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Assessing the Impact of a Property Tax Cut on Rental Affordability in New Brunswick

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New Brunswick is in the midst of a housing crisis, yet the market-based solutions proposed by industry and the Conservative government thus far fail to address its impact on tenants and risk making the situation much worse.

For the last several months, New Brunswick's Irving-owned media have regularly published editorials demanding that the province's government fulfill an election promise to cut the provincial property tax levied on residential landlords. In the Irving media, the tax is commonly known as the "double tax," the product of an aggressive, 20-year branding campaign led by the New Brunswick Apartment Owners Association, which is nonetheless misleading. It is also often argued that New Brunswick's property taxes are much higher for residential landlords than they are in other provinces, which is also misleading.

Ostensibly, the tax cut will reduce costs for landlords, and help take some pressure off rising rents. **If enacted, however, the tax cut will have the opposite effect**. Furthermore, it will be a huge gift to the province's largest landowners—including the Irving family, who have been its greatest promoter—and who are best positioned to make use of its gains. *This report is informed by a political economy approach to housing*. A political economy approach assesses how structural transformations in the economy shift the balance of power between market actors, resulting in new distributions of goods, services, or credit. Rather than a neoclassical approach to the housing market, which focuses on supply and demand of houses (and sometimes of credit), a political economy approach assesses the market power of different actors, and the impact of government regulations and subsidies on specific markets.

This report argues that long-running changes in the portfolio management strategies of institutional investors have produced a demand for new asset classes capable of generating higher investor returns in a period marked by historically low bond yields—government bonds having been the traditional, low-risk, fixed-income asset in a mixed-asset portfolio. Rather

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than relying on government bonds to help balance riskier investments in stocks or commercial loans, institutional investors (e.g. pension funds, hedge funds, private equity, university endowments, and others) have sought ways to add rental income to their portfolios. Rental income from residential sources is considered a profitable, and relatively secure source of income and has steadily been 'financialized,' or progressively transformed into an asset class for institutional investors over the last three decades. This process has also affected New Brunswick. It has brought new actors into the real estate market, who assess property markets with statistical data and benchmarks, and who evaluate properties by comparing them to national averages using capitalization rates which are increasingly standardized across Canadian regions. The result is that financial investors from outside the region have come to recognize that, by comparisons with similar regional cities, **New Brunswick landlords undervalue the market price of their properties. A property tax cut will make this situation worse**.

Therefore, provincial government should consider the potential public cost of further real estate inflation in assessing the merits of a property tax cut for large, residential landlords. **To help assess these costs, this report outlines how a property tax cut would operate for financial investors**. It demonstrates how increased operating income translates into higher market valuations, which financial investors have already demonstrated a willingness to pay. While local landlords are facing rising costs due to increased financialization of the rental sector in the province, these cost increases cannot be resolved by a tax cut, which will disproportionately benefit the largest landlords in the province. It will do little to restrain the fastest rental inflation in Canada.

The Real Estate Boom is Inflating Taxes

The New Brunswick Coalition for Tenants Rights decided to clarify the impact of a tax cut on property valuations by looking at one Fredericton property, 951 Regent Street, a 63-unit building of bachelor 1-, 2-, and 3- bedroom apartments, whose rents varied in 2021 by unit type (roughly $730/$900/$1015/1227). That property's assessment in 2022 jumped 20%, from $5.6 million to a new assessed value of over $6.7 million, reflecting the property's higher market value as a result of the real estate boom.

The tax increase stems from this rising assessment, which was caused by the high demand from REITs and financial investors for similar apartment buildings in New Brunswick. That seems set to continue if one looks at multi-family apartments currently for sale, many of which are priced two and three times above the assessed value.

951 Regent is an older building close to the universities, but also houses older adults, who appreciate its proximity to the Dr. Everett Chalmers Hospital and other amenities. Its rents make it a good representative of the "average" rent in Fredericton, which was overall $980 per month according to the CMHC's October 2020 market survey of the primary rental market (the average varied by unit-type and building age, but $980 is close to the average for this type of building).

The 2022 tax levy for 951 Regent St. has not been posted yet, but in 2021, according to publicly available data on the New Brunswick Property Assessment site, it was $146,754.74. Given the building's 63 units, per unit (assuming equal value per unit for simplicity's sake) that comes out to taxes of $2,329.44 per year, or $194.12 per month.[1]

If the tax levy increased a full 20% this year, it would rise by a hefty $29,350.95. If that were passed on entirely to tenants at 951 Regent St, it would raise the tax portion per unit by $465.89 per year, or $38.82 per month to a total of $232.94 in taxes per unit, per month ($194.12 + $38.82).

