Can Retail Vacancy Taxes Reduce Urban Storefront Vacancies?

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Urban “Retail Apocalypse”?
Vacancy rates have been rising

Source: New York City Department of Finance Real Property Income and Expense (DOF RPIE) data
Outline

1. What factors contribute to retail vacancy?

2. How would a retail vacancy tax affect the vacancy rate? Unintended consequences?

3. How does retail vacancy relate to housing?
Measuring retail vacancy is hard!

- **Vacancy**: total retail space not occupied by a tenant
  - Of interest to local government and community members
  - Want to know vacancy for a whole neighborhood/city
  - Many cities don’t collect/disseminate systematic data on where vacancies are located
    - NYC started in 2019 under Local Law 157

- **Availability**: retail space that is being marketed as available for leasing
  - CRE brokers report quarterly availability rates for **specific corridors only**

We are able to **observe vacancy directly**.
Our data

- **Occupancy/Vacancy Data**
  - All Manhattan storefronts, ~2016-February 2020
  - Tenant industry (grocery, restaurant, etc)
  - Open/close date
  - Location of door
  - ~45k unique tenants, ~41k unique storefronts

- **Rent Contracts**
  - Sample of ~10k leases, 2010-2020
  - Rent /sqft
  - Sqft
  - Execution, commencement, expiration dates

- **NYC OpenData**: ACRIS (via DoF), PLUTO (via DCP)
Outline

1. **What factors contribute to retail vacancy?**
   - **Demand:** Tenants find some locations more desirable than others
   - **Lease length:** Landlords are hesitant to lock in low-rent tenants long-term
   - **Search:** Costly (in time + $$) for landlords/tenants to find each other
   - **Mortgage covenants:** Banks impose minimum rent landlords can charge

2. **How would a retail vacancy tax affect the vacancy rate?**

3. **How does retail vacancy relate to housing?**
1. Location, location, location!
2. Leases are long

Source: CompStak
## Pros and cons of long term leases

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<tr>
<td><strong>Tenant</strong></td>
<td>Takes time to recoup move in costs</td>
<td>Longer leases are more expensive per annum (on average)</td>
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<td><strong>Landlord</strong></td>
<td>Stable source of cash flow many years into the future (necessary to obtain financing)</td>
<td>Lose the chance to take advantage of possibly higher future rents</td>
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Money today or option value tomorrow?

- Landlord trades off:
  - Signing a tenant today (and locking them in long-term)
  - Waiting for someone new (hopefully better) tomorrow

- If the landlord thinks that they can find someone tomorrow who will pay more, they will wait

- When rents are rising, many landlords think they can do better by waiting → higher rents, higher vacancies
3. Search frictions are large

- Brokers get paid a lot
  - If it were easy for landlords and tenants to meet and contract by themselves, who would use a broker?

- Spaces are heterogeneous
  - Location, *zoning*, size, shape, kitchen/no kitchen, etc
  - Landlords with desirable spaces can extract higher rents

- Rent dispersion is *huge*, even controlling for location, tenant type, sqft, and other characteristics
  - If there were no search frictions, differences in rent for similar spaces should be competed away

If it’s hard for landlords and tenants to find a good match, vacancies can last a long time
Rent dispersion is high
4. Banks constrain rents landlords can charge

• Around 80% of the properties in our data have an outstanding mortgage at some point

• Commercial mortgages come with **covenants**, which can take several forms:
  • Forbid landlords from renting their spaces at “below market” rates
  • Impose rent floors based on current rents

• Covenants can prevent landlords from lowering rents:
  • during market downturns / “busts”
  • especially in neighborhoods that have a history of high rents
Covenant Examples

Ex: 560-566 Broadway

“No Space Lease with a term of more than five years or for a rental less than the rental payable under the immediately preceding Space Lease covering the same space will be executed by the Mortgagor without the prior written approval of the Mortgagee . . . provided, however, that such approval shall not be required for rentals which are not less than 85% of the rental payable under the immediately preceding Space Lease . . . if such a reduction is required . . . due to a change in market conditions”
The importance of our 4 channels may vary by location

