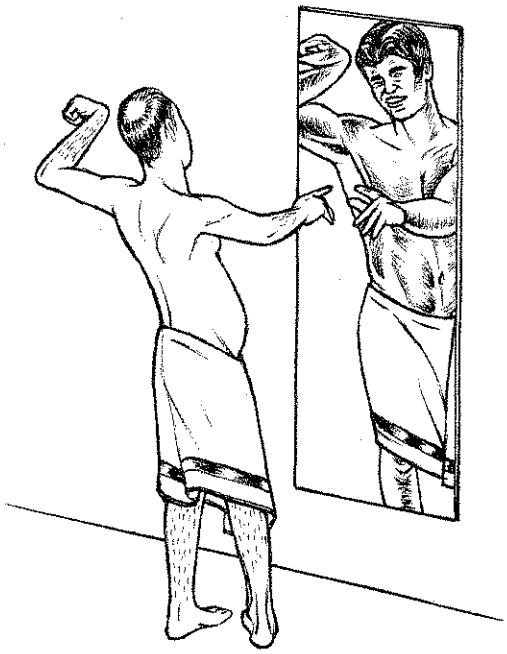
Most people in the investment business have read Burton Malkiel's wonderful book "A Random Walk Down Wall Street." Malkiel's central idea is that a stock's price incorporates all the available knowledge about the value of the company and the best predictions about the future of the stock. If some people believe that the price of a stock will be higher tomorrow, they will buy more of it today. This, in turn, will cause its price to rise. If all assets in a market are correctly priced, no one can expect either to gain or to lose by trading.

We now know, however, that the theory is not quite right. Many individual investors lose consistently by trading, an achievement that a dart-throwing chimp could not match. The first demonstration of this startling conclusion was put forward by Terry Odean, a former student of mine who is now a finance professor at the University of California, Berkeley.

Odean analyzed the trading records of 10,000



This article is adapted from "Thinking, Fast and Slow," by Daniel Kahneman, out this month from Farrar, Straus & Giroux.



brokerage accounts of individual investors over a seven-year period, allowing him to identify all instances in which an investor sold one stock and soon afterward bought another stock. By these actions the investor revealed that he (most of the investors were men) had a definite idea about the future of two stocks: he expected the stock that he bought to do better than the one he sold.

To determine whether those appraisals were well founded, Odean compared the returns of the two stocks over the following year. The results were unequivocally bad. On average, the shares investors sold did better than those they bought, by a very substantial margin: 3.3 percentage points per year, in addition to the significant costs of executing the trades. Some individuals did much better, others did much worse, but the large majority of individual investors would have done better by taking a nap rather than by acting on their ideas. In a paper titled "Trading Is Hazardous to Your Wealth," Odean and his colleague Brad Barber showed that, on average, the most active traders had the poorest results, while those who traded the least earned the highest returns. In another paper, "Boys Will Be Boys," they reported that men act on their useless ideas significantly more often than women do, and that as a result women achieve better investment results than men.

Of course, there is always someone on the other side of a transaction; in general, it's a financial institution or professional investor, ready to take advantage of the mistakes that individual traders make. Further research by Barber and Odean has shed light on these mistakes. Individual investors like to lock in their gains; they sell "winners," stocks whose prices have gone up, and they hang on to their losers. Unfortunately for them, in the short run going forward recent winners tend to do better than recent losers, so individuals sell the wrong stocks. They also buy the wrong stocks. Individual investors predictably flock to stocks in companies that are in the news. Professional investors are more selective in responding to news. These findings provide some justification for the label of "smart money" that finance professionals apply to themselves.

Although professionals are able to extract a considerable amount of wealth from amateurs, few stock pickers, if any, have the skill needed to beat the market consistently, year after year. The diagnostic for the existence of any skill is the consistency of individual differences in achievement. The logic is simple: if individual differences in any one year are due entirely to luck, the ranking of investors and funds will vary erratically and the year-to-year correlation will be zero. Where there is skill, however, the rankings will be more stable. The persistence of individual differences is the measure by which we confirm the existence of skill among golfers, orthodontists or speedy toll collectors on the turnpike.

Mutual funds are run by highly experienced and hard-working professionals who buy and sell stocks to achieve the best possible results for their clients. Nevertheless, the evidence from more than 50 years of research is conclusive: for a large majority of fund managers, the selection of stocks is more like rolling dice than like playing poker. At least two out of every three mutual funds underperform the overall market in any given year.

