CHAPTER 1

Introduction

Roots of the Bankruptcy

Orange County, California, became the largest municipality in U.S. history to declare bankruptcy when it filed for Chapter 9 protection at 4:52 P.M. on December 6, 1994. Municipal bankruptcies are rare events that generally occur only in rural places. Large cities had always sidestepped bankruptcies when their state governments came to the rescue. On that date in December 1994, the fifth most populous county in the United States, a suburban region with two and a half million residents, began an odyssey that may well rewrite the books on local fiscal crises in the United States.

This Southern California county, in between Los Angeles and San Diego, is best known as the home of Disneyland and the rich and famous who live in its million-dollar "Gold Coast" homes. It is also the unofficial capital of Republican politics, claiming Richard Nixon as a native son and electing a string of outspoken conservatives to Congress. A municipal bankruptcy was a shocking turn of events for a county with a national reputation for its affluent residents and conservative politicians.

When Government Fails provides a comprehensive analysis of the Orange County bankruptcy. This introductory chapter presents a framework for understanding the unique nature and outcome of this financial crisis. The chapters that follow delve into the underlying causes of the fiscal catastrophe. We then follow the dramatic story from the events that led up to the bankruptcy, through the local officials' response to the fiscal emergency and the road to recovery, to the local government reforms implemented in response to the crisis. This book also discusses the larger lessons to be learned from the mistakes made in Orange County and offers policy recommendations for state and local governments to avoid future fiscal catastrophes.

WHAT HAPPENED?

The Orange County government backed into a massive financial crisis in a most unusual manner. County Treasurer Bob Citron was in charge of the Orange County Investment Pool. By 1994 he had gathered about $7.6 billion in deposits from the county government and nearly 200 local public agencies. Citron had a track record of providing high-interest income to his local government investors. He boasted, "We have perfected the reverse repo procedure to new levels." He did this by borrowing money and investing it in derivatives, inverse floaters, and long-term bonds that paid high yields. Then he borrowed more money with the borrowed money. By 1994 the size of the county pool had ballooned to $20.6 billion as he borrowed $2 for every $1 on deposit. He was on a desperate mission in which he took more risks to raise more interest income for local governments that had recently seen their tax allocations cut by the state. The Federal Reserve Board kept raising interest rates throughout 1994. Bob Citron kept buying securities on the hunch that the Fed would lower rates at the end of the year.

In the spring of 1994 the challenger in the county treasurer's race issued warnings that the county pool had suffered massive losses and did not have the cash to pay back the massive short-term loans to the Wall Street firms. No one listened. Citron won reelection and kept betting on lower interest rates throughout the summer months. The Board of Supervisors and other county officials did not stop him until it was too late. By November 1994 county officials found out that he had lost about $1.64 billion in government funds through these risky investments. The county did not have the cash on hand to withstand a run on the money by the Wall Street lenders and local government depositors. County officials went into panic mode in early December. They urged and sought their treasurer's resignation. They unsuccessfully tried to sell off the risky securities. The banks that had lent Citron the money threatened to seize the securities from the county pool that they held as collateral. The county government declared bankruptcy after the first bank took this action. Their hope that the bankruptcy filing would halt other fund seizures by the Wall Street lenders proved to be misguided. The bankruptcy, however, did stop the fund withdrawals by the local government depositors. The county government, twenty-nine of thirty-one Orange County cities, all of the school districts, and most of the transportation, water, and sanitation agencies had large sums of money on deposit. Their $7.6 billion in government funds were now frozen.

The days after the bankruptcy declaration in Orange County were filled with chaos and confusion. The county supervisors were seeking a way to keep the county government functioning. They were also trying to limit the financial meltdown of the county pool, which had a real possibility of experiencing further massive losses if interest rates rose again. Officials from the schools, cities, and special districts were trying to assess the damage that would be done to their local operations by the bankruptcy. Their feelings of betrayal and distrust toward the county officials who held their money were growing. The public was venting its anger and frustration toward local elected officials, whom they blamed for allowing such an irresponsible use of taxpayer money. There were threats of a state takeover and the temporary appointment of a state trustee if the fiscal crisis in Orange County grew worse. But there was no signal that the state government would provide a bailout for this struggling county.

