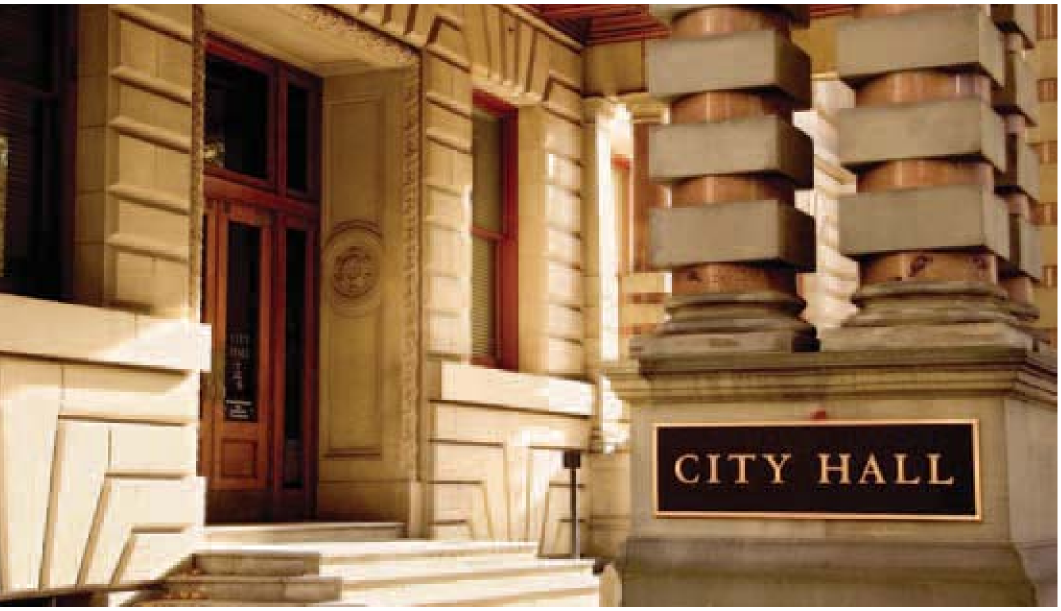
The Municipal Fiscal Crisis and Payments in Lieu of Taxes by Nonprofits



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Municipalities around the country face a daunting fiscal crisis. Federal stimulus assistance has expired, and many states have made significant cuts in aid to municipalities. Meanwhile property values have declined 31 percent since their 2006 peak according to the S&P/Case-Shiller national home price index.

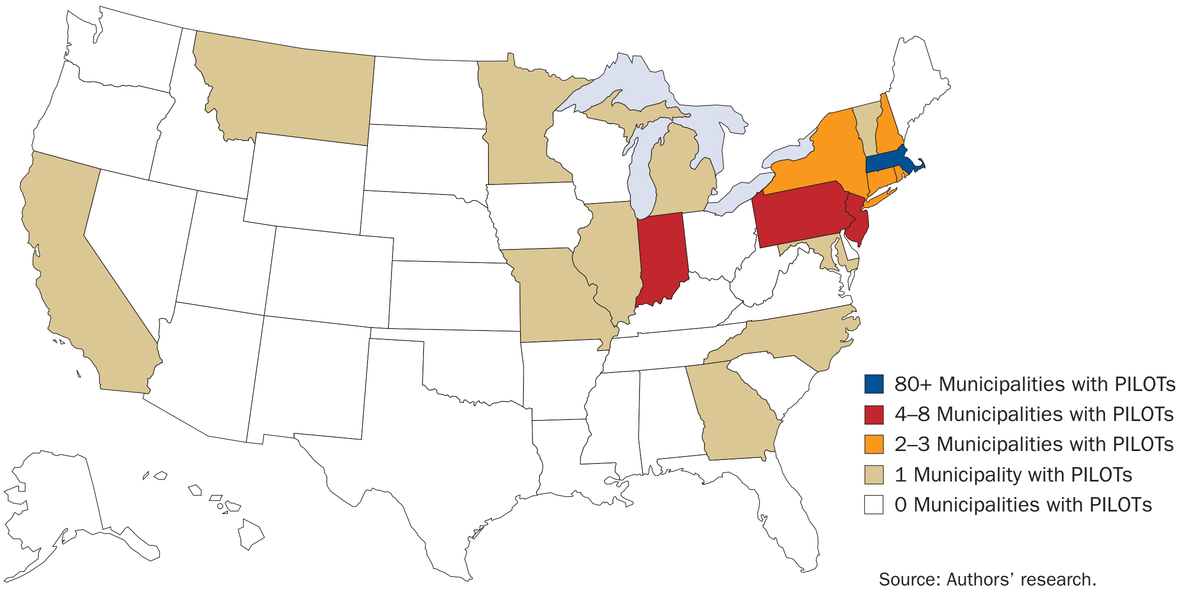
It will take several years to know how this historic decline will affect property tax revenues, because changes in property tax bills significantly lag changes in market values. However, cities faced declines in general fund revenues of 2.5 percent in 2009, and approximately 3.2 percent declines in 2010 (Hoene 2009; Hoene and Pagano 2010). Municipal responses to revenue shortfalls have included making cuts to personnel (71 percent of cities), delaying or cancelling capital projects (68 percent), and making across the board cuts (35 percent) (McFarland 2010).

