City and County of San Francisco

Office of the Controller - Office of Economic Analysis

Improving San Francisco's Business Tax:

An Analysis of Two Alternatives

Interim Report

Comments welcome by May 25, 2010. Please send comments to: controllertaxreport@sfgov.org. Final report will be published May 27.

May 11, 2010

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Main Conclusions

At the request of the Mayor and the President of the Board of Supervisors, the Controller's Office has led a working group examining alternatives to San Francisco's business tax. The City levies a 1.5% tax on the payroll of most companies doing business in San Francisco that have over $250,000 in payroll. However, this represents only 6,000 out of 80,000 businesses registered in the city: sole proprietorships, non-profits, banks, insurance companies, and many small businesses pay no taxes.

San Francisco is the only city in California that bases its entire business tax on payroll. The economic effect of the tax is to raise labor costs and discourage job creation. While the payroll tax has grown substantially over the past ten years, it is highly unstable. In 2009, for example, payroll tax dropped by over 12% compared with the previous year.

Because of these shortcomings of the payroll tax, the Controller's Office created two alternative business tax systems. The first, a progressive payroll tax option, changes the payroll tax from a flat 1.5% rate into two tiers: an upper tier taxed at 1.5%, and a lower tier taxed at 1.2%. This reduction in the payroll tax is offset by a new 1.395% tax on the gross receipts of commercial property renters. The second, a gross receipts option, eliminates the payroll tax completely and charges different gross receipts rates for different sectors of the economy. It includes the 1.395% gross receipts tax on commercial rent. Both proposals also include a new tax credit; all businesses would be able to reduce their tax burden by $1,500. This is the equivalent of reducing taxable payroll by $100,000 under the current tax system.

The Controller's Office believes that the two proposals outlined in this report have the advantage of fostering economic growth, raising a small amount of revenue for the City, and generating the vast majority of that revenue from employers that are not currently paying the payroll tax.

In addition, tax systems are often evaluated based on their economic efficiency, administrability, stability, and equity. The impacts of the current tax, and the two alternatives, on these four criteria are outlined in the table below.

Criteria	Current Payroll Tax	Progressive Payroll	Gross Receipts
Economic Efficiency	Discourages Job Creation	Boosts economy by shifting tax burden off of labor costs on to rent.	Boosts economy by shifting tax burden off of labor costs on to rent and material inputs.
Administrability	Relatively straightforward	Somewhat more complex to administer.	Considerably more complex to administer.
Stability	Has been highly unstable, changing by over 10% in many years.	Basing the tax on payroll and rent is likely to be more stable than payroll alone.	Shifting to Gross Receipts would likely mean slower, but more stable growth in the future.
Equity	Only approximately 6,000 businesses pay the tax out of 80,000 registered in San Francisco	Rent tax would be passed through to all commercial tenants in the City, effectively broadening the tax base.	Rent tax would be passed through to all commercial tenants in the City, effectively broadening the tax base.

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INTRODUCTION AND BACKGROUND

Introduction and Purpose of This Report

Like many cities in California, San Francisco levies a tax on private businesses to fund public services. The impact of this tax on public finances and the broader city economy has been the subject of vigorous debate for many years. In the Fall of 2009, the Controller's Office began a review of the City's business tax, at the request of the Mayor and the President of the Board of Supervisors.

An important assumption underlying this review is that the City's current business tax system is economically inefficient, and needlessly harmful to job creation and economic growth. This opinion appears to be broadly held in San Francisco, in both business and government circles. If this is true, it should be possible to devise a better business tax that is less damaging to the economy. The creation of a better business tax has been the key purpose and function of this review.

The review was conducted as a working group process, initially consisting of staff from the Offices of the Controller, City Attorney, Treasurer and Tax Collector, and Economic and Workforce Development. The working group reviewed legal options, the prevalence of different types of business tax systems in other California cities, and staff research on the fiscal and economic impacts of alternative taxes.

The group was then broadened to include perspectives from outside City government, including the San Francisco Chamber of Commerce, San Francisco Planning and Urban Research Association (SPUR), and the Human Services Network. On the basis of their feedback, the Controller's Office devised two potential alternatives to the current business tax, which are detailed in this report.

Tax policy often involves a trade-off between the competing goals of promoting economic development and funding public services. This trade-off involves political, not economic decisions. It is explicitly **not** the purpose of this report to recommend one side or the other of this trade-off. The shift to a better tax system could be designed to hold the City's revenue constant, and stimulate economic growth by lowering the effective tax burden on business. Alternatively, a better system could be designed to generate tax revenue without harming the economy.

This report does not argue for one side or the other. It presents two alternative tax systems. Both of these alternatives, we believe, have three significant advantages over the current business tax system:

- They are less harmful to the economy than the current business tax.

- They generate more revenue for the City than the current business tax.
- They generate the vast majority of this additional revenue from sources that are currently not taxed, or are under-taxed relative to their business operations in San Francisco. In other words, for the most part, they do not raise revenue from existing business taxpayers, either directly or indirectly.

The Controller's Office welcomes public comment to these draft proposals. We have also contracted with two outside economic consulting firms to review our analysis and assess these statements.

San Francisco's Business Tax

While most cities in the state levy a business tax of one sort or another, San Francisco is the only city in the state that derives almost all of its business tax revenue through a tax on business payroll.

After the property tax, the City's business tax is its second largest source of tax revenue. In Fiscal Year 2008-09, the Payroll Tax generated approximately $380 million in revenue for the City. Over 99% of this revenue is placed in the City's General Fund.

There are several exemptions to the payroll tax. Under state law, cities are not allowed to levy local taxes against financial and insurance corporations, as they are taxed by the State. Thus, the City receives no business tax revenue from banks and many insurance companies that do business in San Francisco. These businesses do pay a tax to the State that other industries do not pay.

In addition, the City has elected to establish a small business exemption, under which businesses that have less than $250,000 in payroll are exempt from paying any tax. This exemption creates a “hard cap” at that level of payroll; a business with $251,000 in payroll would pay the full 1.5% tax on their entire payroll expense

Finally, businesses formed by self-employed individuals, which are the most common type of business in San Francisco, generally do not pay the payroll tax. This is because their earnings are not considered as payroll. According to the Bureau of Economic Analysis, nearly 120,000 people work in sole proprietorships or partnerships having zero paid employees in San Francisco.

This combination of legal and policy constraints creates a situation in which about only 6,000 businesses pay the payroll tax, out of 80,000 businesses which are registered to do business within the city. This narrow base of tax payers creates both stability and equity concerns with the present tax system.

From an economic point of view, a tax on payroll raises the cost of labor to businesses, and discourages hiring. In earlier reports, the Office of Economic Analysis has estimated that the City's 1.5% payroll tax could depress employment in San Francisco by 1%, or about 5,500 jobs. In addition, it is likely that a portion of the payroll tax is passed on from businesses to San Francisco workers, depressing their wages and spending within the City, and further constraining economic growth.

The Business Tax Lawsuit

Prior to April 23, 2001, the City imposed an alternative-measure tax pursuant to which a business's tax liability was calculated as a percentage of either its gross receipts or its payroll expense, whichever amount was greater. Between 1999 and 2001, approximately 325 businesses filed either claims and/or lawsuits, arguing that the alternative-measure tax violated the Commerce Clause of the United States Constitution. In 2001, the City entered into a settlement agreement resolving most of these lawsuits and claims for considerably less than the total amount of outstanding claims.

Concurrently with the settlement of the lawsuits, the City repealed the alternative-measure tax in 2001. Payment on the lawsuit settlement, and the loss of business tax revenue associated with the repeal of the gross receipts tax, cost the City approximately $30 million in the first year. Under California's Proposition 218, any attempts to raise a local tax must be approved by the voters. General-purpose tax measures may be passed with a simple majority vote only when they are placed on the November ballot of an even-numbered year. Since 2000 there have been several attempts to raise business tax revenue by getting voter approval; until 2008, all had failed.

In 2000, Proposition I would have replaced the revenue lost from the gross receipts tax by raising the payroll tax rate to as high as 1.7%, with the actual rate fluctuating based on the revenue growth rate. In 2002, Proposition L would have raised the real property transfer tax rate, which is paid by sellers of real estate when it is sold. Prop L proposed to raise the rate on large commercial properties, to make up the business tax revenue when the gross receipts tax was repealed. In 2004, Proposition K would have imposed a small, uniform gross receipts tax rate of 0.1%, in addition to the payroll tax.

