MASSACHUSETTS
BUDGET AND POLICY CENTER

January 10, 2007

PROPERTY TAXES IN MASSACHUSETTS
Trends and Options

In recent months, property taxes in Massachusetts have received a great deal of attention. Throughout his campaign for office, Governor Deval Patrick argued that budget cuts imposed during the Commonwealth's fiscal crisis have "[shifted] the fiscal burden onto local communities in the form of increased property taxes and mandatory fees" and have created "too much reliance on local property taxes as a source of revenue for essential services." Accordingly, one of the principal charges to his transition team's budget and finance workgroup has been to "[identify] mechanisms for providing property tax relief."

This report examines recent trends in property taxes in Massachusetts and explores a few options for addressing those trends. It observes that, while property taxes are no higher today, relative to personal income, than they were in the early 1990s, three factors may be contributing to heightened public concerns about property taxes: (i) property taxes, as a share of income, declined in the late 1990s, but began to climb due to local aid cuts beginning in FY 2002 (ii) there has been a trend towards greater reliance on residential property taxes relative to those from commercial and industrial sources; and (iii) income growth has been concentrated among high-income households in recent years, meaning that low-and moderate-income families' ability to pay their property taxes may not have risen at the same rate as those taxes. Finally, this report details two options available to policymakers for addressing the strains associated with property taxes and discusses several changes in tax policy that could be adopted to offset the additional costs associated with those options.

Property Tax Trends in Massachusetts

The Long-Term Trend:
State Taxes Have Fallen as Property Taxes Have Grown Modestly

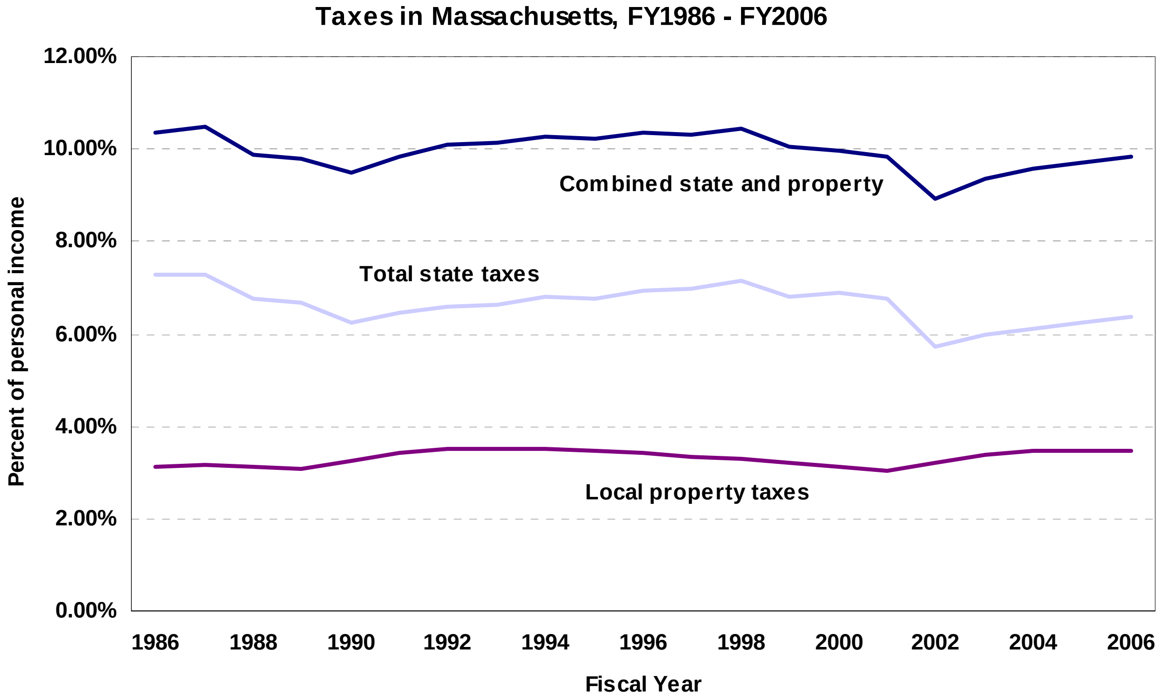
Property taxes are a critical source of revenue for Massachusetts' cities and towns. They should not be considered in isolation, however, since fiscal developments at the state level are often eventually felt at the local level as well. For example, Figure 1 presents data on local property taxes, total state taxes, and combined state and property taxes (all measured as a share of personal income) for the period FY 1986 to FY 2006. It shows that state taxes in Massachusetts, as a share of personal income, fell considerably during the FY 1998 to FY 2002 period and, as a result, are lower today than they were 20 years ago. In FY 1986, total state taxes amounted to 7.3 percent of personal income; in FY 2006, they equaled 6.4 percent. This means that state taxes in Massachusetts are $2.5 billion lower than if the Commonwealth had the same overall level of taxation as it had twenty years ago.

