



Payments in Lieu of Taxes

THE BOSTON EXPERIENCE

© iStockphoto.com

Boston is home to many hospitals, universities, and other tax-exempt organizations.

Ronald W. Rakow

Historically communities with high concentrations of nonprofit institutions such as hospitals, colleges, and museums have struggled with the reduced tax base associated with these tax-exempt properties. For Boston, Massachusetts, the preponderance of tax-exempt property, combined with a high reliance on the property tax for local revenue, has made this impact particularly acute. Beginning in the early 1970s, Boston began seeking payments from its nonprofit organizations as a way of offsetting the loss of revenue and the increase in public service demands associated with the institutions it hosts.

Although these payments in lieu of taxes (PILOTs) expanded over time, the City of Boston remained dissatisfied with its PILOT program. The revenue from PILOTs represented a small fraction of the city's overall budget, and the size of contributions from nonprofit institutions varied widely. Since

2008 Boston has developed and implemented a new approach to PILOTs that has received considerable national attention. This article examines the conditions that led to the development of Boston's new PILOT program, describes its approach, and reports on the city's experience in its first full year.

Constraints on Boston's Tax Base

Boston traditionally has been at the center of any discussion regarding PILOTs. The confluence of several political, fiscal, and demographic forces has created a volatile mix for the city and its nonprofit institutions. Boston is the economic and cultural center of New England and is home to some of the world's most renowned hospitals and universities. As the state capital of Massachusetts, Boston also hosts a large number of government office buildings and facilities. Among its more unusual challenges is the city's small geographic size in relation to its metropolitan area. Boston is the 22nd largest city by population, but it represents the 10th

largest metropolitan area. As a result, exempt institutions that service the entire metropolitan area are concentrated within the city's relatively small boundaries. In fact, over 50 percent of Boston's land area is exempt from taxation (figure 1).

Boston also has a revenue structure that is unique among its large-city peers, primarily because it has no income, payroll, sales, or other significant source of tax revenue. Instead, Boston relies heavily on the property tax, which represents two-thirds of all city revenue (figure 2). While New York or Chicago also have large amounts of institutional property exempt from the property tax, those cities are able to tax the incomes, sales, and other economic activity which the universities, hospitals, and other large nonprofit institutions generate. In contrast, Boston receives no direct compensating revenue associated with the economic activity that is generated by its vibrant nonprofit sector.

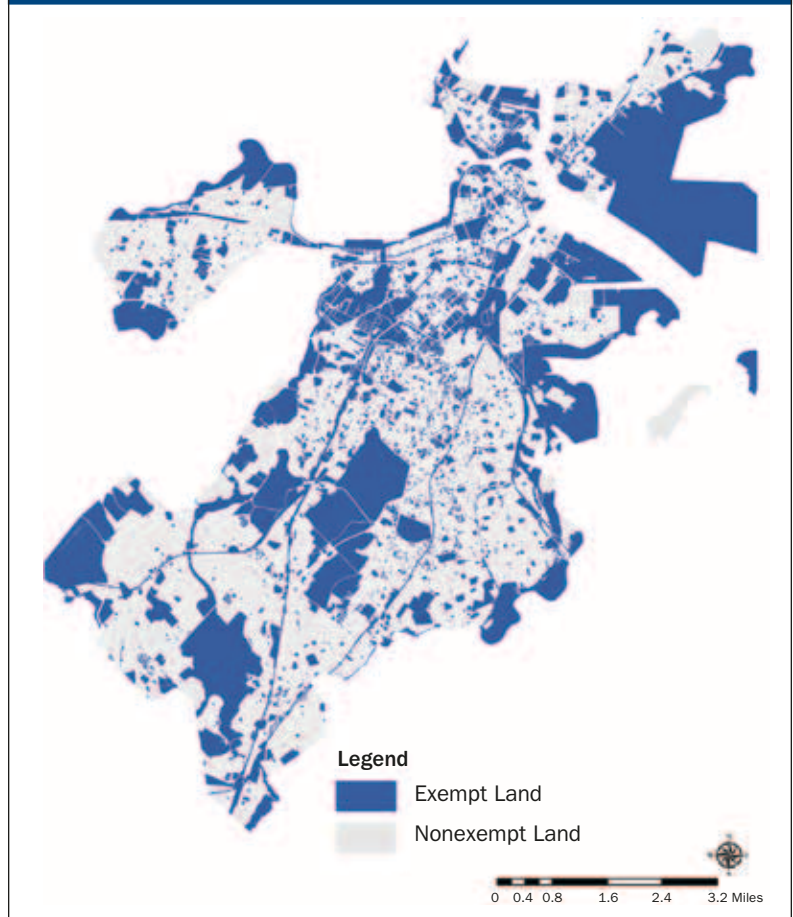
Further, the growth of the property tax in Boston is constrained by Proposition 2½, a statutory limit on the level of property taxes. The most significant limitation is that the property tax levy for existing properties can increase by only 2.5 percent per year. Proposition 2½'s other primary limitation is a cap on the overall effective tax rate of 2.5 percent. As Boston is well below this limit at 1.8 percent, the impact of exempt property is not a factor for this provision as it is in other Massachusetts communities. The combined impact of the concentration of exempt property, the high reliance on the property tax, and the limits placed on property tax growth by Proposition 2½ result in a more profound fiscal impact of exempt property in Boston than in most major cities.