To avoid further cuts, municipalities will need to raise additional revenues. But with anti-tax sentiment running high, many cities and towns may try to avoid raising tax rates and look instead to increased reliance on fees and other alternative revenue sources. One alternative that has attracted the attention of many local officials recently is payments in lieu of taxes (PILOTs) by nonprofit organizations.

PILOTs are voluntary payments made by tax-exempt nonprofits as a substitute for property taxes. These payments typically result from negotiations between local government officials and individual nonprofits, but the exact arrangements vary widely. PILOTs can be formal, long-term contracts, routine annual payments, or irregular one-time payments. The payments can go into a municipality's general fund, or be directed to a specific project or program. PILOTs are most frequently made by hospitals, colleges, and universities, but also by nonprofit retirement homes, low-income housing facilities, cultural institutions, fitness centers, and churches. Some such payments are not even called PILOTs, but are known as "voluntary contributions" or "service fees."

Since 2000, PILOTs have been used in at least 117 municipalities in at least 18 states (Kenyon and Langley 2010). These payments are concentrated in the Northeast, and especially in Massachusetts where they have been made in 82 out of 351 municipalities (figure 1). It is hard to make definitive statements about trends in the use of PILOTs, because there is no comprehensive source that tracks them, but press accounts suggest growing interest in PILOTs since the early 1990s, with a noticeable uptick in recent years. Major multiyear agreements have recently been reached in Pittsburgh and Baltimore; commissions have studied PILOTs in Boston, New Orleans, and Providence; and many smaller municipalities have reached new agreements with local charities.

FIGURE 1
States with Municipalities Collecting PILOTs (2000–2010)



Source: Authors' research.

