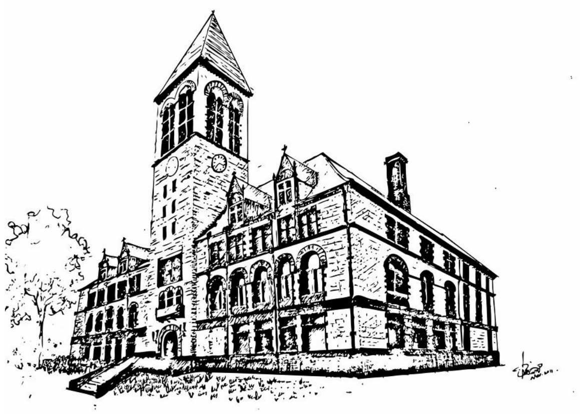
Agenda for October 28, 2024, City Council Roundtable/Working Meeting

A Joint Roundtable/Working meeting with the City Council and the School Committee to discuss macro-economic trends in Cambridge and the City's budget.

- Opening and Introductions
- Presentation from the City
- Discussion with the City Council and School Committee

CITY OF CAMBRIDGE

Maintaining Financial Flexibility in a Shifting Macroeconomic Environment



City Council & School Committee Roundtable

October 28, 2024

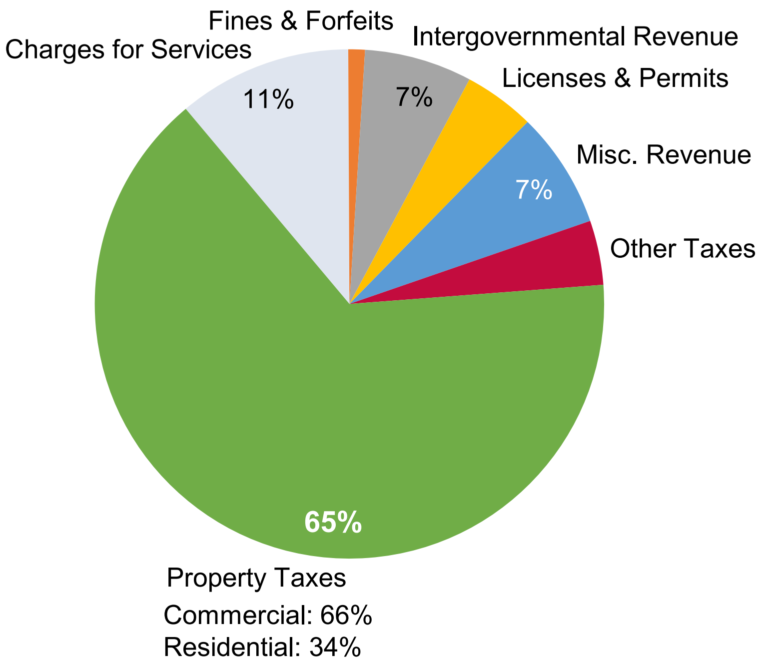
Executive Summary

- Today, we are planning to discuss macroeconomic trends that affect the City's financial flexibility and how we can maintain our financial flexibility moving forward.
- Over the past decade, the City benefitted from a highly favorable macroeconomic environment, which significantly expanded our taxable base and increased building permit revenue. This has supported major operating and capital investments in priorities such as affordable housing, early childhood education, and new school buildings.
- Looking ahead, the macroeconomic outlook for the next several years is less favorable.
  - We anticipate decreases in new commercial construction and increased office and laboratory vacancy rates.
- This outlook has multiple potential implications for the City including:
  1. A greater dependence on property taxes to fund the budget because our non-tax revenues (e.g., building permits) are expected to remain flat or decline.
  2. An erosion of our excess property tax levy capacity if we do not moderate operating budget growth while new property growth slows, which will impact the City's overall financial flexibility.
  3. A potential tax burden shift from commercial properties to residential properties due to expected declines in commercial valuations while residential values continue to increase.
- While the extent of these impacts are uncertain, we are taking them seriously and proposing a multi-year approach to moderate our budget growth, prioritize our new investments, and sustainably fund existing commitments.

The City's operating budget is mainly supported by property taxes

FY25 Operating Budget

Operating Budget Revenue = **Operating Budget Expenditures**



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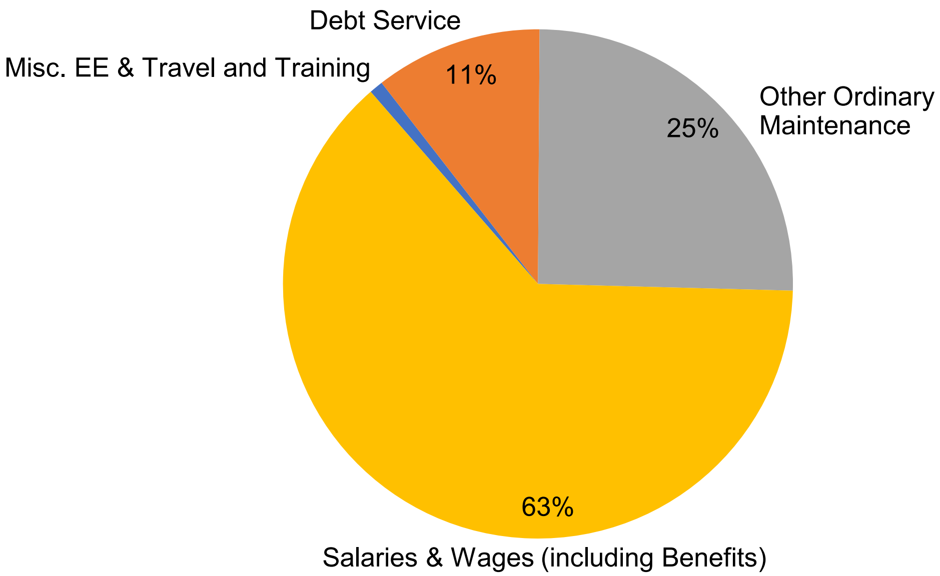

