

The crisis in local finance: Orange County was no lemon

by Marcia Merry Baker

The question of, "What next, after Orange County?" was taken up at hearings on July 26-27, in the Subcommittee for Capital Markets, Securities, and Government Sponsored Enterprises of the House Banking Committee in Washington, D.C.

Although these sessions received little or no publicity, the picture presented by the 20-plus witnesses, shows that U.S. state and local debts add up to \$1.2 trillion nationally, and hundreds of the 50,000 entities backing this debt are at risk of undergoing shutdown of the physical-economic necessities of the regional economies (water, transit, health and education services, etc.) The entities concerned include counties, towns, irrigation districts, and state pension funds.

This is thus a "national" debt crisis, occurring at the local level, where, among other reality checks, you can't print money to paper over the crisis.

In other words, the bankruptcy of Orange County, California was no "lemon"—that is, one bad location in an otherwise good situation. There are financial blowouts popping up everywhere in state and local government finances. The Conservative Revolutionaries may choose to ignore this, as they did this summer in the federal budget debates, grandstanding about shifting federal government functions to the state and local level (block grants for discretionary use by local governments, etc.). But events are proving them to be idiots.

In December 1994, Orange County, California disclosed \$1.7 billion in losses in its municipal funds pool, and on Dec. 6 it declared Chapter 9 bankruptcy—the largest municipal bankruptcy in U.S. history. Six months later, voters there turned down a referendum to increase sales taxes to pay Merrill Lynch and other creditors.

Orange County (where 1 in 100 Americans lives, and

with a gross household income larger than some nations), is just the most dramatic example of local financial crises occurring all across the country. During summer just three years ago, the state of California itself was paralyzed in a budget crisis, and issued scrip for weeks to employees and creditors.

There is no "Shangri-la County," where all is safe and happy. The same week as the congressional hearings, the state of Hawaii announced a severe fiscal crisis. Gov. Ben Cayetano reported on shortfalls in state funds, and mooted plans to eliminate two of Oahu's four school districts, and make other drastic cuts.

Also in July, Mobile, Alabama shut down its city bus system; Birmingham made extreme cuts in transit.

However, at the annual meeting of the National Conference of State Legislators July 15-20 in Milwaukee, investment broker spokesmen were on hand at a seminar on financial management, trying to deny the existence of any systemic financial crisis. They even praised financial derivatives as a hedging tool for "sophisticated" public officials, though a list of losses from derivatives totalling \$3.073 billion by public entities (counties, pension funds, schools, irrigation districts) was circulated.

Subcommittee Chairman Rep. Richard Baker (R-La.) said on opening the hearings, "Orange County is the most notable, but clearly it is not the only municipality to incur problems. Large cities, such as New York, Cleveland, and Philadelphia, have had severe financial problems. The reason I called these hearings is to examine the municipal finance markets and see if recent events are isolated occurrences, or are trends beginning to develop. . . . These are not 'derivatives' hearings. . . . These are not 'Orange County' hearings."



A school building in Flint, Michigan. School districts around the United States are being squeezed dry, as the debt burden rises and the tax revenue base falls.

What the information made available at the hearings showed, is that a high percentage of the \$1.2 trillion state and local debt is associated with essential hard and soft infrastructure systems across the country—safe water and sewerage, public health (county hospitals and clinics,) roads and bridges, school districts. Therefore, the question of the solvency of states and localities is not merely a financial matter; it is a question of the physical economy of the country.

Ignoring reality

The majority of the witnesses at the hearings avoided this reality factor. Therefore, the proceedings turned out to be a forum for agents of the Wall Street financial crowd—Moody's, Standard and Poors, law counselors to investors—to demand that Congress guarantee their interests at stake in municipal finances. As the Congressional Research Office described the financial investors' concerns, in a July 12 pre-hearing memorandum to the subcommittee on the implications of Orange County's December 1994 declaration of bankruptcy: "The concern seems to be that many local governments will decide that stiffing one's creditors, even when one has the capacity to pay, will become a preferred policy of local governments."

The Wall Street witnesses asked for legislation to require mandatory disclosure by municipalities of their financial condition (heretofore not as stringently required as for non-governmental entities), and for measures to prevent localities from voting down taxes with which to pay Wall Street bondholders and other creditors.

No financial witness dared use the term "debt moratorium," but instead said that under no account must citizens be given the power for "debt invalidation" (the term used by Moody's).

The following are selected quotations from witnesses at the hearings, under subtopics supplied by *EIR*.

Documentation: the scope of problem

Richard H. Baker (R-La.), *chairman of the House Banking Committee Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises:*

Big money in municipals. "The size of the municipal finance market is evidence enough of why this is such an important topic; the *Bond Buyer* reported that during 1994, local and state governments raised over \$204.4 billion in long- and short-term debt (July 6, 1995). Paving roads, building schools, and maintaining our ports are just a few examples of capital projects financed by municipalities in the bond markets."