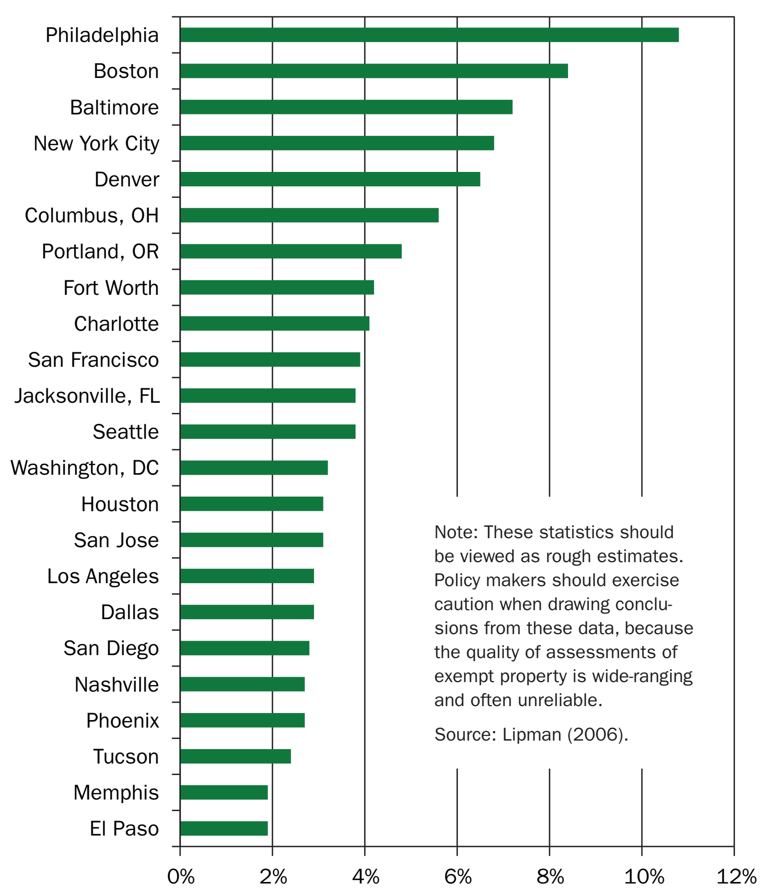
The Revenue Potential of PILOTs

The revenue potential of PILOTs varies across municipalities because of large differences in the impact of the charitable property tax exemption on their tax bases. Figure 2 shows that in 23 large U.S. cities the value of tax-exempt nonprofit property as a share of total property value ranged from 10.8 percent in Philadelphia to 1.9 percent in Memphis and El Paso. Similarly, a fiscal year 2003 study of 351 municipalities in Massachusetts found that if the tax exemption for charitable and educational nonprofits were removed, these organizations would account for more than 10 percent of the property tax levy in 18 municipalities and between 2.5 and 10 percent in another 68, but less than 1 percent of the tax levy in 179 municipalities (McArdle and Demirai 2004).

Since nonprofit property tends to be highly concentrated in a relatively small number of municipalities, especially central cities and college towns, PILOTs have the potential to be a very important revenue source for some municipalities, even if they are unlikely to play a significant role in financing local government in the majority of cities and towns. Table 1 looks at PILOTs in ten municipalities where they rarely account for more than 1 percent of total revenues, but the dollar figures are often significant.

The impact of the charitable property tax exemption on municipal budgets also depends on the

FIGURE 2
Estimated Value of Exempt Property Owned by Nonprofits as a Percent of Total Property Value



Note: These statistics should be viewed as rough estimates. Policy makers should exercise caution when drawing conclusions from these data, because the quality of assessments of exempt property is wide-ranging and often unreliable.

Source: Lipman (2006).

degree of reliance on property taxes as a revenue source. Local governments with a heavier reliance on sales and excise taxes, user fees, or state aid are in a better position to deal with forgone property tax revenues through those other sources.

Collaboration on PILOT Agreements

In seeking PILOT agreements, local officials sometimes resort to adversarial pressure tactics, which can backfire and jeopardize important relationships between municipalities and nonprofits. A more collaborative approach is usually more successful when local officials work to build genuine support among nonprofits for a PILOT program that is rooted in shared interests and mutual dependence for each other's long-term success.

Many large nonprofits like hospitals and universities are quite immobile, and other smaller nonprofits may be committed to serving their local communities even if they could relocate with relative ease. The long-term success of these organizations depends on the municipality's success. Because population loss, crime, and crumbling infrastructure can imperil a nonprofit's future, having a local government with the capacity to provide quality public services is in its own self-interest.

Similarly, nonprofits are often major employers and provide services and activities that attract people to a city and improve the quality of life for local residents. Thus, the success of these organizations is also crucial for a municipality's future. Even if the nonprofits are tax-exempt, their presence can significantly expand the local tax base by attracting businesses and homeowners.

