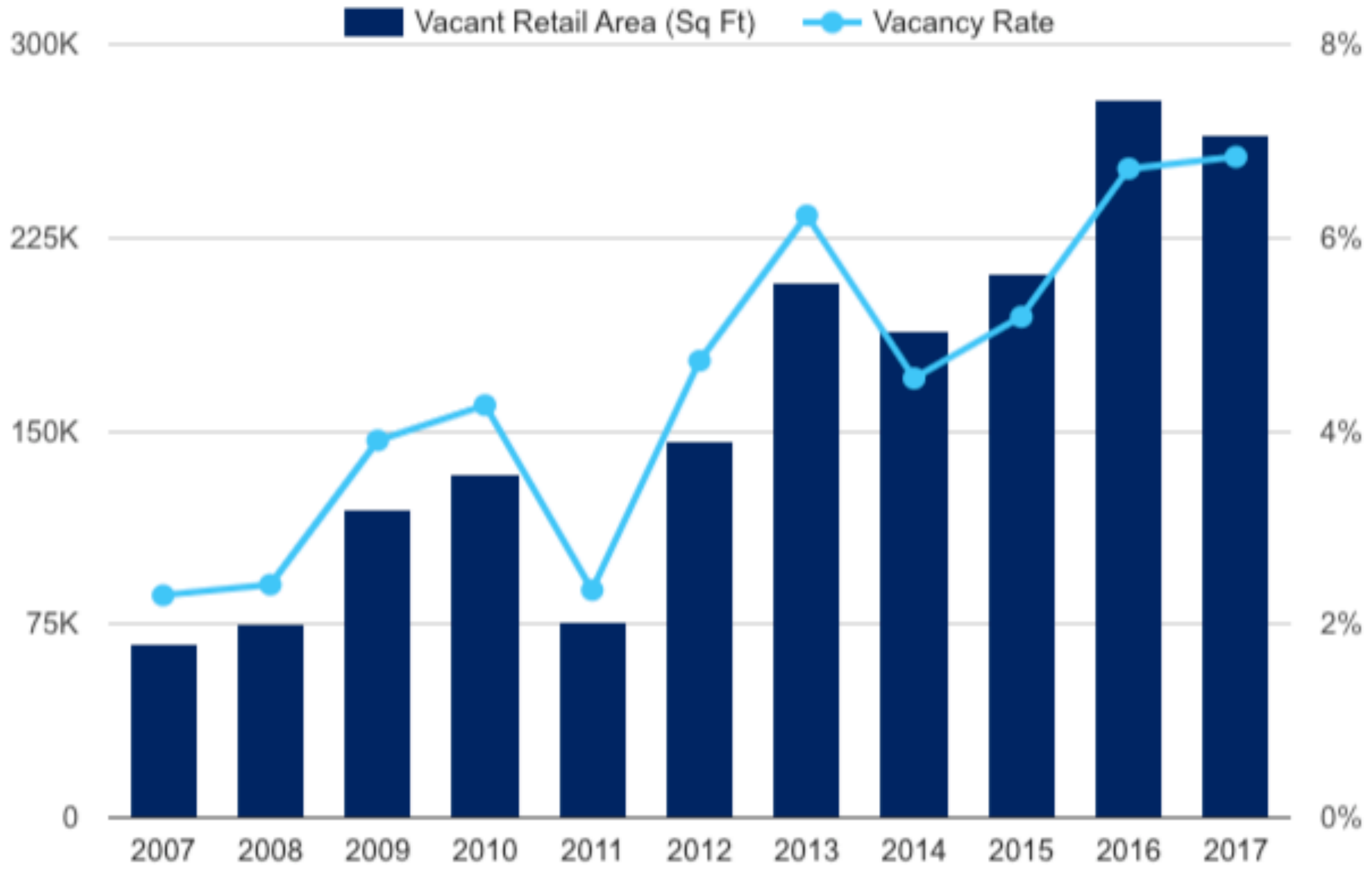
Can Retail Vacancy Taxes Reduce Urban Storefront Vacancies?