Reconciling the Benefits and Costs of Nonprofit Institutions

Despite these fiscal impacts, Boston is fortunate to have a vibrant nonprofit sector. The city hosts some of the world's most prestigious hospitals and universities that provide exceptional health care, research, and education to their clients. In addition to fulfilling their charitable missions, these large institutions are significant economic generators that form the backbone of Boston's knowledge-based economy. The health care industry alone accounts for 125,000 jobs in Boston.

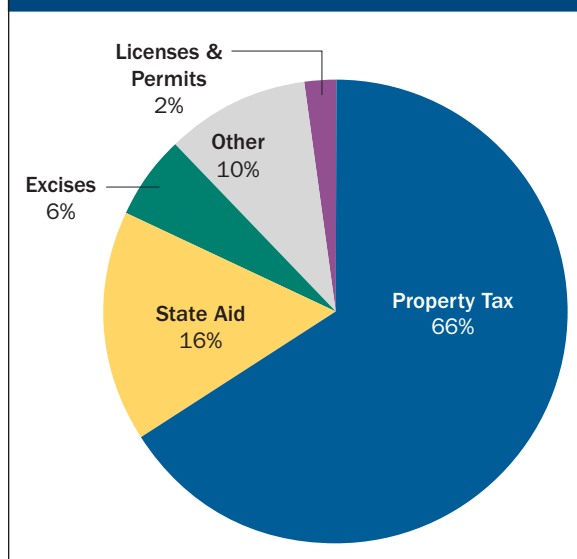
There is an economic disconnect, however, between the benefits of nonprofit institutions and the costs of providing their properties with tax

FIGURE 1
Tax-Exempt Property in the City of Boston, FY2012



Source: Courtesy of City of Boston Assessing Department.

FIGURE 2
Revenue Sources for the City of Boston, FY2013



Source: City of Boston Office of Budget Management (2012).

exemptions. The benefits of Boston's nonprofits do not stop at the city's borders; the educational, scientific, and cultural benefits of Boston's institutions accrue to the region, state, country and, in many cases, the entire world. Yet the cost of providing public services to these institutions and the loss in revenue from removing their properties from the tax base fall squarely on Boston's taxpayers.

This point is critical to understanding the importance of PILOTs to a city like Boston. Many observers believe that the current interest in PILOTs is driven by the short-term fiscal stress associated with the recent recession. According to this school of thought, once the economy recovers and the municipal outlook brightens, the pressure for PILOTs will ebb. Boston's experience contradicts this assertion. The city has struggled with the fiscal impact caused by its nonprofit sector over a long period, through good fiscal times and bad. It is this fundamental disconnect between institutional benefits and fiscal costs that is the ultimate source of this debate. Until these benefits and costs are better reconciled, financial tension between the city and its nonprofits will continue.

Measuring the Fiscal Impact of Tax-Exempt Property

The impact of tax-exempt property on the city as a whole has long been the focus of spirited public discussion in Boston. One question that has often been asked is how much nonprofit institutions would pay if their properties were fully taxable. For a long time this question could not be answered. Since tax-exempt property paid no property taxes, the city had little incentive to maintain accurate data and up-to-date assessments for institutional property. However, the continuing focus on the fiscal impact of exempt property clearly required an answer to this question.

Given the scarce resources available for a project to value exempt property, Boston needed to be creative in coming up with a method to generate reliable assessments while minimizing the costs of collecting data. At the city's disposal was a particular type of tax return that nonprofit institutions are required to file annually, as well as broad statutory authority to request from property owners the information necessary to value their properties.

