downtown leadership paper

An occasional series of working papers prepared by the **Downtown DC Business Improvement District** to foster dialogue about critical issues relating to Downtown Washington's economic, social and physical development.

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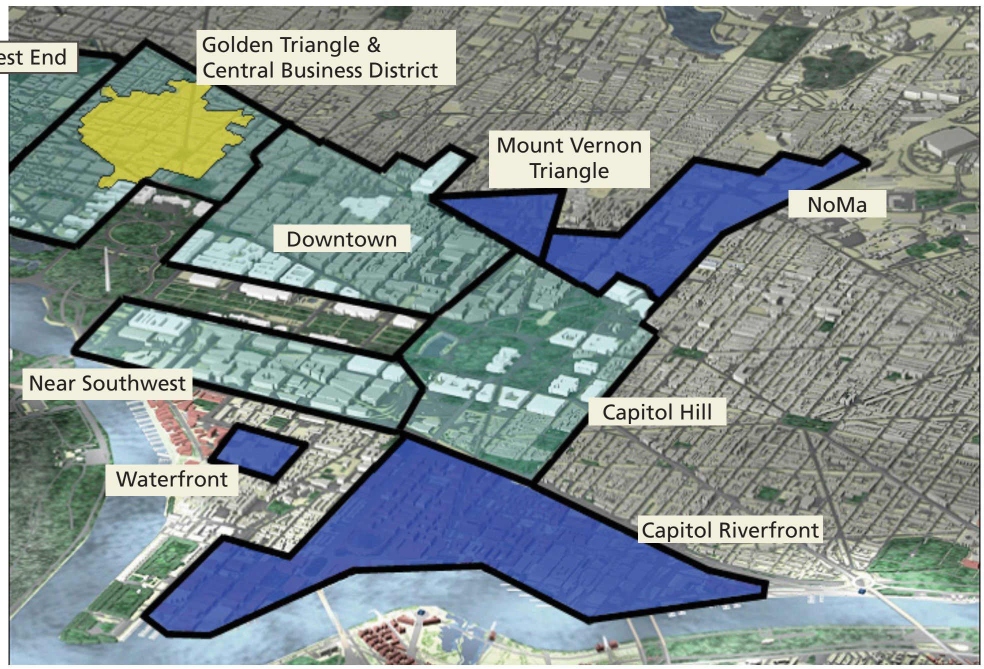
The District of Columbia's Competitive Position in the Regional Office Market

Executive Summary

Washington, DC has enjoyed a robust office market over the past decade. However, high business costs and increased competition from other regional office markets may be endangering current and future growth, just at the time that DC is counting on office markets emerging in NoMa, Mount Vernon Triangle and the Capitol Riverfront areas to sustain this momentum and further economic expansion.



DC's Center City Office Markets Established Markets Emerging Markets

A loss of momentum in the commercial office market poses a substantial risk to the city's job expansion and financial health, as property taxes from this sector represent an increasing revenue source for the DC government to meet key social initiatives.

The city has added an average of more than 2 million square feet (SF) of office space annually since 1998, providing substantial financial return to office developers and increased tax revenues to the DC government. With an additional 30 million SF of currently vacant land in the center city area available for office development, DC would realize an estimated additional $510 million in annual taxes, which can assist in keeping the city's office market competitive regionally, nationally and internationally and in meeting social needs.

