

SPECIAL

REPORT

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BOSTON'S SHIFTING TAX BURDEN IN FISCAL 2004

The Potential Impact to Homeowners and Businesses

For many communities in the Commonwealth, including Boston, the sharp increase in residential property value combined with a decrease in business value will cause a major shift in the tax burden from the business to the residential class in fiscal 2004. In Boston, this could result in an increased tax bill for the average homeowner of \$816 or 41.4% from fiscal 2003, while the tax per square foot for downtown commercial office space could decrease by \$1.35 or 17.1%. In response, the City of Boston proposed legislation to change existing tax law regarding the classification of property in an attempt to soften the residential increase yet still maintain some - albeit less - relief for commercial office property that represents 48.9% of all business property value in fiscal 2004. However, with this legislative change, other commercial, industrial and personal properties whose values remain level or increase would experience a tax increase. Based on Boston's proposal, the Legislature passed and the Governor signed interim legislation (Chapter 138 of the Acts of 2003) that stopped short of enacting Boston's proposed changes to allow further study of this issue before taking action.

The new law established a 5-member commission to recommend new legislation to amend the classification law, but only for fiscal years 2004-2008. The commission held a public hearing on December 30th, and will present recommendations to the Legislature by January 12, 2004. A key issue for the proposed temporary increase in the business ceiling is the certainty that it will be restored to 175% by no later than fiscal 2008.

CLASSIFICATION IMPACT IN FISCAL 2004

The shift in tax burden is due to a divergence of business and residential property values with the business share of the levy having reached the maximum ceiling of 175% last year. Residential property value for fiscal 2004 increased by 26.5%, while business value decreased by 2.2%. Commercial office value decreased by 8.3% even with new growth included. Under the mechanisms of classification, this situation will create a potential shift of about \$113 million from the business to residential class. With no change in legislation, the tax bill for the average single-family homeowner would increase by \$816 or 41.4% while the tax bill for the average three-family homeowner would increase by \$1,292 or 56.6%.

City of Boston					
Impact to Boston of Changing Classification Law in Fiscal 2004					
Residential/Business Sectors	FY02	FY03	175% FY04	200% FY04	Difference FY04
Average Single Family Tax Bill	\$1,740	\$1,972	\$2,788	\$2,244	
Change	-	\$232	\$816	\$272	(\$544)
% Change	-	13.3%	41.4%	13.8%	-19.5%
Office Tower Tax/Sq. Ft.	\$8.08	\$7.89	\$6.54	\$7.47	
Change	-	(\$0.19)	(\$1.35)	(\$0.42)	\$0.93
Change	-	-2.4%	-17.1%	-5.3%	14.2%

Boston initially proposed relief via its legislative package submitted to the General Court in December of 2002. The City proposed that the current classification limits be changed to reduce the residential class's minimum floor from 50% to 45%, and to increase the business class's maximum ceiling from 175% to 200%. The residential tax increase would be significantly reduced and some relief for the commercial office component would be retained but not for other business properties.

THE COMMISSION'S CHARGE

The special commission must report back to the Legislature by January 12, 2004 with proposed legislation to temporarily amend the current property tax classification law. To assist in its efforts, the interim legislation provides the commission with the following guidelines:

- The current business ceiling of 175% of full value share may be temporarily increased by eligible municipalities, not to exceed 200%.
- No participating municipality may increase its current business threshold by more than 25 percentage points.
- The business ceiling must be reduced back to 175% by no later than fiscal 2008.
- The business ceiling may be reduced back to 175% earlier than fiscal 2008 if growth in business value reduces the residential share of the levy to its fiscal 2003 level.

Chapter 138 also authorizes cities and towns using a quarterly tax payment system to issue third quarter preliminary tax bills, and to consider other mechanisms such as a small business exemption.