MASSACHUSETTS BUDGET AND POLICY CENTER
15 COURT SQUARE, SUITE 700, BOSTON, MA 02108
TEL: 617.426.1228 • FAX: 617.695.1295 • www.massbudget.org

`

In contrast, property taxes as a share of personal income are now somewhat higher than they were in the late 1980s, but are at about the same level as they were in the mid-1990s. During the late 1980s, property taxes ranged from 3.08 percent of personal income to 3.18 percent. Over the last three years, they have been close to 3.45 percent, much as they were from FY 1992 to FY 1996.

Figure 1.



The Short-Term Trend: Rapid Property Tax Growth to Pay for State Tax Cuts

As Figure 1 indicates, property taxes as a share of personal income have grown almost continuously since FY 2001, climbing from 3.04 percent to 3.45 percent over the last five years. This more recent upswing is likely due in part to a real drop in local aid since FY 2002 – discussed in greater length below – that is, in turn, the direct result of the decline in state taxes at the end of the 1990s.

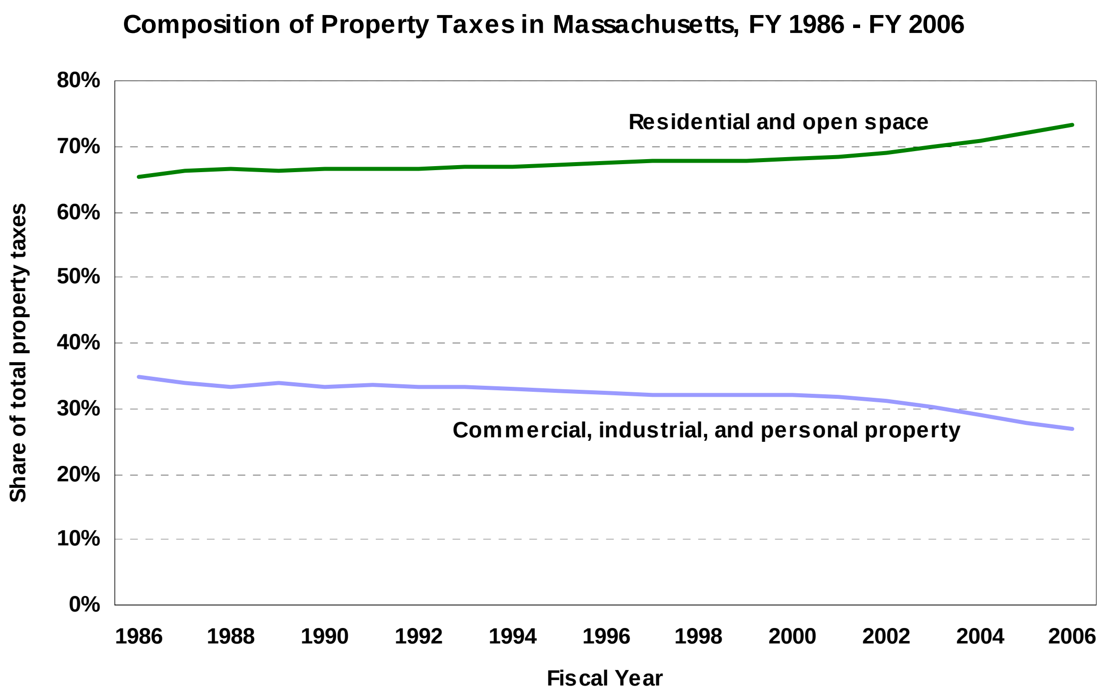
Looking forward, policy makers could set a goal of reversing this trend. In measuring whether taxes are going up or down, it is important to ask “in relation to what?” Often the most useful answer to this question is “in relation to incomes.” The appropriateness of this measure is most intuitively clear in context of income taxes. Most people recognize the income tax as declining if the rate is reduced and rising if the rate is increased – even if changes in an individual’s income level lead to higher total tax payments when rates are falling or lower total tax payments when rates are rising. In evaluating property tax trends and measuring changes in the future, it is important to keep in mind the need to be clear about how tax levels are most appropriately measured.

