Occasional Papers

When Government Fails: The Orange County Bankruptcy
A Policy Summary

The Second Annual California Issues Forum
After the Fall: Learning from the Orange County Bankruptcy
Sacramento, California
March 18, 1998

Public
Policy
Institute *of*
California

*When Government Fails: The Orange County Bankruptcy**
A Policy Summary

1. Introduction

On December 6th, 1994, Orange County California became the largest municipality in U.S. history ever to file for bankruptcy. The financial difficulties leading to the bankruptcy were the direct result of an enormous gamble with public funds taken by a county treasurer who was seriously under-qualified to deal in the kinds of investments he chose. Because of his shortcomings, because of Orange County's national reputation as a land of rich, spoiled, archconservatives, and because the bankruptcy did not play out as other municipal financial crises have, many observers have dismissed it as an anomaly. It may have been a nasty surprise for Wall Street, they argue, but it is not something that is likely to happen again, even in Orange County.

In *When Government Fails: The Orange County Bankruptcy*, Mark Baldassare presents compelling evidence to the contrary. Orange County may have provided sufficiently dramatic warning of the dangers of County Treasurer Bob Citron's kind of investment strategy to prevent others from going down that particular slope. However, the conditions and resulting imperatives that drove the county to gamble persist. Moreover, as Baldassare argues, the conditions exist in cities and counties across California and the nation. As the fervor for smaller government, tax limits, and local autonomy grows and spreads, many more municipalities may find the specter of bankruptcy looming—especially when the economy takes the next downturn.

This policy summary briefly describes the findings, conclusions, and recommendations of the book. Its purpose is to underscore the lessons learned from the bankruptcy, as presented by the author at the Public Policy Institute of California's Second Annual California Issues Forum. The forum, entitled **After the Fall: Learning from the Orange County Bankruptcy**, was held on March 18, 1998 at the Sacramento Convention Center. The invited audience included California government, business, and other opinion leaders, as well as the media.

---

* University of California Press 1998: A Joint Publication with the Public Policy Institute of California

2. What Happened and Why Does It Matter?

How did Orange County wind up in bankruptcy and how did it emerge from bankruptcy only 18 months later? As municipal financial crises go, the story is—on the surface—unprecedented. Looking only at the surface, one could conclude that this was just a matter of a rogue trader run amok, in a county of high-income voters who do not want to pay their bills, in a state where a Democratic state legislature did not want to bail out an arch-Republican county. In other words, it is something unlikely to have much relevance for the rest of the political and financial world. However, a deeper look at what happened counters that conclusion.

What Brought Down Orange County's Financial House?

Having kept him in office for 24 years, the voters of Orange County had every reason to believe County Treasurer Bob Citron was a capable, experienced financial manager. However, about two or three years before the bankruptcy, Citron embarked on an investment strategy that very few people in the county were aware of and even fewer understood. In charge of the Orange County Investment Pool, he had, by 1994, about $7.6 billion in deposits in the pool from the county government and almost 200 local public agencies (Orange County cities, school districts, and special districts). Some of these agencies (e.g., schools) were required to invest their funds in the County Investment Pool. Many others voluntarily joined, attracted by the high interest rates Citron realized and aggressively advertised.

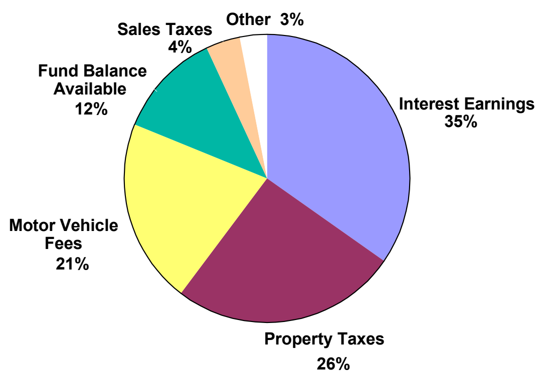
His strategy was to use the funds on deposit to borrow money to invest in derivatives, inverse floaters, and long term bonds that paid high yields. He then borrowed more money, with the borrowed money as collateral (see Table 1). For reasons related to the aftermath of Proposition 13, Orange County relied more than other counties in the state on interest income: In FY94, interest amounted to 12 percent of revenue for Orange County—in contrast to 3 percent for all other California counties. Citron was driven by the need to raise more interest income for local governments, whose tax allocations had recently been cut again by the state. For the FY95 budget, he promised that interest earnings would account for 35 percent of the county's general fund revenues (Figure 1). In this context, he took more risks. The size of the pool increased to $20.6 billion in 1994, as he borrowed $2 for every $1 on deposit (Figure 2). In essence, as *The Wall Street Journal* noted, he was "borrowing short to go long" (Editorial, *The Wall Street Journal*, December 9, 1994) and investing the dollars in exotic securities whose yields were inversely related to interest rates.

Table 1.
The Leveraging of the Orange County Investment Pool

	Amount	Percent
Original investment of 194 agencies	$7.6 billion	37%
Investments bought with borrowed money	$13.0 billion	63%
Total investments	$20.6 billion	

Two dollars borrowed for every one dollar on deposit

Source: California State Auditor, 1995.