All three of these failed proposed measures were tax rate increases that did not address any of the perceived weaknesses of the payroll tax system. In 2008, Proposition Q did modify the City's business tax system, by closing the so-called "partnership loophole" that allowed profits taken by owners of partnerships to be excluded from the payroll tax. It did not address the earnings of sole proprietors, and it also raised the small business exemption, further narrowing the base of business taxpayers in San Francisco. Proposition N also passed in 2008, which raised the transfer tax on properties over $5 million, which are largely commercial properties.

Outline of This Report

This report begins by assessing the current payroll tax against criteria commonly used in the evaluation of tax systems. It finds, in keeping with the general perception in San Francisco, that the payroll tax is economically inefficient, an unstable source of revenue, and is inequitably levied. The report goes on to review other local business tax approaches in practice across California's largest cities, and how they were received by the business working group.

The following sections detail two alternative proposals, and how they affect the City's overall finances, the tax responsibilities of individual businesses in different industry sectors, and the overall economy.

EVALUATING BUSINESS TAX SYSTEMS

The EASE Criteria

When the City of Los Angeles revised its business tax, it produced a voluminous study of potential alternatives. These alternatives were evaluated against a set of criteria called the EASE system, which is a common way to assess different approaches to taxation.

The EASE criteria suggest that four factors be weighed in considering any tax system:

- Efficiency: how does the tax affect the economy?
- Administrability: how straightforward and inexpensive is it to administer, collect, and audit the tax?
- Stability: to what extent does the tax generate predicable cash flows that make budgeting easier/
- Equity: is the tax fair?

The payroll tax can be evaluated against these four criteria, which can also point to better alternatives for the City.

Economic Efficiency of the Payroll Tax

Economic efficiency refers to the economy of raising a given level of tax revenue by the government. Economists generally believe most taxes create inefficiencies, or "dead-weight" loss, in the economy. This has nothing to do with the relative efficiency of public- vs. private-sectors operations. This inefficiency is caused by the fact that people and businesses that are levied a tax have an incentive to change their behavior to minimize their tax payments, and this change in behavior distorts markets.

The inefficiencies in the payroll tax are easily and widely understood. The 1.5% tax on payroll raises the cost of employing a worker in San Francisco. Based on the simple economic principle that the markets want less of things that cost more, higher labor costs translate into less job creation. Furthermore, the *incidence*, or actual burden, of the tax falls on both the business and the worker. Reducing the income of both reduces spending in San Francisco, depressing the economy.

The final chapter of this report details the expected economic impact of the shift away from the current payroll tax to either of the proposed alternatives. It goes into greater detail about the inefficiencies of the payroll tax, and why a switch to either of alternatives can be expected to be good for the city's economy.

Administrability of the Payroll Tax

A second important criterion for judging a tax system is the cost and risk associated with administering the tax. Every tax requires resources to administer, collect, and audit, from both the City and the business tax payers. Different taxes, however, have different administration costs. A local tax may impose difficult and expensive record-keeping burdens on business, involve complex calculations, involve legal ambiguities, or be challenging for the City to audit. All of these factors increase the administration costs of the tax.

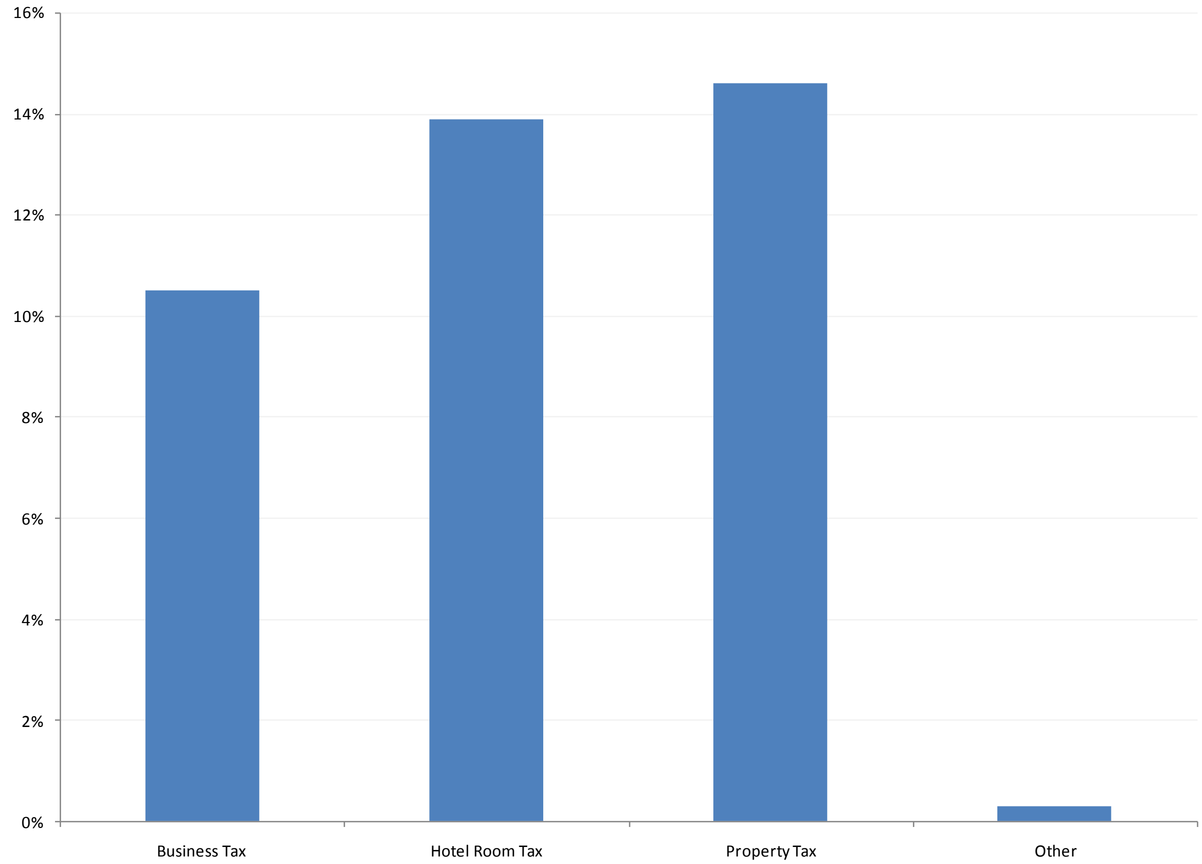
Administrability appears to be one area in which the payroll tax appears to perform well for the City. Payroll expense is a reasonably well-understood concept by both taxpayers and the City, and both have benefited from the experience of paying and collecting the tax for many years.

Stability of the Payroll Tax

There is substantial evidence that private sector payroll has been one of the fastest-growing economic indicators in San Francisco over the last twenty years. Since this is the tax base of the payroll tax, this has resulted in rapid growth in business tax revenue relative to the overall growth of the economy.

From 2000 until the onset of the recession in 2008, the City's General Fund revenue increased by over 35%, despite low inflation, and relatively stable population and employment growth in San Francisco. The majority (56%) of this increase has come from property tax revenue, which has risen significantly during the decade's property boom. But business taxes—including the payroll tax and the hotel tax—also grew by over 10% per year from 2003 to 2008.

