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California Cities Keep Declaring Fiscal ‘Emergencies,’ and Investors Are in on It.

Communities in the Golden State are using a loophole and citing financial distress so they can put new taxes on the ballot. Pasadena is exploiting it to tax pot.

The phrase may trigger images of desolate streetscapes and fiscal pain, or evoke a new risk for investors who buy municipal bond funds in search of tax-exempt income. But for many Golden State cities, the words signal opportunity. Because of rules designed to limit tax increases, cities can get proposed tax hikes on Tuesday’s primary ballot only by declaring a crisis. At least two have done so this year, following at least 50 since 2008. Muni bond investors and analysts are in on the ruse—in many cases giving it the equivalent of a shrug. To get a tax question before voters this week, Santa Cruz has issued such a declaration for the third time in 13 years. Over that time, the Monterey Bay beach town’s bond rating has improved.

Unlike other states, which lay out a process for a town to be deemed in distress, California leaves it to municipalities themselves to determine. There’s no checklist or external agency deciding whether a situation meets the layman’s understanding of the words “fiscal” and “emergency.” And there are few consequences. Pasadena, the triple-A-rated home of the Rose Bowl, declared a fiscal emergency so it can ask voters on Tuesday to approve a cannabis tax. Otherwise the palmy town north of Los Angeles, where tourists stroll past Victorian estates and historic landmarks, would have to wait for the 2020 election.

“They’re nowhere close to being insolvent or threatening to file for bankruptcy,” says Eric Friedland, director of municipal research for Lord Abbett, which manages about $20 billion in municipal bonds, including for a mutual fund that specializes in California debt. “This is more of brinkmanship.”

In California, government needs often run up against strong anti-tax rules that began with Proposition 13, a landmark decision by voters in 1978 to limit property tax hikes. Then, as cities turned to fees and other levies, voters 18 years later passed Proposition 218 to ensure those were subject to their approval as well. Now a town that wants a new general tax or a targeted increase can ask voters only during an election in which the members of the governing body are running. The exception: when there’s a unanimous vote by a governing body declaring an emergency.

No agency tracks the declarations, but after the last recession there was a spate from Colusa County to Los Angeles, according to Moody’s Investors Service. Eric Hoffmann, senior vice president at Moody’s, calls such moves a “pinkish flag.” A fiscal emergency may actually show that a city is heading off a crisis, he says.

That’s partly the case for Santa Cruz officials, who anticipate a gap of as much as 11 percent of the general fund in fiscal 2022 as revenue slows and costs such as pensions rise. They’re asking voters to approve a sales tax increase to 9.25 percent from 9 percent. The referendum normally would have gone before voters in November, says Marcus Pimentel, the city’s finance director. But because the county may float a tax to address housing at that time, the City Council declared an emergency to get its ask considered in June. “They didn’t want to put anything that risked voter fatigue on tax measures for November,” says Pimentel. Even though it’s the third time the city has pulled the maneuver, its bond rating remains a strong AA. “It really doesn’t impact our rating like somebody defaulting on their home on a credit report,” he says.

A consultant eased Pasadena’s concerns that its first emergency would hurt its AAA rating from S&P, says Finance Director Matt Hawkesworth. With recreational marijuana legal in California as of January, the city has to pay to regulate the industry. “We don’t have the financial resources to support the work that we’re required to do,” he says.

Cities are abusing the system, says Jon Coupal, president of the Howard Jarvis Taxpayers Association, which pushed for the restrictions on tax increases. “Patently inappropriate,” he says of Pasadena’s move in particular. “Very rarely is there a true emergency.”

In other states, a municipal fiscal emergency is a grave event. Michigan can install emergency managers with sweeping power to overhaul finances and services. Their decisions can be momentous, for better or worse. The state-appointed viceroy in Detroit pushed a plan to leave a once-record bankruptcy that cut pensions and payments to bondholders. But cost-cutting decisions by an emergency manager in Flint led to the city’s drinking-water crisis in 2014. New Jersey took over the finances of the seaside resort town of Atlantic City in 2016, yet it remains at risk of bankruptcy.

In California, an emergency declaration can also allow a municipality to skip an outside evaluation of its finances and file immediately for court protection. San Bernardino did just that in 2012. But cities that aren’t intent on filing for bankruptcy with their declarations must contend with reputational risk and local ire. At a recent meeting in Moraga, a quiet San Francisco suburb where the typical home sells for $1.3 million according to Zillow, council members discussed fury from their residents. Last year they declared a fiscal emergency when the costs of a sinkhole and a bridge failure drew down their savings. Even as they rescinded the action, most of the members continued to insist it was the right move.

“We had everything but the locusts attacking us at that moment,” said Vice Mayor Teresa Onoda during the meeting.

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