Recognition of these shared interests by both sides is crucial to reaching sustainable PILOT agreements. Private conversations between high-ranking municipal and nonprofit officials can help break down barriers that sometimes block PILOTs. To make the case for PILOTs, municipalities often appeal to the nonprofits' sense of fairness and community responsibility—arguing that it is fair for nonprofits to pay for the cost of public services they consume, and that a contribution will directly benefit the community.

These conversations should also touch on what the nonprofits need for their future success. In practice, municipalities are often most successful in obtaining PILOTs when nonprofits need something from the local government, such as building permits or zoning changes. The *quid pro quo* nature of these agreements is often viewed negatively—as a form of extortion or special treatment. However, accommodating these requests is often in a municipality's own interest.

For major nonprofit development projects, a shortened approval process with less red tape can cut overall costs significantly, and such discussions can result in more creative arrangements. For example, as part of a 20-year PILOT agreement with Clark University, the City of Worcester, Massachusetts agreed to work with the university to convert a short section of a street into a pedestrian area.

When local officials use more aggressive tactics to obtain PILOTs, such as trying to shame nonprofits into making payments or threatening to

TABLE 1
PILOT Contributions to City Revenues in Selected Cities

City	PILOT Revenue Generated ($)	City Budget ($)	Year	PILOT Revenue Generated as a Share of Total Budget (%)
Baltimore, MD	5,400,000	2,935,976,521	FY2011	0.18
Boston, MA	15,685,743	2,380,000,000	FY2009	0.66
Bristol, RI	181,852	43,846,275	FY2011	0.41
Butler, PA	15,000	8,442,098	FY2010	0.18
Cambridge, MA	4,508,000	466,749,012	FY2008	0.97
Lebanon, NH	1,280,085	42,312,510	FY2010	3.03
Minneapolis, MN	158,962	1,400,000,000	FY2009	0.01
New Haven, CT	7,500,000	648,585,765	FY2010	1.16
Pittsburgh, PA	2,800,000	507,797,100	FY2011	0.55
Providence, RI	3,686,701	444,544,123	FY2010	0.83

Source: Authors' research.

challenge their tax-exempt status in court, the organizations may become defensive and less willing to cooperate. Charitable nonprofits have a strong record of defending their property tax exemptions, so such divisive tactics are likely to leave a municipality with no PILOT, potentially significant legal fees, and a damaged reputation.

Problems with PILOTs

PILOTs have the potential to provide crucial revenue for municipalities with large nonprofit sectors, but there are many problems with these payments compared to more conventional taxes and fees.

First, at the same time that municipalities face a fiscal crisis caused by the recession, nonprofits face their own fiscal crisis due to declining endowment values and donations. In addition, government contracts—a major funding source for health and human service nonprofits—were cut, and some government entities are delaying contracts or payments. A 2009 survey found that 80 percent of nonprofit organizations were experiencing fiscal stress in the wake of the recession (Center for Civil Society Studies 2009). To nonprofits facing uncertain financial futures, it appears unfair for local governments to begin requesting PILOTs at this time (National Council of Nonprofits 2010).

Second, some degree of horizontal and vertical inequity in PILOT programs is almost inevitable, because their voluntary nature means there is no way to ensure that nonprofits with similar property values make comparable PILOTs. For example, even with Boston's long-standing PILOT program, the four largest universities in the city made very different contributions in fiscal year 2009. Boston University paid $4,892,138 (8.53 percent of what it would pay in property taxes if taxable); Harvard University paid $1,996,977 (4.99 percent); Boston College paid $293,251 (1.92 percent); and Northeastern University paid only $30,571 (0.08 percent).