`

Shifts in the Property Tax
from Commercial and Industrial Property to Residential Property

Over both the long- and the short-run, there has been a decline in the share of property taxes paid by commercial and industrial property owners. As Figure 2, based on data from the Department of Revenue's Division of Local Services (DLS), demonstrates, property taxes on residences and open space now comprise a larger share of total property taxes than at any point in the last twenty years. Moreover, property taxes from these two sources have particularly risen as a share of total property taxes since the turn of the century. In FY 1986, residential and open space property taxes constituted 65.3 percent of all property taxes collected in Massachusetts; commercial, industrial, and personal property taxes made up the remaining 34.7 percent. The former share rose modestly – to 68.3 percent of all property taxes – between FY86 and FY01, just as the latter declined – to 31.7 percent. These developments continued between FY01 and FY06, but at sharper paces. From FY01 to FY06, residential and open space property taxes' share of total property taxes climbed to 73.2 percent; commercial, industrial, and personal property taxes fell to 26.8 percent. With the cooling off of the housing market in Massachusetts, this trend may begin to reverse itself, but it is worth keeping in mind going forward.

Figure 2.

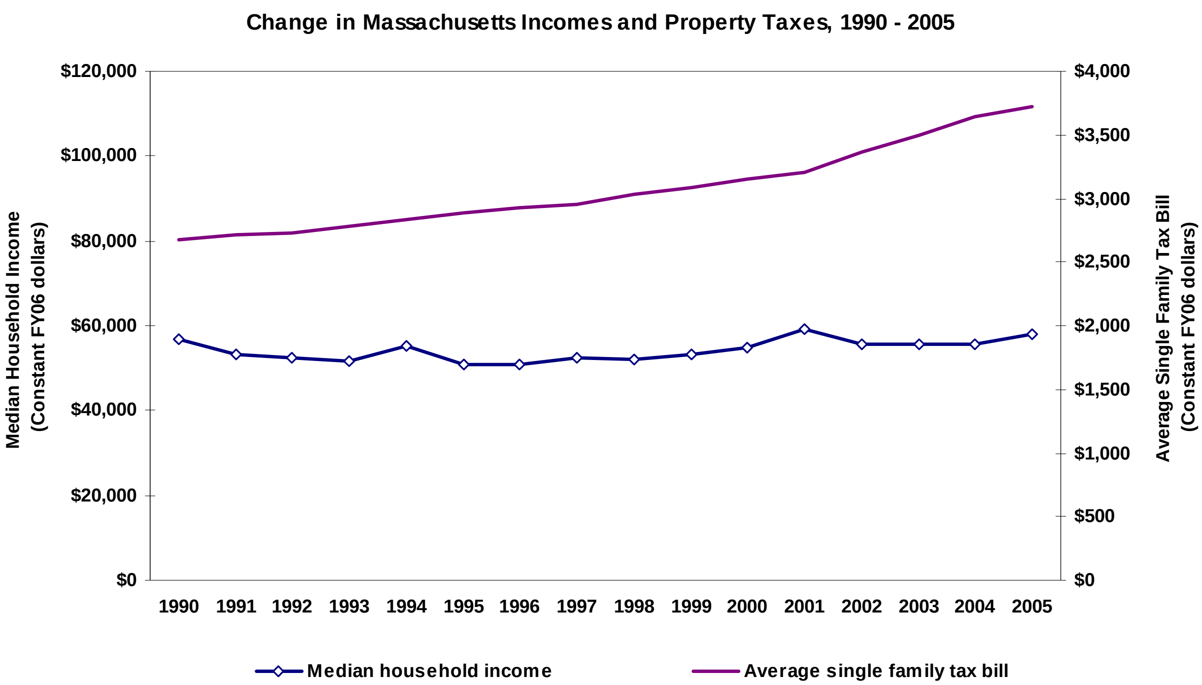


`

Property Taxes Have Remained a Relatively Constant Share of Overall Income, But Middle Class Incomes Have Not Grown at the Same Rate as Overall Income