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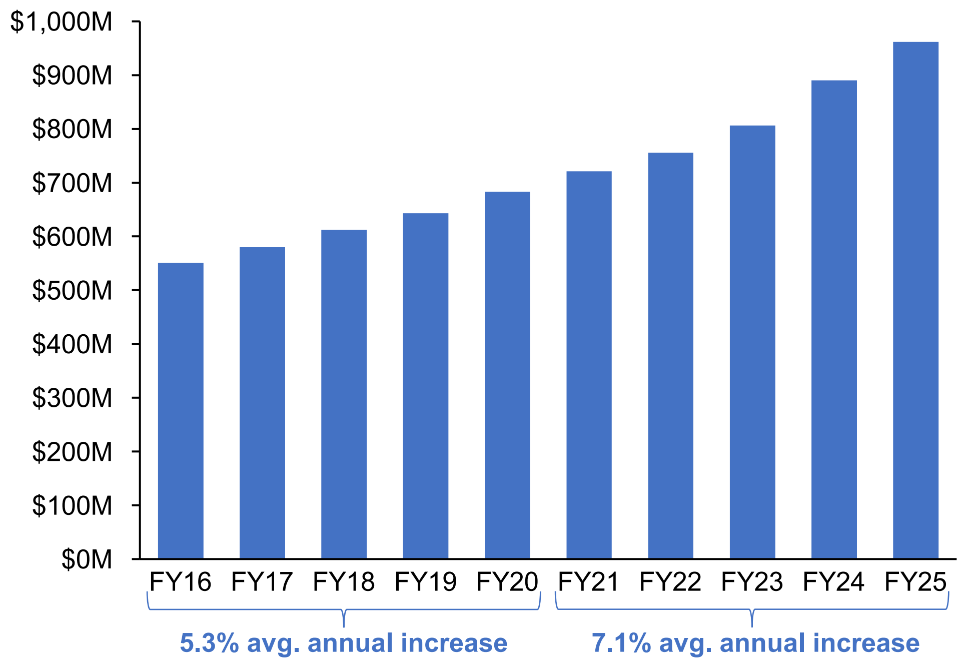
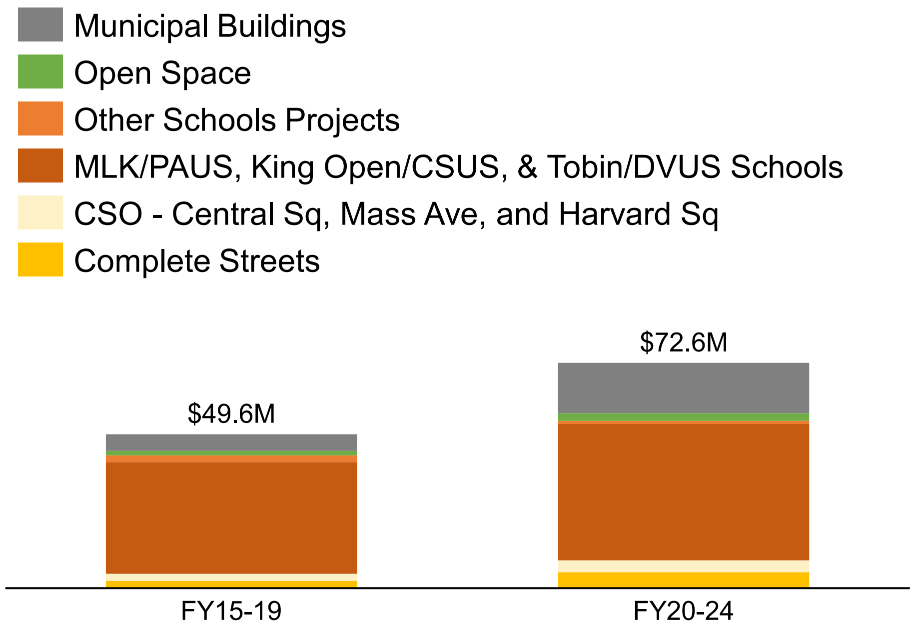
Over the past decade, the City benefitted from a favorable macroeconomic environment, which enabled major operating and capital investments

Annual Operating Budget
($M)



Growth in the operating budget reflects investments in affordable housing, early childhood education, climate initiatives, and extended school day, and increased debt service related to capital projects.

Annual Tax-Supported Bonding
Five-year average ($M)



The capital budget also grew, with increased borrowing for 3 new school buildings, streets, cycling safety and deferred maintenance projects. The cost of repaying borrowed funds ("debt service") is reflected in the operating budget.

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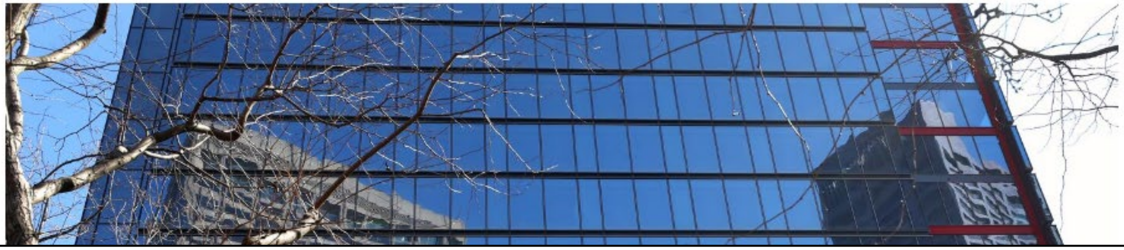
Looking ahead, the macroeconomic outlook for the next several years is less favorable

The Boston Globe

Amid hybrid work and sluggish economy, Boston's office market is hurting

By some measures, vacancy has hit its highest level in three decades, as companies re-evaluate their office needs and forestall big expansions.