More important, the year-to-year correlation among the outcomes of mutual funds is very small, barely different from zero. The funds that were successful in any given year were mostly lucky; they had a good roll of the dice. There is general agreement among researchers that this is true for nearly all stock pickers, whether they know it or not — and most do not. The subjective experience of traders is that they are making sensible, educated guesses in a situation of great uncertainty. In highly efficient markets, however, educated guesses are not more accurate than blind guesses.

Some years after my introduction to the world of finance, I had an unusual opportunity to examine the illusion of skill up close. I was invited to speak to a group of investment advisers in a firm that provided financial advice and other services to very wealthy clients. I asked for some data to prepare my presentation and was granted a small treasure: a spreadsheet summarizing the investment outcomes of some 25 anonymous wealth advisers, for eight consecutive years. The advisers' scores for each year were the main determinant of their year-end bonuses. It was a simple matter to rank the advisers by their performance and to answer a question: Did the same advisers consistently achieve better returns for their clients year after year? Did some advisers consistently display more skill than others?

To find the answer, I computed the correlations between the rankings of advisers in different years, comparing Year 1 with Year 2, Year 1 with Year 3 and so on up through Year 7 with Year 8. That yielded 28 correlations, one for each pair of years. While I was prepared to find little year-to-year consistency, I was still surprised to find that the average of the 28 correlations was .01. In other words, zero. The stability that would indicate differences in skill was not to be found. The results resembled what you would expect from a dice-rolling contest, not a game of skill.

No one in the firm seemed to be aware of the nature of the game that its stock pickers were

playing. The advisers themselves felt they were competent professionals performing a task that was difficult but not impossible, and their superiors agreed. On the evening before the seminar, Richard Thaler and I had dinner with some of the top executives of the firm, the people who decide on the size of bonuses. We asked them to guess the year-to-year correlation in the rankings of individual advisers. They thought they knew what was coming and smiled as they said, "not very high" or "performance certainly fluctuates." It quickly became clear, however, that no one expected the average correlation to be zero.

What we told the directors of the firm was that, at least when it came to building portfolios, the firm was rewarding luck *(Continued on Page 62)*

SHOPPING HOME

CONFIDENCE

(Continued from Page 33)

as if it were skill. This should have been shocking news to them, but it was not. There was no sign that they disbelieved us. How could they? After all, we had analyzed their own results, and they were certainly sophisticated enough to appreciate their implications, which we politely refrained from spelling out. We all went on calmly with our dinner, and I am quite sure that both our findings and their implications were quickly swept under the rug and that life in the firm went on just as before. The illusion of skill is not only an individual aberration; it is deeply ingrained in the culture of the industry. Facts that challenge such basic assumptions — and thereby threaten people's livelihood and self-esteem — are simply not absorbed. The mind does not digest them. This is particularly true of statistical studies of performance, which provide general facts that people will ignore if they conflict with their personal experience.

The next morning, we reported the findings to the advisers, and their response was equally bland. Their personal experience of exercising careful professional judgment on complex problems was far more compelling to them than an obscure statistical result. When we were done, one executive I dined with the previous evening drove me to the airport. He told me, with a trace of defensiveness, "I have done very well for the firm, and no one can take that away from me." I smiled and said nothing. But I thought, privately: Well, I took it away from you this morning. If your success was due mostly to chance, how much credit are you entitled to take for it?