Interest would be major source of general fund revenues

Source: County of Orange, 1995a, Los Angeles Times Orange County Edition, 1995c.

Fig. 1--Citron's Promise for FY95 Budget

Source: California State Auditor, 1995.

Fig. 2--The OC Investment Pool Quadrupled in Four Years

Unfortunately, also in 1994, the Federal Reserve Board began and kept on raising interest rates and Citron kept buying securities in the desperate belief that what went up must come down. At least one person understood enough about the financial strategy and situation to sound an alarm: Citron's opponent in the spring county treasurer's race repeatedly charged that the county pool had suffered serious losses and was not solvent enough to repay the Wall Street firms for the huge short-term loans. But no one listened—not the county government, not the savvy Orange County investors, not even the media. Most everyone dismissed the charges as a Republican vendetta against the only elected Democrat in county government. Most everyone also seemed intent on overlooking the common wisdom that high-return investments are almost invariably high-risk investments—and the higher the return the higher the risk.

Citron won reelection and continued to bet on lower interest rates, borrowing $600 million more and buying throughout the summer. A year earlier, he was warned about the potential danger the high-risk securities posed and one firm even offered to buy back some of the riskier ones. But he refused and they continued to sell to him. Although county business leaders began to hear rumors in early fall from their Wall Street contacts that something was amiss, they did not follow up with Citron nor with the county supervisors. Even if they had, they might not have gotten a hearing. As the then-Chairman of the Board of Supervisors said, "It doesn't bother me that he is a Democrat. This is a person who has gotten us millions of dollars. I don't know how in the hell he does it, but he makes us all look good" ("Tax Collector To Meet Second Challenger in 24 Years," *Los Angeles Times* Orange County Edition, April 2, 1994, p. 1).

No one paid attention until the walls began to tremble. In November, auditors told county officials that Citron had lost about $1.64 billion. In early December, the supervisors realized that the county did not have the cash to withstand a run on the money by Wall Street lenders and the local-government pool depositors. With that, the financial house came down. The supervisors asked for and got Citron's resignation. As the county unsuccessfully tried to sell off the risky securities, the lenders threatened to seize the county pool securities they held as collateral. After the first bank took this action, the county government declared bankruptcy on December 6, 1994.

Their hope that this action would stop other Wall Street lenders from other fund seizures proved illusory. However, it did stop the local government depositors from withdrawing funds. The county government, all but two of the Orange County cities, all of the school districts, and most of the transportation, water, and sanitation agencies had large sums on deposit. The total came to $7.6 billion in frozen funds for these local public agencies

How Did Orange County Recover?

The trip back from bankruptcy was hard and marked by false starts and breakdowns. The county's credit rating fell to "junk" status. The Wall Street firms continued to sell off the billions of dollars in securities that they held as collateral. Called in to manage the county pool, former state treasurer Thomas Hayes sold off the risky securities, establishing the pool loss at $1.64 billion. He also set up a mechanism to allow the local governments to withdraw some of their funds from the pool on an emergency basis. The Board of Supervisors appointed the county sheriff and two other county officials to a crisis team to keep the county government working. They also appointed a local financial executive, William Popejoy, to the newly created position of chief executive officer for the county in early February. Popejoy initiated severe staff and budget cuts necessary to balance the budget and removed county officials tainted by the fiscal collapse.

Three local business executives led a negotiating team that arranged a settlement between county government and the pool investors to divide the remaining pool funds. Under the settlement, the latter could get most of their deposits back immediately and were promised the rest at a later date, on condition that they not sue the county government. However, debts were still mounting and a worse financial crisis seemed imminent: $1 billion in bonds were coming due in the summer months and the bankrupt county had no way of borrowing this money.

With no other apparent recourse, in March 1995 the Board of Supervisors put a proposal on the ballot for a half-cent sales tax increase as part of the financial recovery plan for Orange County. They did this even though polls showed that it was doomed and even though local governments were against it. The voters rejected this increase resoundingly on June 12, 1995. That rejection led the national press to characterize them as deadbeats who refused to honor the "full faith and credit" understanding that is the basis on which financial institutions lend to governments, and state and municipal bonds are offered to the public. In another shock to observers familiar with the historical model of municipal financial crises, the state refused to bail the county out.

At that point, things looked grim indeed and the scramble began for another recovery plan. Rather than lose their principal, the bond investors agreed to roll the county's debts over for another year in exchange for more interest earnings and, in August 1995, the county developed another plan, with the following elements:

- The county would divert tax funds from other county agencies (e.g., transportation) so the county government could borrow the money to pay bondholders and vendors.
- The local governments who lost money would agree to wait for full payment until the county wins the lawsuits it filed against Wall Street firms for their alleged culpability in the bankruptcy.

- The county would issue $880 million in bonds to pay the debt on existing bonds, refinance other debt, pay for bankruptcy litigation, etc.

The state legislature passed the bills needed to divert the tax dollars to a recovery fund and the governor signed the bills in October 1995. The county presented its recovery plan to the U.S. bankruptcy court in December 1995. In June 1996, the county sold the $880 million in bonds and the bankruptcy officially ended on June 12th—just 18 months after it was declared.