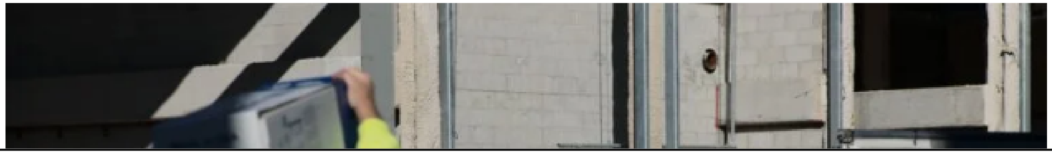
By Catherine Carlock Globe Staff, Updated January 17, 2023, 6:09 a.m. 131



THE BOSTON GLOBE

'A cloud hanging over everybody's head': New construction in Greater Boston faces a slowdown

Permits are down even as the region focuses on trying to build more to address a mounting housing crisis.



BISNOW

Nearly A Third Of U.S. Lab Space Is Available For Lease As Supply Drowns Demand

September 26, 2024 | Patrick Sisson, National

The expected outlook has important implications for the City's financial health

1. A **greater dependence on property taxes** to fund the budget because our non-tax revenues (e.g., building permits) are expected to remain flat or decline.

2. An **erosion of our excess property tax levy capacity** if we do not moderate operating budget growth while new property growth slows, which will impact the City's overall financial flexibility.

3. A **potential tax burden shift from commercial properties to residential properties** due to expected declines in commercial valuations while residential values continue to increase.

The expected outlook has important implications for the City's financial health

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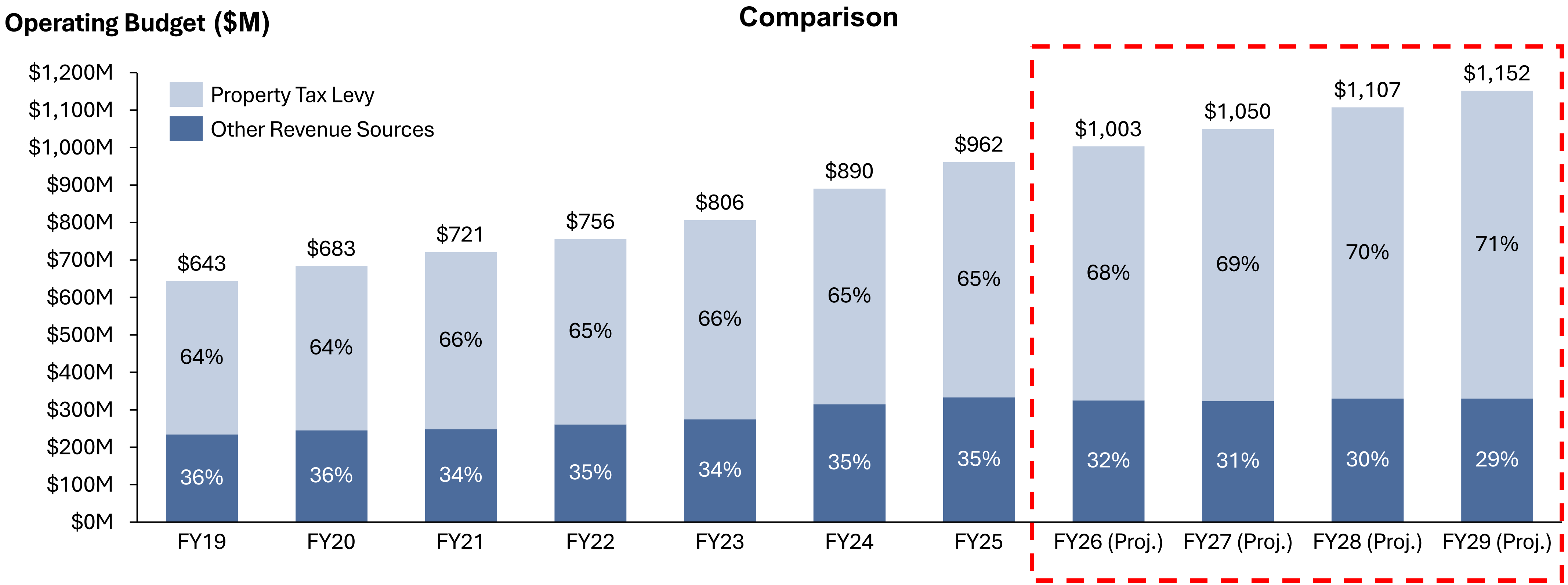
We are projecting a greater dependence on property tax because our non-tax revenue streams (like building permits) are expected to remain flat or decline

Property Tax Levy: Other Revenue Source Comparison



FY26 - FY29 projections for “Other Revenue Sources” show declining growth; therefore, increases to the property tax levy will be needed to support projected rising expenditures.

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How does the City's undesignated fund balance ("free cash") factor into budget planning?

Cambridge's 5 yr avg. annual Certified Free Cash amount (*excluding Mitigation Receipts*)= $199.4M

How is it generated?

- When actual expenditures are *less than* what was budgeted, and actual revenues are *greater than* what was budgeted.

Why is it important?

- Provides important flexibility to quickly appropriate financial resources to address unplanned expenses or opportunities.
- But should only be used for one-time expenditures and not relied upon to fund recurring expenses.
- Is one of the factors that the rating agencies consider when reviewing and determining the City's bond rating each year.
- In Cambridge, Free Cash is typically used as a revenue source to lower the required property tax levy.