The Orange County fiscal crisis had many twists and turns from the dark days in December 1994 to the emergence from bankruptcy eighteen months later, in June 1996. The county's credit rating immediately fell to "junk status," and the Wall Street firms continued to sell off the billions of dollars in securities they held as collateral for the county's borrowing. A former state treasurer, Tom Hayes, was called in to manage the county pool. By late January Hayes had sold off the risky securities and established the pool loss at $1.64 billion. He set up a mechanism allowing the local governments to withdraw some of their funds from the pool on an emergency basis. In December the Board of Supervisors appointed the county sheriff and two other county officials to a crisis team to keep the county government working. They made sure that the county programs had the funding they needed and recommended a first round of budget cuts. A local financial executive, Bill Popejoy, was appointed to the new position of chief executive officer of the county government in early February. He set in motion the severe staff and budget cuts that were needed to balance the budget and made a sweeping housecleaning of the county officials who were tainted by the fiscal collapse. Three local business leaders headed up a negotiating team that arranged a settlement between the county government and the cities, schools, and special districts on how to divide the remaining county pool funds. Local governments could get most of their deposits right away, with promises to get the rest back at a later date, if they agreed not to sue the county government. This settlement plan was approved by all parties.

By March 1995 the Board of Supervisors reluctantly placed a proposal for a half-cent sales tax increase on the ballot as part of the financial recovery plan for Orange County. They had run out of other ideas to pay for the mounting debts of their bankrupt county government. A worse financial crisis seemed imminent, since there were $1 billion in bonds coming due in the summer months and no way to borrow this money. Local voters overwhelmingly defeated the sales tax increase on June 27, 1995, after a campaign that saw local elected officials distance themselves from this county ballot measure. This would create a mad scramble for another recovery plan. The governor refused to bail out the county and threatened a state takeover. The bond investors agreed to roll over the county's debts for another year in exchange for more interest earnings.

After a few false starts, a recovery plan was shaped by the county government in August 1995. They would divert tax funds from other county agencies to the general fund so they could borrow the money to pay bondholders and vendors. The local governments who lost money in the county pool agreed to wait for the county to win the lawsuits they had filed against Wall Street firms to be paid back in full. The state legislature passed the bills that were needed to divert the current 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, a year after its Chapter 9 filing. In June 1996 the county government sold the $880 million in bonds it needed to pay off its debts. The Orange County bankruptcy officially ended on June 12, 1996.

The bankruptcy is over, yet this is far from a happy ending for Orange County. The county government had to take on a crushing level of long-term debt to resolve its fiscal problems. Orange County's bonds are still rated as speculative, meaning that the county pays a higher cost for borrowing. The local governments are still about $850 million short because of the funds they are still owed from the county pool. All of this limits the abilities of the local governments to respond to current needs and plan for the future. Most hurt are the county's poor, whose services were cut during the bankruptcy and have not been fully restored. The only hope for financial recovery is if the county wins the billions of dollars in lawsuits filed against the Wall Street firms that did business with the county treasurer. That hope remains a dream as of this writing.

WHY DOES IT MATTER?

The Orange County bankruptcy is worthy of careful consideration for several reasons. First, this is the biggest municipal bankruptcy in U.S. history. Previous bankruptcies involved relatively small sums of money and took place mostly in rural locales. Never before had a local government in a large municipality taken the step of declaring bankruptcy. Nor were the amounts previously lost close to $1.64 billion.

This fiscal crisis in local government was also like no other. The bankruptcy was in a growing suburban county rather than a declining central city. It was precipitated by a risky investment strategy instead of a shortage of taxes and too much spending. The fiscal crisis had serious implications for a large number of local governments, not just one municipal government. The county government was forced to redirect existing tax dollars rather than turning to the state for a bailout. Orange County was able to exit bankruptcy in eighteen months, whereas fiscal crises usually take years to resolve.

The Orange County bankruptcy also merits scrutiny because the same problems could be repeated in other municipalities throughout the United States. Orange County is not the only municipality where local officials are searching for creative ways to increase their revenues in order to provide more public services. Many local governments are operating under tight fiscal conditions. Elected officials in numerous locales are faced with voters' demands for more public services and their unwillingness to pay higher taxes. Other local governments also have structures that allow public officials to operate with great autonomy and little fiscal oversight. It is thus important to identify the lessons to be learned from the Orange County experience.

