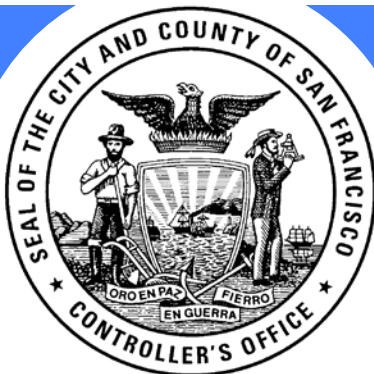


Taxing Commercial Vacancies: Economic Impact Report



CITY & COUNTY OF SAN FRANCISCO

Office of the Controller
Office of Economic Analysis

Item #191005

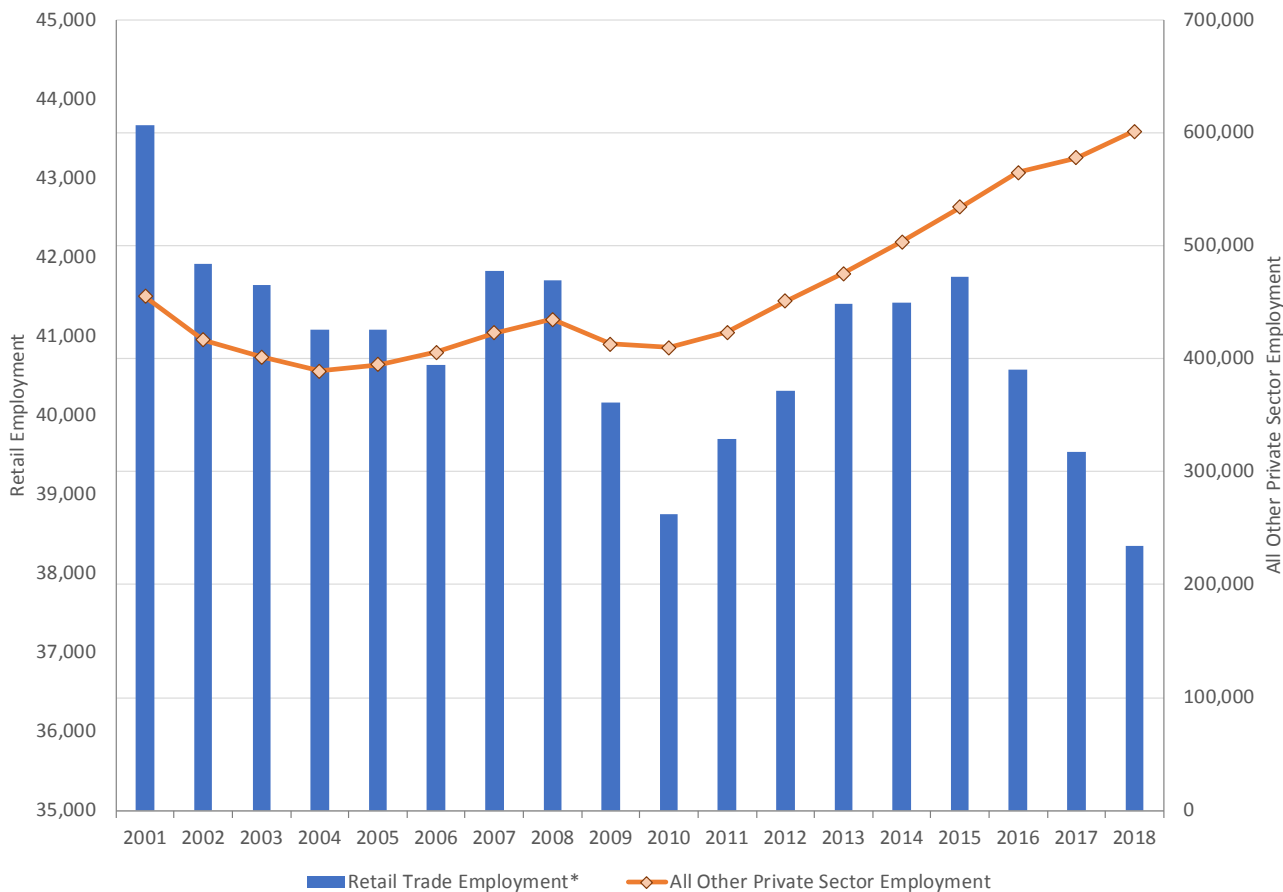
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- The proposed legislation would place an excise tax relating to vacant commercial property on the March 2020 ballot in San Francisco. Under California law, all tax increases must be approved by the voters.
- The proposed tax would apply to most ground-floor non-residential properties within neighborhood commercial areas in the city. If the owner (or tenant) of such a property keeps it unoccupied for more than 182 days in a given year, a tax equal to \$1,000 per linear foot of the street frontage of the property would be incurred.
- Exceptions are provided, for a time-limited period, if the vacancy is due to fire or natural disaster; construction, repair or rehabilitation, or a pending conditional use authorization from the City.
- While the tax is expected to affect few property owners and generate little revenue, it is structured in a way that could have consequences for the city's changing neighborhood commercial areas. For this reason, the Office of Economic Analysis has published this economic impact report.