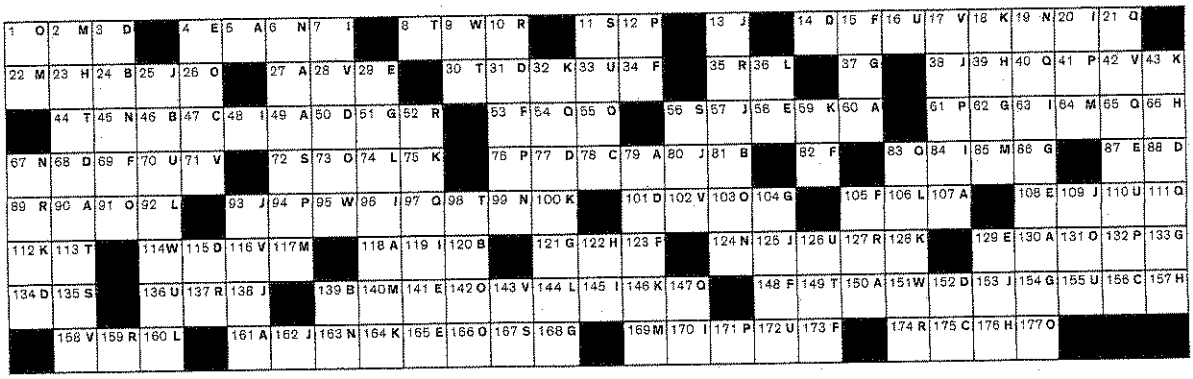
We often interact with professionals who exercise their judgment with evident confidence, sometimes priding themselves on the power of their intuition. In a world rife with illusions of validity and skill, can we trust them? How do we distinguish the justified confidence of experts from the sincere overconfidence of professionals who do not know they are out of their depth? We can believe an expert who admits uncertainty but cannot take expressions of high confidence at face value. As I first learned on the obstacle field, people come up with coherent stories and confident predictions even when they know little or nothing. Overconfidence arises because people are often blind to their own blindness.

True intuitive expertise is learned from prolonged experience with good feedback on mistakes. You are probably an expert in guessing your spouse's mood from one word on the telephone; chess players find a strong move in a single glance at a complex position; and true legends of instant diagnoses are common among physicians. To know whether you can trust a particular intuitive judgment, there are two questions you should ask: Is the environment in which the judgment is made sufficiently regular to enable predictions from the available evidence? The answer is yes for diagnosticians, no for stock pickers. Do the professionals have an adequate opportunity to learn the cues and the regularities? The answer here depends on the professionals' experience and on the quality and speed with which they discover their mistakes. Anesthesiologists have a better chance to develop intuitions than radiologists do. Many of the professionals we encounter easily pass both tests, and their off-the-cuff judgments deserve to be taken seriously. In general, however, you should not take assertive and confident people at their own evaluation unless you have independent reason to believe that they know what they are talking about. Unfortunately, this advice is difficult to follow: overconfident professionals sincerely believe they have expertise, act as experts and look like experts. You will have to struggle to remind yourself that they may be in the grip of an illusion. ◆

ACROSTIC

By EMILY COX and HENRY RATHVON

Guess the words defined below and write them over their numbered dashes. Then transfer each letter to the correspondingly numbered square in the pattern. Black squares indicate word endings. The filled pattern will contain a quotation reading from left to right. The first letters of the guessed words will form an acrostic giving the author's name and the title of the work.



A. Chart-topping song of October 1962 (2 wds.)
79 130 49 107 118 60 90 150 5 161 27

B. Fourth-wall breaker
24 139 46 81 120

C. Scream
78 175 156 47

D. Home of Mammoth Hot Springs
115 50 14 152 77 101 3 134 88 68 31

E. Constantly scolding
29 87 141 58 108 165 129 4

F. Mad scientist's stereotypical lab assistant
105 15 123 148 34 53 82 69 173

G. With precious little left in the tank
86 154 104 37 62 51 168 133 121

H. Like Prokofiev's French horn
23 122 176 66 157 39

I. Comics villain since 1940 (2 wds.)
145 48 63 170 20 96 119 84 7

J. Emergency exit (2 wds.)
80 138 93 13 38 153 125 109 162 25 57

K. Time often embellished in retrospect
75 146 59 100 32 112 43 128 164 18

L. Dueling weapon in "The Devil Went Down to Georgia"
36 106 92 160 74 144

M. Nonsense
85 64 22 169 2 117 140

N. Setting for loopy demonstrations (2 wds.)
67 6 163 99 45 19 124

O. Billy known for a hard kind of bop?
73 91 166 1 103 177 55 142 131 26

P. 1931 portrayer of a made man
132 171 41 61 94 76 12

Q. Catchers of some waves
111 40 97 147 85 54 83 21

R. Breathing holes
159 35 10 127 89 137 174 52

S. Picture-taking session
135 167 11 72 56

T. Reversible or reciprocal (hyph.)
30 8 149 44 98 113

U. Sort of person who should know right from wrong
70 110 136 126 172 155 16 33

V. Classic film line shouted twice by Gene Wilder in 1974 (2 wds.)
102 17 71 158 42 28 143 116

W. Potential pickup site
95 9 151 114