



PRESIDENT'S MESSAGE

August 2023

I am starting this month's newsletter by referring to a report recently published by the McKinsey Global Institute titled "Empty spaces and hybrid places: the pandemic's lasting impact on real estate". Although the report is primarily concerned with the wider real estate market, it raises issues that are clearly already having an impact on property tax systems around the world. Below are selected extracts from the report.

The report summary states:

- Hybrid work is here to stay. As a result, office attendance has stabilized at 30 percent below pre-pandemic norms.
- The ripple effects of hybrid work are substantial. Untethered from their offices, residents have left urban cores and shifted their shopping elsewhere. For example, New York City's urban core lost 5 percent of its population from mid-2020 to mid-2022, and San Francisco's lost 6 percent. Urban vacancy rates have shot up. Foot traffic near stores in metropolitan areas remains 10 to 20 percent below pre-pandemic levels.
- Demand for office and retail space in superstar cities will remain below pre-pandemic levels. In a moderate scenario that we modeled, demand for office space is 13 percent lower in 2030 than it was in 2019 for the median city in our study. In a severe scenario, demand falls by 38 percent in the most heavily affected city.
- Real estate is local, and demand will vary substantially by neighborhood and city. Demand may be lower in neighborhoods and cities characterized by dense office space, expensive housing, and large employers in the knowledge economy.
- Cities and buildings can adapt and thrive by taking hybrid approaches themselves. Priorities might include developing mixed-use neighborhoods, constructing more adaptable buildings, and designing multiuse office and retail space.

The report continues: When the COVID-19 pandemic began, it dramatically changed the way people worked, lived, and shopped in cities around the world. The starkest change was where and how they worked. Obeying lockdowns and office closures, tired of uncomfortable masks, and enabled by remote-work technology, many employees abruptly retreated from traditional offices to home offices. Many of those employees, newly freed from their daily commutes, chose to move out of urban cores. And now that fewer of them were working and living near urban stores, fewer of them shopped there. In recent

months, some of those behavioral shifts have slowed. Others persist, particularly among office employees continuing to engage in hybrid work (that is, a combination of remote and in-office work).

The behavioral shifts have already had major effects on real estate in “superstar” cities - roughly speaking, cities with a disproportionate share of the world’s urban GDP and GDP growth. In superstar cities’ urban cores, the percentage of office and retail space that is vacant has grown sharply since 2019, and home prices have increased more slowly than in the suburbs and other cities.

To what extent could real estate in superstar cities continue to suffer? In this research, the McKinsey Global Institute has modeled future demand for office, residential, and retail space in several scenarios. In those scenarios, demand for office and retail space is generally lower in 2030 than it was in 2019, though the anticipated reductions in our moderate scenario are smaller than those projected by many other researchers. Our analysis also shows that the ripple effects will be complex - for example, that certain kinds of cities and neighborhoods will be more heavily affected than others. We considered a wide variety of factors, including long-term population trends; employment trends, such as the ongoing effects of automation; office attendance patterns by industry; employee coordination, defined as the maximum share of workers in the office at a given time; workers’ ages and incomes; the share of a city’s population that commutes from elsewhere; housing price variation among neighborhoods; and shopping trends, such as the ongoing increase in online shopping. In addition to many secondary sources, our modeling includes information from a large global survey that we conducted to understand the behavioral shifts caused by the pandemic.

We performed this research during a time of exceptional macroeconomic uncertainty. Inflation and interest rates are high; fears of recession are mounting; stress in the financial system has been making headlines. Actual outcomes, of course, will depend on how those variables and others play out.

What is certain is that urban real estate in superstar cities around the world faces substantial challenges. And those challenges could imperil the fiscal health of cities, many of which are already straining to address homelessness, transit needs, and other pressing issues. But the challenges also provide an opportunity to spur a historic transformation of urban spaces. By becoming more flexible and adaptable in everything from the makeup of neighborhoods to the design of buildings - in essence, becoming more “hybrid” themselves - superstar cities can not only adapt but thrive.