Why Does the Bankruptcy Matter?

The Orange County bankruptcy is worth close consideration for at least three reasons. First, municipal bankruptcies are rare and usually involve very small municipalities and small amounts of money. A Chapter 9 filing by a large local government was unprecedented prior to the Orange County case. Large cities—Washington, Philadelphia, Cleveland, and New York—have come to the brink of financial collapse before, but in every case bankruptcy was avoided. Consequently, financial markets have come to trust municipal bonds as safe. Most municipal bankruptcies are also small in scale: The 362 filings between 1937 and 1994 amounted to a *total* debt of about $217 million—in contrast to the $1.6 billion Orange County lost in 1994 and the $1 billion in debt it almost defaulted on in 1995. Thus, the Orange County event called the expected outcome and scale of municipal financial distress into question.

Second, by calling that outcome into question, the bankruptcy also had financial consequences for other California counties and for the state itself. Proposition 13 and other measures have severely limited local governments' ability to levy or raise taxes. Because of those measures, Orange County government could not—as other large municipalities have done—simply levy new or raise old taxes to pay its debt. This was the first financial crisis in which that decision rested with voters—and they refused. This realization about post-Proposition 13 California shook to the foundations the relations between California municipalities, bond investors, and Wall Street firms. The state's refusal to intervene—as the state of New York had intervened on behalf of New York City—increased the temblor. In the words of a financial advisor quoted in the *New York Times*, "In every other major credit crisis in government in the last 25 years, states have taken a lead role. . .There is an implied moral obligation of states to help their municipalities" ("A Bankruptcy Peculiar to California," *New York Times*, January 6, 1995, A-I).

In light of these responses, it seems likely that other California municipalities and the state itself may also face an "Orange County penalty" in the financial markets. As the state treasurer noted after the bankruptcy, "While it is impossible to quantify the yield penalty California issuers will pay as a result of the Orange County crisis, it could be as much as $200 million or more annually on a statewide basis" ("Orange County Bankruptcy Hikes Government Debt," *Cal-Tax News*, March 1, 1995, 34 (13):3).

Third, and as much of the above implies, the Orange County bankruptcy matters because it didn't follow the "New York model": In causes and outcomes, it is different in kind from the historical model of municipalities in financial trouble. When potential lenders and investors think about the financial health of local governments, they are accustomed to financial stress in old, large cities. Typically, troubled cities are those whose tax bases are eroding because they are losing businesses and middle class taxpayers to cities in other regions or to suburbs, and whose remaining or growing populations are those who put the greatest demands on public services such as health and welfare. They are also accustomed to believing that local governments will stand behind bonds with their "full faith and credit," which includes raising taxes or whatever is necessary to back their debts. If that fails, the state government will intervene to prevent a bankruptcy. Finally, it will take the municipality a long time to recover. As an official from Moody's Investors Service noted, "New York City did not borrow on its behalf for six years after the default and Cleveland for five years. Philadelphia lost market access for three years due to serious fiscal difficulties and it never defaulted" (Senate Special Committee on Local Government Investments; Hearing, Friday, March 3, 1995; Sacramento: State of California).

In virtually every way, Orange County and its financial troubles departed from this model. What makes the situation and events there matter so much is that they may well comprise a new model for local government failure in California—and other states as well. This is not to imply that the New York model is now defunct. It is to imply that the reasons for the bankruptcy and its outcomes in Orange County are likely to constitute a competing, if not dominant, model. This is a model that policymakers and financial markets in the state and the nation would do well to study.

3. The "Orange County Model" of Local Financial Crisis

As noted earlier, some observers have dismissed the policy importance of the events in Orange County because the bankruptcy is unprecedented and because so much about it smacks of aberration. To begin with, there is the myth of Orange County—supposedly mostly wealthy, all white, and archconservative. Based on his 16 years as director of the Orange County Annual Survey (conducted at the University of California, Irvine), Baldassare explodes that myth. In fact, Orange County is representative of the suburbia where most Americans live. Response to the surveys shows that Orange County is mostly middle class, though it does have a large immigrant population. Sixty-nine percent of respondents consider themselves lower-middle or middle class and only 27 percent claim to be upper-middle or upper class. Orange County is not "all white." According to the 1990 census, 35 percent of Orange County residents are people of color, compared with only 18 percent across all U.S. suburbs. Moreover, Orange County residents do not consider themselves archconservative. Instead, most characterize themselves as mainstream—19 percent "somewhat liberal," 27 percent "middle of the road," and 31 percent "somewhat conservative."

The putative weirdness of Orange County aside, many people believe that Bob Citron and his dealings with Wall Street constitute the necessary and sufficient conditions for what happened and that, absent a Bob Citron, it could not happen in their backyards. However, Baldassare's definitive reconstruction and analysis of the situation, events, and outcomes counters that belief. He shows that the chain of immediate cause and effect has significant antecedents and deeper underlying causes. Specifically, Baldassare identifies three key factors in the Orange County context (writ large and small) that created the necessary conditions for the bankruptcy and the nature of the recovery. Bob Citron was not the cause of the bankruptcy; he was the catalyst that made those three necessary conditions sufficient. What makes the model important is that these conditions exist, to a greater or lesser degree, in counties across the state and nation. The three conditions are **political fragmentation**, **voter distrust**, and **state fiscal austerity**.