The expected outlook has important implications for the City's financial health

1. A **greater dependence on property taxes** to fund the budget because our non-tax revenues (e.g., building permits) are expected to remain flat or decline.

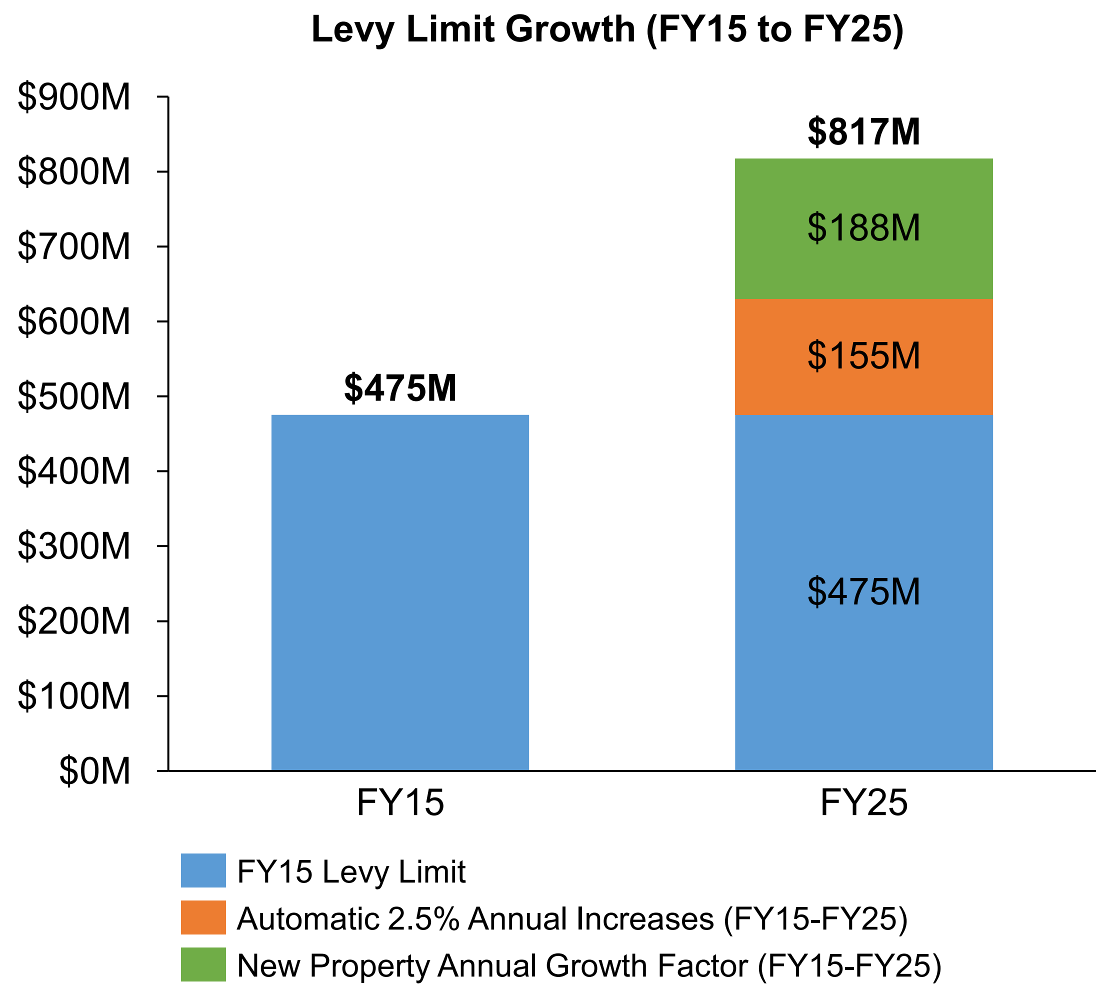
2. An **erosion of our excess property tax levy capacity** if we do not moderate operating budget growth while new property growth slows, which will impact the City's overall financial flexibility.

3. A **potential tax burden shift from commercial properties to residential properties** due to expected declines in commercial valuations while residential values continue to increase.