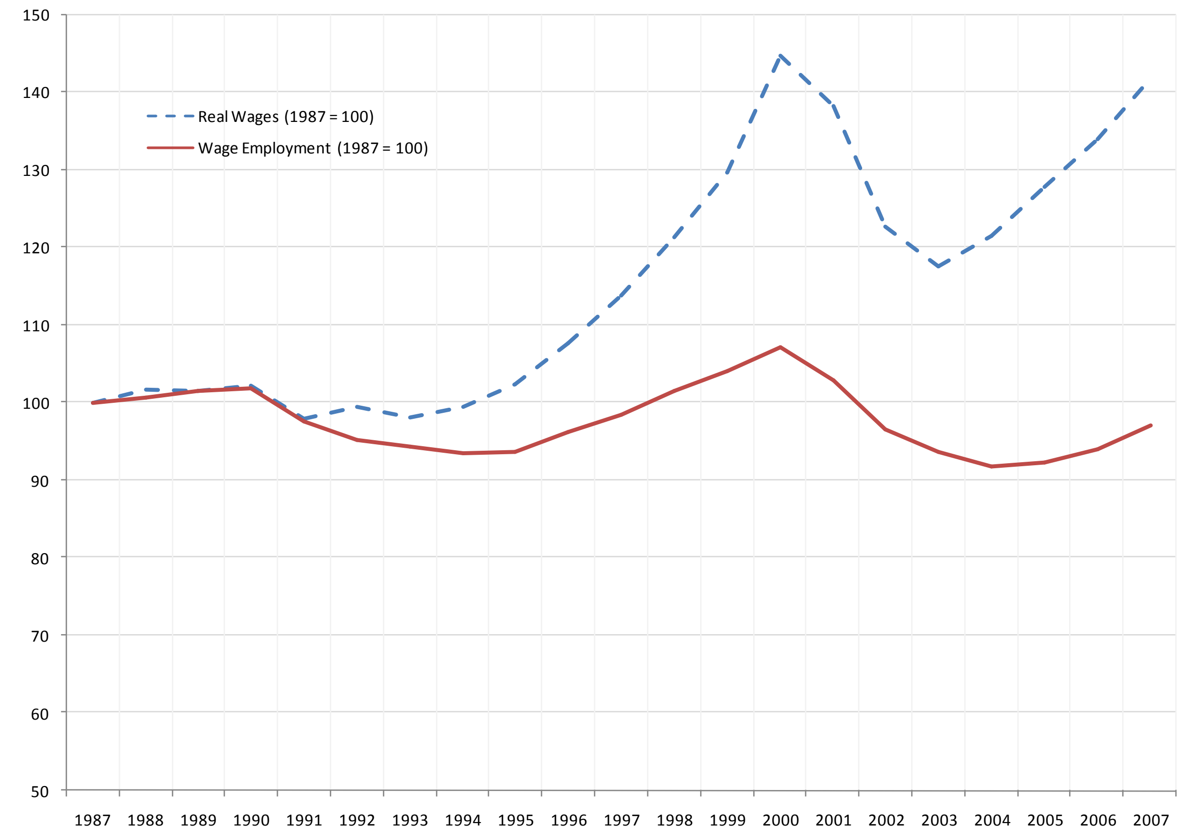
FIGURE 1 **Average Annual Growth Rate of General Fund Revenue Sources, 2004-2008.**



Source: Controller's Office

While the revenue growth favored the City's finances as it emerged from the recession of the early 2000s, the volatility of business tax revenue creates budgetary challenges. In 2009, for example, the Controller's Office projects that the payroll tax declined by over 12% versus 2008. Employment in the San Francisco area, on the other hand, declined by only 5% in 2009. Since 1987, in fact, total payroll in San Francisco has grown, on average, but has been highly sensitive to economic swings. Total employment has been much less volatile, but the city has seen little if any net job growth since 1987.

FIGURE 2 **Inflation-Adjusted Wages, and Total Employment in San Francisco, Indexed (1987=100)**



Source: Bureau of Economic Analysis

The primary source of growth in payroll has been the growth of high-wage professional and financial service industries. Since the City is prohibited from taxing financial corporations by the California Constitution, this means that the City is becoming increasing reliant on a single industry—business and professional services—for the growth of its business tax revenue. In fact, the OEA estimates that 87% of the growth in payroll tax revenue over the past decade has come from growth in this single sector, which now accounts for over 40% of payroll tax revenue. This heavy and increasing reliance on a single sector of the economy is a sign of an unstable tax system.

Equity of the Payroll Tax

The equity of a tax system is ultimately a subjective determination, but two principles, which somewhat conflict with one another, are sometimes put forward:

1. Does tax payment correspond to an ability to pay? Are payers with a relatively equal ability to pay taxed

about the same, and are payers with different abilities to pay taxed accordingly?

2. Does tax payment have a nexus, or a correspondence between the tax payment and the use of services funded by the tax?

Under the first principle, ability to pay, the payroll tax in theory is an equitable tax in some respects. The best measure of a business's ability to pay is its profitability, but a tax on business profits can be complicated to administer within a single city. Although payroll is not the same as gross profit, it is probably roughly proportional to gross profit in a service-based economy. Thus, for many industries, payroll is not a bad proxy for ability to pay.

In practice, however, the fact that 74,000 of 80,000 registered businesses do not pay the payroll tax means that it is an inequitable tax by any standard. Financial corporations are highly profitable at the moment, but cannot be taxed. Some non-profits have substantial retained earnings, but are not taxed under the City's current system.

The small business exemption is sometimes pointed to as evidence of progressivity in the business tax. In fact, size is likely a poor predictor of profitability or ability to pay. While many small neighborhood businesses have low volumes and profit margins, many other small businesses, in technology and advanced service sectors, are extremely profitable. Moreover, industries with low payrolls but high gross receipts, such as real estate, may be very profitable despite relatively low payroll.

Features of a Better Business Tax

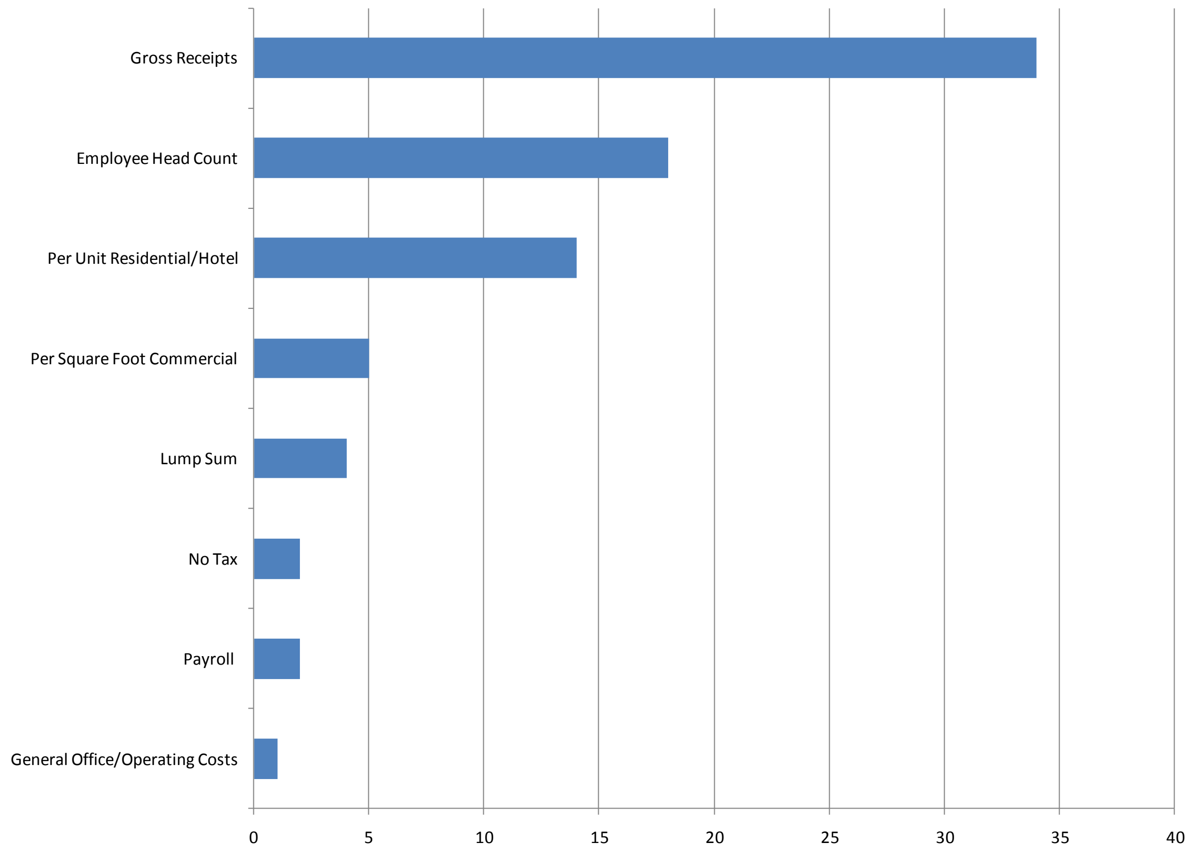
San Francisco's payroll tax system suffers from many shortcomings as a local business tax. It is widely acknowledged to discourage job creation, and likely also lowers wages in the city somewhat. The tax has also proven itself to be unstable, which exacerbates the City's budget challenges during downtowns. Finally, it is a very narrowly-based tax that does not directly correspond to business' ability to pay, or use of City services.

A Profile of California's 50 Largest Cities

As stated earlier, San Francisco is the only city in California that taxes payroll as its sole source of business taxation. If the payroll tax has weaknesses as a local business tax, the experience and practices of other California cities may be helpful in identifying potential alternatives to the payroll tax.