Defining the Conditions

Political Fragmentation. A large suburban area typically includes dozens of local city governments, a county government, regional single-purpose agencies, local school districts, and local special districts. Although these individual entities often have overlapping geographical boundaries and jurisdictions, an area is politically fragmented if each pursues its own goals and separate policies without regional coordination and often in competition with others. This fragmentation gives rise to problems such as traffic congestion, air pollution, sprawling land-use patterns, lack of affordable housing, inefficient delivery of local public services—and in the case of Orange County, lack of oversight for a county treasurer who would push the county into financial crisis.

Political fragmentation is pervasive and persistent in the suburbs because it is rooted in the "local orientation" of suburbia. Public opinion polls and community studies show that suburban residents are wary of large urban government bureaucracies, favor smaller communities, prefer decentralized public services, and are strongly committed to local home rule. Thus, despite the problems fragmentation creates, suburban residents have generally rejected ballot measures that would create regional governments. Local elected officials tend to support their constituents' preferences because it keeps them in office and keeps their political powers intact.

Voter Distrust. The tax revolt and term limits are two highly visible manifestations of voter distrust of government. Politics and elections in the suburbs have been dominated by voters who are characteristically reluctant to have their taxes raised. The anti-tax sentiment cuts across political parties and ideologies and exerts a strong influence on local politics across the United States. Its base of support is middle-class, well-educated residents in suburban regions. However, this citizens' revolt against taxes should not be confused with a desire to have local government cut *spending* on the services that these voters value. They are voting against high taxes, but they want current levels of spending to be maintained. Only with regard to welfare and other government services for the poor are middle-class voters willing to accept less government spending.

The logic of this position is questionable and has led commentators to say (especially of California voters) that anti-tax voters simply want something for nothing. However, it seems less illogical if one accepts the premise on which these voters operate: Many believe that most public bureaucracies, including their own local governments, are inefficient, if not dishonest, and squander tax monies. This distrust and low regard for officials' handling of money explains why these voters can justify their demand for lower taxes while asking local leaders to maintain current spending levels and provide high-quality services. No matter how draconian the cuts, anti-tax voters continue to believe there is financial waste in government that can be transformed into sufficient funds for the services they want.

In California, beginning with Proposition 13, voters have used the initiative process to establish their control over local taxing power. Obviously, such voters also seek to elect local officials who share their tax and spending views. Thus, between initiatives that require voter approval for levying and raising taxes, and elected leaders who share, or must at least respect, those views, citizen preference has come to dominate local government finance. While the resulting breed of "New Fiscal Populists" in local government flourishes under the conditions of voter distrust, they also face a serious dilemma: They must devise fiscal strategies that allow them to maintain or decrease taxes and at the same time maintain or increase spending for local services. There is just so far they can go with measures to increase productivity, improve fiscal management of existing tax revenues, and selectively adopt low-visibility revenue-raising devices. When, as happened in 1994, the state cuts local revenues, local leaders must be especially creative. The difficulty of the dilemma explains why Orange County local leaders closed their eyes to possible problems with a high-risk investment strategy that was giving them badly needed high-interest income.

State Fiscal Austerity. Local governments have long relied on federal and state monies to fund programs and help build the infrastructure that made possible the mass migrations to the suburbs after World War II. However, in the 1980s and 1990s, the federal government has faced large budget deficits that resulted in fewer financial resources to aid state and local government. In California, state budget pressures have cut back the state's ability to fund public infrastructure projects and local public services. This austerity at higher levels puts suburban governments, like Orange County, under tremendous pressure to find additional funds for services.

As the discussion above implies, voter distrust has deepened fiscal austerity. In June 1978, Proposition 13 (a California citizen initiative) offered existing homeowners a substantial savings on their property taxes and limited the growth of property taxes to 2 percent annually. This had the immediate effect of cutting property tax revenues for local governments. Since Proposition 13 also constrained the ability of state and local governments to raise new taxes, local governments found themselves with greatly reduced means for providing services. Despite some policy experts' concerns about the negative effects of tax limitation measures, the state's voters have continued to defend Proposition 13. In fact, they have extended its powers several times through subsequent ballot measures. Most recently, in November 1996, they passed Proposition 218, which extended the limitations on local tax increases. Even Orange County voters supported it by a wide margin, despite their funding shortage after the bankruptcy.

Through the various measures, the tax revolt has greatly increased county governments' dependency on the state. The year before Proposition 13 was passed, county governments collected over $3 billion in property tax revenues (34 percent of general county revenues); by 1981-1982, those revenues had dropped to $2.4 billion (22 percent of general county revenues). In response, state aid to counties increased during the same time from $2.09 billion to $3.58 billion, and the state assumed all of the cost of some county programs and part of others. The state also redistributed local property tax revenues. One way in which the state tried to help counties increase revenues was to loosen state restrictions on local government investment practices. However, given what that produced in Orange County and in the wake of the bankruptcy, the state tightened the restrictions up again. In sum, counties have lost much of their budgetary flexibility and rely heavily on the state for revenues.