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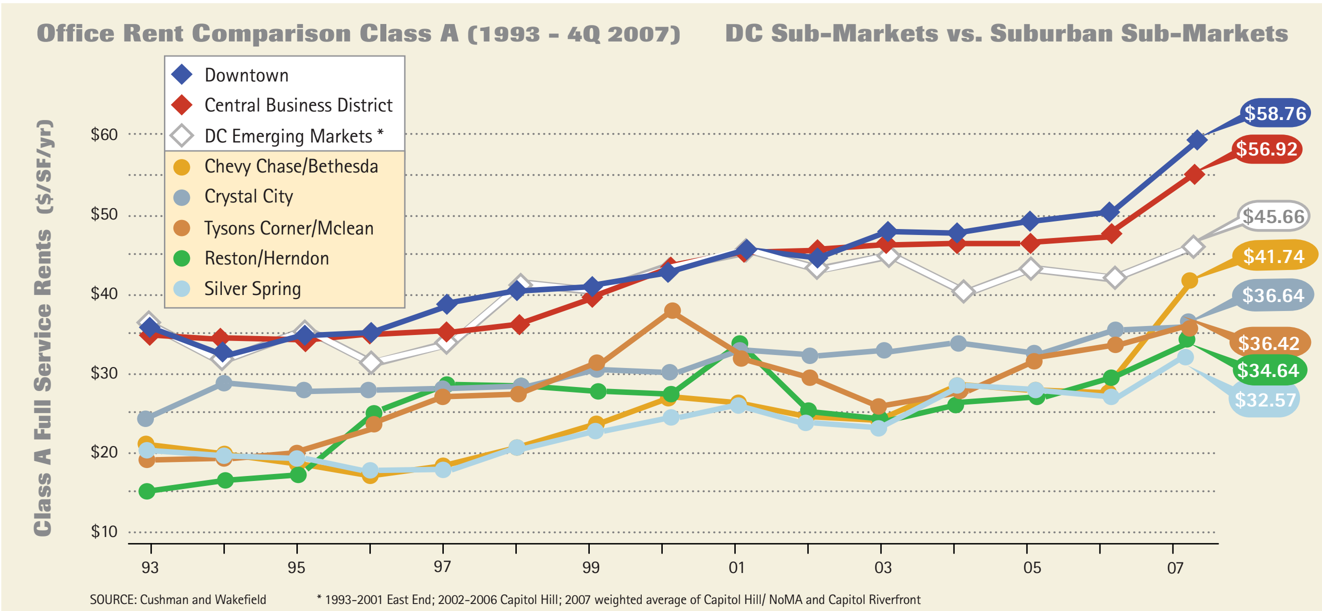
1. **Overview of DC's Office Market and Its Competitive Position in the Region**

DC's office market has thrived over the past 10 years. Solid job growth and low vacancy rates have led to strong office rental growth. As of the end of 2007, the city's office market ranks fourth in the U. S. behind Midtown Manhattan, Downtown Manhattan and Boston in Class A rental rates, and second nationally in sales prices for office buildings behind Manhattan. In addition, the vacancy rate for the DC office market has also been strong over the past 10 years and is 7.1% as of December 31, 2007.



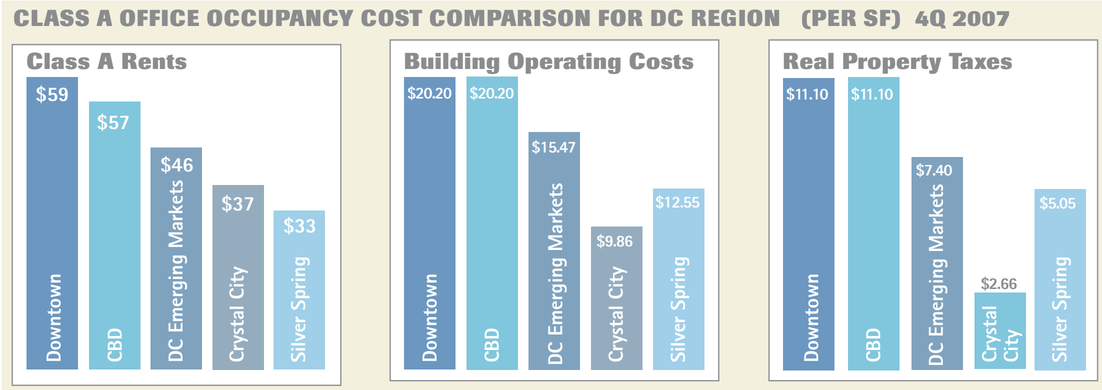
Office space growth of more than 18 million SF is due primarily to DC tenant's internal expansion, as only a modest number of new tenants came into the DC market. Although many tenants, such as law firms, consulting firms and federal agencies, have been able to afford DC's high rents, or are required to locate in the city, many others have decided to locate in surrounding jurisdictions, where the cost of doing business is much lower. In fact, tenants leasing 2.1 million SF have left the city over the past six years.

Indeed, the growing disparity between office rents in DC and the rest of the metropolitan region raises serious questions about whether the city can maintain its current office development momentum. The rental rate disadvantage affects established office markets in Downtown, the Central Business District and Near Southwest, as well as emerging office markets in the Capitol Riverfront, NoMa and Mount Vernon Triangle areas. As of December 31, 2007, Class A office space in Downtown cost $20 to $26 more per SF than in nearby suburbs. Class A office space in the center city's emerging markets costs $9 to $13 more per SF than in the suburbs.

