After the Wildfires: Why We Should Care About What Happens Next in Los Angeles

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Climate change has raised the stakes for city and state governments in meeting their duty to protect people from danger. The rising frequency and severity of climate-related events from wildfires to floods is unprecedented in modern history.[i] This trend is confronting elected officials with challenges that are exposing weaknesses in how state and local governments manage critical infrastructure, public safety resources, and respond to crisis. This developing operating environment is also creating new financial stresses on government entities that will likely impact the credit profile of these issuers. [ii] The Los Angeles wildfires, and the region's response to this crisis, is a long-term test of a government's ability to respond to this threat. We will analyze the Los Angeles response to the wildfires both to explore these challenges, but also to establish a framework for evaluating the ability of local government to respond in the longer-term.

It should be clear that the tragedy of the Los Angeles wildfires was born from two parents: climate change and reports of failed governance. Innocent lives were lost in raging infernos that consumed hillsides and homes. Brave first responders acted heroically to save beloved family members and property. Yet, their success was undermined by circumstances beyond their personal control.

Climate models have long predicted that a calamity of this scale was possible.[iii] Yet, the warning signs did not lead to government action, and inaction led to death, destruction, and an uncertain future for the region's economy. Can Los Angeles, and for that matter, the state of California move in new policy directions that support better outcomes?

The story of how Los Angeles recovers from this crisis has yet to be written, yet it matters for the entire state of California, the United States, and beyond. Its outcome will likely have an impact on the growth and inflation rate of the United States – this impacts capital markets broadly and how specific asset classes, such as municipal bonds and real estate, are priced. It has already had a direct impact on how insurers price property risks for homeowners and commercial real estate in the state and the nation.

Overview

A quick review of the basic economic data highlights why everyone has an interest in a positive outcome for Los Angeles and California.

- The gross domestic product of California's economy is about $4 trillion dollars and represents about 15% of the entire economic output of the United States.
- If California was an independent nation, only the United States, China, Germany, and Japan would be larger economically.
- Particularly important, not only is California the largest state in population, but California taxpayers also contribute the most in income taxes to the federal government. The Los Angeles metropolitan area accounts for approximately 25% of the state's entire economic output.[iv]

What Went Wrong?

It should be clear that the resolution of this crisis in California matters to everyone. Long- lasting solutions will only be found and implemented after a thorough investigation of what went wrong is completed. This has yet to begin. Nonetheless, we can analyze the contours of the crisis and this analysis will help us establish benchmarks to evaluate if the region can emerge stronger, or weaker. Climate change set the stage for crisis, these failures in governance made the disaster worse:

- Budget cuts to the LA Fire Department budget just months before the fires impacted readiness and staffing levels. It has been argued that the LA Fire Department has been underfunded for about a decade.[v]
- A key reservoir needed to provide water to extinguish wildfires was empty for over a year even though its essential role in suppressing wildfires during dry season was well known.[vi]
- Obsolete fire hydrants and low water pressure contributed to a cascading series of operational failures.[vii]
- Government investments in emergency notification communications failed: some people in danger were not notified in some cases leading to tragic consequences. False evacuation orders were sent to residents that were not in danger and they experienced panic.[viii]
- Underinvestment in improving local infrastructure meant it was harder for first responders to swiftly deploy to the communities consumed by the wildfires, and harder for residents to safely escape.[ix]
- Governance and regulatory oversight of local utilities remains in question as ongoing lawsuits and investigations seek to determine their roles in either causing or exacerbating the fires.[x]

A patchwork of county, city, and various local governments made a swift and effective regional response to the wildfires more complicated. This aspect of the response raises the question about the need to reform these organizations.[xi]

What Needs to be Fixed

A successful resolution of the problems above requires a meaningful public investment in climate resilient infrastructure, communications technology, and a visionary reconsideration of utility oversight to create a grid that supports growth and reduces the risk of future wildfires. There is considerable discussion in Sacramento about these matters. No clear plans have emerged. Governor Newsom has requested $40 billion in federal aid to help with the rebuilding process, but this would be just a start.[xii]

Yet, in order for the economy to successfully rebound not only does infrastructure need to be reconsidered, so does the regulation of insurance in California. For many years, state insurance regulation sought to limit the cost of property insurance. This policy had the unintended consequence of causing insurers to leave the state.