Under these circumstances, when the state hits a financial pothole, counties go into financial whiplash. In the first part of the 1990s, the state faced growing expenses and declining revenues because of a serious economic recession and rapid population growth fueled by immigration. The state also claimed that many of the services mandated by the federal government were not fully funded. Not only was there no surplus of state funds to pay for local government services, but the state budget had a huge deficit. In FY93, the state took back millions of dollars in property tax funds that it had previously committed to counties, cities, and special districts, as part of a fiscal relief plan following Proposition 13. Many counties tottered on the brink of fiscal collapse, with few options for making up the lost revenues. In Orange County, the treasurer took greater and greater risks to help local governments try. When that house of cards collapsed, the state's fiscal situation was still sufficiently austere that there was no possibility of any form of state bailout for the county.

How These Conditions Played Out in the Orange County Model

Table 2 presents a summary of how the three conditions led to the bankruptcy, affected the recovery efforts, and persist in a set of circumstances that keep Orange County in jeopardy today. Clearly, the representation simplifies the interactions among these conditions and neglects other elements that bore and still bear on the situation. Nevertheless, the table provides a convenient schematic.

Going Into Fiscal Crisis. Without Bob Citron and his investment strategy, the Orange County bankruptcy would most probably not have occurred. Nevertheless, as Baldassare argues, Bob Citron could not have brought the county to bankruptcy in the absence of political fragmentation, voter distrust, and state fiscal austerity.

Orange County was politically fragmented in ways that allowed him to operate and that kept the various stakeholders and observers from understanding how big the risks were. The county government was headed by five supervisors elected by district to represent the interests of the district not the county as a whole. There was no county mayor or CEO. The county departments were headed by elected and appointed officials who operated fairly autonomously—like the county treasurer. No other county officials had oversight over Bob Citron. Elected countywide, he was not directly accountable to either the Board of Supervisors or the county administrative officer. Since the other county officials could not keep track of what the treasurer was doing, they did not have up-to-date information on the county's finances. Moreover, they were also not in a position to question, much less dictate, the treasurer's investment decisions.

Outside of county government, Orange County has 31 cities, 27 local school districts, 126 special districts, and a regional transportation agency. Almost all of them had invested in the county investment pool, but with a single focus on what the investments meant to their own localities. They did not consult with one another about the decision to invest. If they had, they might have noticed that Citron was making them all the same promises about safety, liquidity, and high yield—promises that were questionable given the number of local governments in the pool.

Of course, their need for high returns on investment made them want to have faith in the pool and to dismiss the challenges and rumors they heard in 1994. That need was driven by the combined effects of voter distrust and state fiscal austerity. Voter distrust statewide motivated the passage of Proposition 13 and subsequent initiatives, which, in turn, cut previous tax revenues and constrained Orange County local governments from raising taxes. Yet, Orange County voters continued to demand plentiful, high-quality public services. And refusing them would have meant political suicide for local government leaders. When the state took back more property taxes during the recession, voter distrust put the leaders under pressure to invest even more in the county pool. Citron was not

INSERT TABLE 2

the only one who borrowed money to invest: A number of the pool investors also took that plunge. None of this would have been possible if state fiscal austerity had not prompted the state to offer local governments some relief by loosening the county investment regulations

Getting Out of Bankruptcy. As the county sought to get back on its feet, the three conditions shaped its efforts. The political leadership was paralyzed and required outside help. The effects of political fragmentation were implicitly recognized when the Board of Supervisors appointed a CEO and a crisis management team to create the central authority and internal cohesion that had been lacking. And it required a team of business leaders to mediate financial disputes among the many local governments and between county and local officials.

Instead of recognizing the forces that led to the bankruptcy, the voters felt that their distrust of government had been vindicated by this almost archetypal example of public officials mismanaging funds. They were more angered than afraid of what the bankruptcy might mean. Their rejection of the sales tax increase indicated that they continued to believe there was fat in government that could somehow be rendered into the means of paying for public services and paying off the county's debts. That rejection was implicitly encouraged by local elected officials who distanced themselves from the proposed increase in sales taxes, for fear of angering their constituents. Instead of confronting the need for new taxes, they agreed to divert county tax funds from long-term projects for the regional infrastructure. That, along with the $880 million bond issue to service debts and pay for suits against the financial establishment, effectively put Orange County's fiscal future in hock to pay off its past mistakes.

Nor did the state do anything to help, afraid that stepping in would incite the county to demand that state leadership put its money where its mouth was. Instead, the state allowed the diversion of the tax funds intended for other purposes—a legally questionable tactic.

Trying to Reform. The resilience of political fragmentation is seen in the local government reforms that were rejected or accepted. Basically, they amounted to increasing oversight of the county treasurer and prohibiting risky investments of the county pool funds. A CEO was appointed but has thus far focused only on improving fiscal accounting within county government. Otherwise, there has been little restructuring of county government. Most of the cities joined a council of government (COG) to improve their communications, but county government and the regional transportation agency are not members. Relations between county government and other local governments are still strained.