During the pandemic, workers’ office attendance plummeted. Untethered from their daily commutes, urbanites moved away from urban cores in greater numbers than they had before the pandemic (and fewer people moved in), and people spent less in urban stores. The rate of out-migration has now returned to its pre-pandemic trend, but our research suggests that few of the people who left will return and that urban shopping will not fully recover.

Employees still spend far less time working at the office than they did before the pandemic, according to our survey. In early 2020, as they adopted remote work and hybrid work in response to lockdowns and health concerns, office attendance in the metropolitan areas we studied dropped by up to 90 percent. It has since recovered substantially but remains down by about 30 percent, on average. As of October 2022,

office workers were visiting the office about 3.5 days per week. That number varied among cities, from 3.1 days in London to 3.9 in Beijing.

Office attendance also varies by industry and neighborhood. In large firms in the knowledge economy - which we define as the professional services, information, and finance industries - employees tend to go to the office fewer days per week. Characteristics of areas with lower office attendance include expensive housing, a higher ratio of inbound commuters to residents, and a small share of retail, according to our research on US counties. Local culture also plays a role.

There are several reasons to believe that the current rate of office attendance could persist. First, the rate has remained fairly stable since mid-2022. Second, three key numbers - the number of days per week that survey respondents go to the office (3.5), the number of days they expect to go to the office after the pandemic ends (3.7), and their preferred number (3.2) - are not far apart. Third, 10 percent of the people we surveyed said that they were both likely to quit their jobs if required to work at the office every day and willing to take a substantial pay cut if doing so let them work from home when they wanted. That group contains many senior, high-income employees, suggesting that they may wield influence over companies' decisions. Nevertheless, it is not certain that the current rate of office attendance will persist; it could change, for example, if labor market dynamics shift or if research conclusively indicates either a negative or a positive relationship between hybrid work and productivity.

During the pandemic, a wave of households left the urban cores of superstar cities, and fewer households moved in. For example, New York City's urban core lost 5 percent of its population from mid-2020 to mid-2022, San Francisco's lost 6 percent during the same period, and London's lost 7 percent from mid-2020 to mid-2021. The main reason was out-migration. In the suburbs, by contrast, populations grew, or they shrank less dramatically than populations in the urban cores did. In the United States, suburbanization had already been happening before the pandemic, and the shock accelerated an existing trend; by contrast, in most of the European and Japanese cities we studied, urbanization gave way to suburbanization.

The urban cores where population growth was smallest in relation to their suburbs tended to be those with expensive homes, high office density, a high share of workers in the knowledge economy, and limited retail presence - some of the same characteristics that shaped office attendance. London, Dallas, New York, San Francisco, and Boston were the most affected. In general, US urban cores were more affected than European and Japanese ones, which tend to have more mixed-use development, in which office, residential, and retail space exist alongside one another. The migration trends in Beijing were primarily shaped by pre-pandemic efforts to control the population size in urban cores by encouraging out-migration, efforts that were paused during the pandemic. Out-migration from urban cores of superstar cities seems to have slowed, but it is still above pre-pandemic levels.

Hybrid work seems to have contributed significantly to out-migration. In our survey, among respondents who moved after March 2020, 20 percent said that their move was possible only because they could now work from home more frequently. In the United Kingdom and the United States, people who had moved from urban cores to suburbs, and who said that their move was possible only because they could now

work from home, said that they were drawn by housing conditions: better neighborhoods, the prospect of homeownership, and outdoor space. In Japan and China, wanting to own a home was far and away the strongest factor motivating people's moves to the suburbs.

Out-migration from urban cores of superstar cities seems to have slowed, but it is still above pre-pandemic levels. From 2019 to 2021, net out-migration from US superstar city cores doubled; then it fell in 2022, although it remained above 2019 rates. In other words, the people who moved out during the pandemic are not moving back, and others keep leaving.

As people stayed home during the pandemic, they radically shifted the way they shopped. Foot traffic plummeted near stores in the cities we studied, and online spending as a share of retail spending spiked.