MAXIMIZING HOMEOWNER BENEFIT

The City of Boston has maximized tax benefit to the homeowner through full classification and application of the highest residential exemption allowed by law. These strategies were designed to retain and attract a strong middle class, ease the tax burden on lower income residents, and strengthen the intricate link between housing affordability, business activity and neighborhood vitality.

Full classification results when a municipality chooses to assess the residential class at the minimum percentage of full value allowed by law, thereby maximizing the tax burden on the business class. As such, Boston traditionally assesses the residential class at slightly more than 50% of its full value, and in turn assesses the business class at the percentage of full value necessary to reach the limit of classification law.

Until fiscal 2003, the assessment percentage for business property required to reach full classification was below the 175% legal maximum. Full classification in Boston has led to the business class traditionally paying 70% of the levy on about 40% of total value, and the residential class paying 30% (the lowest amount allowed by law) on about 60% of total value. In dollar terms, the impact of classification in fiscal 2003 resulted in Boston's business class subsidizing the residential class by paying \$302 million more in property taxes than it would have if full classification were not in place.

In addition, the City has traditionally applied the maximum residential exemption rate allowable, which is currently 30% of assessed value, based on average residential value. In fiscal 2004, the residential exemption would increase to approximately \$1,375 with no legislative change, and to \$1,107 if the business ceiling were increased to 200%. In fiscal

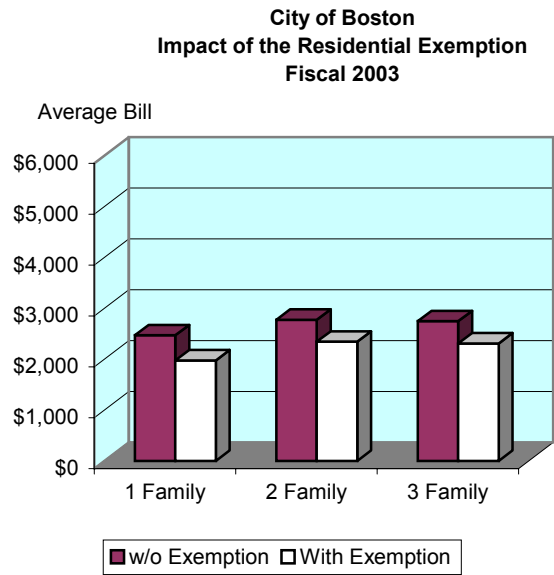
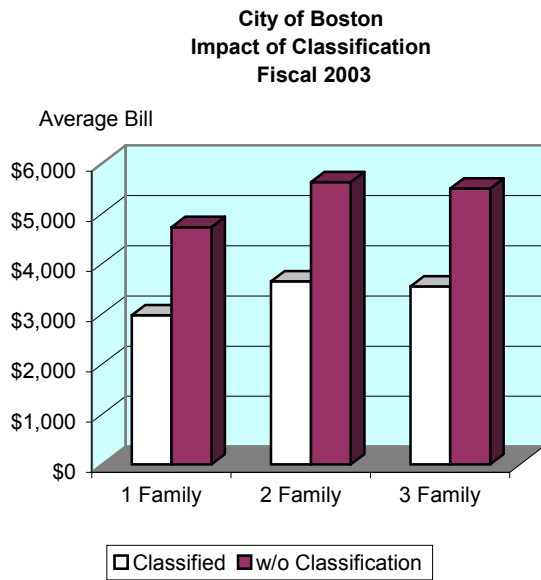
CLASSIFICATION: STATE LAW THAT ALLOWS TAX BURDEN SHIFT TO BUSINESS

Faced with a state requirement to revalue all taxable property at full and fair cash value, which would have caused a significant shift of the property tax burden from business to residential property, the political leaders of Boston and other cities succeeded in 1978 in securing enactment of a constitutional amendment for the classification of property. This change was intended to, in effect, maintain the tax share status quo as it existed at that time, when the business class paid the major portion of the total levy. In addition, a municipality could exempt up to 10% of the average assessed valuation of residential real property when used as the taxpayers' principal residence. The residential exemption does not affect the normal residential share of the levy, but shifts the burden by the amount of the total exemption from principal residences to non-domicile residential properties.