Having rejected the tax increase, voters went on to reject a coherent restructuring of regional government. They voted against a county charter because it would have strengthened the powers of the Board of Supervisors and made the county treasurer an appointed rather than a countywide elected official. Apparently they wanted the power of electing officials such as Bob Citron, even if they had made a mistake. The alternative explanation is that they expect even worse choices from their county leaders. That would seem consistent with their overwhelming vote for term limits for the County Supervisors and for their approval of Proposition 218. That measure requires that voters be asked for permission to raise local taxes and fees not covered by Proposition 13.

State fiscal austerity also affected the post-bankruptcy reforms. State officials tightened the rules governing investments and reporting by local treasurers. However, they did not return any of the lost revenues nor did they make any efforts to reform the system of local and state government finance that contributed to the Orange County financial crisis and made it more difficult to resolve.

4. What Can Be Done To Prevent Future Crises?

The unprecedented events, the speed with which Orange County exited bankruptcy, and the economic upturn have all reinforced the tendency to dismiss the episode as a fluke, something that could not happen again in Orange County and certainly could not happen elsewhere. Baldassare argues that, in fact, Orange County is quite vulnerable to another financial crisis. Considering how the story might have ended differently, he concludes that most of these "what ifs" are not likely without serious, tough-minded efforts to address the conditions that led to the bankruptcy in Orange County.

The Continuing Vulnerability of Orange County

Orange County is growing and business is booming. Yet, the picture looked similar to Wall Street only months before the bankruptcy. A more considered look at Orange County's situation suggests that the fiscal story has had a far-from-happy ending. The county government has taken on a crushing load of long-term debt that will not be used to build its future. Its bonds are still given low ratings, which means that it pays a higher cost to borrow. The local governments are still about $850 million short because of the funds owed them from the investment pool. All of this hobbles local governments in meeting current, and making plans for future, needs. Particularly hurt are the county's poor: Their services were cut during the bankruptcy and have not been fully restored.

Those who believe that Orange County is out of the financial woods are ignoring an unpleasant truth: Local governments will not achieve financial equilibrium—much less financial health—until and unless the county wins the billions of dollars in lawsuits against the Wall Street firms that dealt with the county treasurer. Moreover, the conditions that led to the bankruptcy and shaped the recovery persist. At this writing, fiscal austerity at the state level has been eased by a booming economy. However, the relative prosperity is very much hostage to business cycles; and in post-Proposition 13 California, recession hits government financially hard because of the voter-imposed constraints on local governments' ability to raise taxes. The distrust that led voters to impose those constraints has, if anything, grown stronger—and not just in Orange County. The same is true of political fragmentation: After the bankruptcy, the voters overwhelmingly rejected a proposed charter that would have created a more coherent, cohesive government for the county.

Changing the Ending

There has been a lot of discussion about who was to blame and how the story might have ended differently. To take just a few examples, put "what if" in front of the following sentences: Proposition 13 had not cut taxes and required voter authority for new local taxes. The state had not allowed counties to make risky investments to raise revenues. Bob Citron had not put profit and public approval above his public trust. County supervisors had accepted responsibility to scrutinize the treasurer's actions and heeded suggestions that they needed a CEO to oversee county agencies. Other local governments had insisted on investment reports. Wall Street firms had stopped selling risky securities to Citron. The media had investigated the charges of his financial mismanagement as diligently as they do rumors about politicians' sex lives. The governor and legislature had agreed to co-sign loans to avoid bankruptcy. Voters had passed the sales tax in 1995 and voted against Proposition 218 in 1996.

The past is immutable and, Baldassare concedes, there will be future fiscal crises regardless of attempts to remove the conditions that led to the bankruptcy and shaped its aftermath. However, the Orange County episode suggests that the present way of thinking about the causes of fiscal strain are too narrowly focused on the economic characteristics of the local government and its ability to pay debts. This focus does not reflect conditions in today's fiscal world. To reflect those conditions and avoid replicating the Orange County model, a number of changes are necessary.

Some good reforms were instituted after the Orange County financial crisis, but they have not gone far enough in dealing with the larger issues. The lessons learned from that crisis can be translated into ten policy recommendations. They also suggest a broader need to change state and local government relations.

Ten Policy Recommendations

1. **Local governments need to maintain high standards for fiscal oversight and accountability.** This was a theme stressed in bankruptcy hearings and recommendations at the state and local level. The state auditor's report recommended several steps to make sure that local funds are kept safe and liquid. These include having the Board of Supervisors adopt and approve the county's investment fund policies, appointing an independent advisory committee to oversee investment decisions, requiring more frequent and detailed investment reports from the county treasurer, and establishing stricter rules for selecting

brokers and investment advisors. The state treasurer recommended, among other things, a statement of investment policy delivered to the Board of Supervisors and quarterly investment reports. The state legislature passed two bills as part of the recovery plan: They restricted the amount of leveraging and purchasing of risky securities. They also required an oversight board and reporting requirements. In Orange County, the new treasurer implemented more restrictions on investing and the CEO has moved toward a team approach to involve more county officials in the investment decisions. New state regulations are a good start, but vigilance at the local level is essential. Local officials should adjust government structures to make sure they have the proper financial controls in place at all times.

