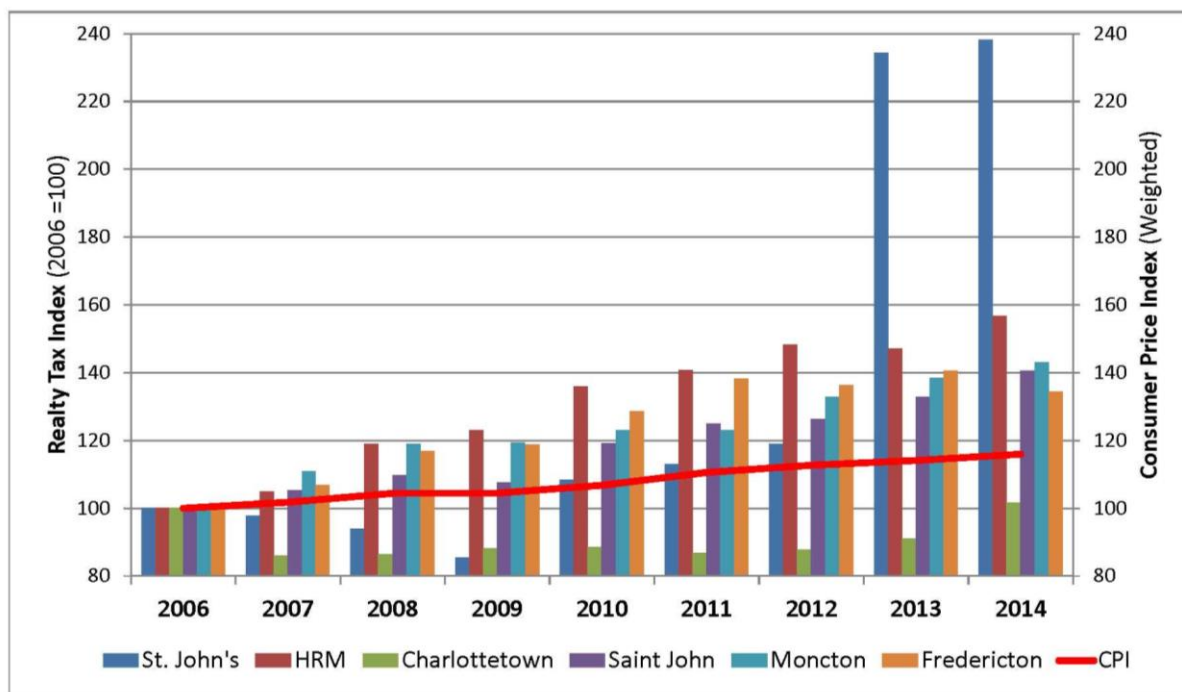


## KILLING THE GOOSE THAT LAID THE GOLDEN EGG



Source: Turner Drake & Partners Ltd. Market Surveys

Our Economic Intelligence Unit has conducted semi-annual surveys of office and industrial space available for rent in each of the six major centres in Atlantic Canada since 2006. The surveys cover 34 million square feet in buildings 5,000 ft.<sup>2</sup> or greater in area. The responses to each survey range between 88% and 100% and are recorded in a database specifically designed for the project. Using a team of trained researchers we capture information on the rentable area, vacancy, net absolute rent, realty taxes, common area maintenance (CAM) and gross rent. A free copy of each municipal survey is provided to each participant.

The graph shows the increase in the Realty Tax load per square foot for **office** space in each of the communities (Greater St. John's, Halifax Regional Municipality, Greater Charlottetown, Greater Moncton, Saint John and Fredericton). The Realty Taxes per square foot of rentable area have been converted to a common base 100 at year 2006. (Halifax Regional Municipality started to phase out its Business Occupancy Tax in 2006, transferring the tax load instead to the Realty Tax. Some portion of the Realty Tax increase since that date was therefore due to that phase out: it had been completely eliminated by 2012). We have also shown the Atlantic Region Consumer Price Index, to act as a benchmark.