A valuable research tool in this regard is the annual Kosmont-Rose Institute Cost of Doing Business Survey, prepared by the Kosmont Companies and Rose Institute at Claremont-McKenna College. The survey tracks the business tax structure and rates of many cities in California. For the purposes of this paper, what is of interest is the variety of tax bases, more than the rate. The frequency of different types of business tax bases across California's largest cities is captured in Figure 3. Some cities charge more than one type of tax, so the total sums to more than fifty.

FIGURE 3 **Frequency of Business Tax Structures Among California's Fifty Largest Cities**



Source: Kosmont-Rose Institute Cost of Doing Business Survey 2009, various cities

Gross Receipts Tax

Gross receipts is by far the most common business tax base among California's largest cities. Thirty-four out of the fifty largest cities in the state charge a gross receipts tax on the majority of their businesses.

In almost every case, gross receipts rates vary by industry sector. This is necessary to equalize the tax burden across industries. An industry with a very low margin (ratio of profit to gross receipts), such as wholesale trade, should not be taxed at the same rate as a high-margin industry such as professional services, if the desire is to equalize the tax burden.

Although it seems like a simple concept, in practice defining gross receipts for the purposes of business taxation is somewhat complex. A review of the largest cities in California that charge gross receipts does reveal some similarity in what is meant by the term. As detailed in Table

1, gross receipts refers to any funds received from the sale of a good or service, without any deduction for the cost of labor, supplies, or other inputs necessary to create the good or service[1]. What can be deducted from gross receipts is refunds, discounts, and taxes paid as part of the purchase price, such as sales tax. San Francisco actually used some identical language in its old gross receipts tax in the 1990s, as shown on the right-most column.

TABLE 1 **Frequency of Gross Receipts Definitions in the Municipal Code of Selected California Cities Levying a Gross Receipts Tax**

Definitions of Gross Receipts:	Oakland	Los Angeles	Fresno	Sacramento	Santa Ana	Anaheim	Stockton	Fremont	San Francisco (1990s)
The total amount actually received or receivable from all sales	x		x	x			x	x	x
The total amount or compensation actually received or receivable for the performance of any act or service, of whatever nature it may be, for which a charge is made or credit allowed, whether or not such act or service is done as a part of or in connection with the sale of materials, goods, wares or merchandise;	x	x	x	x	x	x	x	x	x
Included in "gross receipts" shall be all receipts, cash, credits and property of any kind or nature, without any deduction therefrom on account of the cost of the property sold, the cost of materials used, labor or service costs, interest paid or payable, or losses or other expenses whatsoever, except that the following shall be excluded therefrom:	x	x	x	x	x	x	x	x	x
Allowable Exclusions:									
Cash discounts allowed and taken on sales;	x	x	x	x	x	x	x	x	x
Credit allowed on property accepted as part of the purchase price and which property may later be sold, at which time the sales price shall be included as gross receipts;	x			x	x	x	x		
Any tax required by law to be included in or added to the purchase price and collected from the consumer or purchaser;	x	x	x	x	x	x	x	x	x
Such part of the sale price of any property returned by purchasers to the seller as refunded by the seller by way of cash or credit allowances or return of refundable deposits previously included in gross receipts;	x	x	x	x	x	x	x	x	x
Amounts collected for others where the business is acting as an agent or trustee to the extent that such amounts are paid to those for whom collected, provided the agent or trustee has furnished the Director with the names and addresses of the others and the amounts paid to them.			x	x	x	x	x	x	
Receipts of refundable deposits, except that refundable deposits forfeited and taken into income of the business shall not be excluded.			x	x	x	x		x	

Source: Municipal codes of the respective cities

[1] Taxes that do allow such deductions, like a net receipts or value-added tax, better approximate business income and hence a business's ability to pay. However, they can be unwieldy to administer at a city level, and are rare as a local tax for that reason.

Many cities that levy a gross receipts tax also include gross receipts on the rental income from commercial properties. Among the thirty-four cities that levy gross receipts taxes, thirty-one include a tax on commercial rent[2]. Among large California cities, the uniform practice is to levy the tax on the lessor of commercial property (the person who receives the payment). In New York City, however, the tax is levied on the rental expense of businesses, not their commercial landlords.

It is common, but by no means universal, for the gross receipts rate on commercial rent to exceed the rate levied on most other sectors of the economy. For example, in Oakland, the commercial property gross receipts rate of 1.395% is higher than it is for any other sector. The same is also true for Fremont, Anaheim, and Sacramento, but not Santa Ana, Los Angeles, Fresno, or Stockton.

Employee Head Count Tax

Eighteen of the largest fifty cities in California charge businesses based on their number of employees. In comparison with San Francisco's payroll tax, an employee head count tax is more regressive. If the City made a revenue-neutral shift from a payroll tax to an employee head count tax, the rate would have to be set such that businesses which hired lower-income workers paid more and those which hired higher-income workers paid less. The working group was of the opinion that these incentives were not a good policy direction for San Francisco.

Per Unit / Square Foot Taxes

Several cities levy a tax on the amount of real estate that a business operates or utilizes, such as a per-room tax on hotels, a per-unit tax on apartments, or a per-square foot tax on commercial occupancy. The latter tax is a regressive form of the gross receipts tax on commercial rent, and was rejected by the working group on that basis. The per-room tax is a regressive version of the City's existing hotel tax, and was rejected for that reason. The per-unit apartment tax, like other potential taxes on residential real estate, was rejected as outside of the scope of business tax reform.

Other Taxes

Beyond these taxes, some cities charge businesses a simple lump sum business registration fee, and others charge no business tax at all. These do not provide good models for San Francisco's tax reform.

Another tax on business that is not normally considered alongside a gross receipts or payroll tax is the utility user tax.

[2] A typical definition of commercial rent for the purposes of this tax may be found in the City of Oakland: "Every person engaged in the business of renting or letting a building, structure, or other property for commercial/industrial purposes, or a portion of such building, structure or property within the city for a purpose other than dwelling, sleeping, or lodging to a tenant shall pay a business tax of thirteen dollars and ninety-five cents ($13.95) for each one thousand dollars ($1,000.00) of gross receipts or fractional part thereof."

In San Francisco, only businesses pay the utility user tax of 7.5% on gas and electricity expenses. Raising this tax—on businesses and consumers—would have the salutary effect of reducing the city's carbon footprint. The OEA has recommended a revenue-neutral increase in the UUT (coupled with a cut in the payroll tax), which would be economically positive and would reduce greenhouse gas emissions in the most economically efficient way. However, the payroll tax currently brings in approximately 9 times the revenue as the UUT on gas and electricity. While raising the UUT as a carbon tax may be good environmental policy and create economic benefits, it cannot solve all of the problems with the payroll tax without being raised to extremely high levels.

OUTLINE OF TWO ALTERNATIVES

Features of the Two Alternatives

The shortcomings of the payroll tax, and the practices of other large cities in California, suggest that an alternative tax system could be devised that would have three advantages over the current system:

- Creates incentives for job creation and economic growth, compared to the current tax system.
- Offers a more stable and diversified source of revenue.
- Broadens the base of taxpayers, particularly incorporating employers that the City is not currently taxing.

As detailed in this section, these objectives may be advanced through either a moderate, or a complete, move away from the payroll tax.

Progressive Payroll Option

A Progressive Payroll option would be a moderate shift away from the current payroll tax, and consists of the following changes to the current tax system:

- Creating a two-tiered payroll tax structure, in which businesses report their payroll expense on workers who earn more than $85,000 per year, and less than $85,000 per year. The $85,000 cut-off would be indexed to inflation and rise each year.
- On the upper tier, levy the current payroll tax rate of 1.5%.
- On the lower tier, levy a lower rate of 1.2%.
- Levy a 1.395% tax on the local gross receipts of commercial real estate lessors.
- Allow all businesses to deduct $1,500 from their annual business tax expense. This would be the equivalent of exempting $100,000 of their payroll from the payroll tax. The credit would be indexed to inflation and increase each year.

Gross Receipts Option

The Gross Receipts option consists of the following changes to the current tax system:

- Eliminate the payroll tax, for every type of business except corporate headquarters.
- Reduce the payroll tax rate to 1.4% on corporate headquarters.
- Levy a 1.395% tax on the local gross receipts of commercial real estate lessors.
- Levy a tax on the global gross receipts of all other

businesses, at the rates shown in Table 2. The Controller's Office believes these rates will result in a reduced tax burden for the vast majority of businesses in each sector of the economy.

- Allow all businesses to deduct $1,500 from their annual business tax expense. The credit is also indexed to inflation and would increase each year.