As noted above, since FY 2001, property tax growth has outpaced aggregate personal income growth in Massachusetts. Figure 3 shows that this trend has been particularly acute when median household incomes are compared to average property taxes. While this comparison has some shortcomings, it nevertheless suggests that property tax bills have climbed much more sharply than the income of the typical household since 2001.[1] More specifically, in 2001, the median household income in Massachusetts was $59,386 (in constant FY06 dollars); the average single family property tax bill was $3,212 in FY01 (also in FY06 dollars). By 2005, median household income appeared to have dropped to $55,625, a decline of 2.1 percent, while the average property tax bill jumped to $3,725 in FY05, an increase of 16 percent.

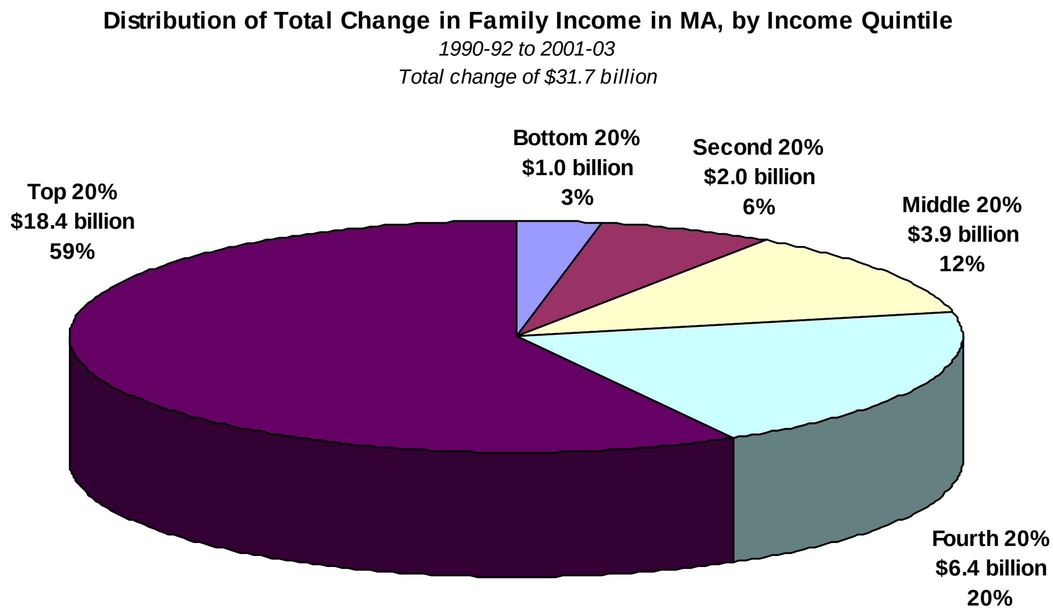
Figure 3.



[1] Among some of the shortcomings inherent in the comparison found in Figure 3 is that the data on average single family tax bills, compiled by the Department of Revenue's Division of Local Services, does not include communities, such as Boston and Cambridge, that offer residential exemptions on their property taxes; further, due to data limitations, the Division recommends against attempting to include those communities in any modified average. An additional shortcoming of the comparison found in Figure 3 is that some fraction of the households included in the state median household income figures presumably rent rather than own; any property taxes they may pay as part of their rent would not be reflected in the figures on average tax bills.