Erica Moszkowski (Harvard/HBS)
Daniel Stackman (NYU Stern)

4/8/2022
Joint Center for Housing Studies
Housing Research Seminar

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** [Source: Live XYZ]
  - 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** [Source: CompStak]
  - Sample of ~10k leases, 2010-2020
  - Rent /sqft
  - Sqft
  - Execution, commencement, expiration dates
- **NYC OpenData:** ACRIS (via DoF), PLUTO (via DCP)

Outline

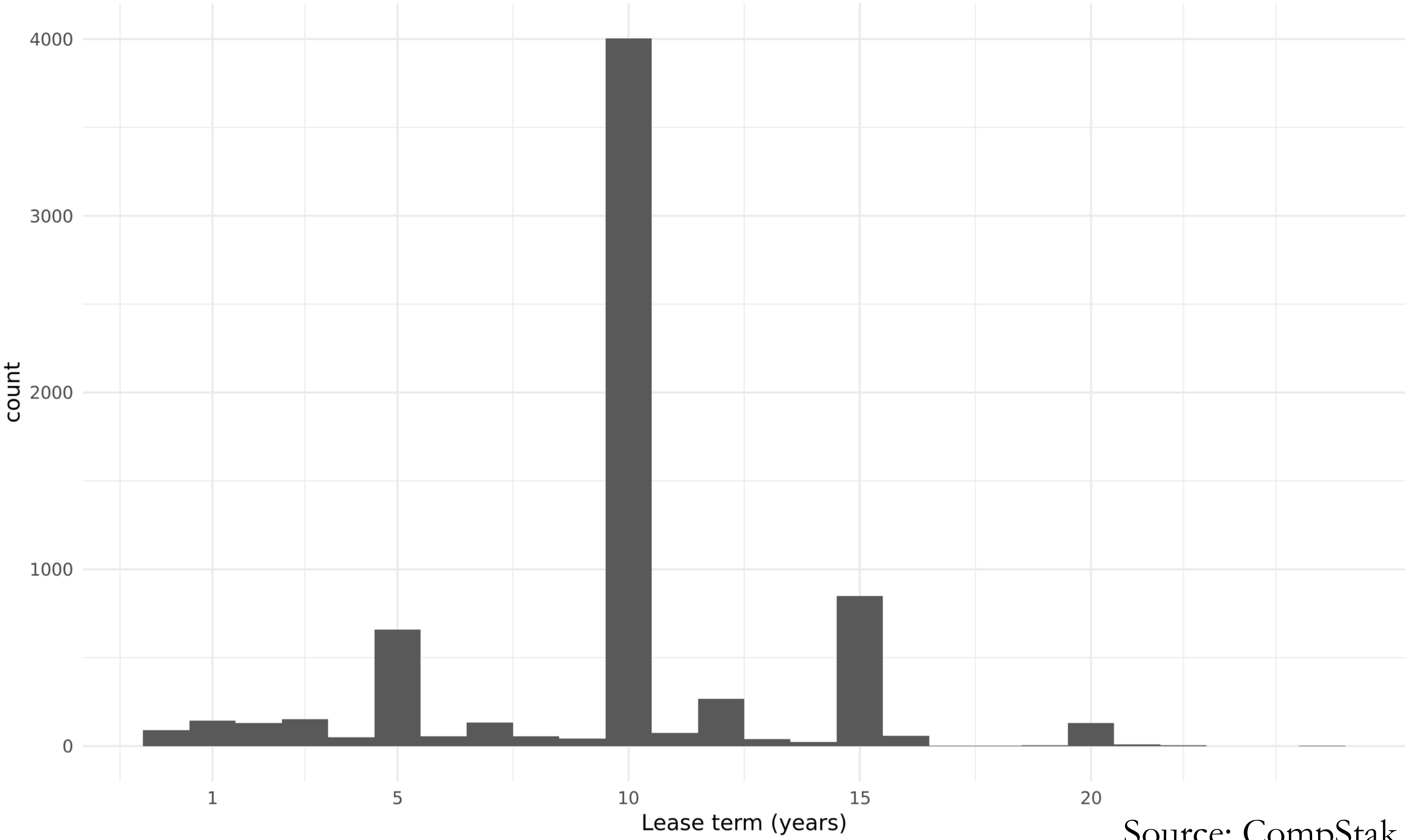
1. **What factors contribute to retail vacancy?**
   - Demand: Tenants find some locations more desirable than others
   - Lease length: Landlords are hesitant to lock in low-rent tenants long-term
   - Search: Costly (in time + $$) for landlords/tenants to find each other
   - Mortgage covenants: Banks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