This book seeks to fill a large void in the knowledge about the Orange County bankruptcy. There has been a blizzard of news stories about this event, but the emphasis of the media inquiries has generally been narrow. The few scholarly works on the subject to date tend to focus on the investment and finance issues surrounding the bankruptcy (see Jorion, 1995; Kearns, 1995; Petersen, 1995; Flickinger and McManus, 1996; Johnson and Mikesell, 1996; Chapman, 1996; Johnston, 1996; Lewis, 1996; Jump, 1996). So far the Orange County fiscal crisis has not generated the amount and variety of scholarly research seen following fiscal crises in big cities (see Clark, 1976; Sinnreich, 1980; McClelland and Magdovitz, 1981; Benjamin and Brecher, 1988; Liebschutz, 1991; Fuchs, 1992) or when Proposition 13 passed in California (see Sears and Citrin, 1982; Kaufman and Rosen, 1981; Laffer and Seymour, 1979; O'Sullivan, Sexton, and Sheffrin, 1995; Schwadron and Richter, 1984; Adams, 1984; Lo, 1990). Yet the size, nature, and relevance of the Orange County fiscal crisis point to the fact that an objective and comprehensive analysis of this event is needed. This book is written with the goal of providing a detailed account of the bankruptcy and its implications for a broad audience of policymakers, academic scholars, politicians, and concerned citizens.

SHOCK VALUE

The Orange County financial crisis was a surprising event for many people. The residents of Orange County, the local news media, and local elected officials were astonished to learn that their county government had declared bankruptcy. So were the sophisticated Wall Street investors, state leaders, federal officials, academics, and public policy experts. This fiscal disaster was unlike any that had been previously seen or even considered. Many observers began to wonder if this unexpected crisis could be repeated elsewhere. This book considers some of the special qualities of the Orange County bankruptcy, each of which offers an important reason to study this extraordinary event carefully.

At the outset, it is important to note that municipal bankruptcies are very uncommon events. The *New York Times* headline on December 7, 1994, "In Rare Move, California County Files for Bankruptcy Protection" (*New York Times,* 1994a), speaks to the shock value generated by a bankruptcy court filing. Although businesses and individuals commonly rely on the bankruptcy courts to sort out their financial troubles, this is not the case for local governments. The Chapter 9 bankruptcy filing was created for municipalities during the Great Depression. However, there had been only 491 municipal bankruptcies in the United States between 1937 and 1994. Since 1980 there had been 120 municipal bankruptcy filings. To place this number in perspective, there were an average of 16,000 U.S. corporate bankruptcies per year in the 1980s (California Debt Advisory Commission, 1995, pp. 49–50; *New York Times,* 1994a).

Although municipal bankruptcies are rare, a Chapter 9 filing by a large local government was unprecedented prior to the Orange County case. Before December 1994 most municipal bankruptcies involved small cities and small special districts in rural places. In 1991 Bridgeport, Connecticut, became one of the larger places to file for Chapter 9 protection, but the court ultimately disallowed the bankruptcy and ruled that they were able to pay their bills. Large cities such as New York, Philadelphia, Cleveland, and Washington have been on the brink of financial disaster, but in every one of these cases a bankruptcy filing was avoided (California Debt Advisory Commission, 1995, pp. 49–50; *New York Times*, 1994a). Financial markets had grown to accept the fact that municipal bonds were safe. Even the large and troubled local governments ended up paying their debts and escaping bankruptcy. The Orange County event thus redefined the expected outcome of municipal fiscal stress.

The Orange County financial crisis was on a scale never seen before. The county government had a budget of over $3.7 billion and had about 18,000 employees. The Orange County Investment Pool that was frozen by the bankruptcy filing was a $20 billion fund that had lost about $1.6 billion. The county government defaulted on over $100 million in bonds within days of the bankruptcy. It found itself in real danger of defaulting on over $1 billion in short-term debt within a few months. Previous bankruptcies had typically involved relatively small amounts of money.[1] For instance, the 362 filings between 1937 and 1994 amounted to a total debt for those municipalities of only about $217 million. Other estimates place the average default per municipal bankruptcy at $2 million throughout the 1970s (California Debt Advisory Commission, 1995, pp. 49–50; *New York Times*, 1994a). The Orange County case was the first instance in which there were large sums of money in a municipal bankruptcy.