As the graph demonstrates, the rise in the tax burden borne by office property owners exceeded the increase in the cost of living in every municipality surveyed, other than Charlottetown. The most egregious examples were Greater St. John's and Halifax Regional Municipality (HRM). During the eight years post 2006 the Atlantic Region CPI increased by 16% while office realty taxes per square foot shot up by 138% (St. John's) and 57% (HRM). Greater St. John's realty taxes moved up to an average of \$3.12/ft.<sup>2</sup> in 2014 from a low base of \$1.31/ft.<sup>2</sup> in 2006. (This was partly due to the fact that the City of St. John's phased out its Business Occupancy Tax in 2013, effectively doubling the Realty Tax, but also because 2013 was a province wide tri-annual re-assessment year. Although assessments jumped in value, the municipal mill (tax) rates were not reduced commensurately). HRM's realty taxes topped them in 2014 with an average of \$4.23/ft.<sup>2</sup>, up from a base of \$2.70/ft.<sup>2</sup> in 2006.

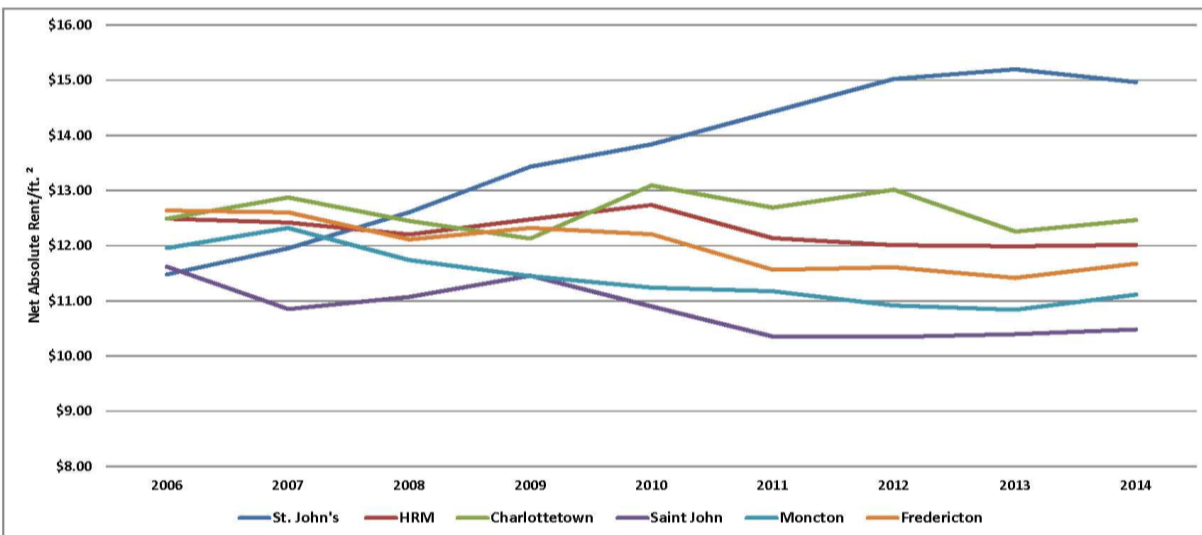
Although increases in property taxes are frequently laid at the door of the assessment authority, this is really a case of shooting the messenger. Even if the assessment tax base doubles in value, the amount paid by the property owner will not change. In fact, if the community is expanding, as is still the case in the major municipalities in the region, the taxes paid per square foot should fall, everything else being equal. Our research has shown that the problem lies with municipal budgets: if assessments increase, budgets expand to spend the additional money generated by applying existing tax rates to the newly increased assessment base. Unfortunately it does not work the other way: if the property assessment base falls, budgets do not contract commensurately... instead municipalities raise the tax rate. This occurs because the majority of the municipal budget is consumed by staff salaries, and the personnel are often unionised so

effectively have jobs for life.

