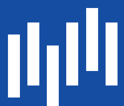
THE FISCAL FALLOUT OF BOSTON'S EMPTY OFFICES

FEBRUARY 2024



THE CENTER FOR
STATE POLICY
ANALYSIS

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The market for office space is foundering, and Boston is especially vulnerable.

As a result of the ongoing collapse in office values, Boston is likely to face a cumulative revenue shortfall of more than $1 billion in the next five years. And with no clear prospect for recovery, such shortfalls could persist for decades, triggering a long-term decline in public services and economic vitality.

How bad will things get? And what can be done to avoid a true urban "doom loop," where declining tax revenues make Boston a less safe and attractive place to live? We engaged the Center for State Policy Analysis at Tufts University to help us better understand the current issues and model the fiscal implications.

We found that:

- More than one-third of Boston tax revenue comes from commercial property taxes, by far the highest proportion among major U.S. cities. This leaves Boston especially vulnerable to falling real estate values.
- With the value of office space expected to decline 20–30 percent by 2029, and overall commercial real estate prices by 12–18 percent, we estimate that Boston will face a cumulative revenue shortfall of $1.2 billion to $1.5 billion over the next five years.
- This is not a short-term challenge but the arrival of a new normal, where annual tax collections in 2029 and beyond will be roughly $500 million below the current trend.
- Boston will have few ways to compensate for this lost tax revenue. Massachusetts precludes cities from introducing local sales and income taxes; and fully offsetting the decline in commercial real estate would require a 25 percent to 30 percent increase in residential property taxes.
- Looking across the economy, turmoil in the commercial real estate market will have an immediate impact on real estate development and then widening effects in areas like banking and business services. Already, we see sharply falling wages among property managers and construction workers in the commercial sector.

What follows is a fuller exploration of these findings, including background on Boston's tax system, an overview of current challenges in the commercial real estate market, and options for avoiding an urban doom loop.

HOW BOSTON BALANCES ITS BUDGET

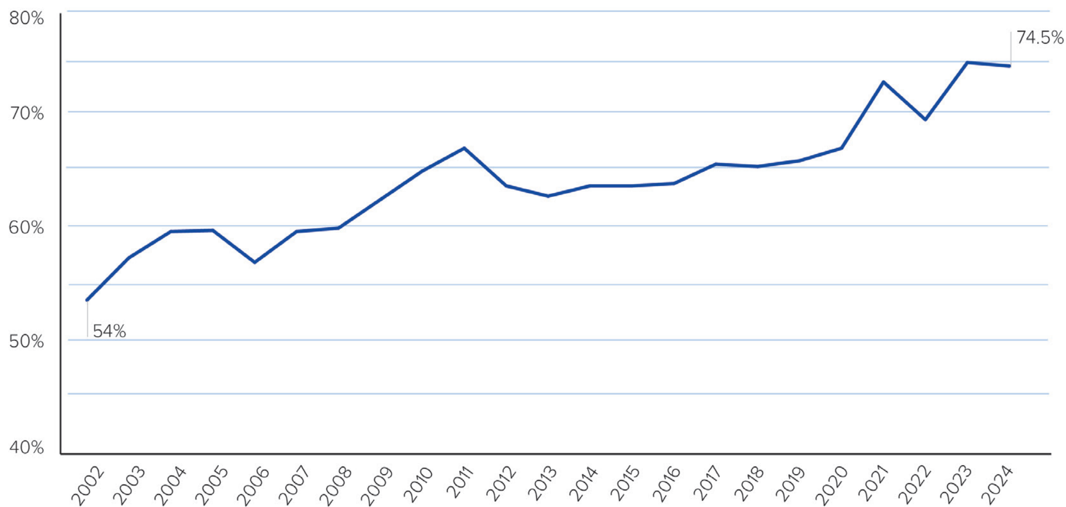
Each year, the city of Boston spends about $4 billion on core services—everything from education to police, parks, streets, and city workers.

To pay for these vital public services, the city is heavily reliant on property taxes. And this reliance has grown over time. Whereas property taxes comprised roughly 55 percent of city revenues in 2002, today they account for 75 percent.