More recently, foot traffic near stores in metropolitan areas has risen again, but it is still 10 to 20 percent lower than it was before the pandemic. A major reason for the decline is that online spending as a share of retail spending, which admittedly grew more slowly after the initial spike, nevertheless remains higher than it was in 2019.

Retailers in urban cores face particularly acute challenges in attracting customers. As of October 2022, foot traffic had recovered noticeably less near those stores than near suburban ones. In New York, for example, foot traffic near suburban stores was 16 percent lower than it had been in January 2020, but foot traffic near urban stores was 36 percent lower. And office-dense neighborhoods in urban cores are facing even more challenges. The reason seems to be that when people come to the office less often, they shop less often near the office. In our survey, respondents in the United States who worked at the office no more than one day per week reported doing much less of their total retail spending near the office than did those who worked in the office two to five days a week.

The behavioral changes caused by the pandemic - lower office attendance, accelerated out-migration from cities, and less shopping in office-heavy neighborhoods - will push down demand for real estate in most superstar cities. By 2030, in the scenarios we modeled, demand for office and retail space is generally lower than it was in 2019. Residential space is less affected, though the price differences between urban cores and suburbs are narrower than they used to be.

The report goes on to provide a more detailed consideration of the impact of all these changes on real estate values in both the commercial and residential sectors and how cities might respond. Although the report does not specifically deal with the impact of all these changes on property tax systems and, in particular, property tax valuations, it is clearly relevant to the property tax world. A copy of the full report, which is well worth a read in my opinion, is available via the link below:

<https://www.mckinsey.com/mgi/our-research/empty-spaces-and-hybrid-places>

Moving on to IPTI activities, one of the interesting projects we are currently working on is the impact of wildfires and other natural disasters on property tax valuations. As readers will be well aware, wildfires have been raging in many different parts of the world this year. Their impact on property values - particularly in the longer term - varies and we are looking at how property markets respond.

Looking ahead, as usual, we have a full programme of events extending to the end of the year full details of which can be found on our website: www.ipti.org

Now it's time for a quick look at what is making headlines concerning property taxes in selected jurisdictions and countries around the world. For more information, and links to the original news articles, please refer to IPTI Xtracts which can be found on our website: <https://www.ipti.org/ipti-xtracts>

In New Zealand, it is reported that Aucklanders may be experiencing the largest jump in rates since the supercity formed in 2010, but Auckland Council say this is what city dwellers wanted. Last month, Auckland Council finalised plans for this year's financial budget, agreeing on a 7.7% increase in rates for householders. The Auckland mayor's first budget proposal included lower rates and spending cuts, but he was not able to please both the public and his council colleagues, leading to higher rates decision. It's the highest rate increase for Auckland since the Supercity was formed 13 years ago, with mayoral predecessors keeping domestic rate increases to between 2.4% and 5%. Aucklanders who own a home with an average value residential property will be paying an extra \$253 in rates each year, around \$5 a week. Business ratepayers face an average rates rise of 8.1%, or \$1,464 a year for the average value business property, the equivalent of almost \$30 a week. However, if the rates did not increase, Auckland Council say they would have to cut or reduce a number of council services to fill the \$325m gap in the proposed budget. "We've seen rapid rises in inflation and interest rates on top of an already tough operating environment," the mayor said, "including the extreme weather events that caused widespread damage earlier this year. This meant some tough budget measures to respond to a \$325m gap between our revenue and operating expenses, along with a \$40m gap to fund storm-related costs in 2023/2024".

