CONCRETE THOUGHTS

Nailing the Albany Amoeba to the Wall

As state bumbles toward a budget, what you should be concerned about and why

EXECUTIVE SUMMARY:

- Dysfunction in Albany affects New York City's real estate markets by impacting taxes and the psychology of investors.
- State spending cuts are necessary to avoid raising taxes even further.
- State tax increases will only add to the federal tax burden, which includes the sunset of Bush tax cuts and the rise in the capital gains rate.
- Legislators in Albany need to step up and make tough spending decisions. Don't hold your breath.

In high school biology, we learned that one of the simplest forms of life is the amoeba. An amoeba is a one-celled protozoan characterized by a granular nucleus surrounded by a jellylike mass—a spineless life form. It appears Albany is overrun by amoeba, as legislators are proving incapable of making difficult decisions relative to our state budget, which is nearly three months past due.

One of the most frequent questions I am asked when I encounter Concrete Thoughts readers is why I focus on New York's political landscape and the happenings in Albany. The answer is simple: From a business perspective, and, more myopically, from a real estate perspective, what our Legislature does dramatically impacts our economy. It also significantly impacts the psychology of participants in our marketplace. Clearly, the more optimistic participants are, the more activity there will be; and, as intermediaries, we rely on transaction volume for our livelihood.

Robert Knakal
Columnist

Among the biggest concerns today is the political dysfunction that we are seeing in Albany as we approach three months with no approved state budget. Without a state budget in place, municipalities are unable to set their own budgets with confidence, as the level of the state's contribution is uncertain.

Something that has unfortunately become apparent in our state is the lack of political will to tangibly address spending cuts. The fiscal irresponsibility demonstrated by Albany in last year's budget (where spending was increased over the prior year by the full $7 billion in stimulus funds, plus an additional $4 billion in new spending) has our present spending level $11 billion higher than in 2008. When spending initiatives are expanded within, or added to, a budget, it has become nearly impossible to remove or reduce them. This fiscal irresponsibility has left the state facing a $9.2 billion budget deficit.

Not surprisingly, tax revenues have been lower than expected, which has added to this budget deficit. Consequently, spending cuts are necessary in order to avoid increasing taxes even more than expected. New Yorkers are already burdened with the highest tax levels in the U.S. Governor Patterson has had to implement weekly emergency budget extenders in order to keep the government open for business and provide services to New York residents. Imbedded in last week's extender were hundreds of millions of dollars in spending cuts. Although it was approved by the entire Senate, some individual Democratic senators this past week indicated they would rather shut the government down than agree to further spending cuts.

On June 14, the Legislature will vote on another extender, this one with hundreds of millions of dollars of additional spending cuts. With health care and education making up more than 50 percent of the New York State budget, politicians must have the intestinal fortitude to deal with the ire of the unions that dominate these two sectors. Governor Patterson has had the will to address spending reductions in these areas, as he is not running in November. The unfortunate reality is that most politicians care more about getting reelected than about doing what's necessary. Hence, the impasse on getting a budget approved.

Unfortunately in Albany today, legislative malpractice is only surpassed by economic illiteracy. Common sense would dictate that budget cuts are necessary. You know, the same type of expense cuts that businesses and individuals have found unavoidable during this economic downturn. Without the will to cut spending, there is likely a better than 50-50 chance that there will be no budget resolution before the elections in November.

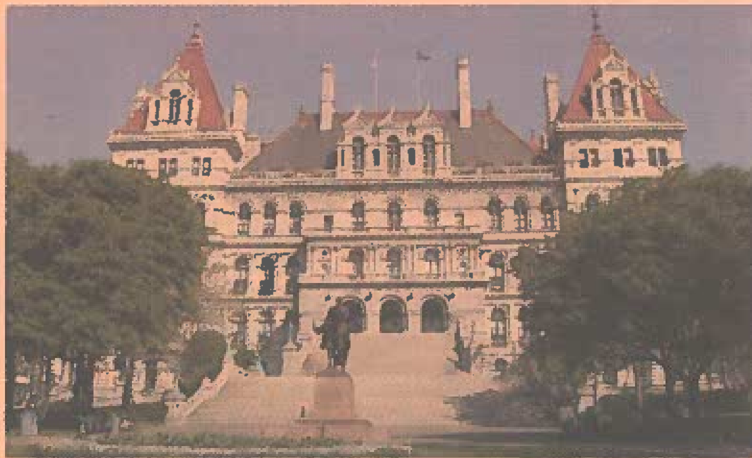
That is, of course, unless our legislators decide to put us into an even deeper hole by borrowing more money to meet current obligations. In one proposal, the state government will borrow money from the state pension system to pay obligations to—you guessed it—the state pension system. This shell game is the real estate equivalent of increasing mortgage borrowing on a building that is severely underwater to make current mortgage payments. Ultimately, losses just become larger and obligations are passed on to someone else. The state pension system is grossly underfunded already, even taking into consideration the fallacy of an expected annual return of 8 percent on its assets.