FIGURE 1

Boston Has Grown More Reliant on Property Tax

Property tax collections as a share of total revenue, by fiscal year



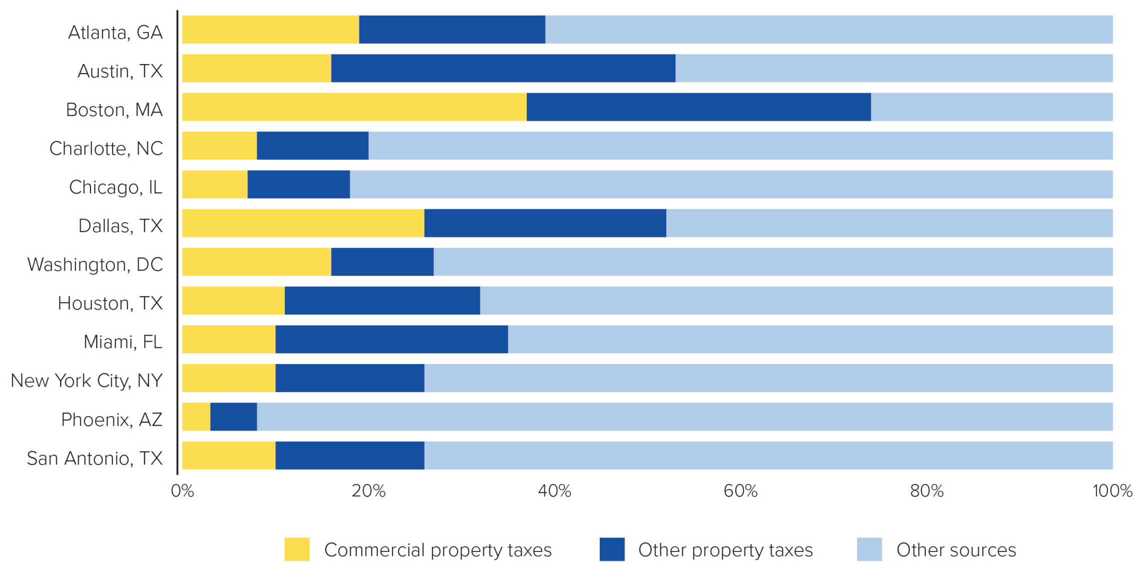
Source: Massachusetts Division of Local Services, cSPA Calculations

More important for this analysis, the bulk of property tax revenue comes from commercial buildings—not homeowners.

Such outsize dependence on commercial property is unusual. In Chicago, Miami, New York, and Washington, D.C., commercial property taxes comprise roughly 5 percent to 15 percent of total revenue. That's less than half what you find in Boston.

FIGURE 2

Commercial Property Taxes Across Cities, 2022



Source: Tax Policy Center
Note: Data for Chicago from 2021; Data for Boston re-calculated by cSPA

One key reason other cities are less reliant on property taxes is that they can levy local sales and income taxes, which is something that Massachusetts largely prohibits.

The other main reason Boston is an outlier is that commercial properties are taxed at roughly 2.5 percent compared with around 1.1 percent for residences.

Note that this differential tax rate makes it extremely tricky to compensate for declining office values by converting offices to apartments or raising tax on residents. A $20 million apartment building is a lot less valuable—for tax purposes—than a $20 million office, so while efforts to convert commercial buildings into housing may help revitalize downtown spaces, they permanently reduce the city's tax base.

Now, relying on the property tax does have some upsides. Property taxes tend to be very stable compared to sales or income taxes. And this stability is back-stopped by the fact that property taxes are based on assessed values rather than market values.

Basically, the city keeps a record of the value of every single property. And even when real estate prices fluctuate, actual tax payments remain more consistent—because they depend on these underlying assessments, which the city doesn't adjust too quickly or dramatically.

But while this mechanism provides some short-term stability, eventually the assessed values have to adjust to better match market values. And this is thekey to understanding why the meltdown in commercial real estate hasn't yet affected the Boston city budget, and why it soon will.

SLOW-MOTION COLLAPSE IN COMMERCIAL REAL ESTATE

Downtown office buildings just aren't as valuable as they used to be.

The biggest culprit is the rise of remote and hybrid work. Across the country, about a third of all workers now spend at least some days at home, and while that number has certainly fallen since the lockdowns of 2020, it has been stable for more than a year now.

Not all industries have been affected in the same way. Health care remains largely in-person; biotech firms need lab space; and some companies have tried to force employees back to their daily commutes. But there's no denying the broader trend. Businesses in 2024 don't need as much space as they did in 2019, and this reduced demand for office space drives down the price.

This isn't the only force weighing down commercial real estate in Boston. High interest rates also play a role.

Here's a simplified picture of how this works. Building owners often rely on mortgages that they never really pay off. They borrow money to buy a building, pay interest on the loan, and then roll over into a new mortgage when needed. This works fine when borrowing costs are low, but when interest rates spike—as they have in recent years—the cost of these mortgages shoots up, making it less profitable to own commercial buildings.