TABLE 2 **Proposed Gross Receipts Tax Rates by Sector**

NAICS Sector	Rate
Construction	0.300%
Manufacturing	0.175%
Wholesale Trade	0.090%
Retail Trade	0.090%
Transportation & Warehousing	0.375%
Information	0.300%
Financial Activities	0.300%
Professional & Business Services	0.700%
Education and Health Services	0.250%
Leisure and Hospitality	0.350%
Other Services	0.150%

Rationale for the Tax on Commercial Rent

Both proposals feature a reduction in the direct tax burden on most businesses, combined with a new tax on the local gross receipts of businesses that rent commercial property. The reason for including this proposal in both taxes is twofold. First, from an economic efficiency point of view, a strong case can be made that shifting from a tax on payroll to rent creates a positive economic impact. The Controller's Office's analysis suggests that, because of this shift, both proposals have a net positive economic benefit while growing the City's business tax revenue, at least in the short run. Several OEA economic impact reports have determined that tax increases typically have a long-run negative economic impact on the city's economy. However, both of these proposals feature a reduction or elimination of the payroll tax, together with the new tax. Both of these tax packages, our analysis finds, would have a net positive economic impact.

Secondly, there is good reason to believe that the vast majority of the commercial rent tax will be passed on from landlords to business tenants. This pass-through is part of the design of the tax system, and could happen in a number of ways. Many commercial property lessors have a lease clause that explicitly allows the pass-through of any new tax to tenants. Even if that clause is missing, the tax will likely become incorporated in market rents, because it will equally affect all commercial property for rent in the city.

The implication of this passing-through of the tax to tenants is that every business which rents property in San Francisco will see their rents rise somewhat, and thus will indirectly contribute to the City's business tax base. In this way, the business tax will be able to indirectly incorporate contributions from sectors that are not currently taxed. Of course, existing payers will also see their rents rise under both proposals—but they will also see their direct tax burden decline.

In fact, in both proposals, the Controller's Office believes that the vast majority of new revenue generated will come from employers that are currently not paying the business tax. The tax on commercial rent is the only local tax, we believe, that will provide a sufficiently broad pass-through to create this impact: simply because essentially every San Francisco business with employees needs commercial real estate.

In both proposals, the tax on rent is intended to be placed on the lessor, and then passed on through market forces to the commercial tenant. It is possible, and likely equivalent in terms of the economic impact, to place the tax on the tenant. This is how rents are taxed in New York City, for example. In this case, however, the City would still not be able to indirectly broaden the tax base to include financial corporations and any other employer that is not covered by the business tax.

Fiscal Impacts of the Progressive Payroll Option

The second significant feature of the progressive payroll tax is the restructuring of the payroll tax into a two-tiered system, in which the upper tier pays the current payroll tax rate (1.5%), and the lower tier pays a rate of 1.2%. It is important to stress that this is truly a progressive tax, in that the payroll tax affecting lower-earning workers is lower than the rate on higher-earning workers. Since there is reason to believe that the payroll tax depresses worker earnings as well as company profit, the progressive payroll tax both encourages the hiring of, and raises the take-home pay of, workers who make less than $85,000.

The third key feature of the progressive payroll proposal is the addition of a basic deduction of $1,500 from the business tax. This feature is added to both plans to help offset the impact of higher rents on small businesses. While all business taxpayers would benefit from the change, as a percentage of the total tax payment it would benefit smaller businesses the most. The existing small business exemption, which exempts businesses with less than $250,000 from paying the tax entirely, would remain in place.

The latest available estimate of 2009 payroll tax revenue is

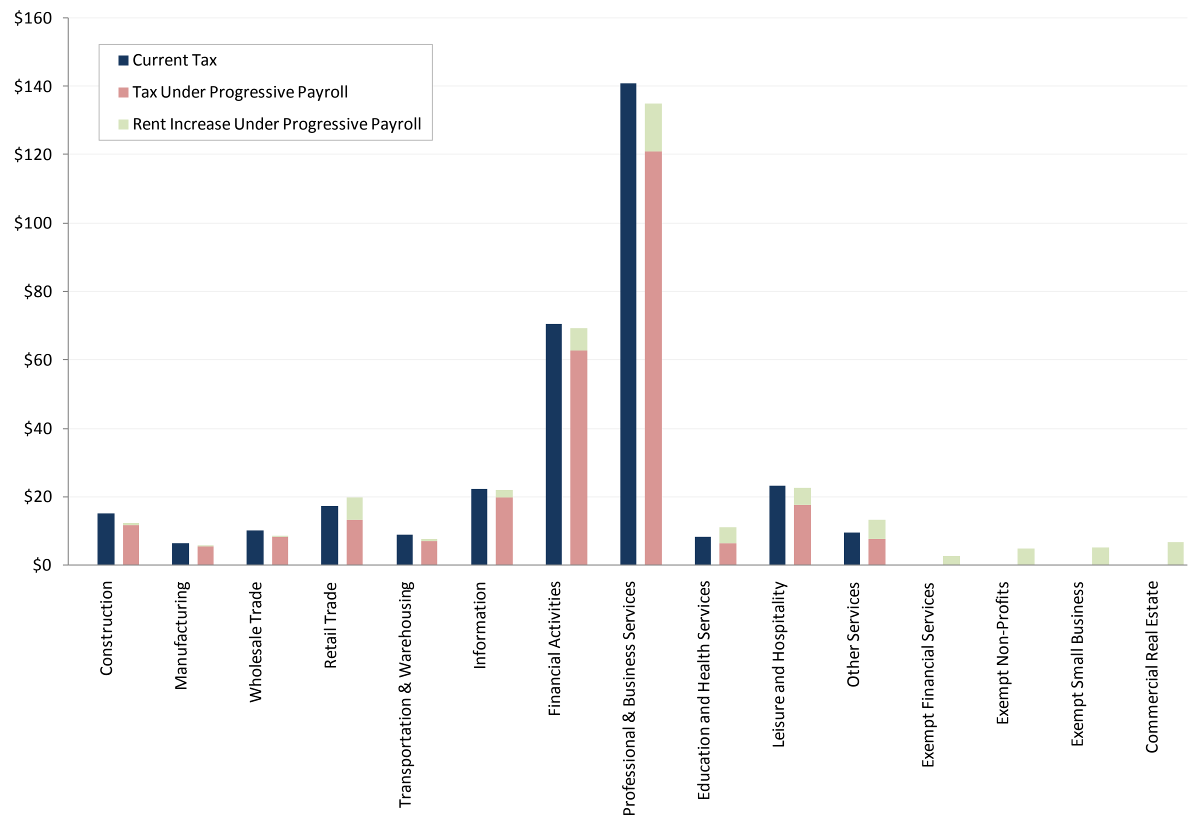
$332.4 million. The fiscal impacts of a switch to the progressive payroll option are detailed in Table 3. The City would generate approximately $11 million in new revenue in Year 1, but the amount of revenue generated from payroll would decline to $291 million. *Even with higher rent payment considered*, the existing payroll tax payers would pay less than they currently pay as a group, approximately $325 million versus $332 million.

TABLE 3 **Projected Fiscal Impact of the Progressive Payroll Option**

	Commercial Rent Tax Revenue	Progressive Payroll Tax Revenue	Total
Current Payroll Tax Payers:			
Construction	$844,663	$12,444,440	$13,289,103
Manufacturing	$467,197	$5,423,787	$5,890,983
Wholesale Trade	$543,525	$8,569,039	$9,112,564
Retail Trade	$6,658,419	$14,378,548	$21,036,967
Transportation & Warehousing	$518,917	$7,048,094	$7,567,011
Information	$2,177,527	$19,738,602	$21,916,129
Financial Activities	$6,548,964	$63,394,177	$69,943,141
Professional & Business Services	$14,213,867	$126,627,306	$140,841,173
Education and Health Services	$4,752,739	$7,039,125	$11,791,864
Leisure and Hospitality	$4,699,359	$18,703,682	$23,403,041
Other Services	$5,689,223	$7,856,303	$13,545,526
Total Revenue	$47,114,399	$291,223,103	$338,337,502
Less Cost of $1,500 deductible			-$13,289,808
Sub-total: Current Payroll Tax Payers			$325,047,694
Difference vs. 2009 Payment ($332.4M)			**-$7,352,306**
% Change vs. 2009 Payment			**-2.2%**
Exempt from Payroll Tax:			
Exempt Financial Services	$2,503,263	$0	$2,503,263
Exempt Transportation	$51,892	$0	$51,892
Exempt Non-Profits	$4,603,413	$0	$4,603,413
Exempt Small Business	$4,920,384	$0	$4,920,384
Sub-total: Exempt from Payroll Tax	$12,078,951	$0	$12,078,951
Other Sectors:			
Commercial Real Estate	$6,577,039	$0	$6,577,039
	$65,770,388		$343,703,683
Difference vs. 2009 Payment ($332.4M)			**$11,303,683**
% Change vs. 2009 Payment			**3.4%**

The before-and-after impacts are graphically shown in Figure 4 below. The sectors that currently pay the payroll tax are shown on the left side of the chart, and the amount of payroll tax they pay is indicated by the blue bar. On the right side of the chart are exempt financial services, non-profits, exempt small businesses, and the commercial real estate sector. Other than the commercial real estate sector, which pays approximately $1 million in payroll tax now, these sectors are not paying payroll tax. They would continue to not pay tax directly, but their rents would rise as they indirectly contributed to the gross receipts tax on commercial rent. The green bars to the right of the chart indicate the new revenue generated from new payers by the progressive payroll tax package.