Boston was able to leverage these tools to collect detailed information on the property owned by nonprofit institutions—specifically, the physical

characteristics (size, age, condition) and uses. Most major institutions maintain accurate data on their property holdings. Once the assessors had access to these data, they were able to plug the information into the city's computer-assisted mass appraisal system (CAMA) to generate assessments for the properties. Site inspections were performed to verify the information provided by the institutions and to ensure the accuracy and reliability of the CAMA-generated assessments.

The resulting assessments were then shared with the institutions. Each was given the details on the valuation estimates for their real estate holdings and provided with an opportunity to meet with assessors to review the results and raise any concerns. The city incorporated this feedback to complete the final value for the properties. Given that this was the city's first effort to generate assessments for nonprofit property, this review step provided a valuable check of valuation data quality as well as an opportunity to share the preliminary results of the revenue impact of their property tax-exemptions with each institution.

The analysis, which was completed in 2009, revealed that educational and medical tax-exempt property would have generated \$347.9 million in revenue if it were taxable (City of Boston 2010). To put this amount in perspective, it would equate to approximately one-quarter of the city's total tax levy of \$1.4 billion in Fiscal Year 2009, and would be equivalent to roughly half the revenue generated by the office, retail, and hotel properties that make up the commercial tax levy (figure 3).

PILOT Task Force

Once the assessment information was used to determine the amount of tax each institution would pay in a nonexempt scenario, a number of shortcomings of the current PILOT program became apparent. While the former program was considered one of the more successful PILOT programs in the country, the amount of realized revenue appeared small when compared with the revenue that exempt properties would generate if they were taxable. PILOT payments from educational and medical institutions in 2009 totaled \$14.5 million, or 4.2 percent of what institutions would pay if their properties were taxed, and equivalent to just 1 percent of the city's property tax levy. In addition, the level of participation varied widely among institutions. Some institutions made substantial

contributions under the program, while others made limited payments or chose not to participate at all.

To address these concerns, Boston Mayor Thomas M. Menino appointed a task force to review the PILOT program and asked it to:

- set a standard level of contributions to be met by all major tax-exempt landowning institutions;
- develop a methodology for valuing community benefits;
- propose a program structure that creates longer-term, sustainable partnerships between the city and its nonprofits;
- clarify the costs associated with providing city services to nonprofits; and
- if necessary, provide recommendations on legislative changes needed at the local or state level.

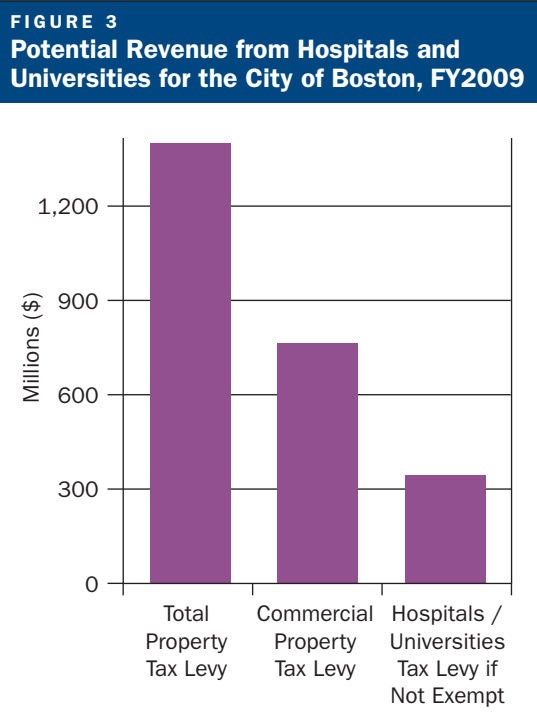
The PILOT Task Force membership drew from a wide spectrum of participants: two leaders each from local colleges, nonprofit hospitals, and Boston’s business community; and one each from the city council, public sector unions, and community-based organizations. The Task Force met over a two-year period to explore both the benefits and costs to Boston of hosting its nonprofit institutions and how these factors should be considered in the PILOT process. Also key was the discussion on how to ensure that institutions contribute to the program on a consistent basis. In December 2010, the Task Force recommended the following PILOT guidelines to Mayor Menino.

PILOT Program Should Remain Voluntary

The Task Force members believed a legal or statutory requirement for PILOTs runs counter to the spirit of partnership between the city and its nonprofit institutions. That partnership is critical to encouraging broad and uniform participation.

