RESEARCH BRIEF

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The Orange County Bankruptcy: Who's Next?

On December 6, 1994, Orange County became the largest municipality in U.S. history to declare bankruptcy: The county treasurer had lost $1.7 billion of taxpayers' money through investments in risky Wall Street securities. Accustomed to the "New York" model of fiscal stress in older cities with an eroding tax base, the political and financial communities were shocked. Here was a large, growing suburban area, with a reputation for affluence and conservatism, amassing a huge public debt through highly risky speculation in the financial markets and then refusing to honor its debts. Shocked as they were, most observers wrote this off as a fluke, caused by an underqualified county treasurer in a stranger-than-usual California county. It may have been a nasty surprise for Wall Street, they claimed, but not something that could happen again—even in Orange County.

In *When Government Fails: The Orange County Bankruptcy*, PPIC Senior Fellow Mark Baldassare presents compelling evidence to the contrary. In this book, jointly published by PPIC and the University of California Press, Baldassare provides the first comprehensive account of the events that led to the bankruptcy, how the bankruptcy unfolded, and how it was resolved. Orange County may have provided sufficiently dramatic warning of the dangers of Treasurer Bob Citron's kind of investment strategy to deter others from following the same path. However, as Baldassare demonstrates, the conditions and resulting imperatives that drove the county to gamble with public funds remain. As the fervor for smaller government, tax limits, and local autonomy grows and spreads, many more municipalities may find the specter of financial collapse looming—especially when the economy takes its next downturn.

The Trail Between Proposition 13 and the Bankruptcy

The immediate cause of the bankruptcy was Citron's mismanagement of the Orange County investment pool. However, he would not have been driven to strive for such high rates of return on the pool—nor would he have been able to invest as he did—had it not been for the fiscal austerity in the state that began with Proposition 13. That citizen initiative, and several subsequent initiatives, severely limited the ability of local governments to raise tax revenue. Recognizing the extreme fiscal pressure these initiatives placed on county governments, the state loosened its municipal investment rules—allowing treasurers, for the first time, to use Bob Citron's kind of strategy.

In 1994, the Orange County investment pool had about $7.6 billion in deposits from the county government and almost 200 local public agencies (cities, school districts, and special districts). Borrowing $2 for every $1 on deposit, Citron increased the size of the investment pool to $20.6 billion. In essence, as the *Wall Street Journal* noted, he was "borrowing short to go long" and investing the dollars in exotic securities whose yields were inversely related to interest rates. Unfortunately, also in 1994, the Federal Reserve Board began and kept on raising interest rates, and Citron kept buying in the hope they would decline. For reasons that Baldassare explains in detail, almost no one was paying attention to what the treasurer was doing and even fewer understood it—until the auditors informed the Board of Supervisors, in November 1994, that he had lost nearly $1.7 billion.

The Enabling Conditions

How did it happen? Why wasn't anyone watching or questioning the treasurer's activities? Was it just a fluke? Are the county's lawsuits against various Wall Street firms and institutions justified? Could it happen again?

Many people believe that the treasurer and his dealings with Wall Street constitute the necessary and sufficient conditions for what happened and that, absent a Bob Citron, it couldn't happen in their backyards. However, Baldassare's definitive reconstruction and analysis of the situation, events, and outcomes counter that belief. He identifies three key factors in the Orange County context and in the state that

created the necessary conditions for the bankruptcy and the nature of the recovery. Citron was not the cause of the bankruptcy; he was the catalyst that made those three necessary conditions sufficient.

What makes the Orange County bankruptcy significant beyond the borders of the county is that these conditions exist, to a greater or lesser degree, in counties across the state and nation. Baldassare identifies these conditions as *political fragmentation, voter distrust,* and *fiscal austerity.* The book traces how these three conditions operated before, during, and after the bankruptcy. It also suggests how they continue to jeopardize Orange County's future—even as the California economy has rebounded and the county itself is experiencing unprecedented growth and voter optimism.

Lessons Learned

Having made a compelling case for the potential threat to local governments inherent in these conditions, the book goes on to present 10 policy recommendations that may help prevent, or at least ameliorate, future county crises. Four of the more pressing reforms point to a basic restructuring of government.

Local governments need to maintain high standards for fiscal oversight and accountability. As noted in the state auditor's report following the bankruptcy, a number of steps should be taken to ensure that local funds are kept safe and liquid. These include having the Board of Supervisors 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. Local officials should adjust government structures to make sure they have the proper financial controls in place at all times.

The State of California should revise the law governing the structure of its counties. 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 emergencies. 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 chief executive officer with authority over the budget and personnel in all county departments.

State government should closely monitor the fiscal conditions of its local governments, rather than wait for serious problems to surface. The state controller collects budget data from county governments and presents them in an annual report. These data should be systematically analyzed to determine which counties show abnormal patterns of revenues or expenditures or signs of fiscal distress. State leaders should discuss fiscal problems and solutions with local officials before the situation reaches crisis stage.

Local officials should be wary about citizens' pressures to implement fiscal policies that are popular in the short run but financially disastrous over time. Distrustful voters believe there is considerable waste in government bureaucracy and that municipalities should be able to cut taxes without doing harm to local services. Local officials need to do a better job of educating voters about revenues and expenditures. 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.

State and Local Government Relations Must Change

Implicit in the above recommendations is the need to reform state and local government relations. County governments are charged with the task of providing many crucial local services. Yet Proposition 13 and its progeny have severely limited their ability to raise revenues to provide these services. The counties' ability to cope (and to some extent that of other local governments) 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. 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, Baldassare notes, should have served as a wake-up call. Yet, there has been no meaningful restructuring in state and local government relations, and the potential for another county fiscal disaster remains very real.

This research brief provides an overview of a book by Mark Baldassare, When Government Fails: The Orange County Bankruptcy. *The book, published jointly by the Public Policy Institute of California and the University of California Press, is available in bookstores or may be ordered by phone (800-777-4726) or through the Internet (www.ucpress.edu). The Public Policy Institute of California is a private, nonprofit organization dedicated to independent, nonpartisan research on economic, social, and political issues that affect the lives of Californians.*

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