`

Figure 4.



While Figure 1 shows that property taxes, as a share of state personal income, are at about the same level that they were fifteen years ago, Figure 3 shows a very different trend when average single family property tax bills are compared to median incomes. This contrast highlights a serious problem that has afflicted the Commonwealth over the past two decades: most of the income growth that has occurred has been concentrated among the highest income residents of the state (see Figure 4). Thus, one major challenge for the state is to develop economic policies that generate income gains not just for those at the top, but also for middle and lower income people who work hard just to get by. This contrast also highlights a shortcoming of the property tax: unlike the income tax, it fails to align tax payments with income. In times when income growth is concentrated among high-income families – as it has been for the past 20 years in Massachusetts – nothing in the property tax automatically adjusts the tax to account for whose incomes are rising. Thus, property taxes can rise for middle-income residents even during a period of time when property taxes are stable relative to overall personal income. If the unequal growth of family incomes continues, it will likely exacerbate the generally regressive nature of the property tax shown in Figure 5.

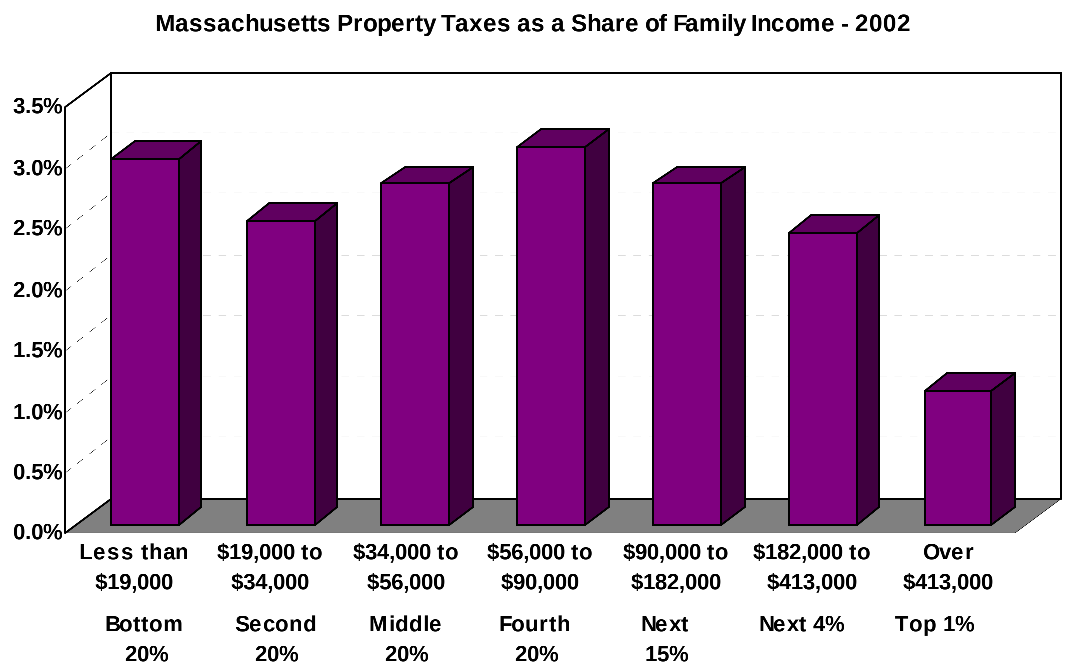
As Figure 4 makes clear, families at the top of the income distribution received the bulk of the increase in family incomes between the start of the 1990s and the beginning of this decade, with families in the middle and at the bottom of the distribution realizing far smaller shares. In the roughly ten-year stretch from 1990-1992 to 2001-2003, the top 20 percent of families in Massachusetts saw their total incomes rise $18.4 billion, an amount equal to almost 60 percent of the total rise in family incomes over that span. By comparison, the poorest 20 percent of