The original classification legislation stipulated that residential taxes could be no lower than 65% of what they would be if there were a single tax rate (full value share), and business property taxes could not exceed 150% of its full value share. The classification law was amended in 1988 to reduce the residential floor to 50% of full value share, while the business class ceiling was increased to 175% of full value share. One condition of the 1988 amendment stipulated that in no case could the residential share of the levy be reduced below its lowest level since fiscal 1984, which for Boston was 30.1%. Also, at that time, the residential exemption was increased to 20%. The residential exemption was increased to 30% for Boston in fiscal 2001.

As of fiscal 2003, 102 or 29.1% of the Commonwealth's 351 cities and have adopted a split tax rate. Of those 102 communities, 11 also apply a residential exemption.

2003, full classification and the residential exemption of \$988 resulted in an average single-family tax bill of \$1,972, which compared favorably with similar tax bills in other surrounding cities and towns. The dual tax benefits to Boston homeowners are further highlighted in the following graphs.



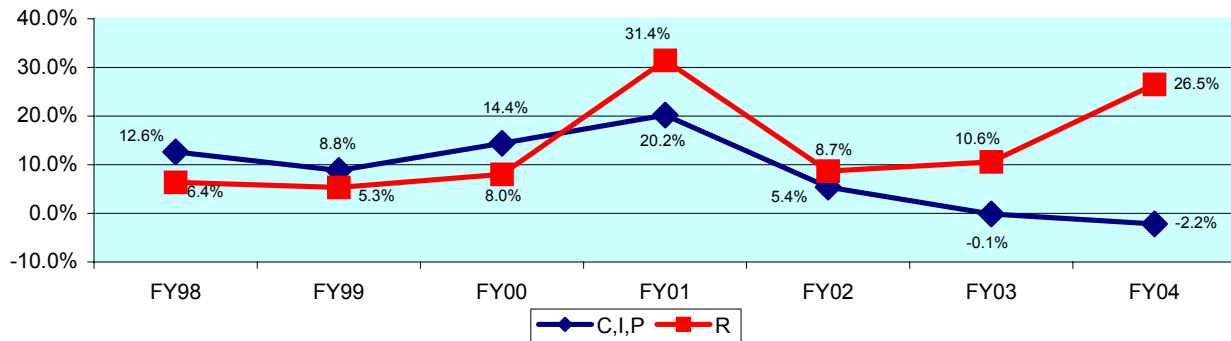
Classification and the Residential Exemption Save Homeowners:

- An average of \$2,745 on a single-family home (\$1,757 on classification and \$988 on the exemption)
- An average of \$2,964 on a two-family home (\$1,976 on classification and \$988 on the exemption)
- An average of \$2,938 on a three-family home (\$1,950 on classification and \$988 on the exemption)

REASONS FOR RESIDENTIAL TAX JUMP

The City of Boston had been able to maintain its traditional 70%-30% business-residential split in tax levy burden through fiscal 2002 in large part because business and residential property values tracked similarly through good economic times and bad. This trend showed a blip in fiscal 2001, when residential values increased at a much higher rate than business values. In fiscal 2003, the business and residential values actually tracked in opposite directions, and diverge by even greater margins in fiscal 2004, as shown below.

**% Growth of Boston's Business and Residential Property
Fiscal Years 1998-2004**



The divergence in value between the residential and business class, compounded with the City of Boston reaching the business ceiling of 175% last year, had the effect of shifting \$19 million in tax burden from the business to the residential class in fiscal 2003. In fiscal 2004, this same value/legal limit dynamic will shift about \$113 million in tax burden to the residential class under the current classification law (175%) or \$23 million if the business ceiling is raised to 200%.