Significantly higher operating costs for DC office buildings, as compared to those in the suburbs, account for the majority of the DC versus suburbs rental rate difference. As a result, the following outcomes for DC are likely: (1) the office market will develop more slowly than it would otherwise; and (2) the office tenant base will narrow as cost-conscious tenants leave the city. In particular, one negative outcome may be losing small to mid-sized organizations and businesses that find it hard to meet higher rents and the associated costs of doing business in DC. Another negative outcome may be a continued out-migration of cost-conscious businesses from the city, along with back-office functions and support businesses. In fact, DC has lost more than 3 million SF of Class B office space since 2000.

Surrounding regional jurisdictions will continue to pose a very strong competitive threat to the DC office market's growth due to two factors other than high operating costs: (1) suburban areas have lower land costs (particularly in Northern Virginia and Prince George's County); and

(2) suburban areas will have greater tenant loss from the Defense Base Realignment and Closure Commission's (BRAC) post-9/11 defense consolidation recommendations, thereby opening up large blocks of available space (4 to 5 million SF of office space in Arlington will be vacated beginning in 2011).



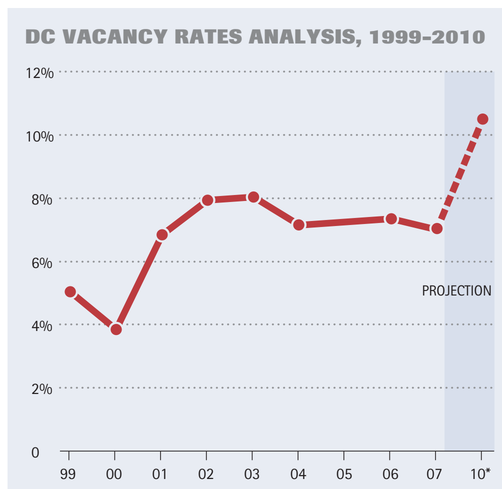
SOURCE: Cushman and Wakefield, Downtown BID and Building Owners and Managers Association (BOMA) survey

Despite a significant rental rate and operating cost disadvantage, DC's office market has competed successfully with nearby jurisdictions because in employers' location decisions, the location and "quality-of-life" amenities outweigh the cost disadvantages. DC offers easy access to the federal government, national institutions and business leaders in other major industries and associations housed here. A wide range of restaurants, entertainment and cultural attractions exist in DC to a far greater scale, and at a higher quality level, than in suburban areas. Beyond this, the region's transportation systems are set up primarily to serve DC, particularly the Downtown and center city areas.

However, DC's amenity differential may be narrowing as surrounding jurisdictions like Silver Spring, Rockville, Reston and Crystal City continue to invest in "urban" amenities to improve their competitive position. In addition, Metrorail's extension to Tyson's Corner and Dulles Airport in the next five to seven years will bring rapid transit to more of Northern Virginia. Lastly, Prince George's County has invested substantially in National Harbor to create a new national and regional convention destination that will compete with several sectors of the DC convention and hotel market. It also is primed to become a significant new residential and office sub-market in the next three to 10 years.

Widening rental rates and operating costs, combined with narrowing amenity advantages in DC (or lack of amenities in the emerging markets) are of serious concern today. DC has lost office tenants representing 1.58 million SF to Northern Virginia and another 480,000 SF to suburban Maryland in the last few years, while bringing in a modest 340,000 SF of new office tenants—a total gross loss of 2.06 million SF and a net loss of 1.72 million SF.

Of additional concern are the storm clouds on the vacancy horizon as 8 million SF of office space is under construction at year-end 2007, and the current pre-leasing of this new office space is only 20%, well below recent historical levels of 40 to 60%. Potentially vacant new office space could increase DC's vacancy rate substantially as projects are completed. The chart on the right shows that the vacancy rate could jump to 10.4% if only 50% of this space is leased by 2010 (a 12.4% vacancy rate if only 25% is leased).



*Assumes that 50% of the 8 million SF under construction in 4Q 2007 is leased by 2010.

