What's Next? – Taxing the Air We Breathe?

With 'new and innovative taxes', stressed state and local municipalities are walking a fine line

State and local governments are under massive pressure as a result of budget gaps that stem from the severe and lengthy national economic downturn, and it remains to be seen how well they will respond to these pressures. We certainly expect that ultimately, all 50 states will find ways to deal with their budget gaps, but it will not be easy, and in some cases the difficulties will be reflected in rating agency downgrades. The local level could be more problematic, particularly in areas with a heavy concentration of problem mortgage loans, and areas with a sharp increase in unemployment, or both. More local governments face credit-rating downgrades than during any recession in the past 40 years because of their reliance on property taxes amid the housing market's collapse.

For municipalities facing substantial budget gaps, the consequences are dramatic in many cases — for residents as well as the economy. To date, budget difficulties have led at least 45 states to reduce services to their residents, including some of their most vulnerable families and individuals. Over 30 states have raised taxes to at least some degree, in some cases quite significantly. If revenue declines continue as expected in many states, additional spending and service cuts are likely. Budget cuts often are more severe later in a state fiscal crisis, after largely depleted reserves are no longer an option for closing deficits.

Spending cuts are problematic policies during an economic downturn because they reduce overall demand and can make the downturn even deeper. When municipalities cut spending, they lay off employees, cancel contracts with vendors, eliminate or lower payments to businesses and nonprofit organizations that provide direct services, and cut benefit payments to individuals. In all of these circumstances, the companies and organizations that would have received government payments have less money to spend on salaries and supplies, and individuals who would have received salaries or benefits have less money for consumption. This directly removes demand from the economy.

Tax increases also remove demand from the economy by reducing the amount of money residents have to spend. While most municipalities may have to cut costs, raise taxes, or tap reserves in order to balance their budgets, several are considering revenue enhancement plans such as creating a new tax revenue stream:

A plan adopted by the Mission City Council in Kansas will impose a transportation utility fee on property owners based on how much traffic the property generates. The new fee will be levied on 5,650 properties in this Kansas City suburb of 9,700 residents, including tax-exempt churches, schools, and government buildings, and will generate an estimated $1.2 million a year. The fee is scheduled to go into effect in December and will help finance a proposed 10-year, $38 million street improvement program. Critics of this new 'driveway tax' claim it will directly harm small businesses, the very people Kansas is looking to for help creating jobs and working to jump-start

the economy. Mission City officials report that homeowners will pay $72 a year in fees, with small retail buildings housing several businesses paying up to $3,600 a year. Large retailers will see annual fees as high as $65,000 a year, with fast-food restaurants being levied up to $12,000 a year.

The City of Mission is not alone in the levy of a 'new and innovative' tax. Proposals around the nation include a soda tax, tanning tax, and garage sales tax. In New York State, in an attempt to raise funds, the cash-strapped Albany legislature is now enforcing a tax on sliced bagels; a bagel will only be taxed if sliced, given any kind of topping or preparation in the store, even just plain, if eaten on the premises.

Many exasperated taxpayers are left wondering where it will all end; what else could possibly be taxed going forward. While many state and local governments see a need to raise tax revenues in order to balance their budgets, at what point does the tax burden become onerous. At what point does the municipality create a situation in which it loses its competitive edge and taxpayers look elsewhere to buy their homes and open their businesses. And at what point does the tax burden begin to decrease consumption, discretionary income, and ultimately hinder economic growth.

Municipalities walk a fine line between creating new revenue streams in order to pay debt service and overtaxing property and business owners, which could drive some away and keep others from moving into the area. While attraction of new business offers strong growth potential, retention and expansion of existing businesses are often primary drivers of job creation and tax base growth for localities.

A balanced approach to closing deficits — raising taxes (nominally) along with enacting budget cuts — is needed to trim budget gaps in order to maintain important services while minimizing harmful effects on the economy. Before purchasing a municipal security, MTAM examines the municipality's total tax levy to make sure there is a comfortable margin in paying debt service, but not a level that will make the municipality less competitive.