

Emerging Markets Queries in Finance and Business

# Impact of property taxes on commercial real estate competition in Romania

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## Abstract

This paper examines the relationship between taxation of property and competition on the commercial real estate market in Romania. In most cases the calculation of service charge contribution for tenants of commercial real estate includes property taxes. As these taxes are passed to the tenants, they in fact increase the cost of property occupation and constitute a source of uncertainty in strategic decision making. We are looking into the composition of service charges for tenants of commercial real estate, the acceptance of triple net rents on the Romanian market and the way in which property taxes vary across different locations, impacting on cost of occupation and distorting competition.

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Selection and peer review under responsibility of Emerging Markets Queries in Finance and Business local organization.

*Keywords:* property tax, service charges, real estate competition

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## 1. Introduction

Real estate is a special commodity in the market because of its heterogeneity, low liquidity; high transactions cost and fix location Zhu, 2004. Real estate development and investment are therefore regarded as local economic activities and are associated with a good comprehension of local markets.

The article looks into the issue of triple net lease and service charge, which usually tenants are confronted

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with in the leasing contracts of commercial properties. In this case only the taxation of commercial buildings owned by companies is considered.

A triple net lease also named as a "net-net-net lease" or a "hell or high water lease" is a lease agreement that designates the lessee as being solely responsible for all of the costs relating to the asset being leased in addition to the rent fee applied under the lease. So, the tenant should pay net real estate/property taxes on the leased asset, net building insurance and net common area maintenance and repairs that the building may require. It is considered that rent charged in the triple net lease is rather lesser than the rent charged in a standard lease agreement (rent varies with other terms in the lease, especially service charge).

Since the property tax is included into service charges, when real estate taxes change also the real estate tax expenses incurred by tenants for rental payments as a reimbursement to their landlords, change.

It is sometimes argued that property tax must be shared by renters, consumers, and labour Sennoga et al., 2008. In some cases, it is hard to legitimate the owner or the lessee as the end-payer of property tax. The incidence of the real estate tax is shifted to other categories of taxpayers: for example, the owner shifts the real estate tax onto a tenant by increasing the rent, so the tax burden falls not on property owners but on lessees.

Furthermore, municipal councils may also establish several specific tax rates which are differentiated by one or several of the following criteria: purpose of the real property, its technical maintenance condition, taxpayer category (size, legal form or social status) and the location of real property within the municipality's territory (the last two are applied for Romania).

These assertions are in disagreement with the hypothesis that fee on buildings, as a local fiscal tool, it is deemed as a buffer role against speculative behaviour in the real estate market.

## **2. A price-map of rents**

The key drivers that influence property rent and guide activities' location decisions reflect the ascertainment of an interdependent relation between offices' levels (physical and neighbourhood attributes: unit size, transportation accessibility, structure quality, view, community amenities, greenness, proximity to their customers, suppliers, raw material,) and correspondent levels of rent. A well-known cliché, "location, location, location" is the most important determinant of rental prices in real estate. In congruence with these, are the plausible assumptions that real estate developers are competing with each other to rank commercial buildings with respect to gain tenants or property value and higher rent fees are charged on more expensive commercial buildings, because they depict a quality dimension. Hence, location obtains its value from the notion of "closeness" (Roger J. Brown, 2005). Besides, it is acknowledged that tenants search for property owners who entail a low "full price" of service rent but when someone looks for a property to rent immediately will do not care about only the "money price" of rent but also about "waiting time price". Also, theory predicts that rents (and therefore values) will be highest where economic activity is most intense and productive, hence profitable (Roger J. Brown, 2005).

Developers have played a leading role in the development of office centres in specific areas of Bucharest, which has significantly altered the city's office location pattern. The rent price started to surge since 2008. The average rent fee for commercial buildings is between below 10 Euros in Pipera area (secondary locations) and 18-19 euro per sqm BOMA in Central Business District, the number of commercial buildings rented has been connected with the slump in property development due to the financial crisis. Since the property developers could not secure financing for their projects starting with 2009 it can be said that the market has been moving very slowly in terms of supply of new buildings.

Today, approximately 12 %, depending on location, of the commercial building stock for rent is vacant as an outcome of a drop in economic growth, a contraction of workforce and a new outlook for working (a limited properly designed space per employee, work from home). But the real state is that tenants even they are facing with these innovative tendencies of working still pay higher rents for space in offices full equipped (restaurants, fitness club etc) in order to benefit from vicinity's amenities. This is a representative factor of a distorted competition in real estate market, tenants being prone to lease buildings sited in multi-functional areas with

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