As a reminder, there are state law restrictions on property tax increases

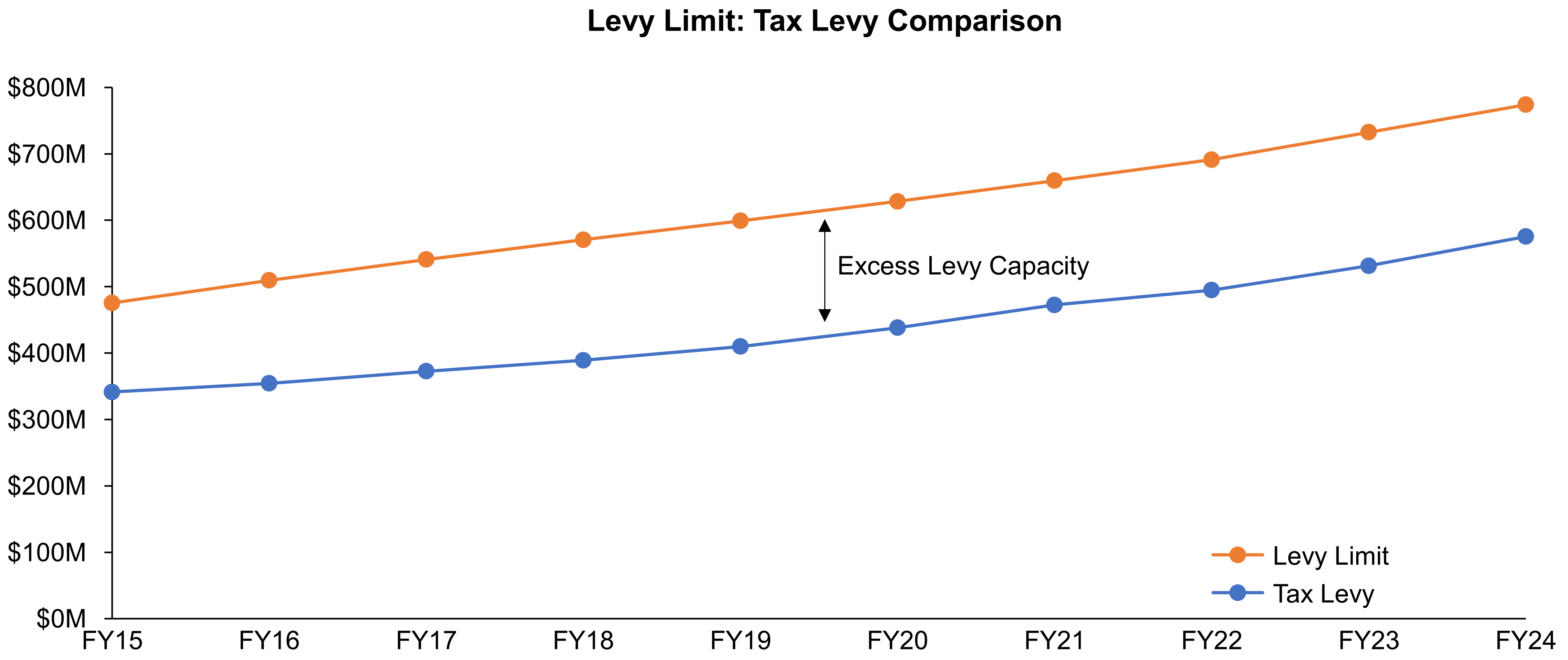
- In Massachusetts, legislation know as **Proposition 2 ½** sets a property tax levy limit and an annual levy limit increase for each city/town, to prevent large annual property tax rate increases.
- The most important Proposition 2 ½ metric is the **Levy Limit,** which is the **maximum allowable** property tax levy each year (without an override).
- Proposition 2 ½ restricts the annual increase to the Levy Limit to include two factors: an automatic 2.5% increase from the prior year levy limit **plus new growth** (additions to a community's tax base through new development)**.**
- **Excess Levy Capacity** is the difference between a community's levy limit and the tax levy in any given year. It represents the amount of additional taxes the City may levy if necessary.
- Excess Levy capacity is an important component of the City's overall financial stability. When the tax levy stays below the levy limit, we preserve future flexibility to raise additional taxes when necessary.
- To preserve this flexibility, we need to maintain a careful balance between how fast the tax levy is growing and the rate at which the levy limit is increasing.

Over the past decade new property growth contributed significantly to our levy limit



- Significant new growth expanded our taxable base (levy limit) and contributed to higher building permit revenue.
- From FY15 to FY25, the levy limit grew $342 million, with 55% of the increase attributable to new growth.
- New growth has contributed to the City's ability to maintain significant excess levy capacity.

Historically, we have been able to stay well below the levy limit



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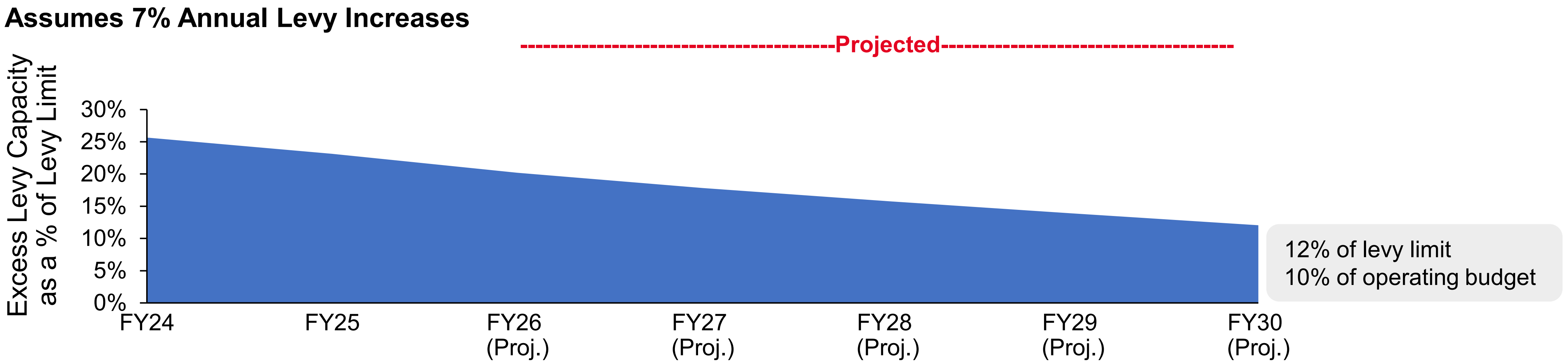
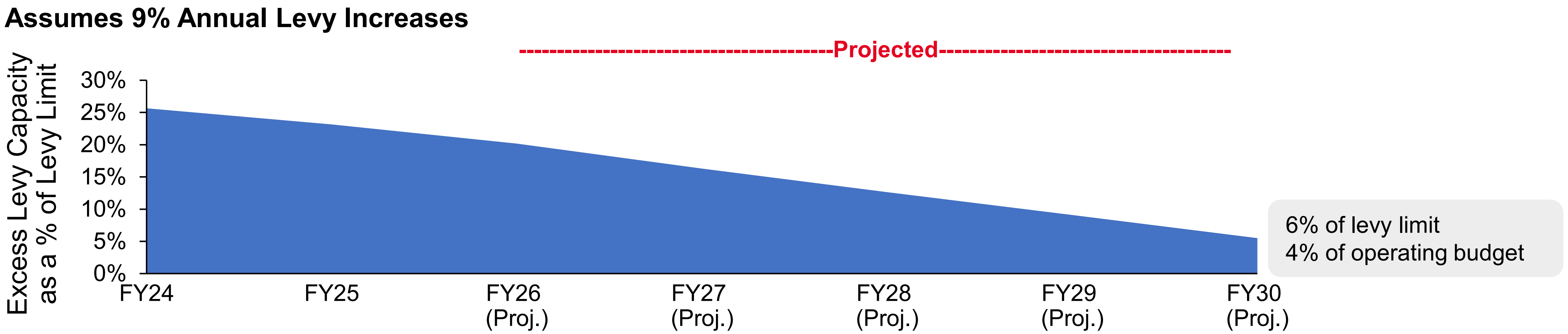
We could face an erosion of our excess levy capacity and overall financial flexibility if we do not moderate operating budget growth while new property growth slows