	+	-
Tenant	Takes time to recoup move in costs	Longer leases are more expensive per annum (on average)
Landlord	Stable source of cash flow many years into the future (necessary to obtain financing)	Lose the chance to take advantage of possibly higher future rents

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

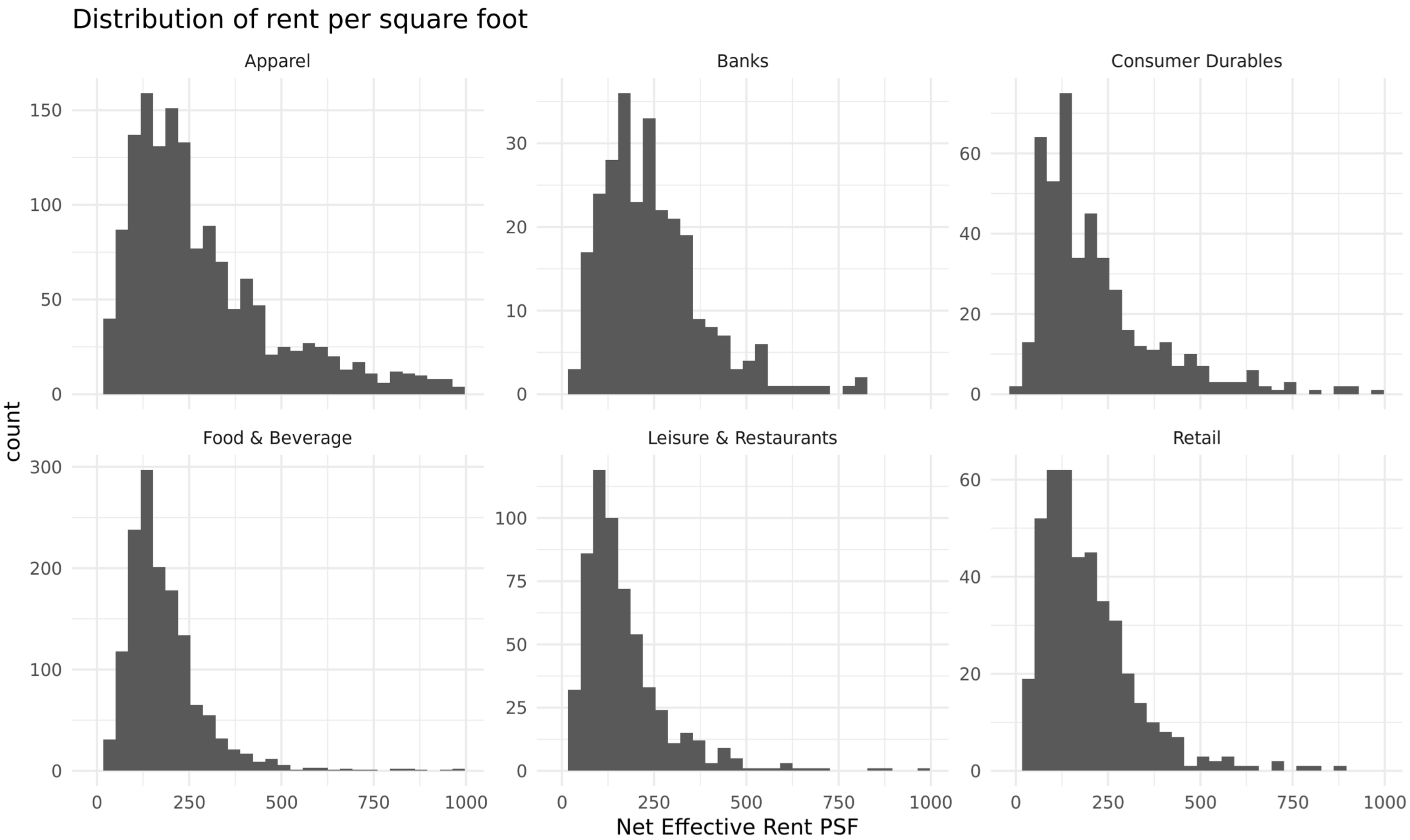
- Brokers get paid **a lot**
  - If it were easy for landlords and tenants to meet and contract by themselves, who would use a broker?

