January 17, 2024 **Policy Brief: Volume 24, Number 3**

High vacancy rates beginning to affect tax coffers

Introduction: Earlier this month a news report noted that three office towers in Pittsburgh's central business district (CBD) won appeals for their property assessments. The Tower on PNC Plaza, one of the CBD's newest office towers, had its assessment cut from $147.2 million to $72.3 million. The U.S. Steel tower assessment was also cut dramatically, falling from $233.2 million to $141.5 million. Three Gateway Center was the third major property to have its assessment lowered, dropping from $62.7 million to $35.5 million.

This is most likely just the beginning of assessment appeals decisions as the office market in Pittsburgh's CBD, and probably across the area, continues to grapple with rising vacancy rates in the aftermath of the pandemic when employees were sent home and have not fully returned.

When office towers have vacant space, it reduces their rental income, which lowers their market value, which is the basis for property taxation. Building owners will appeal assessments that do not reflect new updated, and lower, market values. And, absent a regular reassessment regimen, which the Allegheny Institute has long advocated, it will leave taxing bodies with a large and unexpected drop in revenues when the appeals inevitably favor the property owner.

In the case of the towers mentioned above, those assessments will be retroactive to the 2022 and 2023 taxing year, so the drop in revenues for the three taxing bodies, Allegheny County, City of Pittsburgh and Pittsburgh Public Schools, will be hard felt as they now need to provide refunds for those past years. But as the article noted, about 55 commercial buildings with a total assessed value of $1.5 billion are under appeal. If these are as successful as the others, the consequences for the three taxing bodies will be severe.

Vacancy rate trend

Prior to the pandemic, in the fourth quarter of 2019, the class A (trophy) building vacancy rate in Pittsburgh's CBD was 15.9 percent. By the first quarter of 2021 the rate climbed to 18.1 percent. It dropped a bit in 2022's third quarter to 16.4 percent before rising to 21.5 percent in 2023's third quarter and held reasonably steady at 21.1 percent in the fourth quarter.

Keep in mind that the vacancy rate is calculated by dividing the number of square feet that is not being leased by the total number of square feet available (including subleases). It does not include space that is not being used, as was the case in the direct aftermath of the pandemic when employees were sent home, yet the firms renting space were still responsible for making lease payments. The vacancy rates may have seemed low during, and immediately following, the pandemic, but that had more to do with leases signed prior to the pandemic. As those leases expired, firms began negotiating smaller footprints and more square footage became unleased.

For comparison, Jones Lang LaSalle (JLL), the source of the office statistics in this *Brief*, samples 52 markets across the country. The total vacancy rate for class A office buildings in the sample CBDs for the third and fourth quarters were 20.5 and 20.8 percent, respectively. This is lower than, but mirrors, the steadiness of the Pittsburgh class A office market for the last six months of 2023.

The overall office vacancy rate for all classes of buildings in Pittsburgh's CBD came in at 22.5 percent in the third quarter and 22.3 percent in the fourth. The prevailing thought as to why the overall rate is higher than the class A building rate has to do with what is called the "flight to quality" effect. As leases expired, firms looked to not only lower their footprint, but move to buildings with higher amenities to entice employees back into the office. JLL reports the class B office vacancy rate in Pittsburgh's CBD to be 24.2 percent in the final two quarters of 2023.

In the 52-market sample, the total vacancy rate for all classes of office space (classes A, B and C) in the third quarter came in at 20.8 percent before rising to 21.1 percent in the fourth quarter. With the class A rate being lowest, the theory of flight to quality appears to have merit.

Absorption of office space

Is the vacancy rate poised to turn around anytime soon?

An appropriate measure to look at is the absorption rate of space. Negative absorption implies that leased space became unleased or vacant. Positive absorption implies that unleased space became leased which should lead to lower vacancy rates.

In the third quarter, the absorption rate for class A office space in Pittsburgh's CBD was, in fact, negative (-101,949 square feet of 22,120,971 total square feet), but minimal. For class B space it was virtually zero, but positive (504 of 13,942,513 square feet). The total absorption rate for all classes was just -0.3 percent.

The fourth quarter was a little different with class A having a positive absorption of 89,060 square feet and class B office buildings having a negative absorption of 98,168 square feet. This may lend credence to the flight to quality theory.

However, for the year both classes of office space, A and B, had negative absorption of 312,311 and 447,476 square feet, respectively. As a percentage of total inventory, it is small, -1.4 percent and -3.2 percent, respectively. The key is that it was negative. Firms gave up office space and that drives down the value of these office buildings and subsequently their property assessments are likely to drop as they go through the appeals process mentioned above.

Implications and conclusion

As the pandemic recedes further, many firms are starting to encourage employees to return to the office. While working at home has benefits for employees—saving on commuting costs for example—it has not boosted productivity for many firms. Will this lead to a reversal of work-from-home policies and will firms require more space to accommodate employees returning to the office? Firms may have to offer better amenities to entice them to return. Class A office buildings that have been remodeled or renovated could see vacancy rates begin to fall over the course of 2024 and into 2025.

However, for older building stock, the vacancy rates will likely remain high and the call to have them renovated for other uses, such as residential, will only grow louder. But these calls should not be met with officials offering public money. These conversions will likely be costly. But if a building owner believes it is the best path forward, they should shoulder the cost, not the taxpayer.

The successful property assessment appeals of Pittsburgh's CBD office buildings will have far reaching impacts across the county as high vacancy rates and plummeting market values will prompt other building owners to file appeals of their own. Taxing bodies, most notably school districts that rely so heavily on property tax revenues, could well suffer financial hardships if they are forced to issue refunds for inaccurate assessments in prior years. Could this force taxing bodies to raise millage rates to recoup those losses on the backs of residential property owners?

This situation underscores the importance of regular property assessments. It would provide more certainty not only for taxing bodies, but property owners as well, and be more responsive to fluctuations in the economy and the real estate market.

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