Halifax Regional Municipality, is a prime example. Over the five years to 2014, assessments increased, on average by the following amounts: Automobile Dealerships 29%; Apartments 28%; Industrial property 27%; Offices 26%; Hotels/Motels 10% ... while tax rates fell by just 4%. That's right: 4%! And this during a period when the municipal property base was expanding too. So where did all that extra money go ... into additional or better services? Sadly not: over 60% of HRM's expenditures are consumed by staff salaries and pensions. And HRM's own figures show that staff compensation increased by 82% between 2000 and 2010 ... a period during which the cost of living grew by just 24%. In part this was because salaries soared above those in the private sector, by about 40% in those admittedly few cases where we have been able to compare them with major private sector companies. The *average* salary of a full time HRM employee rose from \$47,301 to \$76,821, a rise of 62% over those ten years. The municipality's staff complement continued to balloon too. While competition was forcing the private sector to innovate: to do more with less, the public sector faced no such pressure. The result is that the municipality has become increasingly dysfunctional: even simple requests now pass through multiple hands as overstuffed departments struggle to justify their work force. (In fairness we should add that similar comments are made to us about some other municipalities: Moncton appears to be the exception that proves the rule). The sting however is in the tail. By November 2010 42% of HRM staff were due to retire in 5 years, 59% of them Supervisors, Managers and Directors. Their pensions will be based on their latter years' earning and will continue for the next 20 to 30 years ... a staggering burden for taxpayers who also face double jeopardy as new personnel are hired at similar inflated salaries and staffing levels.

The major municipalities in Atlantic Canada will eventually have to face the facts: the next 10 years will not be a replication of the past decade. The region's population is shrinking and aging: the ratio of working to non-working age population is declining rapidly and immigration will **not** reverse that process. The smaller municipalities are now experiencing this reality but the major municipalities have been buffered from it by rural to urban migration. This will stop as rural areas are denuded of population. Unfortunately there is little evidence that municipalities are prepared to face up to the situation: expect instead that they will attempt to lobby for additional taxes albeit under a different guise than property tax. There can be little expectation that the "higher" authority, the Provincial government, will be able to bring much pressure to bear ... the municipalities already have much of the provincial population (HRM 41%) and GDP (HRM 55%). The tail wags the dog!