FIGURE 4	Tax and Rent Payments Under the Current Payroll Tax and Proposed Progressive Payroll Option, by Sector ($ million)



Note: Impacts of the $1,500 deduction are included.

Fiscal Impacts of the Gross Receipts Option

The Gross Receipts option differs from the progressive payroll option in that it features a near-complete elimination of the payroll tax. The payroll tax would be replaced with a gross receipts tax, at varying rates, for every sector except administrative headquarters. Those establishments would continue to be assessed a payroll tax at the rate of 1.4%[3].

The gross receipts rates were designed to equalize each sector's future tax and increased rent payments, to their current tax payments. Again, the goal was to raise any new revenue from employers who are not currently paying the business tax. The gross receipts option would generate approximately $20 million for the City upon full implementation, while current payers would actually see a reduction in their tax and rent payments, of slightly less than $1 million.

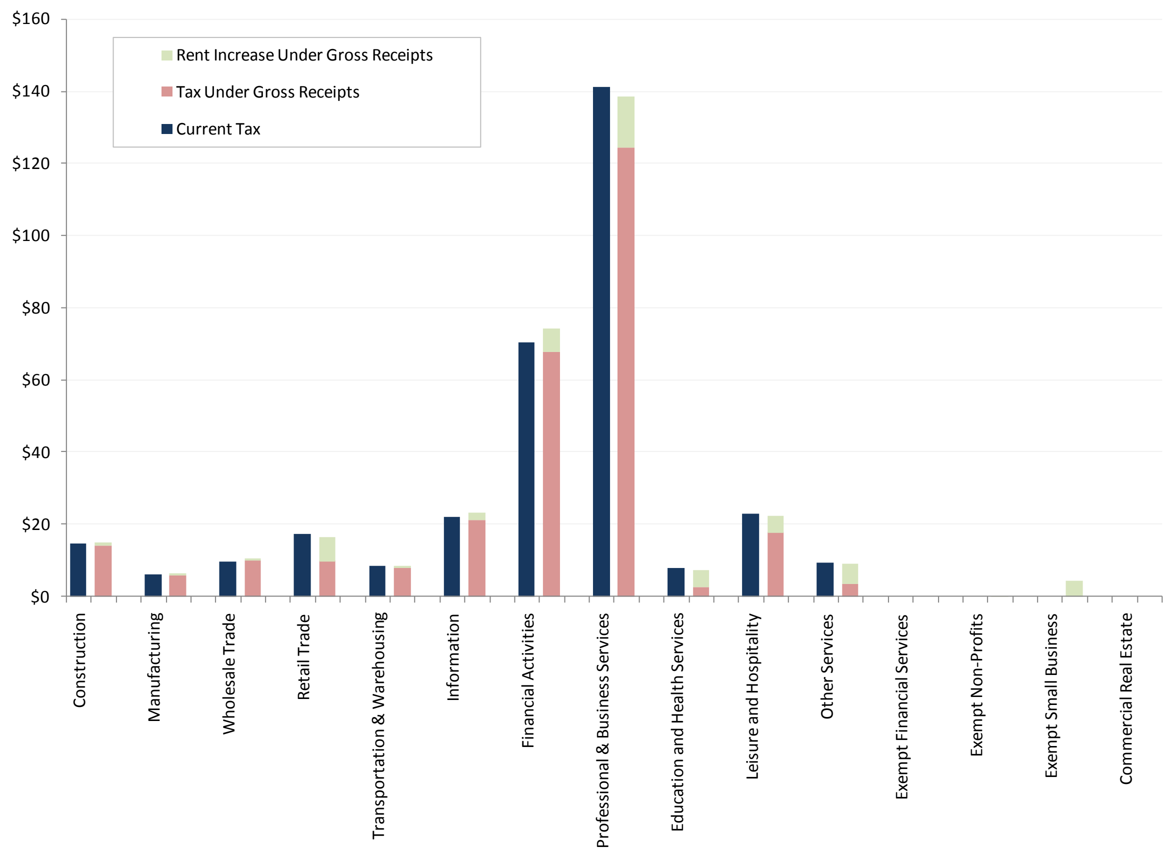
[3] An exception is made for administrative headquarter establishments because of the difficulty of apportioning gross receipts in a large corporation to the headquarters function. For example, if a large manufacturing company was headquartered in San Francisco, but had no manufacturing facilities in San Francisco, how much of its gross receipts is attributable to its San Francisco location? To avoid this difficulty, the proposal maintains a payroll tax on corporate headquarters, albeit at a lower rate than currently, in consideration of the expected pass-through of the commercial rent tax to many of these tenants.

TABLE 4 Projected Fiscal Impact of the Gross Receipts Option

	Commercial Rent Tax Revenue	Gross Receipts Tax Revenue	Total
Current Payroll Tax Payers:			
Construction	$844,663	$15,216,025	$16,060,688
Manufacturing	$467,197	$6,221,744	$6,688,941
Wholesale Trade	$543,525	$10,600,185	$11,143,710
Retail Trade	$6,658,419	$11,177,398	$17,835,817
Transportation & Warehousing	$518,917	$8,169,830	$8,688,747
Information	$2,177,527	$21,268,119	$23,445,645
Financial Activities	$6,548,964	$68,699,596	$75,248,560
Professional & Business Services	$14,213,867	$129,985,946	$144,199,813
Education and Health Services	$4,752,739	$3,446,689	$8,199,429
Leisure and Hospitality	$4,699,359	$18,954,103	$23,653,462
Other Services	$5,689,223	$3,971,788	$9,661,010
Total Revenue	$47,114,399	$297,711,422	$344,825,821
Less Cost of $1,500 deductible			-$13,289,808
Sub-total: Current Payroll Tax Payers			$331,536,013
Difference vs. 2009 Payment ($332.4M)			**-$863,987**
% Change vs. 2009 Payment			**-0.3%**
Exempt from Payroll Tax:			
Exempt Financial Services	$2,503,263	$0	$2,503,263
Exempt Transportation	$51,892	$0	$51,892
Exempt Non-Profits	$4,603,413	$0	$4,603,413
Exempt Small Business	$4,920,384	$0	$4,920,384
Sub-total: Exempt from Payroll Tax	$12,078,951	$0	$12,078,951
Other Sectors:			
Commercial Real Estate	$6,577,039	$0	$6,577,039
Sole Proprietors	$0	$0	$0
Businesses in Federal Enclaves	$0	$2,500,000	$2,500,000
Sub-total: Other Sectors	$6,577,039	$2,500,000	$9,077,039
Grand Total	$65,770,388	$297,711,422	$352,692,003
Difference vs. 2009 Payment ($332.4M)			**$20,292,003**
% Change vs. 2009 Payment			**6.1%**

Figure 5 below graphically illustrates the impact by sector in the gross receipts option versus the current system. Again, the net new revenue is effectively generated by rent tax that is passed through to tenants that are not paying the payroll tax now, together with an estimated 10% of the tax that will remain with the commercial real estate sector, and not be passed through.

FIGURE 5 **Tax and Rent Payments Under the Current Payroll Tax and Proposed Gross Receipts Option, by Sector ($ million)**



Note: Impacts of the $1,500 deduction are included.

IMPACTS ON SPECIFIC BUSINESSES

Introduction

The previous chapter detailed the two alternative business tax proposals, and discussed their impact on the City's tax revenues.