2. **Local elected officials need more financial expertise and objective professional advice so that they can make sound fiscal policy decisions in the complex world of municipal finance.** As part of the state bill that reformed the local treasurer's operations, there are now education qualifications and continuing education requirements for county treasurers. It is necessary but not sufficient for the local treasurer to be a financial expert: Local officials at all levels must have adequate knowledge of the complex investment tools that are common in municipal finance today—both the "plain vanilla" securities and riskier investments. They should also call on objective professional advisors when they are making difficult financial decisions. These steps will not only help prevent fiscal problems; they will also help restore public confidence in local leaders' ability to handle taxpayers' money.
3. **Municipal bankruptcies should be avoided by local governments and state governments, even if extraordinary efforts are required.** A bankruptcy offers only limited protection, can have far-ranging consequences for local governments, and can impose penalties on others, including the state, by association. By rushing to bankruptcy, Orange County ruined its credit, worsened relations with other local governments, and virtually painted itself into the corner of costly litigation in order to repay those governments. San Diego County was also faced with a large paper loss in its county pool. However, it was able to prevent a run on the pool without filing for bankruptcy. County leaders informed pool participants that they would have to take a share in the current losses if they withdrew funds right away. Alternatively, they could wait until the financial markets cooled down and their investments regained value. The participants chose to wait. Other municipalities in trouble should also consider the less costly model of state and local government working together to avoid bankruptcy and bond default. Methods could include the state government extending credit, guaranteeing the safety of local bonds, or otherwise keeping open the local government's access to credit markets.

4. **The state of California should revise the general law governing its counties, because general-law counties currently have a structure that is lacking in local leadership.** The bankruptcy pointed out an important deficiency in the large counties that operate under general law. They lack strong leadership, and this can hurt their efforts to cope with an emergency such as a financial crisis. Suburban metropolitan regions would be better served if they had a mayor elected countywide and highly visible to the people. Their government structure would also be improved by having a CEO with authority over the budget and personnel in all county departments. The state government should also consider requiring the large counties that do not have a county charter to create a new organizational structure that will provide them with county leadership.
5. **State government should encourage the local governments in suburban counties to engage more actively in regional cooperation.** The Orange County fiscal crisis is one type of regional emergency in which county government, cities, schools, and special districts needed to cooperate. They were limited by their lack of experience in working together—or even communicating. As a result, county business leaders had to be called in to negotiate the pool settlement and the recovery plan. More life-threatening situations, such as floods or earthquakes, require regional cooperation even more urgently. It is typical for local governments to resist any efforts associated with regional governance, such as land-use policy coordination or local service consolidations. However, there is evidence that local officials look more favorably on regional efforts when state government is involved. This is why local governments need incentives, particularly fiscal incentives, from the state to cooperate.
6. **County governments need more flexibility in spending the state government funds they receive, especially during a local fiscal emergency.** Orange County had few options for cutting spending after the collapse of the county investment pool. Since the passage of Proposition 13, the trend in state and local government is for much of the county budget to be on "automatic pilot." There are mandated programs for which the state provides all of the funds; but for many programs, it provides only some of the funds and requires the county to pay for the rest. This leaves very little in the way of discretionary revenues or expenditures for other kinds of county government programs. Instead, the county has to spend some of its unrestricted funds to pay for state-mandated programs. The county government clearly has a responsibility to provide services and to spend federal and state funds for their intended purposes. However, there should be some conditions under which county leaders can seek approval from federal and state agencies to make modest and temporary cuts in the level of local funding they are required to provide for services.

7. **The state government should closely monitor the fiscal conditions of its local governments, rather than wait for serious problems to surface.** The state government is vitally concerned with fiscal trends in local governments, for a range of reasons. It would thus make sense to have an early-warning system that would track the fiscal health of counties, cities, and school districts. The state controller currently collects budget data from county government and presents them in an annual report. However, the information is not analyzed systematically to determine which of the county governments may have abnormal sources of revenues or patterns of expenditures or may be showing signs of fiscal distress. A review of the financial data for the 1990s would have indicated that Orange County had a large amount of interest income, which represented a much higher percentage of its revenues than the average for counties. This information should have indicated that Orange County was in or was headed for trouble. Monitoring would give state leaders an opportunity to discuss fiscal problems and solutions with local officials before they reach crisis stage.
8. **The Brown Act's requirements for public meetings by local legislators should be suspended during fiscal emergencies, as it is for other emergencies.** The Brown Act (1953) governs the rights of the public to attend and participate in meetings held by their county supervisors. A meeting is defined as a majority of the board members getting together and discussing any matter related to their local jurisdiction. For most California counties, this means that a conversation by three or more supervisors is a meeting. A regular meeting requires 72- and a special meeting 24-hours public notice. Emergency meetings require only one-hour notice, but they are limited to emergencies involving work stoppages or crippling disasters. There are criminal penalties for county supervisors found guilty of attending meetings in violation of the Brown Act. These rules prevented the Orange County Board of Supervisors from meeting as a group during some of the worst times of the financial crisis. The requirement for open meetings also restricted their ability to meet as a group and candidly and imaginatively analyze and respond to the situation. A fiscal disaster should be treated like a crippling act of nature: Emergency meetings with one-hour notice should be allowed and closed meetings should be permitted when supervisors need to make fast decisions about complex fiscal issues.
9. **Equity issues should be considered in fiscal emergencies; because the poor rely heavily on county services, their voices need to be heard in decisions about budget cuts.** The poor were silent and without representation during the bankruptcy. The county officials heeded the preferences of the middle class throughout the crisis, including the latter's overwhelming rejection of a tax increase. Although some state and local officials