Moreover, the cause of the Orange County financial crisis represented a new scenario for local fiscal problems. In sum, the county treasurer had invested local government funds in risky ways that resulted in the loss of large amounts of public money. Local fiscal stress usually occurs because a large central city is caught in a situation of rising expenditures, such as growing health care and welfare rolls, and declin-

1. The biggest previous bankruptcy involved the Washington Public Power Supply System. The issue here was the inability to pay back $2 billion in tax-exempt bonds for the construction of nuclear power plants (*New York Times*, 1994a).

ing tax revenues, resulting, for example, from middle-class residents and businesses moving out of the central city. At some point the lenders lose confidence in the central city's ability to pay its mounting debts. The investment firms did not stop lending funds to Orange County because the local tax and spending environment had changed. Orange County had one of the highest credit ratings of any county government in California up to a few months before the bankruptcy filing. The Orange County debts were the result of a leveraging of county funds to buy risky securities to create more interest income. A municipality with no outward signs of fiscal stress had brought problems upon itself.

In the past when large cities were near bankruptcy, their state governments always came to their aid. For instance, the state government would extend the city credit or provide state backing for the local government bonds when the financial markets became nervous about the municipality's ability to pay its debts. One reason state governments would act to avoid a local fiscal calamity is because they did not want to place a large number of residents at risk of losing their police and fire protection, schools, and other essential services. Another reason is that a municipal bankruptcy could have ripple effects on other local governments and even on the state's ability to borrow money. A financial adviser to state and local governments said about the Orange County financial crisis, "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" (*New York Times,* 1995a). However, the California state government did not intervene to enable Orange County to avoid a bankruptcy filing. Nor did the state government offer to lend money or back local bond offerings to end the bankruptcy. There were many reasons for this inaction, including the fiscal austerity of California's government in the 1990s. Still, the limited role of the state in this case is a major departure from the ways that large municipal fiscal crises were handled in the past.

The fact that the Orange County financial crisis occurred in a suburban region is another special quality of this event. Large cities are generally the local government entities that get into big financial troubles. Moreover, most municipal bankruptcy filings involve tiny local governments in rural areas. The suburban regions are supposed to have fiscally responsible local governments, with their middle-class residents providing a dependable revenue source. There is simply no precedent for a suburban county government encountering a serious fiscal crisis. It turns out that the suburban context of the Orange County bankruptcy had a role in generating the fiscal problems and limited the ability to have an effective early response to the crisis.

Another important attribute of the Orange County financial crisis is that it struck so many local government entities at once. In previous instances, such as in New York or Cleveland, one large city was faced with a serious fiscal problem. Once again, the fact that the Orange County event occurred in a suburban metropolitan region added a new twist. This county has almost 200 local government entities, including the county government, thirty-one cities, the regional transportation agency, the local school districts, local water agencies, sanitation districts, and many small local special districts. Almost every local government in Orange County had money on deposit in the county pool. When the Orange County Investment Pool went into a tailspin, causing the county government to declare bankruptcy, the funds of all of the local governments were also frozen. The basic public services in Orange County are provided by this large, diverse, and decentralized group of local governments and public agencies. This suburban system of delivering local services is so decentralized that it created a great deal of uncertainty about how residents would be affected by the Orange County bankruptcy. Later on, finding a solution to the fiscal crisis would be complicated by the fact that so many local government leaders would have to agree on a recovery plan.

In the past, voters in local elections had not usually been asked how they would like to resolve their fiscal crisis. All of this was to change with the Orange County bankruptcy. In places such as New York or Cleveland, local taxes and fees would be raised, and local budgets would be cut, as the city officials and state government saw fit. Nearly two decades earlier California voters had placed restrictions on their local governments' abilities to raise taxes. If a tax increase were needed for Orange County to repay its debts and emerge from bankruptcy, this would have to be approved by the local voters. The fact that the local voters had veto power over recovery plans was an unprecedented situation. This realization about post–Proposition 13 California shook to the foundations the relations between California municipalities, bond investors, and Wall Street firms. County government was forced into creative financing of the debt when the Orange County voters refused to go along with their county leaders' tax plans. The state allowed them to divert current tax funds.