- 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

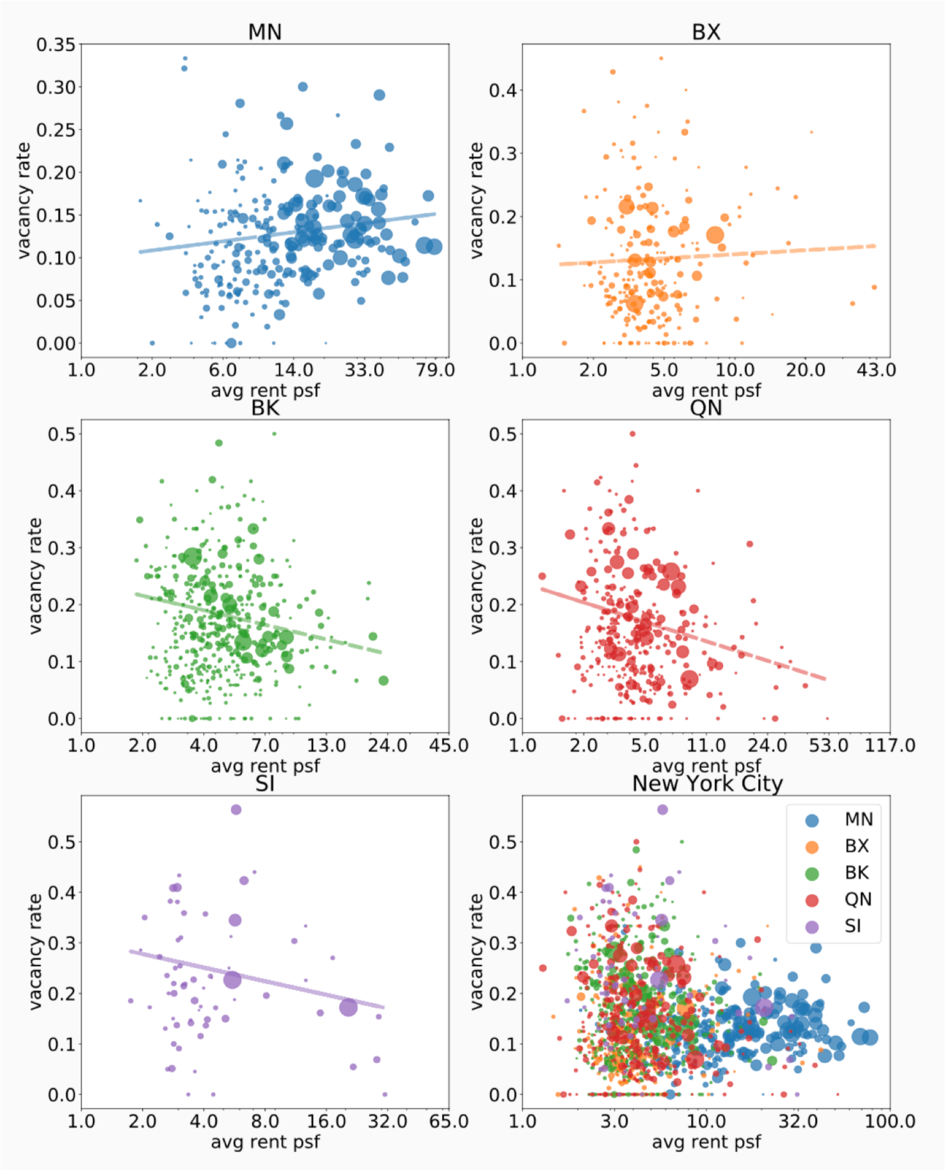
Covenant Examples

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

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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)