- The **4 outer boroughs** have lower vacancy rates in census tracts with the highest rent
  - “Low demand” story analogous to empty shopping centers across America

- **Manhattan** has the opposite correlation
  - Landlords remain vacant *despite* rent being high

- This implies a different balance of our 4 forces (demand, option value, search frictions, and covenants)
  - Policy solutions for vacancies in Manhattan vs outer boroughs may differ accordingly

Source: NYC Department of Finance 2019
Outline

1. What factors contribute to retail vacancy?
   • Demand: Tenants find some locations more desirable than others
   • Lease length: Landlords are hesitant to lock in low-rent tenants long-term
   • Search: Costly (in time + $$) for landlords/tenants to find each other
   • Mortgage covenants: Banks impose minimum rent landlords can charge

2. How would a retail vacancy tax affect the vacancy rate?
   • A vacancy tax will most likely reduce the vacancy rate (and potentially rents), but:
     • Effectiveness is attenuated by matching frictions and lending covenants
     • Could result in worse matches between landlords and tenants

3. How does retail vacancy relate to housing?
NY State Senate Bill S2005/Assembly Bill A670

• Initially proposed in 2019, currently being debated in committee
• Proposes assessing a vacancy tax of 1% of property value on properties that have had a vacancy for more than 6 months:

  § 1351. Imposition of tax. Notwithstanding any other provision of this chapter, or of any other law, for taxable years beginning on and after January first, two thousand twenty-two, an annual tax is hereby imposed on every taxpayer who is the owner of a vacant or abandoned commercial storefront located in a city with a population of one million or more equal to one percent of the assessed value of the property which includes such vacant or abandoned commercial storefront.
The case for a vacancy tax

• Persistently high vacancy can have significant externalities, affecting
  • surviving tenants (via lower foot traffic)
  • residents (via home values, “eyes on the street”, pedestrian safety)

• A vacancy tax could act as a Pigouvian tax, which would force landlords to internalize the externalities vacancy imposes.
  • E.g. carbon tax
  • In the real estate context, a tax would bring the landlord’s cost of vacancy in line with the social cost of vacancy
  • Requires some measure of the social cost of vacancies
The case(s) against a vacancy tax

• If vacancy is primarily caused by search frictions, tenancy covenants, or severe lack of demand, then a vacancy tax is both ineffective and punitive
  • The tax is likely to be especially harmful in areas with low demand for retail space.

• Landlords provide a socially useful screening service, which the tax may distort
  • Landlords only want to sign tenants who are going to be successful (i.e. generate sales)
  • If a landlord doesn’t think a tenant will generate enough sales to pay rent, then it’s unlikely that the tenant will benefit the neighborhood.
  • A tax may cause landlords to accept “worse” tenants than they would in the absence of a tax.
(How) would a vacancy tax work?

- Estimates of this tradeoff are in progress
Outline

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2. How would a retail vacancy tax affect the vacancy rate, retail rents, retail mix, and welfare?
   • A vacancy tax will most likely reduce the vacancy rate (and potentially rents), but:
     • Effectiveness is attenuated by matching frictions and lending covenants
     • Could result in worse matches between landlords and tenants

3. How does retail vacancy relate to housing?
Retail and residential real estate are connected

• Retail amenities affect where people like to live, and therefore home values
  • Almagro and Domínguez-Iino (2021): household neighborhood choice depends on current and expected future retail amenities
  • Chang and Jacobsen (Journal of Urban Economics, 2017): business closures led to highly-localized increases in crime rates

• Who lives in a neighborhood affects which businesses are commercially viable
  • Glaeser, Luca and Moszkowski (2022): when a neighborhood gentrifies, the retail mix shifts towards fewer local idiosyncratic stores and more chains
  • Remote work is an existential threat to Midtown stores and restaurants

• These two effects magnify one another
  • Su (2019): when college-educated workers move into a neighborhood, retail mix changes, increasing the value of the neighborhood to other college-educated workers, who then move in in higher numbers, bidding up rents
Thank you!

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