- The tax has been proposed in the context of reports of rising commercial vacancies in neighborhood commercial areas, at a time of unprecedented strength in the city's overall economy.
- The legislation states that "retail vacancies occur when a property owner or landlord fails to actively market a vacant retail storefront to viable commercial tenants and/or to offer the property at a reasonable rate. Retail vacancies may persist as property owners and landlords hold storefronts off of the market for extended periods of time or refuse to offer the space for a reasonable market rate".
- Vacancy taxes are sometimes proposed as a way to curb speculative behavior in which an owner keeps a property vacant to avoid a long-term lease at current rents, in the hope that higher-paying tenants will be available in the future. However, under local or state law, an owner is not obligated to agree to a long-term lease with a commercial tenant.

San Francisco's Retail Trade Trends in Context

Retail Trade* and All Other Private Sector Employment in San Francisco, 2001-18



Since 2001, the city's retail trade industry has performed very differently from the rest of the city's economy. Brick-and-mortar retail employment declined by 12%, while other private sector employment has grown by 32%. The number of retail establishments in the city has also declined, by 15%. Most such establishments are located in the neighborhood commercial districts that are affected by the proposed legislation.

Since 2015, the trend is even more stark – an 8% decline in retail employment, alongside 13% growth in other private employment

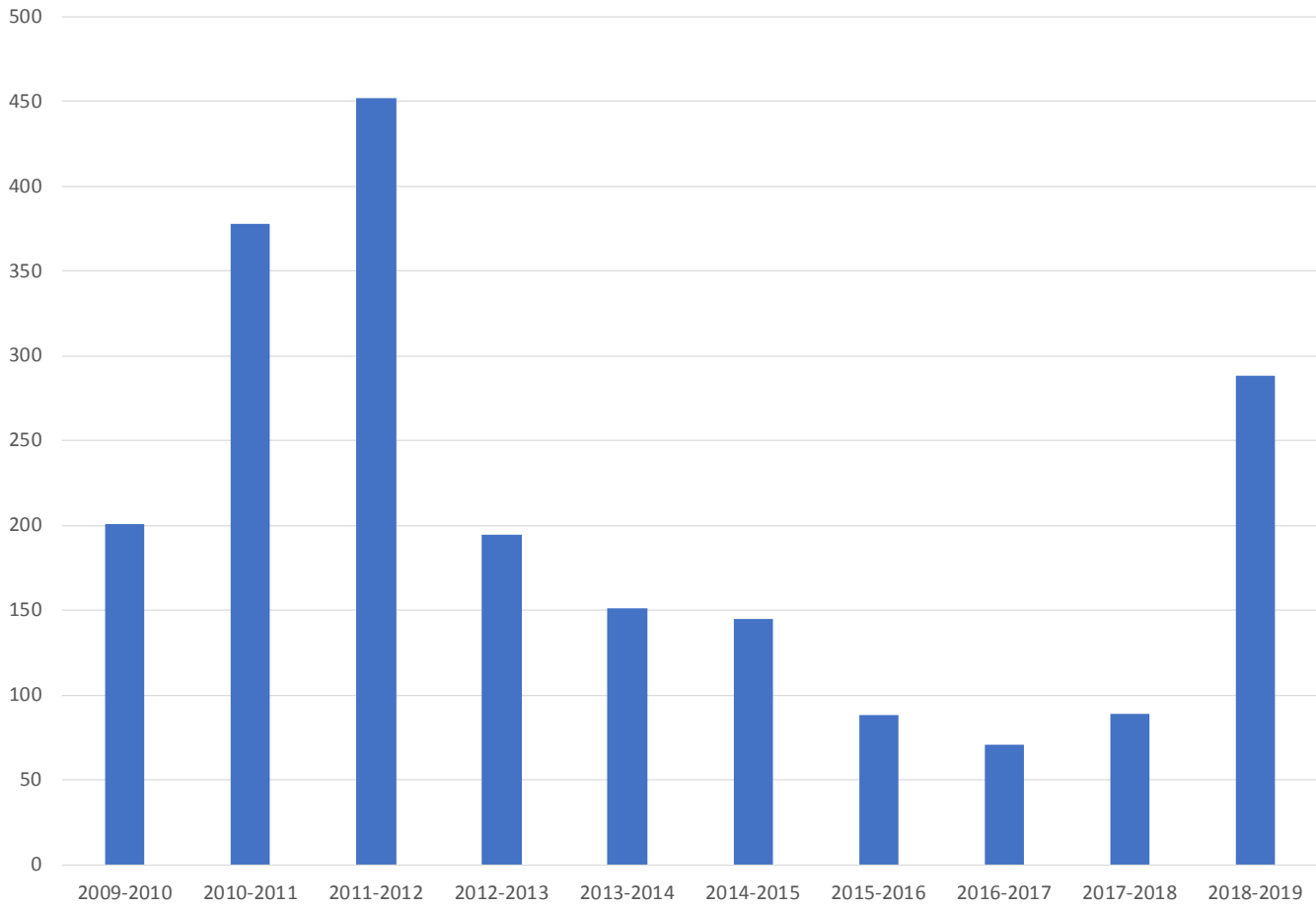
This decline has occurred despite a substantial increase in the supply of retail space in the city. San Francisco's housing supply has expanded by 15% since 2000, with much of that new supply consisting of multi-family housing with new retail space on the ground floor. Most of this supply growth has not occurred in neighborhood commercial areas, however.