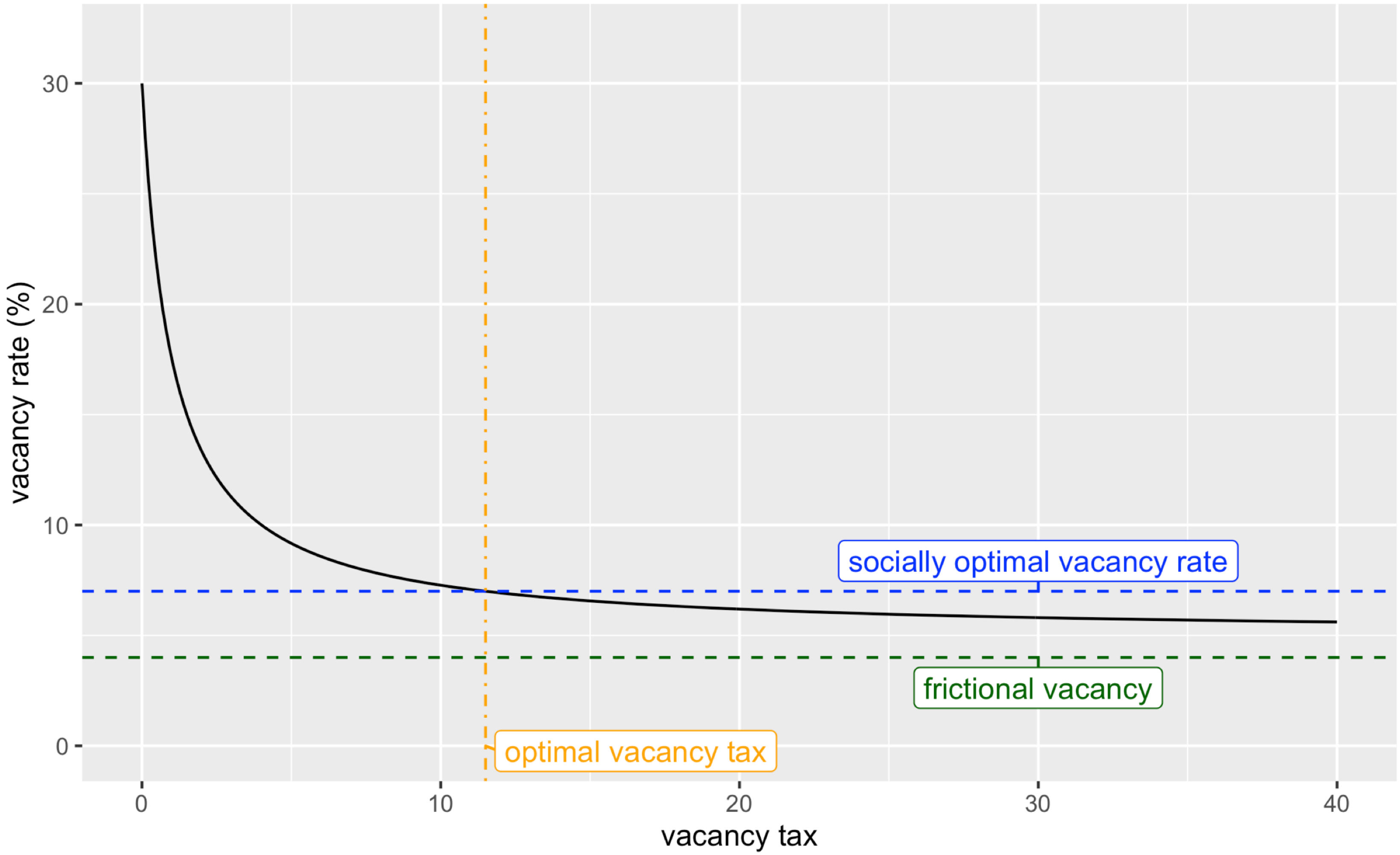
- A vacancy tax could act as a **Pigouvian tax**, which would force landlords to internalize the externalities vacancy imposes.
  - E.g. carbon tax
  - In the real estate context, a tax would bring the landlord's cost of vacancy in line with the social cost of vacancy
  - Requires some measure of the 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

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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
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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!

Erica Moszkowski

emoszkowski@g.harvard.edu

Daniel Stackman

daniel.stackman@stern.nyu.edu