The Orange County plan for full recovery is also a distinctive element of this event. When the voters said no to new taxes, the county government changed its strategy from raising taxes to suing its way out of the financial crisis. Orange County has filed lawsuits worth billions of dollars against many private firms that had financial dealings with the county government. These include the companies that sold the risky securities for the county pool and those that audited the county's finances and rated the county's bond offerings. The complete recovery of the financial losses suffered by the county government, cities, local schools, and special districts will require that the local governments all receive large sums of money from these lawsuits. This has clearly set a new precedent. There has never before been a financial recovery plan devised by local governments that places such emphasis on winning lawsuits.

The quick resolution of the Orange County bankruptcy is another special attribute of this local fiscal crisis. The county government had a recovery plan in the courts a year after it declared itself bankrupt, having reached an agreement with all units of local government in Orange County. Within a year and a half, the county government went to the financial markets again to borrow money to pay off its debts, which allowed it to emerge from bankruptcy. When the financial mess surfaced in December 1994, everyone assumed that it would be with the county for years. This perception was based on the corporate world of bankruptcies, in which claims and counterclaims can take many years to unravel. This view was shared by those who knew about the financial disasters in big cities—for instance, the fact that it was more than half a decade before New York could borrow money on its own again. That the bankruptcy had such a short life is one of the most astonishing facts in this unusual episode of municipal finance history. It is also somewhat deceiving. There will be a legacy of the Orange County fiscal crisis for many years, namely, tight county budgets, large debt payments to recover from the bankruptcy, and service cuts for the poor. The future is highly dependent on the county's winning its lawsuits to recover the financial damages.

The Orange County bankruptcy, because of all the special qualities that have been mentioned, generated much confusion when the financial emergency occurred. It was difficult to ascertain the causes and predict the local impacts. There was a great deal of uncertainty among the local leaders and state officials about how to respond to the immediate problem. It was hard to conceive of a blueprint for recovery from a large municipal bankruptcy. There was a lot of concern about the long-term consequences not only for this region, but also for the state and national municipal bond market.

THE NEW YORK MODEL

For more than twenty years New York City has offered the most dramatic example of a large municipality on the brink of financial meltdown. As a result, our thinking about the causes of and responses to urban fiscal strain have in many ways been conditioned by the New York crisis. Since the New York crisis has become the dominant model for understanding fiscal problems in big cities, I examine this event and contrast it with the Orange County bankruptcy. From a review of the details of the New York model, it becomes clear that the Orange County bankruptcy is different in many respects.

In 1975 New York City was borrowing money with short-term loans to pay for its day-to-day expenses and employee salaries. When these loans came due, they were repaid by borrowing more money in short-term loans. Eventually the banks refused to lend more money without an outside guarantee of payment and better fiscal management. The state of New York intervened by creating agencies that guaranteed the city's loans and imposed tighter fiscal controls on city government. The federal government initially balked at a financial bailout but ultimately loaned the city $2 billion (Clark, 1994b). New York City was unable to enter the credit markets on its own again until the early 1980s.

Over the years many have reached the conclusion that New York City's problems were caused by demographic and economic changes. For instance, the migration of about one million poor blacks and Puerto Ricans to the city had raised the city's expenditures for schools and public assistance. At the same time, manufacturing jobs and the white middle class were fleeing to the suburbs, which depleted the city's tax revenues. Other scholars claim that the public employee unions and attempts to manage political and social conflicts had resulted in severe overspending (Shefter, 1985).

When other large cities had serious financial problems, they resembled the New York experience. These included the cities of Cleveland, Chicago, and Philadelphia. When these problems arose, demographic changes and economic decline were again cited as causes. The serious gaps between increased spending for the poor and the declining tax revenues from the middle class were also noted. In Orange County the problem was a loss of funds from risky investments rather than demographic and economic changes.

When other big cities faced fiscal problems, they followed New York's lead and turned to the state government for help. An official from Moody's Investors Service notes, "While states are not on the hook to secure local debt issues, other states have nevertheless stepped up in cases of adversity. New York State was quite active with respect to New York City's recovery after its 1975 default, the State of Ohio was directly involved following the 1978 default by Cleveland, and the creation of the Chicago School Finance Authority and the Philadelphia Intergovernmental Authority represents significant state responses to local fiscal crises" (Senate Special Committee on Local Government Investments, 1995d, p. 40). The state offered no such aid to Orange County.