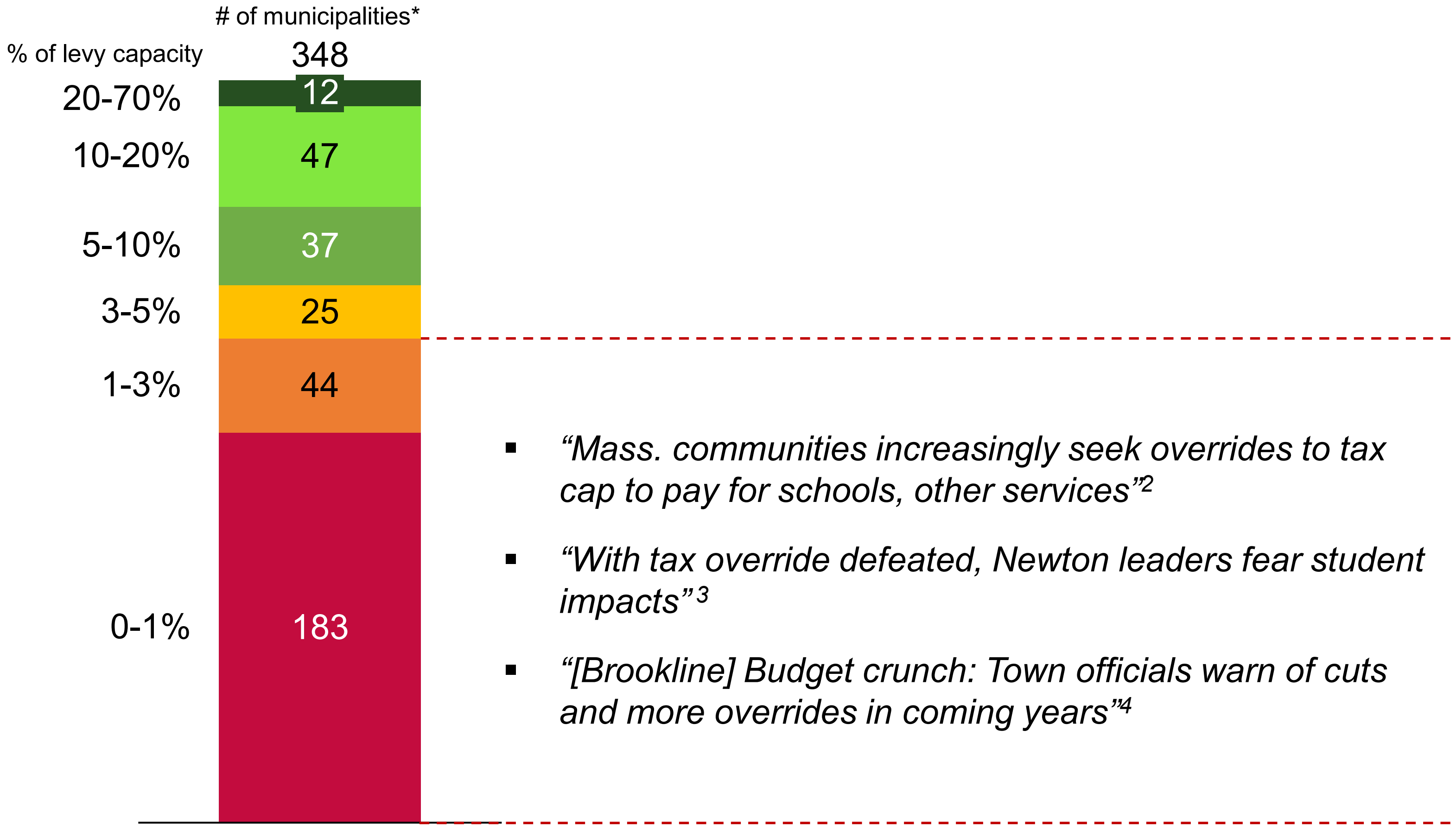




Projections are subject to change

Communities at their levy limit have little capacity for new investments and may need to reduce budgets or get an override passed to support budget growth

Massachusetts Municipalities Excess Levy Capacity FY24[1]



- *"Mass. communities increasingly seek overrides to tax cap to pay for schools, other services"[2]*
- *"With tax override defeated, Newton leaders fear student impacts"[3]*
- *"[Brookline] Budget crunch: Town officials warn of cuts and more overrides in coming years"[4]*

1. Mass.gov 2.Boston Globe 3. WBUR 4. Brookline News
**Mass.gov data does not include 3 municipalities*

The expected outlook has important implications for the City's financial health

1 A **greater dependence on property taxes** to fund the budget because our non-tax revenues (e.g., building permits) are expected to remain flat or decline.

2 An **erosion of our excess property tax levy capacity** if we do not moderate operating budget growth while new property growth slows, which will impact the City's overall financial flexibility.

3 A **potential tax burden shift from commercial properties to residential properties** due to expected declines in commercial valuations while residential values continue to increase.