Third, PILOTs are a limited and frequently unreliable revenue source, rarely accounting for more than 1 percent of total revenues. This limited revenue potential must be weighed against some potentially significant costs associated with reaching PILOT agreements, such as upfront administrative costs, time spent by high-ranking officials negotiating agreements, or costs to obtain accurate assessments of exempt properties. PILOTs can also be an unreliable revenue source from one year to the next if they rely on short-term agreements.

Finally, the process used to reach PILOT agreements is often contentious and secretive, with contributions determined in an ad hoc manner lacking objective criteria. A collaborative approach can make PILOT requests less controversial, but reliance on private conversations also makes the process less transparent.

Systematic Programs to Mitigate Problems

Many of these problems with PILOTs can be mitigated if municipalities set up a systematic program that does not rely solely on case-by-case negotiation, especially for municipalities with a large number of nonprofits. A framework that applies to all organizations can provide guidance and bring consistency to the negotiations with individual nonprofits. The recommendations of Boston's PILOT Task Force provide a concrete example (box 1).

Municipalities interested in establishing a systematic PILOT program should consider the following features.

Use a threshold level of property value or annual revenues to determine which nonprofits to include in the PILOT program. Excluding from PILOT requests certain types of nonprofits, such as religious organizations or small social service providers, may be a popular notion, but it can result in arbitrarily targeting some nonprofits while ignoring others. A more systematic policy with a threshold approach is easy to administer and will exclude only those nonprofits that do not meet the financial threshold to make significant contributions, rather than favor some organizations based on the nature of their activities.

Set a target for contributions that is justified. Instead of reaching an arbitrary dollar figure in negotiations, a target that applies to all nonprofits in the program can reduce horizontal inequities and may raise more revenue by creating the expectation for a certain contribution. For example, the target can be justified by estimating the cost of local public services that directly benefit nonprofits, such as police and fire protection and street maintenance.

Use a basis to calculate suggested payments. Using a basis with the rate set to reach the target contribution will also promote consistency. The fairest basis is the assessed value of exempt property, because the PILOT request will be proportional to the tax savings each organization receives from the property tax exemption. However, BOX 1

Recent Municipal Initiatives on PILOTs

Baltimore, Maryland: The city reached a $20 million six-year PILOT agreement with hospitals and universities in June 2010, with $5.4 million to be paid in each of the first two years. In return, the city dropped a proposed $350 fee per dorm and hospital bed, and protected hospitals and universities from increases in telecommunications and energy tax rates over the next six years (Walker and Scharper 2010).

Boston, Massachusetts: Beginning in January 2009, a task force of representatives from nonprofits, city government, business, labor, and the community met with a goal of making the city's existing PILOT program more consistent. The final report has recommendations on key features of a systematic PILOT program: only nonprofits with property values exceeding a $15 million threshold are included in the program; the target PILOT for each institution is equal to 25 percent of what it would pay in property taxes, because roughly one-quarter of the city's budget is devoted to core public services that benefit nonprofits; assessed value is used as a basis for the payments; and guidelines determine which types of services will count for community benefit offsets (City of Boston 2010).

New Orleans, Louisiana: A Tax Fairness Commission has been tasked with recommending changes to make the city's tax system fairer and to broaden the tax base. While the commission may consider PILOTs, it is particularly interested in narrowing the nonprofit property tax exemption (Nolan 2011). Louisiana has a very broad charitable exemption compared to most states, with all properties owned by eligible institutions exempt from taxation regardless of use, including those not typically tax-exempt such as fraternal organizations, labor unions, and trade associations (Bureau of Government Research 1999).

Providence, Rhode Island: The mayor and city council members sought to increase the amount of PILOTs from the city's four colleges and universities, but the Commission to Study Tax-Exempt Institutions (2010) recommended against renegotiating the 20-year $48 million PILOT agreement reached in 2003. Instead the commission recommended that the city should focus on forming partnerships with local nonprofits to foster economic growth, and the state should provide full funding of its PILOT program and provide Providence with a share of new income and sales tax revenues that result from nonprofit expansion.

municipalities that want to avoid having to accurately assess tax-exempt properties can use another basis, such as the square footage of property or the organization's annual revenues.

