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Testimony of the Boston Municipal Research Bureau

Submitted to the Massachusetts Joint Committee on Revenue
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H. 4805, An Act relative to property tax classification in the City of Boston

Background

The Massachusetts property tax classification law permits Boston to shift a portion of its property tax levy to Commercial, Industrial, and Personal (CIP) properties, up to 175% of what the CIP share would be without classification, as long as the residential share of the levy is not less than 50%. Classification intentionally gives relief to residential property owners, so owners of business properties pay the bulk of Boston's tax bill.

This shift works in both economic growth periods and downturns as long as the growth or drop in property values between the business and residential classes trend similarly or are not materially different. When business property values drop dramatically while residential property values appreciate significantly, more of the tax burden will be shifted to residential property. This is the scenario Boston is currently anticipating. The CIP share in Boston is presently at 175% of its full share value. Due to changing real estate dynamics and Boston reaching the classification limit, if residential values appreciate sharply while business values lag or decline, a significant shift could occur resulting in substantial tax hikes for residential property owners.

In response, Mayor Michelle Wu is proposing a temporary change to classification that would soften the impact of a significant appreciation in residential values and decline of business values. Similar to a 2004 law, H. 4805 would allow the portion of the tax levy coming from CIP properties to rise to 200% of the levy, dropping each year until the cap of 175% is restored in five years. The proposal would also allow the residential share of the levy to fall from 50% to 45% and then increase each year until the floor of 50% is restored in five years.

This proposal is revenue neutral, meaning that any reduction in what residential tax revenue would have been will equal the increase in tax revenue coming from CIP properties.

If the proposal becomes law, business property owners whose properties have lost value may still pay less than they pay now, although the reduction would be smaller. However, if

H. 4805, is enacted business property owners whose properties held or increased in value would pay more than they otherwise would have.

Because tenants in commercial buildings often pay a portion of the building's property taxes, this proposal could have a broad impact. H. 4805 could increase costs for restaurants, retail shops, nail salons, barbershops, convenience stores, and small family-owned operations from East Boston to Hyde Park to Allston-Brighton. This could have an impact far beyond downtown.

Boston homeowners benefit from the City's classification policy of allocating to the residential class the lowest allowable share of the property tax levy and businesses picking up the largest possible share. In FY24, Boston received 58.3% of its property tax revenue from business properties and 41.7% from residential properties. Business property made up 33.3% of Boston's property values and residential property made up 66.7%. Thus, in FY24, business property was just one-third of all property value, but it generated nearly 60% of all property tax revenue.