In that chapter, detail was provided on the tax impact the Controller's Office believes each alternative would have on specific industry sectors. In this chapter, sample pro-formas for individual businesses are presented, which suggest the tax impacts each proposal could have on different types of business. The information in these pro-formas does not originate with actual businesses or City statistics; they are hypothetical examples. Nevertheless, the cost structures of these examples do reasonably represent the situation of an average business in these industries within San Francisco.

As emphasized in the previous chapter, the two proposals were not designed to lower the tax burden for every business. The reader will note that some businesses pay more taxes under each proposal, and some pay less. The pro-formas are presented to help illustrate how each of the two alternatives would affect a typical business.

Pro-formas were created for the following examples:

- Graphic Design Firm with 2 employees
- Dentist's Office with 10 employees
- Hardware Store with 18 employees
- Restaurant with 30 employees
- Grocery Wholesaler with 58 employees
- Software company with 75 employees
- Hotel with 350 employees
- Commercial Bank with 700 employees
- Corporate Headquarters with 2,000 employees

Small Graphic Design Firm

Graphic design is a professional services industry that is an important of San Francisco's media, advertising, consulting, hospitality, and other knowledge-based industry clusters.

There are over 200 graphic design businesses in San Francisco, and well over half of them have fewer than four employees[4]. Thus, the hypothetical pro-forma below closely resembles the situation of many actual businesses in the city.

The sample firm has a total payroll low enough to qualify for the small business exemption under the current business tax plan. Like all businesses that are exempt under the current business tax, it will also be exempt under both alternative proposals. It is anticipated that the firm's annual rent costs will increase, by $226 per year. For the first time, the firm would contribute to the City's business tax revenue, though indirectly, through its higher rent. The firm's cost of doing business increases by 0.04% of its annual gross receipts.

[4] The source for this, and subsequent citations of business counts and size distribution in San Francisco, is the U.S. Census Bureau's *County Business Patterns*, for 2007.

TABLE 5	**Tax Impact of the Two Alternatives on a Small Graphic Design Firm**

Graphic Design Firm
NAICS: 54143
Sector: Business & Professional Services

Information about the company:		
Number of Employees:	2	
Annual Gross Receipts:	$575,000	
Total Annual Payroll	$175,000	
Payroll for Workers Over $85,000	$95,000	
Payroll for Workers Under $85,000	$80,000	
Annual Rent	$18,000	
Current Tax	Tax Paid	
Tax on Total Payroll, @1.5%	**$0**	(exempt)
Progressive Payroll Tax Option	Tax Paid	
Payroll tax on workers > $85,000, taxed at 1.5%	$0	(exempt)
+ Payroll tax on workers < $85,000, taxed at 1.2%	$0	(exempt)
- Deduction	$1,500	
Progressive Payroll Tax	$0	
+ 90% of Rent tax passed through, @1.395%	$226	
Total Progressive Payroll Tax + Rent Increase	$226	
Gain (Loss) vs. Current Tax	($226)	
Gross Receipts Tax Option		
Gross receipts tax @ 0.700%	$0	(exempt)
- Deduction	$1,500	
Gross Receipts Tax	$0	
+ 90% of Rent tax passed through, @1.395%	$226	
Total Gross Receipts Tax + Rent Increase	$226	
Gain (Loss) vs. Current Tax	($226)	

Dentist's Office

There are over 600 dentist offices in San Francisco, and the vast majority have fewer than ten employees. The example firm used in this pro-forma has ten employees, which makes it relatively large, though there are over fifty local firms in this size class.

This business would benefit significantly under either tax proposal, largely because it is too large to quality for the small business exemption under the current system, but would be able to deduct a significant amount of its payroll or gross receipts under the modified exemption.

TABLE 6	Tax Impact of the Two Alternatives on a Dentist's Office
Dentist's Office	
NAICS: 6212	
Sector: Education & Health Services	
Assumptions about the business:	
Number of Employees:	10
Annual Gross Receipts:	$1,200,000
Total Annual Payroll	$450,000
Payroll for Workers Over $85,000	$225,000
Payroll for Workers Under $85,000	$225,000
Annual Rent	$105,000
Current Tax	Tax Paid
Tax on Total Payroll, @1.5%	**$6,750**
Progressive Payroll Tax Option	Tax Paid
Payroll tax on workers > $85,000, taxed at 1.5%	$3,375
+ Payroll tax on workers < $85,000, taxed at 1.2%	$2,700
- Deduction	$1,500
Progressive Payroll Tax	$4,575
+ 90% of Rent tax passed through, @1.395%	$1,318
Total Progressive Payroll Tax + Rent Increase	**$5,893**
Gain (Loss) vs. Current Tax	**$857**
Gross Receipts Tax Option	
Gross receipts tax @ 0.250%	$3,000
- Deduction	$1,500
Gross Receipts Tax	$1,500
+ 90% of Rent tax passed through, @1.395%	$1,318
Total Gross Receipts Tax + Rent Increase	**$2,818**
Gain (Loss) vs. Current Tax	**$3,932**

Hardware Store

The example hardware store detailed below is relatively large by the standards of the nearly 400 such stores in San Francisco. Like the Dentist Office, it benefits from the modified small business exemption, but also from its relatively low rent compared to the average for the retail trade sector. In addition, hardware has somewhat lower gross receipts per dollar of payroll than other branches of the retail trade sector, so the store's savings under the gross receipts option are more substantial.

TABLE 7	Tax Impact of the Two Alternatives on a Hardware Store
Hardware Store	
NAICS: 4441	
Sector: Retail Trade	
Assumptions about the business:	
Number of Employees:	18
Annual Gross Receipts:	$6,500,000
Total Annual Payroll	$750,000
Payroll for Workers Over $85,000	$90,000
Payroll for Workers Under $85,000	$660,000
Annual Rent	$225,000
Current Tax	Tax Paid
Tax on Total Payroll, @1.5%	**$11,250**
Progressive Payroll Tax Option	Tax Paid
Payroll tax on workers > $85,000, taxed at 1.5%	$1,350
+ Payroll tax on workers < $85,000, taxed at 1.2%	$7,920
- Deduction	$1,500
Progressive Payroll Tax	$7,770
+ 90% of Rent tax passed through, @1.395%	$2,825
Total Progressive Payroll Tax + Rent Increase	**$10,595**
Gain (Loss) vs. Current Tax	**$655**
Gross Receipts Tax Option	
Gross receipts tax @ 0.090%	$5,850
- Deduction	$1,500
Gross Receipts Tax	$4,350
+ 90% of Rent tax passed through, @1.395%	$2,825
Total Gross Receipts Tax + Rent Increase	**$7,175**
Gain (Loss) vs. Current Tax	**$4,075**

Restaurant

The sample restaurant detailed below has 30 employees – which is larger than average for San Francisco, but not unusual. Because average salary is quite low in the industry, the total payroll is only $900,000, and the business benefits from the progressive payroll option. It benefits even more from the gross receipts option.

TABLE 8	Tax Impact of the Two Alternatives on a Restaurant
Restaurant	
NAICS: 7221	
Sector: Leisure & Hospitality	
Assumptions about the business:	
Number of Employees:	30
Annual Gross Receipts:	$2,750,000
Total Annual Payroll	$900,000
Payroll for Workers Over $85,000	$90,000
Payroll for Workers Under $85,000	$810,000
Annual Rent	$250,000
Current Tax	Tax Paid
Tax on Total Payroll, @1.5%	**$13,500**
Progressive Payroll Tax Option	Tax Paid
Payroll tax on workers > $85,000, taxed at 1.5%	$1,350
+ Payroll tax on workers < $85,000, taxed at 1.2%	$9,720
- Deduction	$1,500
Progressive Payroll Tax	$9,570
+ 90% of Rent tax passed through, @1.395%	$3,139
Total Progressive Payroll Tax + Rent Increase	**$12,709**
Gain (Loss) vs. Current Tax	**$791**
Gross Receipts Tax Option	
Gross receipts tax @ 0.35%	$9,625
- Deduction	$1,500
Gross Receipts Tax	$8,125
+ 90% of Rent tax passed through, @1.395%	$3,139
Total Gross Receipts Tax + Rent Increase	**$11,264**
Gain (Loss) vs. Current Tax	**$2,236**

Grocery Wholesale

The hypothetical grocery wholesaler detailed below, with 58 employees, would be among the very largest among San Francisco's 200+ companies in the industry. The business pays more with the gross receipts option, but experiences a significant tax savings with the progressive payroll option. This is both because the majority of its workforce earns less than $85,000 per year; the firm also benefits from the modified small business exemption, which is taken from the upper tier.