were concerned about effects on the poor, the county budget cuts fell largely in areas that would be felt most by those in poverty. For example, the budget for Community and Social Services was reduced by 27 percent (from $74 million to $54 million), the budget for Health Services by 25 percent (from $40 million to $26 million). The disadvantaged have much to lose when county services are cut. In the future, their representatives should be included in decisionmaking when there are local fiscal emergencies.

10. **Local officials should be wary about citizens' pressures to implement local fiscal policies that are popular in the short run but financially disastrous over time.** Distrustful voters believe that there is considerable waste in government bureaucracy and that municipalities should, therefore, be able to cut taxes without doing harm to local services. The New Fiscal Populist leaders have fueled these perceptions in their campaign promises. The result is a search for hidden revenue sources, such as interest income from the county pool, that are not easily recognized by the public. Most voters are ignorant about the fiscal conditions actually faced by local governments and the services they must provide. They are not in a position to judge the amount of waste nor whether a tax cut is possible. Local officials need to do a better job of informing voters about how a local government pays its bills and for what necessary services. Officials also have to show more courage in opposing voters' wishes when the officials know that those wishes will threaten the public good. State government should also note that there are no checks and balances against citizen initiatives that can have disastrous effects on county services. Perhaps legislative review and gubernatorial approval should be required for voter-approved initiatives on taxes and spending.

Changing State and Local Government Relations

In retrospect, a county government was the most likely place for a municipal bankruptcy to occur. County governments are charged with the task of providing all local services for unincorporated areas and some services such as public health care, jails, courts, and welfare for the entire county. Yet, Proposition 13 and its progeny have severely limited their ability to raise revenues to provide these services. At the same time, voters continue to demand many, high-quality services. The state has stepped in to provide funding, but that funding has been earmarked in ways that make 90 percent of county budgets driven by state mandates. Worse, sometimes the state has not provided all of the funds required to meet the mandates. The counties' (and to some extent the other local governments') ability to cope is likely to be further eroded as the federal government devolves more responsibility for programs like welfare to the state—and the state to the counties. In both cases, the funds passed on with the responsibility are likely to be inadequate.

The state's legislative analyst concluded (a year before the Orange County episode) that "California's existing 'system' of state and local government clearly does not work" (Legislative Analyst, *1993-1994 Budget: Perspectives and Issues*; Sacramento: State of California, 1993). She called for changes in state and local government responsibilities, with the state given only certain statewide functions and local governments given authority over local programs. Local governments would receive a larger share of property taxes to pay for these services. Other groups have offered similar recommendations. The California Constitution Revision Commission recommended, for example, a requirement for the governor to submit a plan that explicitly assigns responsibilities and finance sources for state and local services. It also recommended a charter for each county and a plan for delivering government services. An incentive for having a charter is that the state government would be prohibited from taking back the property tax revenues allocated to county governments. The California Business Roundtable recommends, among other things, allowing local governments to refuse to carry out unfunded mandates.

This is an era when all governments are challenged to meet growing needs with limited resources. State and local fiscal reform can provide greater certainty about who will pay for services and how they will be delivered to the public in the most efficient and effective manner. The Orange County bankruptcy should have served as a wake-up call. However, there have been no changes in state and local government relations despite the widespread awareness for the need and the proposals offered. Such an effort would require the approval of the governor, the state legislature, and the voters. The first two will be hard to achieve, but the third may be even harder. Therein lies one of the more unsettling lessons highlighted by analysis of the Orange County bankruptcy: Voter attitudes may be the greatest obstacle of all in preventing future crises, fiscal and otherwise, in government.

What happened in Orange County is, in a deep sense, a failure of governance—not just of government. The responsibility lies not only with elected and appointed officials but also with the voters. They showed little interest in who was being elected and a great distrust of government—given the large numbers who did not vote in the local elections and the overwhelming support for tax limits and term limits among those who went to the polls. They put their elected officials in an impossible position by constraining their ability to raise revenues and continuing to demand the same or better services. When the county pool collapsed, the voters turned their backs on the problem and refused to honor the debts that were incurred to pay for those services. In some sense, the voters' actions can be seen as a breach of contract. They were not, of course, the only parties who failed to honor responsibility, considering, for example, the actions of Bob Citron, investment firms, local government and state officials, and the press. However, the voters' role signals a warning that there is a growing schism between government and governed—a disengagement on the part of citizens, if not an adversarial relationship. This disengagement can have profound implications for the future of governance and of U.S. communities.