Both of these challenges—remote work and higher interest rates—are slow-acting, meaning it takes a while for them to work their way through the commercial real estate system and affect prices.

In the case of remote work, that's because most tenants in commercial buildings are locked into long-term leases. Even when workforces shrink, years may pass before business can shed their leases and look for smaller space.

And the reason high interest-rates are slow-acting is that they mostly bite when mortgages expire and building owners have to refinance.

But little by little, the effects have started to accrue. Current estimates suggest that more than 20 percent of all office space in Boston is vacant, with little hope for a near-term turnaround. And while there haven't been a lot of downtown transactions, those few office buildings that changed hands in 2023 were sold at substantial markdowns.

Perhaps the most worrisome aspect of this decline is its durability. Yes, interest rates may normalize, which would alleviate some downward pressure on prices, but remote and hybrid forms of work are here to stay. Which means so is the falloff in commercial property values.

Not to mention that all this is happening at a time when the economy is strong; even a mild downturn could severely exacerbate the problem.

FALLING DOMINOES

Gradually and then suddenly, these challenges in the commercial real estate market are going to reshape Boston's finances.

There's no clear deadline, or triggering event, but tax appraisals are the key dynamic to watch.

As noted earlier, the city levies taxes based on its assessment of the underlying value of each home and building. Year by year, those values are adjusted to better reflect real-world prices and the actual earning potential of commercial properties.

Given the impact of remote work and elevated interest rates, Boston will have to issue new, lower assessments. And while you could imagine the city resisting revaluations—for fear of losing tax revenue—they don't fully control this process.

For one thing, the work of updating property appraisals is generally done by independent experts, rather than city workers.

Plus, any building owners unhappy with their appraisals can mount a challenge with the appellate tax board, invoking their own analysis or other market conditions to demand more realistic tax assessments.

Property owners have a strong ally in this effort to ensure fair appraisals: banks and other lenders. Remember, a lot of building owners rely on borrowed money, meaning that any threat to their profitability—like an unreasonable appraisal—also affects the lenders who issue commercial mortgages.

All the while, behind the scenes, inflation will be doing its part to help with the revaluation process. Say the city does manage to hold the line in some cases, maintaining current assessments in the face of falling market prices. In real terms, those stable assessments would actually be falling at the rate of inflation, say 2 percent to 3 percent per year. And it's these inflation-adjusted values that really matter for Boston's fiscal future.

One way or another, appraised values are going to adjust to better reflect the current, very weak, market conditions. And as assessments fall, so will tax revenue.

Worse—from the city's perspective—there is no quick escape from the world of reduced commercial property values and lower tax revenues. Not only does the hybrid work revolution seem increasingly permanent, but even if downtown offices fill up again, it would take years for price increases to work their way back into appraisals and tax collections.

HOW BAD COULD THINGS GET?

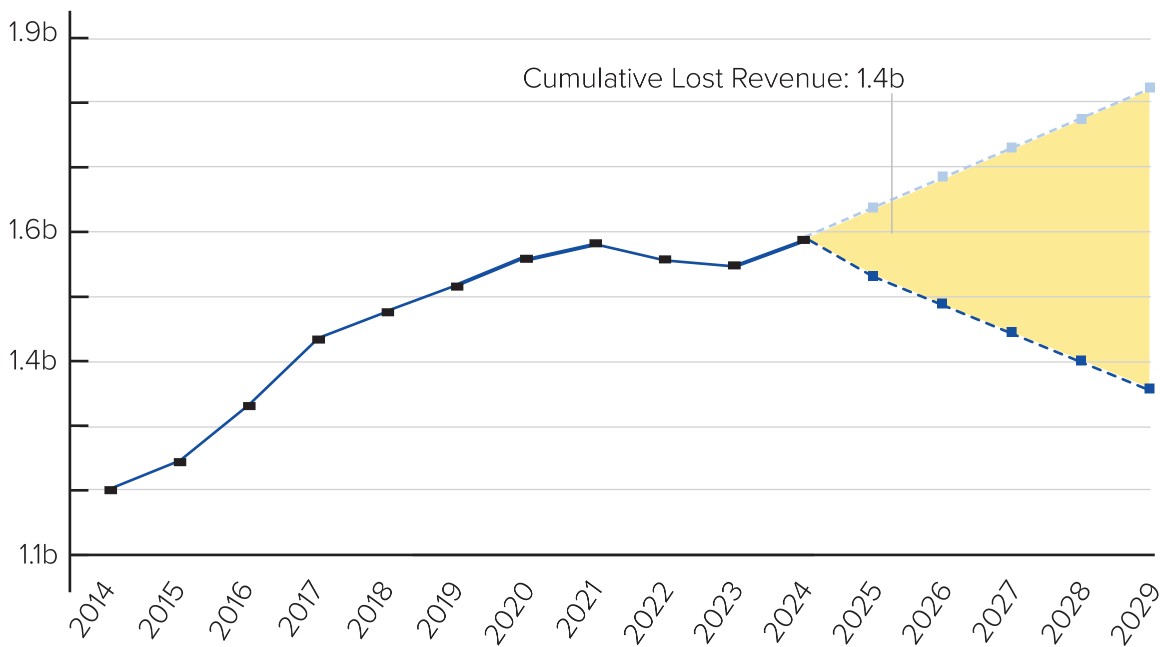
Since 2021, Boston tax collections have started to diverge from their historic trend. But that gap is poised to widen dramatically.

