Slapping Sense Into the Taxman

The Great Depression's real lesson and a warning about the 'Cuomo tax'

Federal and state governments will see sharp reductions in tax revenue collection this year and for years to come. Budget deficits are rising to record levels, and there are only two ways for elected officials to bridge these deficits: by raising taxes and by reducing spending. Since the 1980s, our government has proven that restraining the urge to spend in a meaningful way is far too challenging. When faced with budget deficits, increasing taxes is the easy solution far too frequently implemented.

The federal budget deficit is projected to reach $1.8 trillion in this fiscal year and $9 trillion over 10 years, which is $2 trillion more than forecast just four months ago. These days we throw "trillions" around nonchalantly without realizing how big that number is. To put our $1.8 trillion into perspective, a deficit that large is $3.4 million per minute, $200 million per hour and $5 billion per day.

Robert Knakal
Columnist

State and local governments, representing about 15 percent of the economy, are in the beginning stages of the worst contraction in postwar history amid an aggregate deficit of about $175 billion for fiscal 2010 and a gap of $400 billion in fiscal 2011. The tax revenues of state governments have recently plunged more than 25 percent from a year earlier, as rising unemployment and reduced consumer spending have hurt sales and income tax collections. The drop in total tax receipts is the worst in a half-century. The biggest drop among major revenue sources was in state income taxes, which were down more than 30 percent from a year ago. Sales tax revenues fell by 9 percent. Due to these revenue reductions, three-fourths of the states have deficits exceeding 10 percent of their budgets. Only an emergency infusion of printed federal funny money is keeping most state boats afloat right now.

From 1930 to 2008, our national average annual real GDP growth rate has been 3.49 percent. It has been estimated that it would take GDP growth of at least twice the historical average to return state tax revenues to their previous long-term trend line by 2012. Wishing for an improbably huge boom while chasing your own tail through self-destructive tax increases won't prove to be much of a strategy. Unlike the federal government, states cannot deny reality by borrowing without limit. The Obama administration's "stimulus" package, in effect, shared the use of Uncle Sam's printing press for two years. But after the money runs out, reality will set in. Even if a second round of stimulus is driven by the political panic of bankrupt governors, it would only postpone the day of reckoning.

The reality is that lower tax revenues will be with us for the foreseeable future, requiring reductions in the size and scope of our state governments.

At a time when states should be disciplined when it comes to spending, lessons from the past have not been learned. In New York, for example, our new state budget is $131.8 billion—10.1 percent, or $12.1 billion, higher than last year's. Politicians explain the increase as a result of federal stimulus dollars. This math doesn't add up. Extracting the money provided by the feds, state spending still increased by $5.9 billion, or 4.7 percent. This is more than twice the rate of inflation. Most individuals and businesses have reduced their budgets in the wake of our current financial circumstances, but no such luck for our state. In order to try to pay for this increased spending, the budget includes 137 new or increased taxes, fees and charges.

History has shown us that the act of increasing taxes in difficult times stifles economic recovery and exacerbates problems. The Great Depression consisted of a major recession that began in the early 1930s and a second recession caused by a relapse in 1937. The Smoot-Hawley tariff of June 1930 was the catalyst that got the whole process going. It was the largest single increase in taxes on trade during peacetime. From 1932 through 1936, legislators passed enormous federal and state tax increases, which led to the relapse in 1937.

The damage caused by high taxation during the Great Depression is the real lesson we should learn. A government simply cannot tax a country into prosperity. Notwithstanding this truth, U.S. federal and state tax policies are on an economic-crash trajectory today, just as they were in the 1930s. Net legislated state-tax increases as a percentage of previous year tax receipts are at 3.1 percent nationally, their highest level in decades. The Bush tax cuts are set to expire in 2011, and additional taxes to pay for health care and the proposed cap-and-trade proposal are on the horizon.

The courage to meaningfully reduce spending has proven too difficult for elected officials to muster. There is far more political careerism and dodging of real solutions than the intestinal fortitude to do what is necessary. Unfortunately, in the battle between cutting spending and increasing taxes, tax increases are winning.

There is a groundswell of "tax the rich" rhetoric coming out of Washington as well as from state capitals. Taxing the rich may be a political solution because it affects only 1 percent of voters, but it is not a sustainable economic solution. States that have built their enormous public burdens by focusing on the wealthy will hit the wall first and hardest. Look at California, which extracts more than half of its income taxes from less than 1 percent of its citizens. This example is extreme, but California is hardly alone in its overreliance on a few highly mobile taxpayers. New York is right up there, with the wealthiest 1 percent paying more than 41 percent of all state income taxes. Individuals and businesses are fleeing soak-the-rich states already. New York and Connecticut are currently tied for having the highest state and local tax burden in the nation.

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Our real estate taxes, including transactional taxes and fees, will also be a politically easy target. An additional real estate tax burden now would only add to the distress that is so tangibly imbedded into so many New York City properties. Cash flows are already under tremendous pressure. Real estate taxes already provide a significant percentage of our state revenue. Based upon the way values have fallen across all property types, tax assessments should be decreasing; but because of the way they are calculated, they are, unfairly, continuing to increase, creating even more stress in the marketplace.

Mario Cuomo.

Remarkably, at an event last week, I overheard politicians speculating that the disastrous New York real property capital-gains tax—a.k.a., the "Cuomo tax"—may be revived. This was a 10 percent state capital-gains tax on any real estate transaction over $1 million; it was enacted by Governor Mario Cuomo and the State Legislature in 1983. The tax had a tremendous chilling effect on development and investment in New York. It caused severe reductions in transaction volume, as the costs of selling were too onerous. During this period, real estate investment trusts were emerging as dominant players nationwide, but New York was the last city on their list of targets due to our tax structure.

Because the legislation was drafted by politicians without input from the business community, there were deficiencies that forced some developers to pay the "gains tax" even when they lost money on a transaction. Additionally, every project required an audit that was costly and inefficient for the government to oversee. The fact is that there was a sharp rise in transfer taxes collected after the repeal of the law, in 1996, as transaction volume increased. REITS began to invest in New York City, and the market began an unprecedented run.

The Cuomo tax was thought by many legislators to be "a perfect tax" because it affected only millionaires. Unfortunately, that thinking was flawed, because those are the very people who create economic activity resulting from their investments.

Moreover, another error in that thinking was that it didn't take into consideration all of the people who lived and shopped and worked in the neighborhoods that stagnated during the years the tax was in effect, and that have since benefited from new construction and increased investment. It didn't take into consideration the union construction workers who build or renovate or convert buildings that have been sold or constructed since the tax's repeal. And lastly, it didn't take into consideration the real estate professionals, attorneys and title closers who saw activity increase after the tax disappeared.

The arrogance in thinking that companies and individuals will put up with anything to stay in New York is ill-advised. While it is overly simplistic to argue that taxes alone decide where businesses locate and people live, it is equally absurd to conclude that taxes make no difference in such decisions. We should all encourage politicians to have the guts to take difficult positions when it comes to cutting spending. We must adjust spending to sustainable levels given the outlook for future revenue receipts, and do so while implementing balanced tax policies.

If done correctly, this approach will promote investment, create job growth and lead to a brighter future for our city.

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