Moreover, New York and other big cities faced long-term borrowing problems. The same official from Moody's noted, "New York City did not borrow on its behalf for six years after 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, 1995d, p. 43). By contrast, Orange County returned to the credit market to repay its debts within eighteen months. The bankruptcy attorney for the county government said, "The conclusion of the Chapter 9 case by the end of the year . . . in terms of the history of comparable corporate cases would constitute light speed" (Senate Special Committee on Local Government Investments, 1995e, p. 18).

In the New York crisis and those facing the other big cities, Chapter 9 filings were always avoided because of state actions. When Orange County declared bankruptcy, the investment firms struggled to comprehend the meaning of this radical change. An official from Standard & Poor's noted, "Through bankruptcy filing, county officials sent the message that they did not necessarily intend to repay all the county's obligations. . . . Bankruptcy and default would probably become more common for local officials" (Senate Special Committee on Local Government Investments, 1995d, pp. 47, 49). An official from the Franklin Resources investment firm added, "The phrase 'full faith and credit' really does mean something to the individuals and firms that create the markets. . . . The benefits that state and local governments derive from it are based on a tradition and bond of trust between the lender and the borrower" (Senate Special Committee on Local Government Investments, 1995d, p. 18).

The Orange County crisis does not fit the New York City model. This was not a problem created by demographic and economic changes, out-of-control spending, or a large drop in tax revenues. It was not solved by state aid. An official from Moody's Investors Service observed, "In the case of New York City, they had borrowed six billion more than they had. . . . I would distinguish New York City from Orange County in the sense that . . . Orange County had the ability to pay. The perception was never that New York City had the ability to pay" (Senate Special Committee on Local Government Investments, 1995e, pp. 32–34). In sum, we need to look elsewhere than New York to understand the causes of and solutions to the Orange County crisis.

THE ROGUE TRADER

To understand the causes, events, and implications of the bankruptcy, it is essential to realize how far back the roots of the crisis go. This will dispel some of the myths about the causes and identify the conditions that both enabled and complicated the crisis, the recovery, and Orange County's future prosperity.

The genesis for the Orange County bankruptcy dates back more than fifteen years. In 1978 the state's voters passed Proposition 13, which imposed strict limits on property tax increases and the abilities of local governments to raise taxes. These actions had a crippling effect on county governments, which relied heavily on property taxes as a revenue source. Counties survived only because of a state bailout. After the passage of Proposition 13 county governments were in a frantic search for new nontax revenues, since their property taxes were cut and their voters would not pass tax increases. The state passed a series of bills that deregulated the investments of county treasurers. This would allow local governments to make more money with the funds they had on deposit. They gave county treasurers, such as Bob Citron, permission to borrow money and invest in risky securities. In Orange County local officials became accustomed to living off the interest income of the county pool. They relied on Bob Citron to solve their fiscal problems. His actions led the county and local governments into deep trouble.

The first myth to dispel is that this fiscal tragedy was solely the result of this "rogue trader" named Bob Citron. This belief led some observers early on to conclude that the Orange County crisis has little relevance to other places. This is a dangerous point of view that avoids a more thorough analysis of the structural context of the financial crisis. It prevents us from learning anything from Orange County's mistakes.

In fact, Bob Citron was the catalyst of the Orange County financial crisis. His risky investments put the county in jeopardy. However, the county treasurer's actions took place because certain conditions were present to an extreme degree in Orange County during the early 1990s. Other municipalities and suburban regions today share the qualities that were present in Orange County. The problem could thus be repeated elsewhere, if a catalyst and the same conditions exist.

We have all heard about rogue traders who have wreaked havoc on the financial institutions they represent. These are usually stories about individuals working within private firms. For instance, a few years ago Nick Leeson brought down the Barings Bank of London through his risky investments in the Singapore financial market (Leeson, 1996; Fay, 1996). In the case of Orange County, it was a public official named Bob Citron who was involved in financial wrongdoing. The only lesson to be learned from focusing solely on the rogue trader theory of the Orange County crisis is that greedy people commit illegal acts, which are ultimately uncovered and then punished. I do not intend to minimize the importance of Bob Citron and his actions. Certainly, the huge losses and county bankruptcy would not have occurred without him. The fact is, however, that his actions occurred within a particular institutional setting. Although his risky activities may have represented an inappropriate use of public funds, they were legal according to the state's laws. There was no evidence that Bob Citron was personally profiting from the securities transactions. The Orange County treasurer did commit crimes, but they involved the misappropriation of profits and losses from local governments to the county fund, rather than the risky investments that led to the fiscal meltdown.