Pinning down the precise impact of this slow-motion collapse in commercial real estate prices is tricky, as there are a lot of variables and uncertainties.

FIGURE 3

Boston Faces a Five-Year Tax Shortfall of 1.4 Billion

Gap between long-term trend and expected commercial property tax collections, FY2025–29



Source: Massachusetts Division of Local Services, cSPA Calculations
Note: Based on our central estimate of 15 percent decline in commercial real estate values

If more buildings were trading hands, we'd know more about real prices. Or, if all buildings were the same, we could generalize more easily—but the portfolio of commercial property spans everything from new and desirable class A buildings to older or poorly maintained spaces, hospitals, retail shops, gyms, and more.

Still, it's important to present a best estimate so Boston can plan for the challenges ahead. And to this end, we can build off existing work by analysts at McKinsey and elsewhere suggesting that office values are likely to decline 20 percent to 30 percent (or more) in real terms by the end of the decade, which in Boston would propel a 12 percent to 18 percent decline in commercial real estate prices.

We estimate that between 2025 and 2029, the city will face a cumulative tax shortfall of $1.2 billion to $1.5 billion, compared with the long-term trend.

The annual gap over this window is not constant but slowly expanding as the new reality of commercial real estate trickles through the appraisal process and into the tax system.

The end result is a new normal where the city collects $400 million to $500 million less each year than the long-term trend implies, amounting to an annual reduction of roughly 10 percent of total revenues.

Note that our model makes a number of conservative assumptions, which could actually understate the likely impact.

We assume that the decline in property values is limited to commercial properties, while the prices of residential, industrial, and business equipment follow their long-term upward trend.

We further assume healthy new construction of commercial real estate.

Most broadly, our estimate does not include potential spillover effects on city services, employment levels, or the Boston economy more generally. And yet several of Boston's key industries are bound to the fate of office spaces and commercial real estate, directly and indirectly.

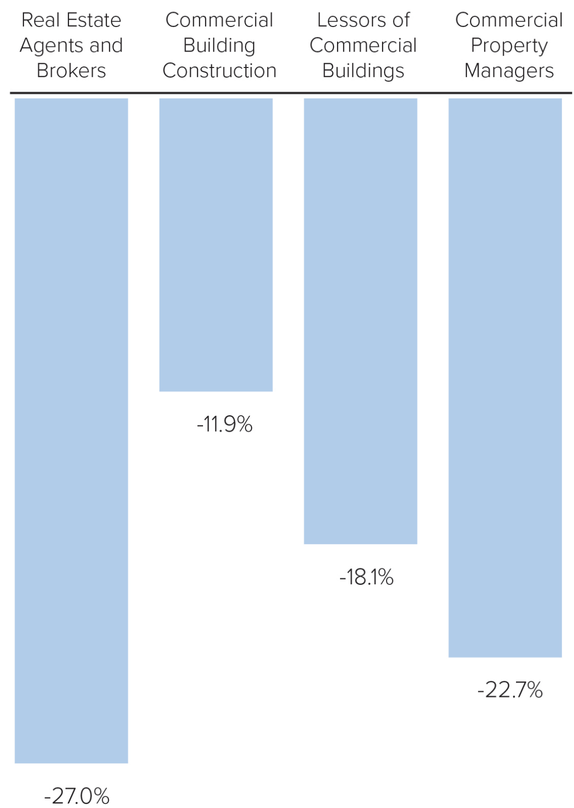
The industries most likely to be affected include commercial building construction, lessors of commercial buildings, and commercial property managers, which together employ nearly 7,500 people in Boston. Workers in these sectors have already seen wage declines of 10 percent to 25 percent in just the past few years.

