The Assessing Department has been analyzing the tax impact of the elimination of rent control in Cambridge periodically for several years. Our current estimate of increased tax revenues from the phase-out of rent control remains in the $4 million to $5 million range.

A more problematic issue is how this increased revenue will "phase in" over time. There are two elements to consider. First: the State Department of Revenue's (DOR) position with regard to how value increases from decontrol mesh with the its regulations governing qualification as "new growth" (ie, those assessment increases which can add tax revenue to the levy limit). Secondly: in the real world marketplace, how, when, and where will rent increases be implemented.

The DOR's regulations specifically qualify as <u>new growth</u> those valuation increases resulting from changes in the land use regulatory framework, including rent control laws and regulations. These same DOR regulations specifically exclude from new growth calculations valuation increases due to <u>market forces</u>. The sharp definition of these DOR regulations obviously conflicts with the real world, where the adjustment of rents to "market" levels is not only a function of "deregulation," but also depends upon the reaction of the market to a huge increase in the supply of "market rate" units in a relatively short period of time. An additional factor is the response of individual landlords, many of whom are not increasing rents to the maximum and whose rents may reach market levels only after many years, or never reach maximum at all.

Even discounting the issue of DOR regulations, the rental market could require many years to reach equilibrium. 13,000-15,000 rental units is a huge number for the market to absorb, considering that the pre-deregulation market-level rental supply was probably well under 10,000 units. Thus demand/supply considerations, plus the behavior of individual landlords discussed above, indicate that "maximum value levels" will probably be reached many years into the future.

What <u>is</u> clear is that the proportion of value increase resulting from decontrol that can be captured as "new growth" tax levy increase must be the subject of negotiations with the DOR. These discussions are under way. Indeed, the first phase resulted in agreement that current year (FY96) valuations of rent controlled property would <u>not</u> be adjusted upward despite the fact that the transitional rent control law took effect January 1, 1995. This agreement reflects the City's position that, because virtually no data existed (either sales or rentals) last spring on which to base valuation adjustments, any such adjustments would have been largely hypothetical or even speculative, and as such would be highly susceptible to appeal by property owners. Further, any substantial tax increases this year on rent controlled property would precede, in the case of many properties, proportionate rent increases. In other words, the City does not feel that it is appropriate to be "ahead of the curve" in the process of adjusting taxes to the decontrolled rental housing environment.

Whatever the conclusions of our discussions with DOR, the Assessors take the position that a two to three year transition is reasonable and practical (preferably three years). A "one-time" adjustment would result in (1) an onslaught of owner-appeals, (2) tax increases far disproportionate to rent increases for many properties, and (3) failure to maximize "new growth" levy limit increase because data (i.e., average rents at the end of 1995) would still reflect levels far below market. A three year transition to full value would permit one year of market adjustment following the complete ending of controls on January 1, 1997. A longer period than three years may result in a somewhat higher "new growth" figure, but would begin colliding with the DOR's position that all "new growth" must derive from regulatory change, not changes in general market conditions.

If we assume a three year transition for planning purposes at this point in time, we would estimate that the \$4-\$5 million levy limit increase would be divided roughly equally among the three years: \$1.5 million per year, plus or minus.

Before elaborating on this point it would be useful to present an overview of our planned valuation methodology and related data collection efforts. (The attachment summarizes the principal elements involved in the implementation of a multifamily valuation system.) In keeping with standard appraisal practice for multi-family properties, we expect to utilize the <u>income approach</u>, which in its simplest form is: (net operating income) divided by (a capitalization rate). Net operating income (NOI) reflects the earning capacity of the property as estimated by the <u>marketplace</u>; in other words, what are <u>market</u> rents and expenses -- not actual. The capitalization rate reflects the cost of money (mortgage interest rates), the investor's desired rate of return for invested capital, and the investor's expectations with regard to inflation and the health of the real estate market in the future. The <u>income approach</u> is also commonly utilized to value most commercial property.

The income approach requires good data about the marketplace. Thus we will, on an annual basis, solicit from all property owners a summary of income and expenses and a rent roll covering the previous calendar year. From this data we will develop a schedule of market rents, vacancies, and expenses for various-sized units and for the different areas of the city. Capitalization rates will determined by analyzing sales of properties and by ascertaining current interest rates and investor expectations.