SOURCES: Cushman and Wakefield and the Downtown DC BID

2. High and Increasing Office Rental Rates Are Caused by High and Increasing Office Operating Costs

A 2007 Staubach Company study ranks the DC market seventh in the world and second in the United States in terms of office workstation space costs—a dubious distinction given DC's significant regional competition. The most significant factor in high rental rates are high operating costs, and the most significant factor in DC's high operating costs are high office property taxes. Thus, most of the regional differences in rental rates are caused by differences in regional office property taxes. Average property taxes in Downtown are $11.10 per SF and $7.40 per SF in DC's emerging markets, versus $2.66 per SF in Crystal City, Virginia, and $5.05 per SF in Silver Spring, Maryland.

And, DC's real property taxes per SF for Class A space rose 94% over the past five years, or an average of 14% per year, from $5.72 per SF to $11.10 per SF.

REGIONAL COMPARISON OF COMMERCIAL OFFICE PROPERTY TAXES PER SQUARE FOOT, DECEMBER 2007

		Commercial Property Tax Rate		Estimated Class A Office Space Assessments ($ per SF)		Commercial Office Property Taxes ($ per SF)	(%) **
DC	Established Office Markets	1.85%	X	$600	=	$11.10	100%
	Emerging Office Markets	1.85		400		7.40	67
VA*	Alexandria	0.815%		$400		$3.26	29%
	Crystal City	0.818		325		2.66	24
	Reston	0.890		425		3.78	34
MD	Bethesda	1.681%		$400		$6.72	61%
	Silver Spring	1.684		300		5.05	46
	Prince George's County	1.451		250		3.63	33

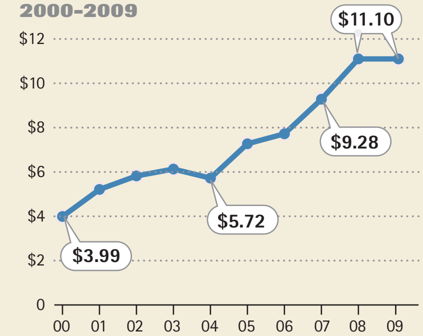
**Arlington and Fairfax counties are reported to be increasing their commercial property tax rate by 0.10% to fund regional transportation projects. In 2006, Virginia passed legislation allowing counties in Northern Virginia to increase commercial property taxes by as much as 0.25%*

***Commercial office property taxes per SF as a percentage of commercial office property taxes per SF in DC established markets*

SOURCE: Downtown DC BID

It is also important to note that although office property assessments have risen in surrounding areas, a number of Virginia jurisdictions have chosen to lower their commercial real property tax rates, thus increasing their competitive cost advantage over DC.

DC AVERAGE CLASS A REAL PROPERTY TAXES PER SF, 2000-2009



SOURCE: Cushman & Wakefield and Downtown BID

The City of Alexandria and Fairfax County are considering moderate increases in their commercial property tax rates to fund a recently authorized regional transportation authority, as well as slight increases in their deed taxes. Still, their commercial rates would remain at or below 50% of DC's rates, with taxes per SF remaining at 24 to 34% of DC's. Similarly, Maryland's urban commercial property tax rates are at 80 to 90% of DC's, with taxes per SF approximately half of DC's.

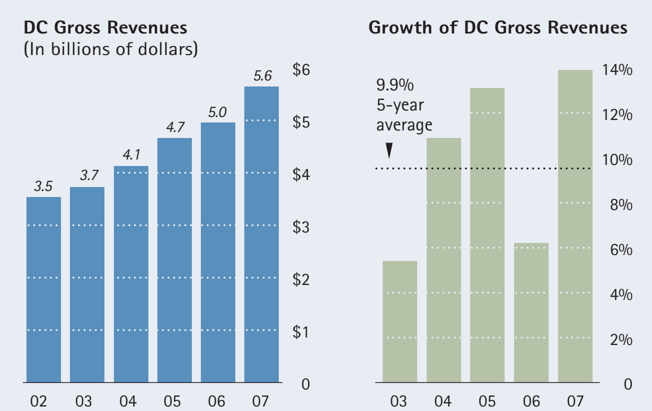
Other costs of doing business in DC also have an impact on companies choosing to locate here. For example, DC unemployment insurance is higher, salaries are higher due to higher costs of living, corporate and unincorporated income taxes are higher and security costs are higher.

3. Office Property and Deed Taxes are Important to the City's Budget

Over the past five years, gross local tax and other revenues have grown 60%, or 9.85% per year, as shown in the accompanying charts. Office property generated taxes contributed much to this revenue growth, but such growth rates are not sustainable in the future and exceed local inflation rates by a wide margin.