From here, risks could easily spread to business service providers, retailers that rely on business clients, parts of the financial world that focus on commercial lending, and other proximate sectors employing tens of thousands of

FIGURE 4

Wage Declines in Commercial Real Estate

Real weekly wages by industry, 2019–2023



Source: Quarterly Census of Employment and Wages

Boston-based workers. These are the areas we should watch for potential signs of a deeper urban downturn.

POLICY OPTIONS

It's important to emphasize that Boston's current and former leaders are in no way responsible for this coming crisis. What we face is something like an economic act of God.

Still, some kind of dramatic political response will be needed.

A tax falloff representing 10 percent of Boston's total spending is too large to be offset by creative accounting or other kinds of financial management. The city will need to raise new revenue or reduce its medium-term spending plans.

On the revenue side, there aren't a lot of good options, especially given the state's limitations on municipal sales and income taxes.

Introducing a tax on high-value real estate transactions would be largely self-defeating, as it would put further pressure on commercial real estate prices and heighten the challenges in that industry. Similar concerns shadow any effort to raise the tax rate on commercial properties.

Increasing the tax rate for residential properties is a more promising path, especially given the run-up in home values. But fully offsetting the decline from commercial property would require a rate increase of 25 percent to 30 percent, pushing residential rates from around 1.1 percent to nearly 1.4 percent. For individual homeowners and multi-family properties, an increase of that size would mean higher tax bills and also reduced home values, as potential buyers reckon with the increased cost of ownership.

Beyond these costly, but relatively direct responses, there are more creative approaches to consider, if the state obliges.

Lawmakers on Beacon Hill could grant Boston new taxing authority, perhaps allowing the city to impose a local sales tax or introduce a congestion charge for downtown driving. Recent proposals to allow higher local meals and hotel taxes point in the right direction, but lack the necessary scale.

Alternatively, the state could provide additional direct aid—especially in light of these twin facts: 1) that this downturn in commercial real estate was wholly outside the control of Boston policy makers; and 2) that any economic distress in Boston could quickly spread across the region.

Strengthening the argument for state aid is the fact that the Boston-centered downturn in commercial real estate is more than offset by increases in real

estate values outside the city. Put differently, the damage that hybrid work has wrought downtown pales beside the boon it has provided to suburbs and exurbs, where remote workers now spend more of their time and money. Taxing the beneficiaries of our new economic landscape to compensate the victims is a classic rationale for redistribution.

And if none of these options sounds particularly appealing, the only real alternative is for Boston to reduce salaries or services, with potentially serious implications for public safety, climate resilience, and efforts to attract future residents.

This is where we push up against the dreaded doom loop, which may not be the most likely outcome but which is more worrisome than it's been in 50 years.

The basic dynamic is as simple as it is devastating:

- Tax shortfalls curtail city services, which
- Makes the city less appealing, leading to
- Additional declines in property values, and then
- Further tax shortfalls and more service cuts

In the worst case, this kind of downward spiral could resonate across the region, ultimately requiring a much more dramatic, and much more expensive, state intervention.

CONCLUSION

Most economic challenges come in cycles: unemployment rises and falls; old industries decline while new ones grow. In these cases, the task of public policy is to provide temporary cushions and short-term remediation.

Something entirely different is happening in Boston. The rise of remote work, and the corresponding decline in office values, is eroding the tax system in a way that seems likely to last a long time.

The challenge—both for the city and the state—is to acknowledge this new reality and find solutions that are equally durable. That won't be easy, but the alternative is difficult to even contemplate: a permanently diminished city.

Methodological Notes

Unless otherwise noted, details about the Boston tax system were drawn from the Massachusetts Division of Local Services Gateway. Values were then adjusted for inflation using the Consumer Price Index, accessed through the St. Louis Federal Reserve's Fred platform.

Projections from 2025 to 2029 involved a number of assumptions. We assumed that residential, industrial, and personal property values would continue growing at the same real, annual rate as they had (individually) grown from 2002 to 2024. We separately assumed new growth would continue at $100 million per year. We further assumed that tax rates would remain at 1.1 percent for residential property and 2.5 percent for commercial, industrial, and personal property. And, finally, we projected inflation to grow at the Federal Reserve target of 2 percent per year.

The decline in tax receipts is measured against a counterfactual where commercial tax receipts continue to grow at the same real, annual rate as they grew from 2002-2024.

Data about local jobs and wages come from the Bureau of Labor Statistics' Quarterly Census of Employment and Wages.

Thomas Brosy at the Tax Policy Center graciously shared the data for Figure 2, comparing property tax collections across major cities.