While the income approach is theoretically simple and relatively easy to implement in a typical market situation, we face some formidable obstacles in getting the process off the ground for the Cambridge decontrolled market. First, owners are not used to providing the Assessing Department annually with income and expense data, and many will simply ignore our data request; others may provide data in an incompatible format -- they may be understandably familiar with aggregating and reporting information which met the Rent Board's requirements. While state law provides some muscle behind assessors' data requests, sanctions tend to apply <u>after</u> the assessment process -- during the appeal process. Secondly, landlords have responded to decontrol in predictably diverse fashion: rent adjustments will vary from zero to dramatic; some owners will await vacancy, then move to full market levels; some will renovate immediately, others will wait; conversion to condos is another ingredient in the mix. The point is that the data we receive will present extreme variability. There will be no clear picture of what market rents are; indeed, what constitutes market rent levels will be elusive until some degree of equilibrium is reached in perhaps three to five years. (There are, however, other sources of information which will illuminate our understanding of the rental housing market. Rental units in owner-occupied two and three family houses represent a mature segment of the marketplace. Mixedincome MHFA developments such as Church Corner and Kennedy Biscuit Lofts are also a good source of market rental information. Newer condos also include many rental units.)

A third difficulty the assessors face in the early stages of developing a multi-family assessment system is deciphering the nature of the market for multi-family buildings. Since the real estate doldrums of the late Eighties-early Nineties the market for these properties has been extremely slow, with little evidence of any recovery. Obviously decontrol has changed the dynamics of the situation and the pace of sales is picking up, though the market is certainly not robust. In any case, the market is the benchmark against which an assessing system is measured, and -- as is the case with rent levels -- we face a somewhat confused and inconsistent pattern of information.

As we develop the multi-family assessment system, one area which is not anticipated to present any problems is that of technical resources: database design, computer system, software, etc. We expect to blend these new assessment tasks into our existing assessment framework, and expect no major difficulties.

Overlaying these data collection, quality, and consistency issues on the specific question of how new tax growth will phase in over the proposed three year period yields the following:

Year 1 (FY97): Next year's assessments (FY97) will be based upon 1995 data. 1995 saw, of course, initial decontrolled rent adjustments and several building sales; indications point to a generally conservative/go-slow attitude on the part of most landlords. All "protected tenants" enjoyed controlled rents for the calendar year. Data from 1995 are likely to indicate, in summary, modest rent increases, which in turn translate into modest valuation increases. On the other hand, most ordinanced condos will have been decontrolled. These units will be largely aimed at the owner-occupancy market. Many have been sold during 1995; in addition, sales of never-controlled units in hybrid buildings will continue. Thus data will point emphatically to assessment levels close to "real" market values for these units.

Year 2 (FY98): Data reflecting 1996 experience will determine assessments. 1996 will be the final year of decontrol. Protection for certain classes of tenants will continue until the end of the year. Many landlords are likely to be more aggressive in their rent increases, but pressure in the other direction will continue for larger and/or institutional owners. As rents go up and protections end for some tenants, more units will be vacated, and rents on these units will be more likely to be adjusted toward what the market will bear. Condo conversions will continue at the modest level established in 1995, but this market segment remains soft. Nevertheless, buildings with notable physical or locational attributes will find buyers, which means substantial value increases. The pace of renovation is likely to increase, but there is usually a year's lag until such construction is mirrored in assessments. Sales activity of buildings will probably increase if the real estate market generally stays healthy. Owners, potential investors, and financial institutions will have had the opportunity to adapt their thinking to the deregulated environment; further, some speculative activity should rear its head. In summary, rent levels should exhibit significant increases over 1995, but averages will remain far below market.

Year 3 (FY99) : 1997 will be the first year without any rent controls. The trends from the previous year should accelerate, with the caveat that general economic conditions remain positive. (By 1997 this is not necessarily a sure-bet assumption.) But average rent levels should still be considerably below "stabilized" market levels. On the other hand, a stronger and more extensive market for multi-family buildings should give us the empirical foundation for reasonable valuation increases.