All Nonprofits Should Participate

Much of the PILOT discussion previously focused on hospitals and universities. The Task Force, however, felt all nonprofits that own tax-exempt real estate within the city should contribute to the PILOT program. To protect smaller institutions with fewer resources, the PILOT program was limited to those nonprofits with property valued at more than \$15 million.



Source: City of Boston (2010).

Determining PILOT Payments

Many alternatives were considered for the basis of PILOT contributions, including a per-student or per-hospital-bed fee, or a charge based on the amount of land or building area. The Task Force determined that a charge driven by the assessed value of the institutions—reflecting size and quality of real estate holdings—would result in the most equity. There was a general consensus that nonprofits should contribute some amount toward their consumption of essential services such as police and fire protection, as well as public works such as street cleaning and snow removal. These services consume approximately 25 percent of Boston’s budget, and the Task Force found that a PILOT equal to 25 percent of an institution’s fully taxable amount was reasonable.

Credit for Community Benefits

The public benefit provided by nonprofit institutions was a major focus of the Task Force, which recommended that institutions receive up to a 50 percent credit on their PILOT in exchange for community benefits. This credit recognized the significant in-kind contributions made by nonprofit institutions that directly benefit Boston residents. The credit was limited to 50 percent of the PILOT amount to ensure significant cash contributions from each

institution. However, the Task Force felt that if an exceptional opportunity for a program or service were available, the 50 percent cap could be exceeded at the city's discretion.

While the Task Force did not offer detailed specifics on the services that were eligible for PILOT credit, it did provide general guidance on the types of services that should qualify. To be eligible, community services must directly benefit City of Boston residents, support the city's mission and priorities, offer ways for the city and nonprofit to collaborate to meet shared goals, and be quantifiable.

Phase-in Period

Finally, the Task Force recommended that the new PILOT formula be phased in over a period of not less than five years. Given the change in scope of the city's PILOT program, the Task Force understood that institutions would require time to make the necessary adjustments in their budget and financial plans to accommodate increased PILOT amounts.

Implementing the New PILOT Program

When Mayor Menino accepted the Task Force recommendations in December 2010, the city needed a plan to implement the new PILOT program. First, letters were sent to all institutions that fell within the criteria of the program. Each letter included a copy of the new PILOT guidelines and an analysis detailing the calculation of the PILOT that the city would request under the new formula. Each letter also indicated that the city would seek a meeting with each institution in the coming months to discuss the new program.

The subsequent meetings were a critical step in the implementation, providing a forum for each institution to ask questions about the program and to voice concerns. While these sessions were designed originally to provide information to the institutions on the new program, they also provided significant, valuable feedback for the city that in turn offered further guidance on the rollout.

The city's previous PILOT program included contracts that laid out the terms of each institution's PILOT commitment. While the contracts were useful as a reference, their value as a legal instrument was questionable since PILOT payments remained voluntary. For example, the city had never sought to enforce payment under a PILOT contract. As the city faced the question of whether contracts would be employed in the new program,

the notion of negotiating, drafting, and executing over 40 contracts with institutions was daunting. Given that the guidelines already provided the details of each institution's requested participation, the city felt those documents should form the basis of the relationship with the institutions and decided to forgo the use of PILOT contracts.

Experience from the First Year

In October 2011, requests for payment of the first installments for FY2012 were sent to all participating institutions, and the results were impressive. The city collected a total of \$19.5 million in cash payments, a 28.4 percent increase over what was collected in FY2011 under the previous PILOT program. This represented over 90 percent of what the city requested—an extraordinary level of participation given the first year of a new, voluntary program (figure 4). Boston also received an equivalent level of contributions in the form of community services provided by the nonprofit institutions, consistent with the PILOT guidelines.