IMPACT TO THE BUSINESS CLASS IN FISCAL 2004

Conversely, with a greater divergence of values in fiscal 2004 and the levy at the 175% maximum, business property would reduce its aggregate tax burden by \$113 million with tax cuts primarily in the commercial class, and in the industrial and personal property classes due to value changes and a reduction in the business tax rate by \$2.66 or 8.5%. If the business ceiling were raised to 200% in fiscal 2004, the business tax burden would reduce by \$23.0 million. The \$23 million shift to the residential class reflects a large cut in the commercial office tax burden that would be offset partially by increases in the other commercial, industrial and personal property classes. At 200%, commercial office property in Boston, which represents 48.9% of all business value in fiscal 2004, generally would experience a 5% decrease in its tax bill reflecting its decline in value. However, a similar reduction would not apply to other business classes. Other commercial, industrial and personal properties whose values remain level or increase would receive a tax increase since the business tax rate would increase by \$1.46 or 4.6% to accommodate the commercial office value decline. At both 175% and 200%, the business share of the tax levy would be less than it was in fiscal 2003. The business class accounted for \$704.9 million or 68.1% of the levy in fiscal 2003. Business property would pay \$631.1 million or 57.7% of the levy if the law were not changed in fiscal 2004, and would pay \$721.3 million or 66.0% of the levy if the business ceiling were raised to 200%.

Fiscal 2003-2004 Figures in 000's				
Business	FY03	FY04	Change	%
Commercial	\$18,640,038	\$17,807,530	(\$832,508)	-4.5%
Commercial Office	11,670,665	10,697,339	(973,327)	-8.3%
Other Commercial	6,969,373	7,110,191	140,818	2.0%
Industrial	602,730	648,818	46,088	7.6%
Personal Property	3,142,579	3,432,029	289,449	9.2%
Total Business	\$22,385,347	\$21,888,377	(\$496,970)	-2.2%

The tax reduction for Boston's commercial office buildings even if the business ceiling is increased to 200% reflects their decreases in value due to declining revenues. During the 1999-2003(Q2) period, average asking rents dropped by about 19% for selected downtown commercial properties while building expenses increased by over 28%. Final negotiated rents often include tenant concessions involving rent and improvements that would further affect revenue. At the end of the third quarter of 2003, the vacancy rate for Boston commercial office buildings was 13.8%.

The dynamic of diverging property value and reaching the limits of classification is not just a Boston issue, as evidenced by the following fiscal 2003 data:

- Business property value statewide increased by 5.3%, while residential value increased 13.8%, creating a \$73.0M shift in tax levy burden to the residential class.
- 20 of the 102 cities and towns that employ classification reached the maximum business ceiling of 175%
- Another 30 of the 102 communities that employ classification had a business ceiling over 155%, and are expected to

CONCLUSION

A key issue for the proposed increase in the business ceiling is whether future Legislatures will honor a plan approved in 2004 to restore the business ceiling to 175% by fiscal 2008. Of concern is that a "temporary" increase in the business ceiling will become permanent. Mayor Menino and other municipal officials have endorsed a temporary increase, expressing confidence that the market will restore the current "anomaly" back to historic levels. What temporary changes are enacted should be considered the final and permanent legislative resolution of this situation that either will mitigate the problem while the market corrects itself in the next few years or will provide a longer time for the residential owners to adjust to a new tax reality even with significant business subsidization.

How soon the market will correct itself is not clear. Residential and business values are expected to continue on divergent paths in the short term. While housing prices have softened recently, they do not show signs of significant decline in the near term, as demand remains high while supply is low. On the other hand, business property supply in Boston shows high vacancy rates combined with increasing supply of about two million square feet of new office space in 2003. Significant job creation, which is currently sluggish, will be required to offset that trend. Commercial values could decline further in fiscal 2005 causing a second year of larger than average residential tax bill increases. It will take time for the effects of value divergence to be mitigated by property values tracking in the same direction, as is historically the case.