Christopher A. Taylor, *executive director of the Municipal Securities Rulemaking Board:*

Municipal securities market is vast. "In the United States, there are approximately 80,000 state and local governments, about 50,000 of which have issued municipal securities. The market is unique among the world's major capital markets, because the number of issuers is so large—no other direct capital market encompasses so many borrowers. Issuers include states, counties, special districts, cities,

towns, and school districts. Total municipal debt outstanding through the first quarter of 1995 is approximately \$1.2 trillion. Municipal securities are issued to finance capital projects such as transportation, education, hospital, housing, public power, and water and sewer systems. . . .

“General obligation bonds—bonds secured by the full faith and credit of an issuer with taxing power—have been considered to be the most secure of all municipal issues because government have the power to levy taxes to meet payments of principal and interest. . . . When municipalities with a large amount of outstanding general obligation debt are faced with financial difficulties, most have taken steps to stave off default in order to avoid the stigma of default and bankruptcy and to allow access to the capital markets at a reasonable cost in the future. . . . Indeed, state-created agencies have allowed troubled municipalities to work out their financial problems under state supervision while assuring bondholders that they will be paid any amounts owed to them.

“For example, in 1975, New York City was unable to meet its short-term obligations and was unable to market its debt. The state created a financing authority, the Municipal Assistance Corporation, which was designed to have a dedicated source of revenue. . . .

“In addition, the City of Philadelphia faced severe financial problems in 1991. With a large long-term operating deficit, and short-term notes about to mature which the market indicated could not be refinanced, the city faced the prospect of declaring default. The state stepped in. . . .

“The Board has been viewing the events in Orange County with interest. It is too early to tell if Orange County is an isolated incident or the beginning of a fundamental change in how municipalities view their commitment to general obligation bondholders. . . .

“Indeed, other issuers in California have already incurred negative effects from the actions of Orange County. It was recently reported that several counties in California have had difficulty selling notes this summer and have had to pay higher interest rates to generate sales. In particular, one recent offering of short-term notes (which went on the market the day after Orange County residents defeated the tax increase) could not be sold without the issuer obtaining credit enhancement in the form of a letter of credit.”

Bond Investors Association (*in testimony of James E. Spiotto, partner, Chapman and Cutler*):

Defaults are increasing. “One group that compiles default statistics, the Bond Investors Association, reports that during the first half of this year, there have been 26 disclosed defaults in the municipal market totaling \$745 million. This is as compared with the \$451 million in defaults the Association found during the first two quarters of 1994. The Association has indicated that, by comparison, the total amount of corporate bonds that went into default in 1994 was approxi-

mately \$3.8 billion. This same group reported \$1.7 billion in new corporate defaults in January of 1995 alone.”

Gaddi H. Vasquez, Orange County Supervisor:

It's difficult. “On Dec. 6, 1994, Orange County, California, filed for protection under Chapter 9 of the bankruptcy code in an effort to stabilize a fiscal crisis that threatened the economic stability of our county. We are now experiencing one of the most difficult times in our country's history, by virtue of the financial collapse of the Orange County Investment Pool, and the loss of \$1.7 billion to the pool. All of the county's funds were deposited in the Orange County Investment Pool and suffered a loss of \$650 million. The school districts, special districts, and cities who invested lost \$1.05 billion. The consequences have included a dramatic reduction in the county budget as well as the reduction and/or elimination of services. . . . Our workforce has been reduced by 1,488 employees.”

Find some 'bad guys' to blame

William J. Popejoy, designated Feb. 21, 1995 as Orange County's first CEO:

Pin it on the local fallguys. “As a 15-year resident of Orange County and someone who has a background in finance, including derivatives, I was astounded and angry that my county had been allowed to ‘bet the bank.’ I wondered how a county government could get itself into such a mess. And while financial leverage and the use of derivatives might be acceptable for high-risk portfolio managers, such strategy had no place where the public tax money was involved. . . . And how could the senior governing body—the five elected supervisors of Orange County—allow this foolishness to take place?”

What does Wall Street want?

Daniel N. Heimowitz, Moody's Investors Service, Inc.:

Give us more information. “Moody's has for almost 90 years published rating opinions and now maintains 56,000 ratings on 22,000 issuers of municipal debt. . . . Orange County was perceived as financially strong and sophisticated and otherwise responsible and well-managed. . . . The Orange County investment experience has altered beliefs and practices in the market. . . . [We are now] requiring changes in the information that all issuers and their financial professional must provide.”