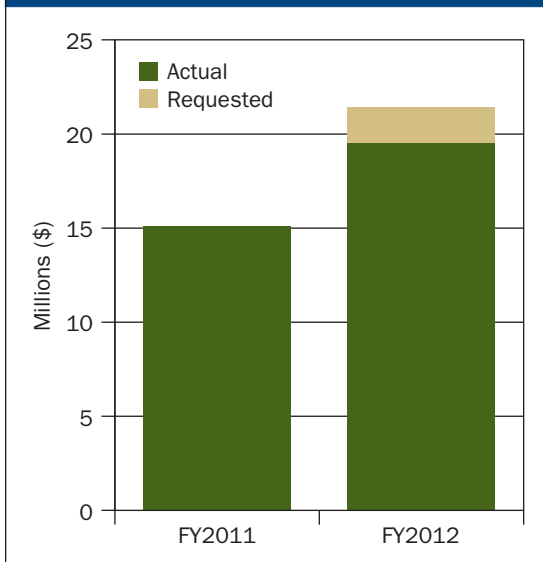
A key component of the program's initial success was the emphasis on promoting a sense of partnership between the city and its institutions. Based on its prior experience, the city understood that a more confrontational approach would not be effective in the short or long term. At the same time, the institutions needed to recognize that as charities they have a level of accountability to their host communities. This accountability was encouraged in part by providing a high degree of transparency in the process. Task Force meetings were open to the public, and materials used during the deliberations were posted on the city's website.

This theme of transparency continued in the implementation phase of the program. Information detailing each institution's participation in the program, from cash payments to the community services provided, was also posted on the city's website. Institutions that had less than full participation in the program were given the opportunity to communicate their reasons. Specific details on the community services delivered by the institutions were also disclosed, providing an opportunity for institutions to highlight and promote their valuable service contributions.

The Importance of Community Services

In its discussions with nonprofit leaders during the implementation of the new program, the city

FIGURE 4
Boston's PILOT Collections in FY2011
and FY2012



Source: City of Boston Assessing Department (2012).

discovered that institutions have a decided preference for providing community services over making cash payments. Given that service delivery is at the core of most nonprofits' charitable missions, this was not surprising. Conversely the city generally places a higher value on cash payments, which provide flexibility in applying resources to meet the highest-priority service needs of the community.

To reconcile these two divergent preferences, the city has recognized that it must further develop its ability to harness the community-service portion of the PILOT program to meet its service demands. Currently community benefits often are offered by the institutions based on their own initiative. While these services have value to the city and its residents, they may not be among the city's current service priorities. Even in cases where specific requests for services came directly from a city official to fill a near-term service gap, such *ad hoc* requests lack the prioritization and review that is associated with a more disciplined budgeting process.

Requests for PILOT services should be planned and prioritized to maximize their value to the city. Under such a structure services are more likely to either reduce or replace the cost to the city of providing a service, or to provide a new service to meet a priority that the city had been unable to deliver previously. Through careful planning, directing institutional resources to priority areas reduces the city's financial commitment and

makes it easier for the city to forgo cash in favor of institutionally preferred services. This planning process is also beneficial to the institutions, as they are better able to budget for their PILOT service commitments. As the program continues through its phase-in period, the ability of the city and institutions to work cooperatively on a structured approach to community services will be critical to the continued success of the PILOT program.

Closing Thoughts

The process Boston has followed to construct its new approach to PILOTs was both thoughtful and inclusive. The expertise and perspectives of the Task Force members, combined with the city's decades of experience on the issue of exempt property, led to program guidelines that were recognized as fair and reasonable. The process also demonstrated that for a PILOT program to be successful the city and its institutions must be partners, not combatants.

This philosophy has formed the basis of Boston's approach to the implementation of its new PILOT program. And, despite its early success, there is still much work to be done. The city needs to balance its need for revenue with the institutions' preference for services. If city officials and local institutions can continue to work cooperatively on the PILOT program, a balance can be struck that will work to the mutual benefit of the institutions, their constituents, and the residents of Boston. **L**

▶ ABOUT THE AUTHOR

RONALD W. RAKOW has been commissioner of the City of Boston Assessing Department since 1992, and he took on the additional role of deputy chief financial officer in 2011. He was appointed in 2010 to the Board of the Massachusetts Convention Center Authority, and is currently serving as the chair of the Research Committee of the International Association of Assessing Officers (IAAO). Contact: rakow@cityofboston.gov

▶ REFERENCES

- City of Boston. 2010. Mayor's PILOT task force final report and recommendations, December.
- City of Boston Assessing Department. 2009. Exempt property analysis: Educational and medical institutions, Fiscal Year 2009.
- City of Boston Assessing Department. 2012. FY 2012 PILOT recap. http://www.cityofboston.gov/Images/Documents/FY12_Second_Half_PILOT_Status_Report_for_Web_tcm3-33007.pdf
- City of Boston Office of Budget Management. 2012. Fiscal year 2013 adopted budget. <http://www.cityofboston.gov/budget/default.asp>.