- California insurance regulations did not allow insurers to use forward-looking climate models to properly price the risk of wildfires, or other climate-related impacts. This created an insurance crisis in the state that is already complicating plans for reconstruction.
- The California state insurer of last resort, called the FAIR Plan, became the only insurer available to homeowners in the wildfire area. This was not the original purpose of the FAIR Plan. FAIR is an acronym that stands for "Fair Access to Insurance Requirements". In 1968, many insurers stopped providing insurance coverage to urban centers in response to rioting that destroyed property. In response, a Federal law gave states the power to create insurance funds that could provide important insurance coverage when there was not a suitable private market solution. The acronym FAIR was derived from this legislation, The California FAIR plan was started in 1968 to provide insurance to residents who cannot purchase it from private insurers. Before the wildfires it was undercapitalized, and its CEO informed the state legislature that the growth of its assets versus liabilities was untenable.
- The FAIR plan has now run out of money and is using its emergency powers to raise additional capital which may further discourage private insurers from operating in California. The outcome of how this will work remains to be tested.[xiii]

There is no clear plan visible to properly address the property insurance crisis in California. This is a headwind for recovery and for property values in the region.[xiv]

Challenges to Rebuilding

Even if the state of California, in collaboration with the private sector, conceives and implements a climate resilient rebuilding plan, there are clear impediments to success:

- The cost of labor is estimated to be about 30% or more of the cost of building a home.
- The cost of labor is likely to go significantly higher if Federal executive orders regarding deportation of illegal immigrants are fully implemented.

- Conflict with the Federal government on immigration policy and its impact on the cost of labor and rebuilding is inevitable. Los Angeles is a “sanctuary city”. The LA City Council has passed resolutions stating it will not cooperate with the Federal government for deporting illegal immigrants.
- One of President Trump’s executive orders targets sanctuary cities that refuse to cooperate with the Federal government by restricting federal funds. The Trump Administration may also take legal action against cities like Los Angeles. This may complicate Governor Newsom’s effort to obtain Federal funding for the recovery.
- LA’s local economy will likely be disrupted by this policy beyond the rebuilding effort itself. LA has 3.8 million residents, more than 800,000 of these are believed to be undocumented migrants. This labor pool is key to the future reconstruction.

The impact of deportation on reconstruction is likely inflationary for the region. According to the National Immigration Forum, construction is one of the industries that require immigration to meet labor demand.

- The National Association of Homebuilders notes that about 30% of the constructions workers in the US are immigrants.
- In California, undocumented immigrants make up about 40+% of all construction workers. Some sources suggest this number may be low.[xv]

Where Do We Go from Here?

The cost of rebuilding Los Angeles keeps going up. The total economic loss is estimated now to be at around $250 billion. This includes both the loss to property and negative economic impact on businesses. Yet, the property losses and business disruptions are only a starting point. The economy for Los Angeles County has been interrupted. Roads and infrastructure are broken, equipment needs to be replaced, dams repaired, and fire department budgets need to go up. People have been forced to leave their homes, and the repairs and environmental remediation are still in early stages. Los Angeles County is expected to see a drop in gross domestic product of $4.6 billion.[xvi]

Summit Trail will be tracking the ongoing implications of how the State of California, and the county and city of Los Angeles, respond to this crisis. We will closely monitor the economic impact, both on growth and inflation. We will also monitor the impact on the credit quality of various municipal bond issuers. If handled well, the crisis has the potential to serve as a catalyst for significant growth in Los Angeles and California. If the recovery dollars are spent well, this could be a remarkable Keynesian event with long-term productivity benefits if a climate resilient infrastructure investment plan supports healthy growth into the future. At the same time, California needs to cut the type of red tape that slows down rebuilding. While new executive orders by both Governor Newson and LA Mayor Karen Bass are intended to accelerate the rebuilding process, it is too early to know if these initiatives will prove effective.[xvii]

California needs to rise to the occasion to maintain its economic competitive advantages. The state needs to reform its regulation of insurance markets further so insurance is priced based on market pricing. This would attract insurers back to the state. It also needs to solve the inevitable labor and supply chain bottlenecks that are likely to develop in reconstruction, including deregulating the construction process in the city and county of Los Angeles. If California rises to the occasion, and develops creative solutions, it can be a model for other states challenged by climate change. If not, the state's longer-term growth trajectory will likely be adversely impacted.

Important information: Disclaimer and Footnotes

The proceeding content is for informational purposes only and based on publicly available information. It is not an offer or a solicitation nor is it tax or legal advice.

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