Assuming that the average rent in the building were $980, if those costs were passed on to renters, that would come out to a monthly rent increase of 4%, to about $1020. This year, that would also roughly be in line with inflation, though most renters are not seeing 4% wage increases.

Apartment Owners can Absorb Tax Increases

The New Brunswick Apartment Owners Association has said publicly that the tax burden on apartment buildings represents [40% to 45% of the total operating expenses of the building]. Let's use the more conservative 40% as an average to figure out how much the other costs are (closer to 45% would mean even higher operating income for landlords).

If $194.12 (the tax per unit paid in 2021) represented 40% of the costs per unit at 951 Regent St., the total operating expenses per month would be $485.30 on average, per unit. If the average rent in the building were $980, that would make the net operating income (NOI, revenue less expenses)[2] for the property above $375,000 per year.[3] This is just one building—some companies own dozens of similar types of buildings in the city.

$375,000 seems like a comfortable margin to absorb some of the tax increases caused by rising asset values.

In 2022, if the tax rate were to increase by the full $29,350, and, to be conservative, we assume that other costs are also increasing to keep the tax levy at 40% of landlords' costs, that would be average costs per unit of $582.35 per month at 951 Regent St. Without any increase in the rent, the net operating income in 2022 would be reduced 20% to just over $300,000.

But rents were increased at 951—between $60 and $180 per month according to online advertisements, meaning income from the building will rise or remain high. If the average rent per unit increased by just $60 to $1040 per month (the real figure is higher), the building would still net operating income of around $345,000.

[1] If we knew how many 1-, 2- and 3-bedroom units there are in the building, using a little algebra, we could find out exactly what the tax take is for each unit type. An average is used for simplicity.

[2] Net Operating Income, or NOI, is operating revenue minus reasonable operating expenses, including insurance, upkeep, repairs, and property taxes. It does not include capital expenses (like major repairs), income tax, or interest payments on loans, so it is not the same as the profit you can immediately access from a building. It is a common metric used in real estate finance to assess the value of buildings, more on that below.

[3] That is the average rent, $980, minus taxes, $485.30, multiplied by 12 months, multiplied by 63 units.

Those increases are important for tenants. But a property tax cut carries no guarantees of rent reductions. On the contrary, it will fuel more speculative investment in New Brunswick rental properties, because cutting the tax raises income for landlords.

Tax Cuts Will Accelerate the Real Estate Boom

The provincial property tax rate for non-owner occupied residences (this includes second homes, and apartment buildings) is about 42% of the total property tax.[4]

If the provincial exemption for homeowners were extended to apartments, their property taxes would drop by 42%. Using the 2022 assessment, taxes on the average unit at 951 Regent would drop from $232.94 per month to $135.11 if the provincial exemption were extended. If all other costs were equal (we should expect that there would be moderate inflation on other costs), net operating income (NOI) from this property would soar to more than $445,000. It would be considerably more if they kept the rent increases from 2022.

But here is the important part: increasing NOI is not the main prize of real estate investment.

Financial investors use Net Operating Income, a known number, to estimate the market value of properties, which is more subjective. ***If you cut taxes,you are increasing the potential profitability of rental real estate in New Brunswick, and therefore, also its potential market value***

Financial investors large and small are comparing properties in different Canadian cities on the basis of the capitalization, or cap rate, which is Net Operating Income (NOI) divided by Market Value, and generally measures risk: higher cap rates signal riskier investments, warranting higher returns on investment.[5] Obviously, a given cap rate will also give you an estimated market value: NOI divided by the cap rate. Financial investors use this cap rate as a reflection of their risk tolerance to estimate the value of rental properties.

For 951 Regent St. the current cap rate for 2021 would look something like: $375K divided by the $5.4 million paid in 2011 for the building (close to the 2021 assessed value), giving a cap rate of 6.9%. The assessed value of the building has risen to $6.7 million on the basis of increased market prices for similar buildings in recent years. The proposed property tax cut would maintain a relatively high cap rate (6.64%) if we used the assessed value as a proxy for its market value (that is, $445K NOI divided by $6.7 million). That cap rates reflect the risk to the owner of holding that property: the owner expects close to 7% income returns per year.

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[4] See: https://www2.gnb.ca/content/dam/gnb/Corporate/Promo/localgovreform/property-tax-rates2021.pdf, where the non-owner occupied provincial tax rate is $1.1233 per $100 of assessed value out of a total tax of $2.6719 per $100 of assessed value, or 42%.

[5] A cap rate, or capitalization rate, is a risk indicator based on expected rates of return on property investment. It enables investors to turn a known number, a stream of income, into a market value estimate. Financialized investors are increasingly using these rates and comparing them across jurisdictions and in relation to other assets like Government of Canada 10-year bonds, to assess the profitability of investing in certain real estate markets. For a brief overview of the cap rate, see https://www.investopedia.com/terms/c/capitalizationrate.asp.