Include community benefit offsets, so nonprofits can reduce their target cash PILOTs in return for providing certain public services for local residents. Charitable nonprofits are typically more willing to provide in-kind services than to make PILOTs, and are well positioned to leverage their existing expertise and resources to provide needed services. For example, nonprofit hospitals can set up free health clinics, and universities can establish after-school tutoring programs. Local officials should be clear and consistent about which services are most needed by local residents and will count for community benefit offsets, and should rely on nonprofits to estimate the cash value of these donated in-kind services.

Reach long-term PILOT agreements. Both municipalities and nonprofits are better off with a long-term approach that allows them to build predictable payments into their respective budgets. Additionally, because PILOT requests can require considerable time to negotiate, both parties will benefit from reaching an agreement and then moving on to focus on their primary missions and perhaps other partnerships to serve the community. Several municipalities have 20- or 30-year PILOT agreements in place.

Alternatives to PILOTs

Given some of the common problems with PILOTs, municipalities with large nonprofit sectors that face revenue shortfalls may want to consider alternative revenue-raising measures.

Increase reliance on traditional user fees or special assessments. This alternative may be the most palatable in the current anti-tax climate. One consideration favoring this option is that nonprofits are typically not exempt from these charges, so increasing reliance on such sources will obtain revenue from a broad group of entities, including tax-exempt nonprofits. For example, a municipality could finance garbage collection through a fee instead of the property tax, or use special assessments to pay for sewer hookups in new subdivisions.

Establish municipal service fees. Some municipalities have carved out specific services that are normally funded through property taxes and instead charged nonprofits a fee for the service.

These fees may or may not be assessed solely against tax-exempt nonprofits, and they often use a basis for the payments related to the size of the property rather than the assessed value. For example, Rochester, New York, has a local works charge to fund snowplowing and street repair. It is applied to both taxable and tax-exempt organizations using the property's street frontage as the basis. Minneapolis, Minnesota, has a street maintenance fee that also uses square footage as the basis, but is only charged to nongovernmental tax-exempt properties.

Develop agreements for needed services. Local officials can decide not to pursue cash PILOTs, but instead develop formal partnerships with nonprofits to provide specific services for local residents or work together to foster economic development. Direct provision of needed services, sometimes known as services in lieu of taxes or SILOTs, will help the fiscal situation of the municipality in the short run, while joint efforts to foster economic development can have significant long-run benefits.

Expand the tax options for municipalities. This final alternative would require a change in state law in many instances. Some municipalities across the country have the ability to levy sales taxes, special excise taxes such as hotel taxes, income taxes, or payroll taxes. But most cities in the Northeast do not have these alternative tax sources, and are especially reliant on the property tax, which can be problematic if the tax-exempt sector is large or growing rapidly.

Conclusion

PILOTs have the potential to provide crucial revenue for municipalities that have a significant share of total property value owned by tax-exempt nonprofits, both as a stop-gap in the current municipal fiscal crisis and in the future. However, PILOTs rarely account for more than 1 or 2 percent of municipal revenues, so expecting these payments to eliminate local government deficits is unrealistic. Furthermore, singling out nonprofits to help address a municipal fiscal crisis is unfair since they face their own challenges due to the recent recession.

Local officials who do want to pursue PILOT agreements must tread carefully if they want to avoid some common pitfalls. First, PILOT requests can be highly contentious when local officials resort to heavy-handed pressure tactics to reach agreements. It is preferable for local officials to work collaboratively with nonprofit leaders to craft PILOT agreements that serve their mutual interests. Second, the voluntary nature of PILOTs limits the revenue potential of these agreements, results in inconsistent treatment of nonprofits, and leads to other problems. Municipalities with a large number of nonprofits can mitigate these problems by establishing a systematic PILOT program to provide guidance and bring consistency to their negotiations with individual nonprofits.

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