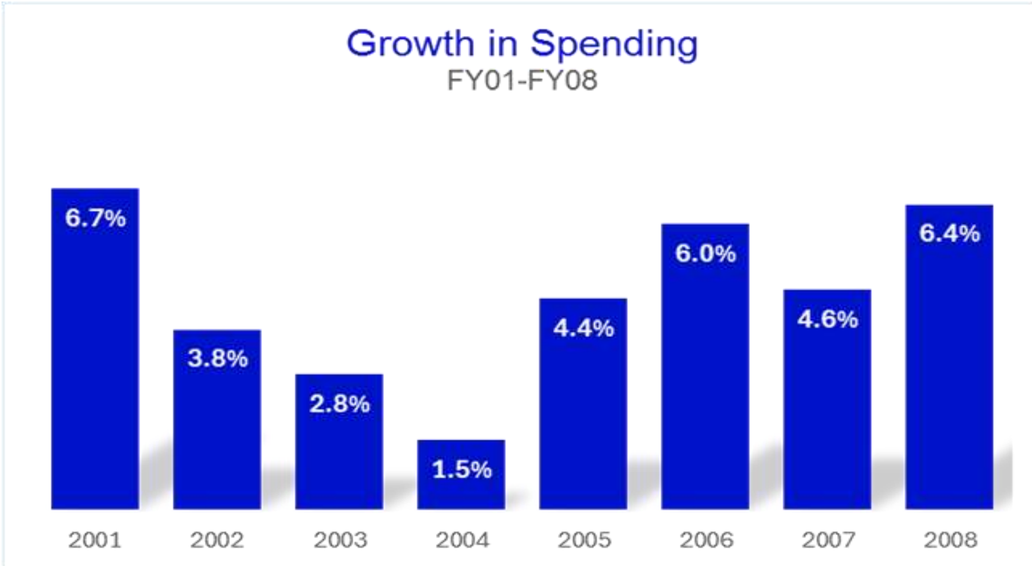
2024 and 2004

H. 4805 is modeled on a 2004 law. Consequently, a comparison of 2004 and 2024 is relevant to the Revenue Committee's consideration of this home rule petition.

<u>Economic Cycle vs Structural Change</u>: In 2004, Boston was in a traditional economic downturn. We have long experience with such economic cycles: with some predictability, prices and values go up, they come down, and they go up again. As a result, because the downturn was understood to be temporary, the solution in 2004 was devised to focus on the short-term.

What Boston is experiencing today is not a typical economic cycle. Rather, Boston is almost certainly in the midst of a structural change in the market following the COVID-19 pandemic. As the Revenue Committee considers this proposal, we need to be honest that the world is not going to return to what it was like in 2019. This is not a short-term challenge for Boston's property tax system.

<u>Growth in spending</u>: Boston slowed its spending growth in FY02, and it did so again in FY03 due to the prospect of a 10% cut in state aid and a slower increase in new property growth. While the total tax levy continued to grow in Boston, the decline in state aid and other factors necessitated a budgetary correction.



In contrast to Mayor Thomas Menino's approach to the budget in FY02-FY04, Mayor Wu proposed an 8% increase in the city's budget for FY25.

One-year snapshots are not the best way to think about fiscal policy, so it is wise to take a longer-term view. Over the past 10 years (from FY15 to FY24), Boston's spending grew by 54.8%. During that time inflation increased 31.5%. There are clear signs that the city can and should slow the pace at which its expenses are growing. A 23-point gap between expenditure growth and inflation is not sustainable.

Growth in Number of Employees: From FY02 to FY04, Boston reduced its headcount by more than 1,500 full-time equivalent (FTE) staff, or 8.7%.

Mayor Wu's FY25 budget projects an increase of 498 in the number of full-time equivalent employees, 209 of whom are shifting onto the payroll due to the move of the Boston Planning and Development Agency to the City.

The growth in headcount projected for FY25 is consistent with steady FTE increases in the past few years. Over the past 10 years (FY15-FY24), the city's headcount increased by 1,293 full-time equivalents or 7.6%. The majority of that growth was in the school department – which coincided with a notable drop in student enrollment.

Alternatives to H. 4805

The Boston Municipal Research Bureau issued a report on May 2, 2024, regarding the tax classification proposal. In the report, the Research Bureau identifies strategies Boston should consider in order to avoid the negative consequences of the tax classification proposal. Some are near-term ideas Boston could adopt immediately and some require more time to implement. Alone or in combination, these alternatives to the classification proposal may be an effective response to the potential problem of divergent residential and business property values.

One idea for how Boston could address the potential rise in residential property taxes concerns Boston's more than $1 billion in reserves. The City could use a modest portion of those reserves in the next year or two to set up a fund to provide relief to homeowners below a certain income level who need assistance in paying their property taxes. We recognize that for some homeowners a tax increase of 10% or more may be a substantial burden. Creating a fund like this would provide short-term relief to those homeowners, just as the home rule petition would do, but without the negative consequences on local businesses.

Alternatively, or perhaps in combination with this type of relief fund, Boston could use its reserves to cover a portion of its expenses, thus reducing the burden on taxpayers in the short term. Using reserves to fund an operating budget is not a long-term strategy (and could require a home rule petition), but this approach would achieve Mayor Wu's goal of near-term relief for taxpayers and still leave substantial reserves.