James E. Spiotto, partner, Chapman and Cutler:

Get rid of the tax cap. “The investment losses suffered by Orange County are best attributed to the desperate efforts of a revenue-starved municipality which had faced shrinking revenues in relationship to expanding costs because of a constitutionally imposed tax cap (Proposition 13.) The difficulty with an artificial and unrealistic tax cap and similar constitutional limits on taxation is that there are certain municipal

services that are required and expected by the citizenry.”

Mark P. Petracca, Ph.D., professor of political science at University of California, Irvine:

Find new “income streams,” for localities to raise revenue and pay creditors. “The one area where greater federal activity seems appropriate relates to the Securities and Exchange Commission. The capacity and propensity for investigation of bonds relating to the provision of municipal services, school districts, new residential and commercial development, and the privatization of formerly public services (such as toll roads) must be encouraged and enhanced.”

William J. Popejoy, designated Feb. 21, 1995 as Orange County’s first CEO:

Shuffle the local officials. “Change the organization of Orange County government from its current form of five supervisors (each, in effect, a CEO) with an elected treasurer, assessor, and auditor-controller, none of whom are directly supervised by the Board of Supervisors—to a functional organization that is more conducive to accountability and that is based on ability.”

Override the local voters

Robert Dean Pope, Hunton and Williams, Richmond, Virginia:

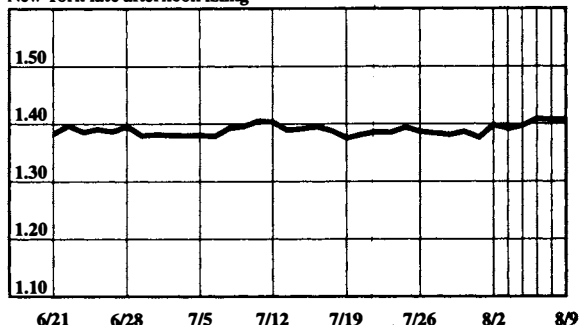
“There have always been opportunities for municipal borrowers, through bankruptcy or other proceedings, political and legal, to evade or delay the payment of their general obligation borrowings. Fortunately, few have ever attempted to do this. But Orange County clearly raises that concern in investors’ minds. An editorial in the *Financial Times* on June 29, 1995, noted, somewhat sarcastically, that the ‘willingness of voters in Orange County to risk their municipality defaulting on its debts is a fine old American tradition.’ ‘The lesson,’ the editorial concluded, ‘is that lending decisions must now focus as much on the willingness to pay as on the ability to pay. In a nation with a strong and growing anti-tax, anti-government sentiment, willingness to pay may no longer be axiomatic.’

“That is perhaps an exaggerated comment, written by an editorialist who lives in England, where investors have elephant-like memories, as the State of Mississippi discovered several years ago when it found out that its ability to borrow funds in London was impaired by the fact that investors still remember Mississippi’s last default—which took place well before the Civil War. The view expressed by the *Financial Times*, however, should not be ignored. If Orange County remains an isolated case, the damage, while real, is likely to be limited in time and in location. If instead municipalities regularly test the limits of the law in avoiding or delaying their obligation to pay and if state governments and courts do not punish them for such transgressions, all of us will pay higher local taxes to reflect higher borrowing costs.”

Currency Rates

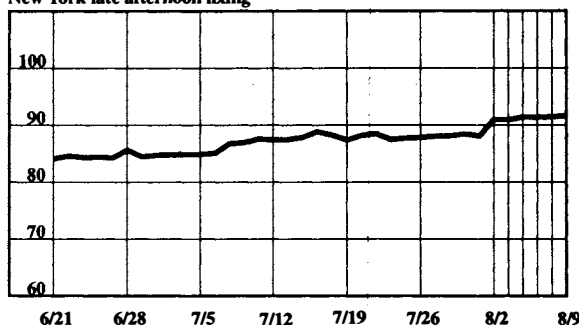
The dollar in deutschmarks

New York late afternoon fixing



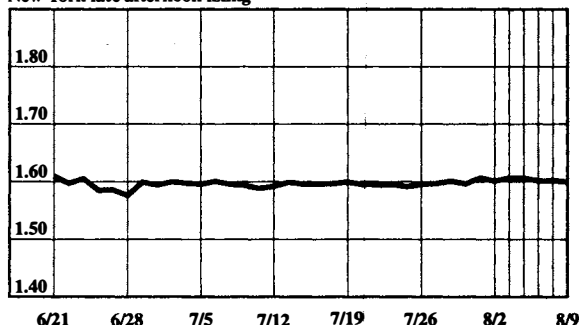
The dollar in yen

New York late afternoon fixing



The British pound in dollars

New York late afternoon fixing



The dollar in Swiss francs

New York late afternoon fixing