### Sub-Optimal Development

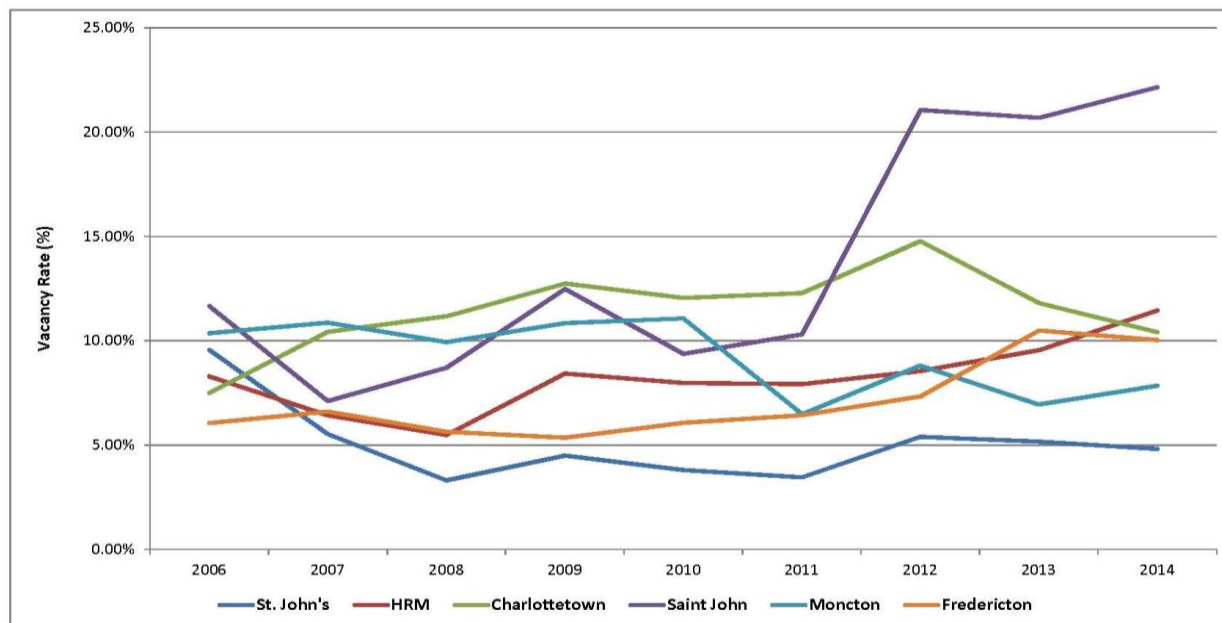


Source: Turner Drake & Partners Ltd. Market Surveys

The graph above tracks the average Net Absolute Rent per square foot for office space in **each** of the six municipalities. (The "Net Absolute Rent" is the money available to pay the debt service on the mortgage and reward the owner for risking their equity). We have expressed the Net Absolute Rent per square foot in constant 2006 dollars, by deflating it by the Provincial Consumer Price Index. With the sole exception of St. John's, Newfoundland, office space has experienced negative real growth in rental value. St. John's has been buoyed by the oil boom and this has driven new office construction in the downtown core. However other municipalities have had new development in their Central Business District with relatively modest increases in rental rates. Tenants cost their rental budgets on the gross rent

i.e. the rent inclusive of operating expenses (CAM) and realty taxes. Landlords have only been able to secure increases in their (deflated) Gross Rental per square foot in St. John's and (marginally) in HRM. They have been able to restrain the growth in their buildings' Common Area Maintenance i.e. operating expenses excluding realty taxes, below the Provincial CPI in every municipality other than St. John's (oil boom) and Fredericton (government town). However the decrease has not been sufficient to offset the increase in Realty Tax. The municipalities are effectively confiscating an increasing share of the Gross Rent forcing the residual Net Absolute Rent per square foot downwards. Since Market Value is a function of Net Operating Income (Net Absolute Rent minus Vacancy) divided by the Overall Capitalisation Rate, the municipalities are reducing Market Value and appropriating a portion of the property owners' equity to fund their own operations. This transfer of wealth from the private sector is eroding capital and reducing the ability of the former to invest in the municipality at optimal levels. In essence government taxation is crowding out private sector investment.

### Transferring Risk



Source: Turner Drake & Partners Ltd. Market Surveys

The graph above details the office vacancy rate in each of the six municipalities. Equilibrium vacancy for office buildings is 5%. Anything above this figure is not sustainable over the long term. The last eight years have been a challenge for office space in the Atlantic Region. In large part this situation is a reflection of the poor economy in areas other than St. John's which, as mentioned earlier, has so far benefited from the offshore oil boom. However it has also been exacerbated by government policy, at provincial and often municipal level, which persists in believing that it is better than the market at choosing winners, or which favours development of its own industrial/office parks over the central business district. Commercial property ownership in Atlantic Canada faces more risk therefore than most other areas of the country. Realty taxes add a further layer of risk since only Newfoundland (excluding St. John's) now levies business occupancy tax. Prince Edward Island does offer some relief for vacant space. But other than the foregoing the landlord bears the full tax burden on vacant space. The three Maritime Provinces are on yearly assessment cycles but Nova Scotia still insists on utilising a Base Date two years prior to the assessment year. Prince Edward Island and New Brunswick have Base Dates on January 1st of the assessment year but will not recognise the impact of vacancy on the assessed value that occurs during the assessment year, until the following year. Newfoundland has a tri-annual re-assessment cycle so the impact of increasing vacancy, and falling property values, may not be reflected in a reduction in the assessment until four years after the event. The bottom line is that the deleterious impact of vacancy will not be reflected in the reduced assessment until after the event ... often several years later. During this period the municipality marches on regardless, happily taxing away as though there was no tomorrow, bearing little of the risk and none of the pain ... a parallel universe whose employees collect their pay packets and pensions sublimely indifferent to the travails of the real world ... or as Marie Antionette may have so eloquently put it "Qu'ils mangent de la brioche."