In Australia, the state of Victoria is expected to collect the highest per-capita property tax revenue for years to come, but New South Wales won't be too far behind. A Victorian Parliamentary Budget Office report has revealed Victoria and NSW's heavy reliance on property taxes, with both states generating substantially more revenue per person through stamp duty and land tax than other Australian jurisdictions. Victoria is expected to post the second highest revenue total from property taxes of all Australian states and territories behind NSW in 2022/23, according to the report by the independent budget office. Total property tax revenue for both Victoria and NSW is projected to be broadly similar from 2023/24 and beyond. But Victoria is forecast to rake in the highest per capita property tax revenue of all the states until 2026/27, with its residents to fork out \$2,120 per person on average in 2023/24. Over the same period, NSW residents will pay \$1,646 in property taxes and Queenslanders will cough up \$1,343. Victoria's combined property tax revenue per person was expected to be about 21 per cent higher than in NSW in 2025/26. "Victoria is expected to rely more heavily on property taxes to generate revenue than any other state," said the report, which was produced at the request of the Victorian Opposition. From January, 860,000 landlords and holiday homeowners in Victoria will pay \$1,300 a year on average in extra land tax as part of a 10-year COVID debt levy.

In the USA, a new study issued by Just Accounting for Health Coalition (JAfH) reports that, in the 18 counties of Western North Carolina, there is a difference between how higher-end properties are assessed for tax purposes and how more modest properties are assessed, resulting in a significant bias in favor of high-end property owners. It is a conclusion the Buncombe County tax assessor strongly disagrees with.

The report's conclusion, according to a spokesperson, "proved beyond any doubt" that the system "penalizes our most economically vulnerable" while "unfairly subsidizing some of the wealthiest". However, the Buncombe County tax assessor commissioned a neutral third-party analyst to study any alleged biases in property assessment, but found none. "Nothing was ever found," he says. "There's no significance to that claim." He continued, "There is no difference in the rate. Everybody in the county pays the same rate", though he does acknowledge there are more likely to be discrepancies in valuation in more expensive properties because of the upgrades you don't see that could result in the property being undervalued. "We don't know what's inside that luxury home," says the assessor. "We don't know if they have imported marble, decorative woodwork and a \$250,000 kitchen." But regardless, he says, ultimately assessed value is tied to the value determined by what buyers are willing to pay for a home, adding, "The assessed value is driven 100% by market value." The JAfH report also included seven recommendations it suggests might help close what it described as the "Assessment Gap". These were: conduct reassessments annually, instead of every 4 to 8 years; precede annual reassessments with a comprehensive inspection of properties; overhaul the appeals process and/or fund a third party support organization to provide free legal service; exercise the 'clawback' provision to the extent required by State Law; unequivocally commit to transparency and integrity; take a development perspective on staff's contributions to equity commitments; and compensate residents who have been adversely affected by unconstitutional property assessments. It will be interesting to see if any of these recommendations are adopted.

A recent article from the UK states "property taxes mean it's not so easy for buildings to be green". It continues: an increasing body of evidence suggests office buildings that achieve green certifications and ratings are more attractive to occupiers, let more quickly to stronger covenants, and benefit from reduced obsolescence. The research reportedly shows that central London office buildings with a BREEAM 'Outstanding' rating have rents 23% higher than the average headline rent. Similarly, buildings with an Energy Performance Certificate (EPC) 'A' rating have rents 17% above average headline figures. However, occupying a superior, green building and, in turn, paying a higher rent, exposes occupiers to higher business rates (the property tax that applies to non-domestic properties in the UK). The article states: this seems counter-intuitive; why should occupiers pay more in property tax to go green? The UK property tax system is based on the premise that rates follow rents, so a 20% rise in rent for offices with the best green credentials or most efficient energy ratings will inevitably result in a 20% increase in business rates. The article argues for a system of allowances or reliefs to be put in place to avoid disincentivising tenants from taking green buildings. It will be interesting to see if the UK government acts upon this suggestion.

And finally, a recent announcement concerning property tax valuations in Nebraska caught my attention. "Valuation increases in Nebraska have become an unbearable burden for homeowners, businesses, and agriculture producers across our state," said Governor Jim Pillen. "We will find a solution that will reduce the burden of insurmountable valuation growth in recent years. It is our job to make sure Nebraska continues to be the best place to live and reckless valuation increases on home and property hinders that commitment to Nebraskans." Not only does this indicate a basic misunderstanding about how property tax systems (should) work, it strikes me as being as futile as King Canute trying to hold back the tide!

Paul Sanderson JP LLB (Hons) FRICS FIRR
President, International Property Tax Institute