There may be a tax burden shift from commercial to residential due to an expected decline in commercial valuations while residential values continue to increase

What is tax classification?

State law allowed municipalities the option to allocate the tax levy between residential and commercial / industrial / personal (CIP) properties using different tax rates. However, there are limits:

- **Max:** CIP properties may pay only up to 175% of their full, fair cash value share of the levy, known as the "maximum commercial factor." This means that the tax rate for CIP cannot be more than 175% of what the single rate would be if the city did not choose to use a split rate.
- **Min:** For Cambridge, residential properties must pay at least 34% of the levy, called the "Residential Percentage."

Once the maximum commercial factor of 175% is reached, no additional tax burden may be shifted to the CIP taxpayers.

- Under the formula today, Cambridge commercial taxpayers pay 66% and residential taxpayers pay 34% of the levy.
- In macroeconomic environments where commercial values are declining and residential values are increasing, this proportion may change and shift more of the tax burden to the residential properties.
- The City has not yet reached the maximum amount it may shift to commercial properties, but with current macroeconomic trends of softening commercial values and increasing residential values, there is an increasing likelihood that the City will reach the maximum commercial factor in the next several years.

Recently, Boston faced challenges related to limits on shifting tax burden to commercial properties

The Boston Globe

Average single-family home in Boston likely to see 14 percent spike in property taxes, city officials say

By Niki Griswold Globe Staff, Updated October 9, 2024, 4:15 p.m.

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…"Homeowners have been bracing for a spike in residential property tax bills next year after city officials warned they would likely rise to **keep the budget balanced**.

More than 70 percent of the city's budget is funded by property taxes. **High office vacancy rates have reduced commercial property values and, in turn, hurt commercial property tax revenues.** At the same time, **residential real estate values have risen, meaning homeowners will face higher property taxes to make up the difference**, or the city would have to make steep budget cuts and not collect the full amount of property taxes it's allowed to by state law."…

The Boston Globe

After long-simmering dispute, Wu and business leaders strike deal on property tax plan

By Catherine Carlock and Niki Griswold Globe Staff, Updated October 23, 2024, 8:22 p.m.

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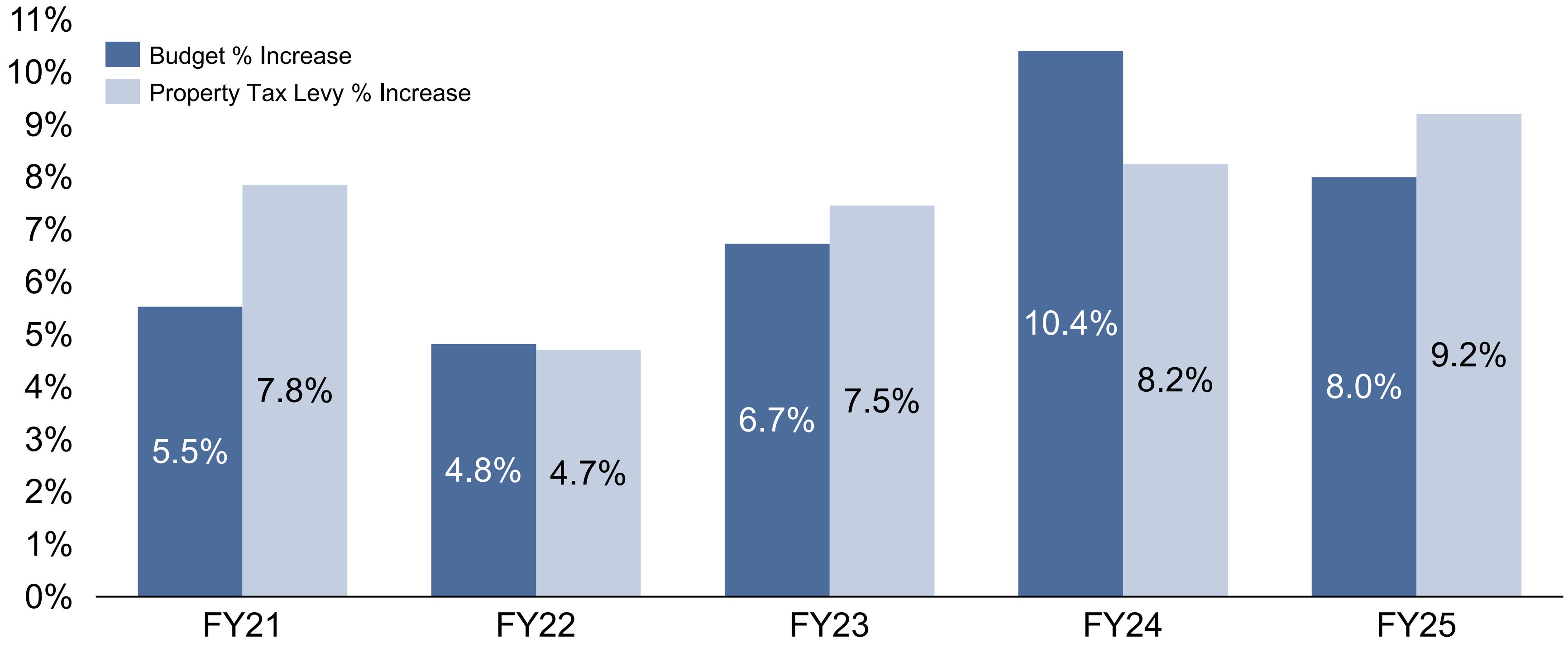
…"Under the compromise, **residential tax rates would increase by around 9 percent** — in line with previous increases. The new **commercial tax rate** was not yet available but would be **capped at 181.5 percent** of the residential rate, up from the current 175 percent ceiling, and step down incrementally over the following two years before returning to current levels…**The compromise is a short-term solution, business leaders said**. Jim Rooney, chief executive of the Greater Boston Chamber of Commerce, suggested the city focus as much on controlling spending as it does on tax levels in the years ahead."…