The office property market accounted for 15% of DC's fiscal year 2007 gross local tax and other revenues, totaling $877 million ($667 million in office real property taxes and $210 million in office deed and economic interest taxes). This is a substantial increase from 11% of gross local tax and other revenues in 2002. In absolute dollar terms, annual office property taxes grew $486 million from 2002 through 2007-- from $391 million in fiscal year 2002 to $877 million in fiscal year 2007, or 23% of the growth in DC local tax and other revenues of $2.1 billion. In the last two years, the growth in office market taxes has produced 30% of the growth in DC local tax and other revenues, or an additional $306 million in annual taxes.

DC GROSS LOCAL TAX AND OTHER REVENUES, 2002-2007



SOURCE: DC Office of the Chief Financial Officer

This growth in office property tax revenues has enabled the local government to fund important initiatives such as public school modernization, affordable housing, healthcare investments, job training, neighborhood redevelopment, resident tax relief and infrastructure repairs and construction. Indeed in December 2007, the Office of the DC Chief Financial Officer released estimates that the DC government would enjoy revenue increases over the June 2007 budget totaling $338 million in fiscal year 2007 and $73 million in fiscal year 2008—$441 million in new revenue within a six-month period. A major reason for these surpluses has been larger than expected increases in office property generated taxes. City officials have chosen to use these funds to support public school improvements and housing for the homeless with $81 million and $30 million, respectively. Another $80 million has been allocated to various programs.

OFFICE GENERATED TAXES GROWTH AS A PERCENTAGE OF TOTAL DC GROSS LOCAL REVENUE GROWTH, FY 2001-FY 2008

	Growth in Revenues		
	DC Gross Local Revenues	**Office Generated Taxes**	**Office Generated Tax Growth as % of DC Gross Local Revenue Growth**
2001	$253	$19	8%
2002	($128)	$40	–
2003	$191	$111	58%
2004	$396	$61	15%
2005	$540	$8	1%
2006	$289	$98	34%
2007 Estimate	$718	$208	29%
2008 Estimate	$82	$50	61%
2001-2007	**$2,341**	**$595**	**25%**

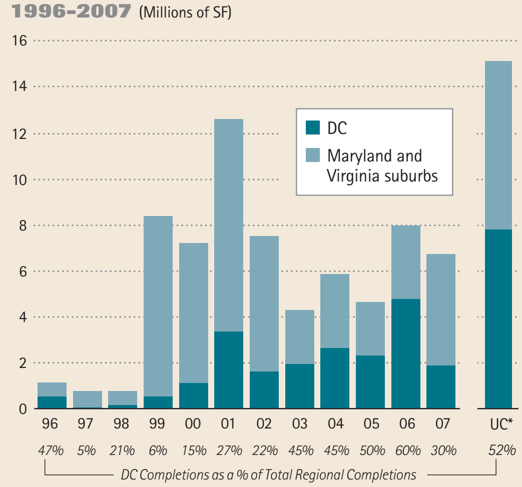
SOURCES: Office of Revenue Analysis (Office of the Chief Financial Officer); 2008 Fiscal Year Budget June 7, 2007); September 6, 2007 Revenue Estimate by Office of the Chief Financial Officer; and Downtown BID.

Additional evidence of the importance of commercial property taxes to DC is a February 2007 analysis of a proposed 10% annual cap on commercial and multi-family residential property taxes by the Office of Revenue Analysis (ORA) in the Office of the DC Chief Financial Officer. The study estimated the total cost of the proposed legislation to be $229 million in fiscal year 2007 and $1.2 billion over four years (with $162 million of this cost in fiscal year 2007 due to commercial property). These large numbers indicate clearly how important commercial property taxes are to future DC budgets, in general, and office property taxes, specifically.

4. Capturing a Larger Percentage of the Region's Office Market Growth Increases Tax Revenues

Since 1990, more than 50% of recent regional job growth has occurred in Northern Virginia, fueled by lower cost office development. DC has lost regional job market share, (though the rate of loss has slowed somewhat in recent years) but has actually gained slightly in its regional share of office jobs over the past five years. Still, in other areas such as retail, education and healthcare jobs, the city continues to lag. If DC can increase its market share from 5,000 to 6,000 jobs to 8,000 to 10,000 jobs out of the region's annual job growth of 40,000 to 50,000 jobs, it can add an additional 1 million to 1.5 million SF of office space a year.