To address spending reductions, advances have been made to the unions to either delay raises, furlough workers or share in compensation concessions to help get through these difficult times. Is it any surprise that these advances have been met with staunch resistance? Clearly, union officials would rather see layoffs than accept positions that would negatively impact members universally. After all, fired union members don't vote in union elections. If concessions are agreed to, disgruntled union members would still be voting.

Therefore, without union cooperation, it is logical to anticipate significant job losses in the public sector moving forward. These cuts, while painful, may be necessary to bridge budget gaps. But will elected officials be willing to make these tough decisions?

No one ever said being a politician was an easy job. Tough decisions need to be made, as running a city or a state is no different than running a business. Expenses must correlate to revenues. Otherwise, revenues need to be increased or expenses need to be cut, or a combination of both.

Many people have said that revenue increases will put New York State at such a competitive disadvantage that it would create a classic negative feedback loop whereby our revenue will continue to erode. An example of this dynamic was observed in the mid-1980s when the state capital gains tax—i.e., the Cuomo tax (Mario, not Andrew)—was increased by an additional 10 percent on any capital gain from the sale of real estate with a price more than $1 million. The purpose was, of course, to raise revenue. Remarkably, after this tax increase was repealed, the gross tax collections actually rose significantly due to the increased transaction volume that occurred.



As we enter campaign season and the November elections draw near, we will all be receiving calls from potential candidates seeking campaign contributions. When I receive calls from these candidates, I ask for a response to one very straightforward question, and that is, "On what three specific budget line items would you be willing to reduce spending?"

Of course, the first, Pavlovian response for any politician is to say that "waste" will be cut. After dismissing this politically benign response, I again ask for three specific areas in which the candidate would be prepared to make cuts. Most often I hear, "I'm not prepared to address that." The response to this question informs us as to the tack the candidate will take relative to the budget. If the response is, "I would prefer to look at the revenue side," we know tax increases would be supported by that candidate. These tax increases would include increases in real estate taxes and personal income taxes. In last year's budget, the Senate approved an unbelievable 137 new or increased taxes, fees and charges. This year, there will be no $7 billion in federal stimulus, making the challenge to meet operating expenses that much more difficult.

Any tax increases implemented on a state level will only add to the growing tax burdens on New Yorkers due to increases in federal tax obligations. The Bush tax cuts are expected to sunset at the end of this year. Personal income taxes will go up significantly, but more important from a real estate market perspective, the capital gains rate will increase from 15 percent to 20 percent. Additional increases in the rate due to Obamacare will result in capital gains rates of nearly 25 percent.

We have already seen some clients deciding to sell properties in 2010 because of the anticipated increases in capital gains rates next year. We are also seeing clients deciding to sell properties now due to the proposed increase in taxes on carried interests.

Carried interests are often a form of compensation that promoters or developers receive when structuring partnerships with passive equity investors. Here, the tax rate is scheduled to go from a capital gains rate level to, essentially, ordinary income levels. This is a byproduct of the present proposals on financial regulation in Washington that are pending in the Senate. Any activity that is taxed at higher rates will experience a reduction in the level of that activity. This would have a deleterious impact on our commercial real estate market.

The passing of Obamacare will also have negative implications for our real estate market (I am not making any commentary here on the social benefits of this program, simply the impact on commercial real estate). Those who support the program insist that the law will significantly benefit small business through a tax credit. In reality, the tax credit is very limited due to the fact that more than two-thirds of small businesses fail the first three of the four tests to qualify: (1) having 25 employees or fewer; (2) providing health insurance; and (3) paying 50 percent or more of the cost.