`

families in Massachusetts received just 3 percent – or $1 billion – of the total $31.7 billion increase in family incomes.[2]

There is one final aspect of the property tax in Massachusetts that ought to be considered. Simply put, the property tax is regressive. That is, low-income taxpayers generally pay a larger share of their incomes in property taxes than upper-income taxpayers do. As seen in Figure 5 below – taken from the January 2003 Institute on Taxation and Economic Policy study *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* – the poorest 20 percent of taxpayers in Massachusetts paid 3.0 percent of their incomes in property taxes in 2002. At the same time, the wealthiest 1 percent of taxpayers – those taxpayers with incomes of $413,000 and up in 2002 – paid just 1.1 percent of their incomes in property taxes. The reason for this is that home values are typically much higher relative to low- and moderate-income taxpayers' annual incomes than they are to affluent taxpayers' incomes; moreover, for renters, higher property taxes are often passed along in the form of higher rents, which again, represent a much larger share of income for poorer taxpayers than for rich ones.

Figure 5.



[2] For more on these data and the change in family incomes in Massachusetts over the last twenty years, see the MBPC's January 2006 report, *The Growing Gap: Income Inequality in Massachusetts*, available at www.massbudget.org/growing_gap.pdf.

`

Options for Alleviating Pressure on Municipal and Household Budgets

Given the above trends, policymakers may wish to explore options for alleviating the pressures associated with the property tax. There are several different options policymakers could pursue, but each must confront the same central challenge: how can they be financed, given the fiscal stress the Commonwealth continues to face? If the Commonwealth's budget is structurally balanced in the current fiscal year, it is only precariously so. Moreover, Massachusetts will continue to face fiscal strains in FY 2008. Consequently, to the extent that any option for reducing the property tax requires an increase in state spending or a reduction in state tax revenue, it will require lower spending elsewhere in the budget or higher tax revenue than would otherwise be the case to achieve budgetary balance.

With that in mind, here are two options state policymakers could use to address property taxes:

- **Provide additional local aid to ease pressure on local property taxes**

  As Governor Patrick has previously noted, the recent rise in Massachusetts' property taxes followed declines in local aid due to the Commonwealth's fiscal crisis. Between FY 2001 and FY 2004, local aid (exclusive of education-related aid) declined 22.7 percent in real terms, falling from $1.5 billion (in constant FY 2007 dollars) to $1.2 billion. Since FY 2004, some of those cuts have been reversed, but local aid (again, after adjusting for inflation) remains 11.4 percent below its FY 2001 level. State government in Massachusetts could continue restoring funding for unrestricted local aid and for primary and secondary education and, in so doing, take pressure off municipal budgets and their principal source of revenue, the property tax.

- **Expand the existing property tax "circuit breaker" to all low- and moderate-income taxpayers to improve the incidence of the property tax**

  Under current law, taxpayers who (i) are aged 65 and older, (ii) have incomes below $46,000 (for individuals) or $70,000 (for married couples), and (iii) have a home valued at less than $684,000 may claim a refundable personal income tax credit of no more than $870 for the amount by which their property taxes exceed 10 percent of their incomes. (Elderly renters who meet the same income criteria may also claim a refundable credit, up to $870, for the amount by which 25 percent of their annual rent exceeds 10 percent of their total income.) At least 11 other states (including the District of Columbia) offer similar property tax "circuit breaker" credits, but do not limit them to elderly taxpayers. Massachusetts could follow their lead and expand the eligibility for its existing circuit breaker by removing the 65 and older age criterion, thus mitigating, to some extent, the impact that higher property taxes may have on those individuals or families least able to afford them. According to the Commonwealth's Tax Expenditure Budget, the existing property tax circuit breaker is expected to reduce state tax revenue by $43.9 million in FY 2007. A 2004 analysis from the Department of Revenue suggests that expanding the circuit breaker to non-elderly taxpayers with annual incomes and home values below certain thresholds would reduce revenue by roughly $140 million per year, though that impact is highly dependent on the number of taxpayers who actually claim the credit.