(The issue of building renovation deserves parenthetical comment. While we may not be able to maximize levy growth derived from decontrol because of both DOR constraints and number of years required to reach a stabilized rental market, building investment will compensate to some degree. We anticipate that levels of investment in multifamily buildings will continue to grow into the foreseeable future, as owners both compensate for deferred maintenance and seek to compete for higher rentals. This investment generally qualifies as "new growth" under DOR regulations (irrespective of the type of property). However, the revenue impact of rehab and renovation work will not likely be dramatic in any one year and is extremely difficult to project at this time.)

This discussion of trends and market forecasts should clarify our position that assessment increases (and tax levy growth) will be a gradual process. Further, so many factors are at work that the assumption of more or less equal increments of annual growth is both reasonable and prudent. The process of decontrol is a new experience for all concerned. From the assessing perspective the process is complex, and the exercise of establishing operating assumptions is fraught with pitfalls. We must remain disciplined by the reality that if we are overly aggressive in our valuation adjustments, we will pay the price in appeals and lost values. Finally, while our estimates of $1.5 million in annual levy growth are somewhat tentative, we retain considerable confidence on our overall levy growth estimate of $4-$5 million.

In conclusion, in response to City Council Order #16, dated 11/20/95, we offer the following summary:

* Approximately $1.5 per year over three years in tax levy growth from decontrol can be reasonably anticipated.

* A three year "phase in" for decontrol-related valuation adjustments is subject to State Department of Revenue concurrence.

* Computer systems and technical resources are already in place to handle the multi-family valuation process.

* A summary of the elements of the multifamily valuation process, with related scheduling is attached.

* Preliminary revenue estimates based upon early data returns and analysis will be available by March-April, 1996, but hard numbers must await summer, 1996.

MULTI-FAMILY MARKET VALUATION PROCESS

DATA BASE DESIGN: December - January

- Apartment descriptive variables
  - number rooms
  - number bedrooms
  - number baths
  - condition
  - functionality
- Income and expense data
  - questionnaire design
  - analysis software

DATA COLLECTION: January - July

- Income questionnaires
  - mail in January
  - review & data enter January - May
  - analysis: February - June
    - market rent levels
    - market phase-in
    - vacancy rates
    - expenses (per square foot or % of rent)
- Sales: 1995-96 sales verification - continuous
- Rent Control Board data transfer: February - March
  - apartment types, room and bath counts
  - units with protected tenants/ related rents
  - parking information
- Begin interior property inspections 1100 properties
  - verify rent control data (may do by mail questionnaire)
  - focus on condition/ deferred maint./mechanical systems
  - exterior inspections already complete

APARTMENT VALUATION: June - July

- Finalize rent and expense tables
- Sales analysis
- Apply income and cost valuation approaches
  - assign rents
  - market vacancy
  - calculate expenses
  - capitalize at market rates
- Value review

2.

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EXECUTIVE DEPARTMENT
ROBERT W. HEALY
City Manager

RICHARD C. ROSSI
Deputy City Manager

January 29, 1996

To The Honorable, The City Council:

In response to the City Council discussion of January 22, 1996 and the Council Order of November 20, 1995, regarding available increased tax revenue as a result of increased values of formerly rent controlled properties, attached please find a detailed report from the Assessing Department.

In summary, the estimate of increased tax revenues over a three year phase is between \$4 and \$5 million dollars. This would average at approximately \$1.5 million dollars annually.

Since the increase in FY97 will in all likelihood be \$1.3 million dollars, that amount combined with the operating savings of \$700,000 in rent control will allow for the second year funding of the City Council's CityHome Program at the combined rate of \$2 million dollars.

I certainly recognize the hardship that changes in households' housing situation can cause. I am requesting the Community Development Department and Affordable Housing Trust develop a recommended spending plan for the use of additional funds in the event they become available. In addition, the report will examine financing sources for affordable housing other than City tax dollars. I will continue to work with the City Council to identify the priorities for City spending within the context of the desire for stable taxes, no reduction in services and other compelling capital needs.

Very truly yours,

Robert W. Healy
City Manager

RWH/mec
attachment

F-11

Consent Agenda #2

Relative to the City Council discussion on January 22, 1996 and the Council Order of November 20, 1995 regarding available increased tax revenue as a result of increased values of formerly rent controlled properties.

In City Council Janaury 29, 1996

Referred to Council Order #9