We modeled a few hypothetical scenarios to understand how changes in value may impact a shift of tax burden to residential taxpayers

Scenarios	**Assumptions**			**Implications**
	Residential value change	Commercial value change	Tax Levy increases	
Optimistic	Flat	Flat	Medium	Stay below the max. commercial factor; maintain commercial 66%, residential 34% tax split
Moderate	Moderate Increase	Moderate Decrease	Medium	Max commercial factor reached within 4 years; residential tax bills increase at a higher rate than commercial
Pessimistic	High Increase	Steep Decrease	High	Max commercial factor reached within 2 years; annual double digit tax rate increases for residential

Increases in the operating budget reflect investments in priorities including early childhood, longer school day, affordable housing, climate initiatives and infrastructure

Budget Growth Impact on Property Tax Levy



- Five-year average operating budget growth: 7.2%
- Five-year average property tax levy growth: 7.5%

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We will need a multi-year approach to moderating operating budget growth to ensure that property tax levy increases are sustainable

	FY26 Budget	FY27-29 Budget Process*
Property Tax Levy Growth Targets	▪ <8% increase	*<7% annual increase*
Operating Budget Targets	▪ 3.5 to 4% increase	*<5% annual increase*

We have some preliminary projections for the FY26 operating budget, which will be refined over the coming months

Expenditures

Our initial projections indicate a 3.7% operating budget increase

- These projections are based on estimated increases for existing city staff and programs
- Salaries and benefits: +5%
- Materials, supplies, and service: +6%
- Debt service: +15%
- Changes in our approved* pension funding plan will decrease the funding required in FY26. This decrease offsets increases in other areas
- Without the decrease in pension costs, estimated increase to the operating budget would be more than 6%

*Our funding schedule is approved by the Public Employee Retirement Administration Commission (PERAC).

Revenues

We are projecting an 8% property tax levy increase to support the estimated budget growth

- Non-property tax revenue is projected to decline 3.9%
- With projected decline in non-property tax revenue sources, the tax levy must absorb 100% of the budget increase, **plus** make up for lost revenue
- The most significant decreases are in building permit revenue and one-time revenue from UPK stabilization fund

Discussion

Appendix

What to know about Proposition 2 ½

What is MA Prop 2 ½ ?

Enacted in 1980 by state-wide voter initiative, Prop 2 ½ sets a tax levy limit and an annual levy limit increase for each city, to prevent large annual property tax rate increases.

- The most important Prop 2 ½ metric is the **Levy Limit,** which is the **maximum allowable** tax levy each year (without an override), originally set as 2.5% of a municipality's total assessed value.
- Prop. 2 ½ restricts the annual increase to the levy limit to include two factors: an **automatic 2.5% increase** from the prior year levy limit **plus new growth.**

Key terms & definitions

- **Tax Levy:** Revenue raised through real and personal property taxes; is the largest source of revenue for City of Cambridge budget.
- **New Growth:** Additions to community's tax base in the prior year (does NOT include higher market values; must result from a change in physical condition, taxable status, or taxable unit of a property).
- **Levy Limit:** The maximum dollar amount a community can routinely levy through taxes in a given year.
- **Excess Levy Capacity:** The difference between the levy limit and actual taxes levied. It represents the amount of additional taxes the City may levy.
    - Excess levy capacity is an important component of the City's overall financial stability. When the tax levy stays below the levy limit, we preserve future flexibility to raise additional taxes when necessary.

What to know about Tax Classification

What is tax classification?

Since 1988, state law has allowed municipalities the option to divide the tax levy between residential and commercial / industrial / personal (CIP) properties using different tax rates. However, there are limits:

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Key terms & definitions

- **Property Tax Classifications**: there are five classes of property. The first four refer to classes of real property - (1) Residential, (2) Open Space, (3) Commercial, and (4) Industrial. The fifth is Personal Property.
- **Single Rate:** The calculated tax rate, which when applied equally to all assessed value results in the total tax levy required in a particular year.
- **Split Rate:** Multiple tax rates are calculated based on the property classification, resulting in a higher rate and lower rate. Together, when applied to specific property classes, these tax rates produce the total tax levy required for a particular year.
- **Residential Exemption:** A residential exemption reduces the tax bill by excluding a portion of the residential property's value from taxation. To qualify, the property owner must occupy their property as their primary residence. Cambridge has adopted a 30% residential exemption, valued at $499K in 2024.
- **Full, Fair, Cash Value (FFCV)**: The law in Massachusetts requires that all property be assessed annually at 100% of its full and fair cash value - the price a willing buyer would pay to a willing seller (arms length transaction).

Cambridge residents currently pay far less percent of the property tax levy than nearby cities

Municipality	Residential % paid of prop. tax levy	Commercial % paid of prop. tax levy	Residential Tax Rate	Commercial Tax Rate
Cambridge*	**33.8**	**66.2**	**$6.35**	**$11.52**
Boston	41.7	58.3	$10.90	$25.27
Watertown	50	50	$11.70	$23.08
Somerville	67.1	32.9	$10.52	$18.20
Brookline	83.9	16.1	$9.77	$16.41
Newton	85.3	14.7	$9.76	$18.33

** Cambridge rates are for FY25, all others are for FY24*

Changes in Residential Tax Bills by Property Class Based on Median Values

	FY21	FY22	FY23	FY24	FY25
Single Family	$246	$545	$419	$743	$587
Two Family	$131	$301	$269	$494	$421
Three Family	$218	$335	$379	$598	$602
Condominium	$3	$33	($107)	($7)	$175

Includes residential exemption