More importantly, the credit is temporary but the increased health care costs are permanent. When this credit burns off, small businesses will be holding the bag for the entire cost. Under the program, employers

will also be required to pay new taxes and new fees and deal with administrative mandates buried in the voluminous new health care law. Just a few months after the law's passage, the Congressional Budget Office projected that the program will cost $150 billion more than originally estimated, eliminating the phantom deficit-reducing benefits proponents espoused. Such government programs typically cost multiples of original estimates.

With the specter of increased taxes and cost looming over the heads of small-business owners, job creation and decisions to lease space or buy property will clearly be affected. Uncertainty is the thing that marketplaces dislike the most. There is so much political and economic uncertainty at the moment that definitive policies in Albany could significantly help the psychology of market participants moving forward. We should encourage policy makers in Albany to make the tough choices necessary to provide a balanced budget and to provide some certainty for our local economy moving forward.

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Ask politicians and political candidates what they are doing to cut expenses. Increased taxes will not benefit New York's economy or New York's real estate market in the short, medium or long term. Sustainable modifications to our budget that set a clear direction are desperately needed. Tough decisions need to be made. Let's hope our legislators in Albany are up to the task.

rknakal@masseyknakal.com

Robert Knakal is the chairman and founding partner of Massey Knakal Realty services and in his career has brokered the sale of more than 1,075 properties, having a market value in excess of $6.4 billion.

THE LOBBY

Cushman's New Client CEO

Cushman & Wakefield hired from within for a new position, chief executive of client solutions. **John Santora**, president and CEO of the brokerage giant's Americas region since mid-2008—and, before that, Cushman's global COO—was tapped for the job, and will be based in New York.

The move was announced by Cushman's president and CEO Glenn Rufrano, himself fairly new to the brokerage, having taken over in March.

"As we streamline our operations to emphasize quality and consistency of service on a global basis, John is uniquely qualified to drive our global corporate services business forward," Mr. Rufrano said in a statement. "Global expertise and coordination is absolutely essential in the delivery of best-in-class services, and John's institutional knowledge and past experience will be a competitive advantage for our firm."

Mr. Santora's new job puts him in charge of 7,000 employees in what, according to the brokerage, is Cushman's largest operating unit. The unit advises investors and office tenants on agency leasing and lease administration, and manages approximately 600 million square feet of commercial space worldwide.

JPMorgan Staffs Up

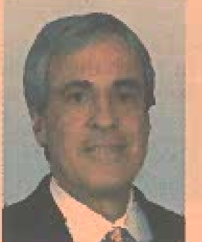
JPMorgan Chase has staffed the leadership of its Corporate Real Estate Group.

Kim Bertin and **David Arena** (pictured) have been named co-heads of the group. Ms. Bertin, a former senior director at CB Richard Ellis and head of real estate at Bertelsmann/Random House, will be responsible for the group's real-estate portfolio for the Americas.

Mr. Arena, a chairman of Grubb & Ellis' Tri-State division (and, before that, head of its day-to-day operations as CEO), will oversee international and retail financial services.

Poach! CBRE Stars Jump

CB Richard Ellis brokers lost two longtime brokers to rival firms earlier this month, according to *The Real Deal*.



Robert Martin, an executive vice president who has been with CBRE since the mid-1990s, was hired away by Jones Lang LaSalle.

James Emden (pictured), meanwhile, jumped to Colliers International, where he will serve as one of the newly rebranded firm's vice chairman of the tristate region. Mr. Emden, who served for 36 years at CB Richard Ellis, was an executive vice president there.

Also Notable...

John J. Kerin will take over as president and CEO of Marcus & Millichap on July 1. Mr. Kerin, 54, replaces Harvey Green, who is retiring after a decade in the top spot. The brokerage is headquarterd in Palo Alto, Calif., but Mr. Kerin will work from an office in Encino.

He was previously the regional manager of Marcus & Millichap's L.A. office, and was named a managing director in 1996, according to a release.

jsederstrom@observer.com

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