But those cap rates on a low-rise multi-family residential building would be higher than the average in Moncton and Saint John, according to a 2019 market report by Turner and Drake, a real estate broker and valuator. Financial investors have higher risk tolerance for holding rental properties, because they have access to historically low interest loans and large pools of excess savings. The long-term trend has been towards "cap rate compression," or lower cap rates, reflecting the growing role of financial investors in real estate markets.

Lower interest rates and pandemic stimulus have helped lower cap rates across the country. According to Colliers Canada, an investment management agency, Halifax's cap rate for low-rise multi-family residential in late 2020 was under 5%.

Fredericton is, of course, not Halifax, but would the market say that the risk differential is worth almost 2% per year for real estate investors? Investors bought New Brunswick properties, even older buildings in Fredericton, at well above assessed rates over the last two years. So it would appear we know the answer to this question, and it is an emphatic no!

Financial investors in real estate see properties like 951 Regent St., and other smaller buildings across the city and the province, as undervalued by the local market. *Their job is to make money by finding investors willing to take on some risk, and force local market conditions towards higher valuations and lower cap rates—because it is more profitable for finance capital*. So far, that has produced some large rent increases across the province. While the province is also dealing with very low vacancy rates, that merely reduces the relative risk for institutional investors, incentivizing further cap rate compression, which inflates market values. Elsewhere in Canada, low vacancy rates did not lead to the type of real estate inflation that New Brunswick has seen over the last two years.

A tax cut for landlords signals to financial investors that already undervalued properties are capable of generating *even more* revenue than previously anticipated. Moreover, because New Brunswick has no rent control and few tenant protections, investors can reap easy gains by increasing rents to help boost the value of their apartment purchases.

For a cap rate of 5.75%, which would still be a full 1% above Colliers' rate for Halifax for a similar building-type,[6] the potential market value of 951 Regent St. would rise from $6.7 million to above $8

[6] The assumption is fair, Halifax itself has a cap rate of only 1% to 1.5% higher than Toronto for similar type of apartments, reflecting the ability of financial firms in Canada to lower cap rates, and spread risk using "financial innovation," such as mortgage-backed securities. Colliers notes that cap rates have come down in recent years. Fredericton real estate debt can now be packaged with real estate debt from across the country and sold on as Canada Housing Bonds.

million,[7] almost 20% above its current assessed value if we assume the moderate rent increases of 4% outlined above.

The owners of 951 Regent St. may tell you they are not selling, so it does not matter what the assessed value is, but that is not really true. A tax cut will support more sales at inflated prices, and push assessments up, including on 951 Regent St. Of course, that will trigger further tax increases for everyone, and along with it, higher average rents.

The Social Relations of Printing Money from Property

Larger landlords in New Brunswick (perhaps large local landlords like Colpitts, but certainly larger national REITs, like Killam), recognize that an increase in property value presents opportunities to raise revenue by refinancing their properties.

According to its 2021 second quarter investors' statement (p. 7), Killam REIT recorded $134.1 million in "fair value gains" supported by cap rate compressions and NOI gains in just that one quarter.

Killam is understandably keen to get Blaine Higgs' tax cut, because it will allow them to boost executive compensation, transfer more money to investors, pad their quarterly returns, and show prospective investors that they are a big player on the Canadian scene, worthy of more capital to finance expansion (Killam is the largest landlord in NS and NB, but is the 9th largest corporate landlord in Canada, a good distance from the top tier, led by Starlight and CAPREIT). Killam is pushing its expansion primarily in the Kitchener-Waterloo region, in a bid to diversify holdings outside the Maritimes. There is no guarantee it would choose to reinvest tax savings in New Brunswick.

[7] That $8 million figure comes from taking the expected NOI with the tax cut and the moderate rent increase of 4% (about $464,000, that is $1020 per unit, minus taxes, multiplied by 12 months, multiplied by 63 units) and dividing it by the cap rate that financialized investors are using to evaluate New Brunswick properties, in this case, the assumption is 5.75%, which reflects a higher risk tolerance than Colpitts' 7%. Cap rates vary by building type and location. It stands to reason that larger investors will have a higher risk tolerance for Fredericton properties for two reasons: they have access to larger pools of low-interest capital than smaller New Brunswick landlords; and crucially, their mortgage originators are able to sell their mortgage loans on to other investors, notably the Canada Mortgage and Housing Corporation, whose Canada Housing Trust buys Canadian mortgage-backed securities, and sells them on to investors looking for rental income. This means that the risk to the mortgage originator is diminished, enabling investors to access credit at lower cost. For most small landlords, however, it may not be possible to tap larger pools of investor credit at ultra-low interest rates, and they will be left managing properties with rising taxes and insurance costs in an environment in which competitors will be appraising their properties at much higher values.