* "Retail trade" refers to companies with NAICS codes 44-45, excluding 454, Non-store retailers, who are mainly internet retailers. Food & Beverage Service Establishments are not included.

Source: Bureau of Labor Statistics, Quarterly Census of Employment and Wages.

Vacancies Increase When Retail Declines

Estimated Number of Citywide Vacant Buildings, FY2010 - FY2019, Based on DBI Fees



The City’s Building Code requires owners of vacant buildings and commercial storefronts to register them with the Department of Building Inspection (DBI), and pay an annual fee.

Based on DBI’s fee revenue, we have estimated the number of registered vacant buildings over time. All types of vacant buildings are required to be registered, so the totals shown here are greater than the numbers that would be subject to the proposed legislation.

The number rose during the recession years, fell during the recovery, and has recently risen again. One likely factor behind the recent rise is increased enforcement by DBI in 2018 and 2019, and a new City ordinance that closed loopholes around the registration requirement. The decline in retail employment since 2015 may also be a contributing factor.

Source: Controller’s Office

Estimated Tax Revenue

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- The tax's revenue is expected to fluctuate with the city's building cycle, with higher revenues seen during an economic downturn, in keeping with the general trend seen in DBI's vacant building fee revenue.
- To arrive at a revenue estimate for the proposed tax, we assume the city's overall vacancy rate for retail properties will fluctuate between 5% - 30%, depending on the business cycle. We further assume that 1% - 3% of those vacancies will be vacant for more than 182 days, and thus be potentially subject to the tax.
- Using the the City's GIS data to measure the street frontage of the affected zones, and multiplying that length by the \$1,000/foot-year tax and the vacancy rate led to a revenue estimate of between \$0.3 and \$5 million per year.

- To the extent that the proposed tax can be tailored to apply only to vacancies caused by speculative or negligent behavior, the tax would likely lead to fewer vacancies, and potentially more vibrant and healthy neighborhood retail areas. Neighboring property values would be protected, along with the incentive to invest in and maintain public and private amenities within the neighborhood.
- However, the fact that brick-and-mortar retailing has declined while the rest of the economy, and the supply of retail space, has grown, suggests San Francisco – like many other areas - may be experiencing a long-term decline in demand for retail space due to the growth of internet commerce.
- A property could also be vacant because of a lack of demand, either due to this long-term decline, and/or a recession. If an owner has a vacant commercial property because the previous tenant went out of business, and cannot secure another tenant because new businesses are not being formed, then a tax is unlikely to improve the situation. On the contrary, the threat of a tax that cannot be avoided will likely depress the value of all properties in neighborhood commercial areas, and inhibit investment in them.

Recommendation: Recession Exemption

- The proposed tax does attempt to identify and protect owners, for a six month period, whose properties are kept vacant because they are in the process of securing a Conditional Use permit.
- However, this “safe harbor” would not benefit an owner unable to find a tenant during a recession.
- This issue could be addressed by, for example, deducting official U.S. recession periods from the 183 day vacancy period, so an owner would not be taxed for being unable to find a tenant during a recession.

Recommendation: Broader Tenant Exemptions

- Additionally, some neighborhood commercial areas have fairly restrictive rules about allowable businesses, even with a conditional use authorization.
- The City may wish to further exempt an owner who has a pending application for a use variance and a lease commitment from certain potential tenants that would not be permitted in the commercial area without a variance.
- As a concrete example – so-called “flexible retail” uses are not permitted in many neighborhood commercial districts (NCDs). The City could exempt from the proposed tax an owner of a vacant unit in an NCD who had a lease commitment from a business that wanted to operate a flexible retail use, if the owner also applied for a variance.
- This kind of broader exemption would make it easier for the owner to demonstrate a good faith effort to limit vacancy, and it is highly unlikely that an owner would prefer a tenant that requires a variance to one that could be more easily permitted.
- Of course, this provision would only exempt the owner from paying the tax; the variance application would be considered separately.

- The problem of vacant commercial storefronts is associated with the decline of the retail trade industry in the city, during a time of strong overall economic growth.
- Small businesses and property owners suffer when vacant storefronts make commercial areas less attractive to customers. To the extent that speculative or negligent behavior by property owners and tenants is contributing to the problem of commercial vacancy, a narrowly tailored vacancy tax can benefit these areas, and the city's economy in general.
- However, properties can also remain vacant for long periods because of economic conditions beyond the control of the owner. In such cases, a tax would not solve the problem, would reduce commercial property values, and discourage investment in commercial areas.
- This risk can be minimized by broadening the current exemptions in the proposed tax, to avoid taxing vacancies during a recession, and to minimize the impact zoning controls can have on commercial vacancies.

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