REGIONAL OFFICE SPACE COMPLETIONS, 1996-2007 (Millions of SF)



From 1996 to 2007, 31% of the regional office space completed was located in DC.

SOURCE: Cushman and Wakefield

** Under Construction at December 31, 2007.*

Currently vacant land, or land being used for low-density operations (such as gravel making), in DC's center city office sub-markets can provide 30 million SF of new office space. Upon full build out, this space would produce $510 million in overall new annual taxes. It is important to note that the 30 million SF of new office space will bring demand for 21,000 housing units (mostly condominiums or apartments) that also will be built in center city areas. These units are included in the $510 million in overall annual new taxes. In addition, the center city can accommodate another 6,000 condominiums or apartments (for a total of 27,000 new residential units), which would bring another $50 million in annual taxes. To fill these 6,000 new units, it is expected that 1.5% of the more than 400,000 DC workers who do not live in DC will choose to move here. Thus, center city markets have the development capacity to add more than $560 million annually to DC's gross local tax and other revenue base of $5.6 billion as of fiscal 2007.

In addition, had tenants occupying 2.06 million SF of office space remained in DC and not moved to surrounding jurisdictions over the past six years, the city would have $35 million more in annual taxes today.

5. Policy Alternatives to Counter DC's Declining Regional Market Cost Competitiveness

A number of possible initiatives can be posited to address concerns about the DC office market's competitiveness. Most important is that the public sector continues to invest in Downtown and center city area place making amenities and public infrastructure. The DC government's net investment over the past 10 years in Downtown is estimated at $300 million, accompanied by $10 billion in private investment. This 3% investment has produced substantial returns in the form of increased revenues and jobs for DC residents.

Established office sub-markets located in the center city have relatively modest infrastructure and place making needs. Emerging office sub-markets—Mount Vernon Triangle, NoMa and the Capitol Riverfront—require more basic investment in transportation, underground infrastructure and place making.

Finally, reducing the commercial property tax rate modestly would decrease the property tax differential between DC and neighboring competitive jurisdictions without having a significant impact on tax revenues. It is important to note that DC has concentrated exclusively on residential income and property tax relief since 2002.

DC Tax Relief and Tax Increases, Fiscal Years 1996-2008

Increase Decrease

	Office Real Property Tax	Residential Real Property Tax*		Deed Recordation and Transfer Tax	Top Marginal Tax Rate on Individual Income
		Multifamily	Single		
1996	2.15%	1.54%	0.96%	2.20%	9.975%
1997	2.15%	1.54%	0.96%	2.20%	9.50%
1998	2.15%	1.54%	0.96%	2.20%	9.30%
1999	2.15%	1.54%	0.96%	2.20%	9.30%
2000	2.05%	1.34%	0.96%	2.20%	9.30%
2001	1.95%	1.15%	0.96%	2.20%	9.30%
2002	1.85%	0.96%	0.96%	2.20%	9.00%
2003	1.85%	0.96%	0.96%	3.00%	9.00%
2004	1.85%	0.96%	0.96%	3.00%	9.00%
2005	1.85%	0.96%	0.96%	2.20%	9.00%
2006	1.85%	0.92%	0.92%	2.20%	8.70%
2007	1.85%	0.88%	0.88%	2.90%	8.50%
2008	1.85%	0.85%	0.85%	2.90%	8.50%

**Residential property taxes are currently limited to a 10% annual increase in taxable assessments, and an 8% cap on total residential revenue growth.*

SOURCE: DC Office of the Chief Financial Officer

Note: DC's economic competition is not limited to the office market. Increasingly, the Maryland and Virginia suburbs are contesting residential and retail markets, and challenging DC's economic prowess in the restaurant, hotel, cultural and entertainment markets as well. These other markets may be the subjects of future Leadership Papers.

DOWN TOWN DC

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The Downtown DC Business Improvement District (BID) is a private, non-profit organization that provides safety, hospitality, maintenance and beautification, homeless, economic development, transportation, streetscape and marketing services to Washington's urban core. Property owners agree to tax themselves to provide services to the Downtown BID area, which covers 138 blocks from Massachusetts Avenue on the north to Constitution Avenue on the south, and from Louisiana Avenue on the east to 16th Street on the west. For more information, visit www.downtowndc.org.