Second, perhaps most obvious step Boston could take is to restrain spending increases. Increasing the FY25 budget by 8% was not a wise decision. It is difficult to justify a significant cost increase on commercial property owners and their tenants when Boston itself is not sharing in the sacrifice. The Research Bureau was disappointed with the Mayor and City Council for not recognizing that they are making the situation more difficult for Boston's businesses.

Relatedly, it is imperative that the City control spending at Boston Public Schools. At $1.53B, the school budget is the largest single expenditure in Boston's operating budget. The cost per student this year will exceed $30,000. The school budget keeps expanding while enrollment is declining. This is not sustainable, and the Mayor, Superintendent, and the School Committee keep failing to address the issue.

A third, longer-term option is for Boston to diversify the revenue sources it depends upon to fund its budget. In FY24, 73% of Boston's general fund revenues supporting delivery of basic services came from property taxes. The Research Bureau is embarking on an in-depth report on ideas for revenue diversification. Substituting new revenue sources for property tax revenue could provide long-term relief to homeowners, so it is wise to begin the analysis now and prepare for the home rule petitions that may be necessary in the 2025-2026 legislative session.

Moody's May 2024 Credit Opinion

In May 2024, Moody's issued its most recent credit opinion on Boston, noting both the City's overall financial health and the anticipated decline in the commercial tax base due to remote and hybrid work. Consistent with the Research Bureau's suggestions, Moody's stated that "tighter control over expenditures and use of reserves" could be needed in the years ahead. It further stated, "the city likely has some limited flexibility to use reserves to help manage short-term fiscal challenges; however significant reliance on reserves to cover operating shortfalls would not be sustainable over multiple budget cycles."

Moody's identified factors that could lead to a credit downgrade, including a multi-year decline of 10% or more in commercial property values and a failure to maintain consistent property tax levy growth in order to keep pace with rising operational expenses. The proposed tax classification change could accelerate the decline in commercial property values as well as slow new commercial development in the next few years. If either occurs, the proposal could lead to a downgrade in the City's credit rating.

Modifications to H. 4805

In 2004, without the classification legislation, the city estimated that the average single-family homeowner tax bill would have increased by 41.4% ($816). Instead, the legislation resulted in an average single-family tax bill increase of 13.8% ($272).

In 2024, without the classification legislation, assuming that residential values go up 5% and commercial values drop 10% -- what Boston believes is a reasonable assumption -- the average single-family homeowner tax bill will increase by 16.5% ($910). This would be paid over four quarters. For some homeowners, this is going to be problematic, which is why the Research Bureau has called for alternatives that can reduce this tax burden on residential property owners.

It is important to keep in mind the goal Mayor Wu is seeking to achieve. She is trying to avoid a steep increase in residential property taxes this fiscal year. Her goal is to make this fiscal year look like prior years. To that end, it is important to note that residential property taxes have increased about 9% a year in the past few years. Consequently, the Research Bureau modeled what would happen under the tax classification proposal if residential taxes go up at the same 9% rate this year – again assuming residential values are up 5% and commercial values are down 10%.

On the commercial property side, Boston would have to move from 175% to 185%, shifting more of the tax levy onto CIP properties but not requiring the shift to 200% as proposed in H. 4805. This would achieve the Mayor's goal of a residential tax increase that is predictable and familiar to homeowners.

Thus, as the Revenue Committee considers potential changes to the proposed home rule petition, it may want to cap the maximum allowed shift at 185%. It is worth asking: if a residential property tax increase of 13.8% was acceptable in 2004, should a similar increase be the goal in 2024 as a way to share the burden across both residential and commercial properties?

Conclusion

As the Revenue Committee analyzes H. 4805, the question is whether businesses in Boston should take on some or all of the financial burden that may be caused by a potential increase in residential property taxes. The Boston Municipal Research Bureau has provided both near-term and longer-term alternatives that do not have the negative consequences of the proposed law.