Similarly, the owner of 951 Regent might refinance their property using new valuations enabled by a tax cut, and essentially create money out of nothing.[8] Rather than making mortgage payments on a property bought for \$5.4 million, they might be able to refinance at \$8 million.

For instance, if 951 Regent St. were refinanced using a new cap rate of 5.75%, which reflected increased risk tolerance in the Fredericton market from the current owners' 6.9%, the value of the property would increase by more than \$1 million above its current assessment, from \$6.7 million to \$8 million (see footnote 7). A landlord with access to credit could refinance their mortgage and pull 75% of the increase in appraised value out of the property.

That is the real prize of a property tax cut: to be able to pull millions of dollars of equity from existing property and provide additional NOI to support cap rate compression (which effectively raises the market value of property using the formula outlined above).

The tax cut is not about reducing rental costs for hard-up landlords. When it is not about immediate corporate profits, it is about financing the construction of new, high-end apartment buildings—not necessarily in New Brunswick. There is currently huge demand for those properties right across Canada, and large landlords want the potential profits from them.

The effect of that, however, is to satisfy the housing needs of the high-end of the market at the expense of those tenants who need access to lower cost housing. Ultimately, the savings of tenants are being transferred to investors in order to pump prime a debt-fueled game of private real estate development and accumulation. The costs of that transfer are born disproportionately by low-income tenants, who are among New Brunswick's poorest residents.

Rather than reflecting what local residents can pay, rents increasingly reflect how local real estate is being used as a financial instrument, mostly benefitting wealthier investors with savings to invest. This new rental market displaces people from their homes, producing all sorts of anxiety and stress, in addition to homelessness. In short, it is *extremely violent*. But its violence is papered over by the cool instrumentations of finance, which deposit quarterly returns in the accounts of mutual fund owners.

This is the new capitalist real estate market, and it is especially failing workers, retirees on fixed incomes, folks with disabilities, students, and anyone who needs an affordable home. Allowed to continue, it will affect middle income groups and detached homeowners as well (detached family homes are also being bought to rent, especially new-built units, contributing to house price inflation).

A property tax cut will not produce more affordable homes in New Brunswick, it will simply accelerate real estate inflation and build houses for those most able to afford the highest rents.

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[8] As an aside, this type of private money creation is the type of thing that conservative economists à la Milton Friedman railed against (it was apparently inflationary) when the state did it in the 1970s. There are important monetary consequences to banking deregulation that permitted mortgage financiers to increase the money supply like this, but for sake of brevity, the main one to focus on here is that it increases income and wealth inequality and dispossesses tenants of more of their incomes.

Alternatives

Our intention here has been to clarify how a property tax cut will be viewed by financial investors, but it is important also to underscore the alternatives that would also deliver construction of more affordable housing—because it is affordable housing that is really in short supply. Affordable housing units are currently disappearing much faster than they can be replaced.

Rather than tax cuts designed to stimulate private investment, the government needs to rediscover the central role that public finance and Crown corporations have played, historically, in the construction and management of affordable housing. Much of our current problem stems from an over-reliance on private developers to provide a basic human need. Rather than relying on risky debt-financed growth, for which the public purse is ultimately on the hook (see footnote 7), regular taxpayers and homeowners would be much better served by non-market mechanisms for building and managing housing that is affordable and democratic.

While the immediate mechanism that is needed to protect affordable housing stock in New Brunswick is rent control and tenant protection—measures that can be enacted by the provincial government—all levels of government need to invest in the construction of non-market housing, which has historically been under-invested in Canada, but which is the norm in many of our OECD comparator countries. The resources for this investment are ready at hand. Rather than spending more than $70 million on a tax cut that will benefit large landlords most, that money could be invested in construction of social housing to reduce New Brunswick's wait list for subsidized units (currently running at about 6,000 households). It could also expand a public stock of affordable housing, or pass legislation giving the province right of first refusal to buy any apartment building that hits the market—enabling the public and non-profit sector to amass housing stock that will otherwise be used as a financial instrument.

These measures are not radical, and do not require major changes to existing property arrangements. But the current financialization of rental real estate is revolutionary, producing entirely new housing relations that risk dispossessing many New Brunswickers of access to a home. The medium- and longer-term social costs of that dispossession will most certainly give rise to more radical politics, and as we have seen recently with the mandate protests that condensed working class social grievances with anger over vaccine mandates, not all of those radical demands will be easily digestible within our democratic institutions, and may help empower political forces bent on undermining them.