By dispelling the myth that the "rogue trader" was the only reason for the fiscal collapse, we focus on the fact that the individual's actions that led to the bankruptcy did not occur in a vacuum. The county treasurer's position was a virtual fiefdom of unchecked powers within the politically fragmented structure of county government. The state government had loosened the restrictions on investments and reporting to such an extent that Bob Citron was allowed to engage in excessive leveraging and the purchase of derivatives. State leaders created this lax environment in response to the financial burdens that the state and local governments faced after Proposition 13. In addition, many local elected leaders approved of his "high risk, high yield" strategy. The interest income from the county investment pool gave the county, cities, and special districts a needed source of revenues. Local elected officials placed pressures on the county treasurer to increase the interest income because the voters placed pressures on them by following a fiscal agenda that included their reluctance to approve new taxes. The state government also provided the motivation to increase the amount of interest income when it began appropriating a larger share of the property tax funds from local governments in the 1990s. In this book I argue that several factors help to explain why the risky actions of Bob Citron were allowed and even encouraged to take place against a backdrop of increasingly dire warnings that his actions would lead to a financial disaster for local governments.

THE REAL ORANGE COUNTY

Another myth that I seek to discredit is that Orange County is an atypical place that has no bearing on the rest of America. A common conclusion drawn from this perspective is that the financial crisis might offer lessons for those in Orange County, but not for anyone else. Thus the dangerous idea is born that bankruptcy is an irrelevant event.

Orange County is often described as a wealthy white suburb. This has led to the belief that this government bankruptcy was a case of rich people gambling and not wanting to pay their debts. Their personal wealth would insulate Orange County residents from any real consequences of the huge losses of local government funds.

Orange County's population is, in fact, more typical than its national image. Most Americans live in suburban regions that are similar in many respects to Orange County. The vast majority of Orange County's 2.5 million residents are not wealthy; they are people who are solidly in the middle class. Many have invested their life savings in owning a home and are financially struggling to pay their monthly bills. They moved to suburbs that were supposed to provide good schools, nice neighborhoods, public libraries, and police protection. The county can no longer be described as racially homogeneous and white. After a large foreign immigration in the 1980s and 1990s, Hispanics and Asians make up about a third of the population. There are large numbers of residents living in poverty. The newly arrived depend heavily on the health care and social services that are provided by the county government. A county bankruptcy would have serious consequences for these groups.

Orange County's politics are often viewed as being far to the right. This is largely a result of its strongly Republican voting patterns and the election of several outspoken conservative legislators. The fact that the local residents did not support a tax increase for the bankruptcy recovery was thus dismissed by some political observers as a response by extremists that would not be repeated elsewhere. This is another reason given as to why the Orange County crisis should be viewed as out of the mainstream.

However, the average Orange County resident is not a political extremist. The vast majority of residents there describe themselves as moderate to somewhat conservative in political orientation. Their policy preferences show a pattern of conservatism on fiscal issues and liberalism on social issues. They oppose welfare spending, favor tax cuts, and do not want the government to interfere in the private decisions of its residents. They are distrustful of elected officials and especially doubtful of their fiscal management skills. Orange County voters have supported tax increases when they thought they were needed, and they have opposed new taxes when they thought the money would not be put to good use. Orange County voters reflect the political ideas and distrust of government leaders expressed by many middle-class residents throughout the United States today.

When we accept the fact that the Orange County crisis happened in mainstream America, and is not solely the fault of a rogue trader, the need to fully explore the bankruptcy takes on a greater sense of urgency. The ultimate purpose of this book then becomes an effort to understand the elements of the financial crisis that have relevance for other U.S. cities and suburban regions. Our attention turns to the conditions that led up to the bankruptcy. Only through a detailed understanding and analysis of each of the conditions that led to this unexpected financial crisis can we identify the specific lessons that can be learned from the Orange County bankruptcy.

THREE CONDITIONS THAT ENABLED THE BANKRUPTCY

Three factors are at the heart of the Orange County financial crisis: the political fragmentation in local government, voter distrust of local government officials, and the condition of fiscal austerity in the state government. These are not unique factors; each can be found in many U.S. locales. What is different is that they were all present, and in strong degrees, in Orange County during 1994.