`

Any additional costs of expanding the circuit breaker could, of course, be constrained by adopting stricter income or asset eligibility thresholds for non-elderly taxpayers.

Policymakers could offset the additional spending or lower taxes associated with these two options by:

- **Replacing further income tax cuts with property tax reduction efforts and the restoration of vital services**

  When it became clear during the fiscal crisis that over three billion dollars in state tax cuts during the previous decade had caused a structural budget gap[3], the Legislature acted to reverse a portion of those tax cuts. At the same time, the Commonwealth enacted deep cuts to state programs and to local aid that shifted costs from the state to cities and towns. Under existing law, certain cuts to the income tax that were suspended in 2002 will be reinstated in the coming years. Rather than implementing state tax cuts that would ultimately cost nearly a billion dollars per year, the state could use those resources instead to fund an expanded circuit breaker, restore local aid, reverse additional cuts to essential state services, and help balance the budget.

- **Further reforming the Commonwealth's corporate excise tax**

  Since 2003, Massachusetts has adopted a number of reforms to its corporate excise tax, including prohibitions on the abuse of passive investment companies and improvements in the treatment of non-business income. These reforms have made the Commonwealth's tax system more equitable and more efficient, but they have by no means put an end to corporate tax avoidance. Additional reforms would further limit the ability of profitable corporations to use sophisticated accounting schemes to shift income out of Massachusetts. Combined reporting, a method of taxation now used in seventeen states, would dramatically reduce the Commonwealth's vulnerability to such schemes and, in so doing, generate as much as $300 million in additional revenue once fully implemented.[4] There are other opportunities for making the Commonwealth's corporate tax laws more effective as well. Legislative proposals developed by Governor Romney's Department of Revenue – such as preventing the use of pass-through entities to avoid the deeds excise or

---

[3] For more information on the origin of Massachusetts' structural deficit, see MBPC's February 2003 report *Trading Places: The Role of Taxes and Spending In the Fiscal Crisis*, available at www.massbudget.org/tradingplaces.pdf.

[4] For more information on combined reporting, please see either *Combined Reporting: A Comprehensive Method of Closing Corporate Tax Loopholes* or *A Few Commonly Asked Questions about Combined Reporting*, both of which are available at www.massbudget.org.

`

the use of differing entity classifications for federal and state tax purposes to avoid Massachusetts' corporate excise – would, taken together, ultimately generate $85 million per year.[5]

- **Adopting a more progressive approach to property taxation**

  While the home is the largest asset of most middle-income families, many high-income residents have much larger holdings of intangible property, such as stocks or bonds. While Massachusetts' cities and towns levy property taxes on real estate, neither the Commonwealth nor its municipalities impose a comparable tax on intangible property. Massachusetts does, however, tax both the profits arising from the sale of certain intangible property and the dividend income derived from such property. The recipients of that dividend income received one of the steepest tax cuts of the last decade: between 1998 and 2002, the tax rate on dividend income was reduced from 12 percent to 5.3 percent. Policymakers should consider whether that was the right property tax to cut, particularly since the cost of that tax cut was expected to breach $300 million in FY2004 and has likely grown since then.

[5] For more information on these proposals, see MBPC's April 2005 report, *Changing Course: A Review of Governor Romney's Tax Loophole Legislation*, available at www.massbudget.org/changingcourse.pdf. Governor-elect Patrick's *Plan for Fiscal Responsibility* (April 2006) explained the need for improvements in the tax code like those recommended by the Department of Revenue (which Governor Romney initially supported, then opposed): "Better clarity in the tax code and more rigorous enforcement of tax cheaters is essential. Businesses that play by the rules deserve a tax structure that is consistent, fair and predictable. First, we will end the practice of corporations using transactions with subsidiaries to shelter income. Second, we will prevent companies from using differing classifications for federal and state taxes to get favorable tax treatment. Finally, we will prevent companies from using intermediaries to avoid the deeds excise when selling real estate. These changes will result in additional revenues of $85 million."