TABLE 9	Tax Impact of the Two Alternatives on a Grocery Wholesaler
Grocery Wholesaler	
NAICS: 4244	
Sector: Wholesale Trade	
Assumptions about the business:	
Number of Employees:	58
Annual Gross Receipts:	$61,000,000
Total Annual Payroll	$3,100,000
Payroll for Workers Over $85,000	$620,000
Payroll for Workers Under $85,000	$2,480,000
Annual Rent	$350,000
Current Tax	Tax Paid
Tax on Total Payroll, @1.5%	**$46,500**
Progressive Payroll Tax Option	Tax Paid
Payroll tax on workers > $85,000, taxed at 1.5%	$9,300
+ Payroll tax on workers < $85,000, taxed at 1.2%	$29,760
- Deduction	$1,500
Progressive Payroll Tax	$37,560
+ 90% of Rent tax passed through, @1.395%	$4,394
Total Progressive Payroll Tax + Rent Increase	**$41,954**
Gain (Loss) vs. Current Tax	**$4,546**
Gross Receipts Tax Option	
Gross receipts tax @ 0.070%	$54,900
- Deduction	$1,500
Gross Receipts Tax	$53,400
+ 90% of Rent tax passed through, @1.395%	$4,394
Total Gross Receipts Tax + Rent Increase	**$57,794**
Gain (Loss) vs. Current Tax	**($11,294)**

Software Company

Software companies and the information technology industry generally have emerged as a significant element in San Francisco's knowledge sector since the 1990s. Roughly a third of the city's 100+ software product companies are larger than the 75-person sample firm profiled here. The business would pay slightly more with the progressive payroll option, and would experience a larger tax savings under the gross receipts option.

TABLE 10	Tax Impact of the Two Alternatives on a Software Company
Software company	
NAICS: 5112	
Sector: Information	
Assumptions about the business:	
Number of Employees:	75
Annual Gross Receipts:	$30,000,000
Total Annual Payroll	$9,000,000
Payroll for Workers Over $85,000	$6,750,000
Payroll for Workers Under $85,000	$2,250,000
Annual Rent	$900,000
Current Tax	Tax Paid
Tax on Total Payroll, @1.5%	**$135,000**
Progressive Payroll Tax Option	Tax Paid
Payroll tax on workers > $85,000, taxed at 1.5%	$101,250
+ Payroll tax on workers < $85,000, taxed at 1.2%	$27,000
- Deduction	$1,500
Progressive Payroll Tax	$126,750
+ 90% of Rent tax passed through, @1.395%	$11,300
Total Progressive Payroll Tax + Rent Increase	**$138,050**
Gain (Loss) vs. Current Tax	**($3,050)**
Gross Receipts Tax Option	
Gross receipts tax @ 0.300%	$90,000
- Deduction	$1,500
Gross Receipts Tax	$88,500
+ 90% of Rent tax passed through, @1.395%	$11,300
Total Gross Receipts Tax + Rent Increase	**$99,800**
Gain (Loss) vs. Current Tax	**$35,201**

Hotel

The large (350 person) hotel profiled below is a major beneficiary under both proposed alternatives, because, like many hotels in San Francisco, it does not rent its property. The business experiences a major savings under the progressive payroll option in particular.

TABLE 11	Tax Impact of the Two Alternatives on a Hotel
Hotel	
NAICS: 7221	
Sector: Leisure & Hospitality	
Assumptions about the business:	
Number of Employees:	350
Annual Gross Receipts:	$52,750,000
Total Annual Payroll	$13,500,000
Payroll for Workers Over $85,000	$945,000
Payroll for Workers Under $85,000	$12,555,000
Annual Rent	$0
Current Tax	Tax Paid
Tax on Total Payroll, @1.5%	**$202,500**
Progressive Payroll Tax Option	Tax Paid
Payroll tax on workers > $85,000, taxed at 1.5%	$14,175
+ Payroll tax on workers < $85,000, taxed at 1.2%	$150,660
- Deduction	$1,500
Progressive Payroll Tax	$163,335
+ 90% of Rent tax passed through, @1.395%	$0
Total Progressive Payroll Tax + Rent Increase	**$163,335**
Gain (Loss) vs. Current Tax	**$39,165**
Gross Receipts Tax Option	
Gross receipts tax @ 0.35%	$184,625
- Deduction	$1,500
Gross Receipts Tax	$183,125
+ 90% of Rent tax passed through, @1.395%	$0
Total Gross Receipts Tax + Rent Increase	**$183,125**
Gain (Loss) vs. Current Tax	**$19,375**

Commercial Bank

Commercial banks, as stated earlier, are not directly taxable by California cities. However, under both proposals, the commercial bank's costs would rise, because it would be paying higher rent from the rent tax passed through by its lessor. The amount is identical under each proposal; the bank would still be exempt from paying tax under a progressive payroll or gross receipts system.

TABLE 12	Tax Impact of the Two Alternatives on a Commercial Bank	
Commercial Bank		
NAICS: 52211		
Sector: Financial Services		
Assumptions about the business:		
Number of Employees:	700	
Annual Gross Receipts:	$560,000,000	
Total Annual Payroll	$90,000,000	
Payroll for Workers Over $85,000	$50,000,000	
Payroll for Workers Under $85,000	$40,000,000	
Annual Rent	$6,125,000	
Current Tax	Tax Paid	
Tax on Total Payroll, @1.5%	**$0**	(exempt)
Progressive Payroll Tax Option	Tax Paid	
Payroll tax on workers > $85,000, taxed at 1.5%	$0	(exempt)
+ Payroll tax on workers < $85,000, taxed at 1.2%	$0	(exempt)
- Deduction	$1,500	
Progressive Payroll Tax	$0	
+ 90% of Rent tax passed through, @1.395%	$76,899	
Total Progressive Payroll Tax + Rent Increase	**$76,899**	
Gain (Loss) vs. Current Tax	**($76,899)**	
Gross Receipts Tax Option		
Gross receipts tax @ 0.275%	$0	(exempt)
- Deduction	$1,500	
Gross Receipts Tax	$0	
+ 90% of Rent tax passed through, @1.395%	$76,899	
Total Gross Receipts Tax + Rent Increase	**$76,899**	
Gain (Loss) vs. Current Tax	**($76,899)**	

Corporate Headquarters

The largest sample business in this series of pro-formas is a 2,000 employee corporate headquarters. Corporate headquarters were the primary driver of the San Francisco economy until the 1990s. Several remain, though the vast majority employ fewer than 1,000 people in the city. Under both proposals, the establishment would pay less in taxes; it particularly benefits from progressive payroll, because a relatively high percentage of its workforce earns less than $85,000 per year.

TABLE 13	Tax Impact of the Two Alternatives on a Corporate Headquarters
Corporate Headquarters	
NAICS: 55	
Sector: Business & Professional Services	
Assumptions about the business:	
Number of Employees:	2,000
Annual Gross Receipts:	$110,000,000
Total Annual Payroll	$250,000,000
Payroll for Workers Over $85,000	$145,000,000
Payroll for Workers Under $85,000	$105,000,000
Annual Rent	$17,500,000
Current Tax	Tax Paid
Tax on Total Payroll, @1.5%	**$3,750,000**
Progressive Payroll Tax Option	Tax Paid
Payroll tax on workers > $85,000, taxed at 1.5%	$2,175,000
+ Payroll tax on workers < $85,000, taxed at 1.2%	$1,260,000
- Deduction	$1,500
Progressive Payroll Tax	$3,433,500
+ 90% of Rent tax passed through, @1.395%	$219,713
Total Progressive Payroll Tax + Rent Increase	**$3,653,213**
Gain (Loss) vs. Current Tax	**$96,788**
Gross Receipts Tax Option	
Payroll Tax @ 1.4%	$3,500,000
- Deduction	$1,500
Gross Receipts Tax	$3,498,500
+ 90% of Rent tax passed through, @1.395%	$219,713
Total Gross Receipts Tax + Rent Increase	**$3,718,213**
Gain (Loss) vs. Current Tax	**$31,788**

Summary of Impacts

The pro-formas detailed in this section are summarized in Table 14 below. In that table, the tax savings or increased tax and rent payment is expressed as a percentage of the total gross receipts of each business[5].

A tax savings is shown as a positive number, while a negative number indicates an increase in the sum of taxes and increased rent. Higher expected rent payments are figured into these totals; most businesses will see their taxes decline so much that it offsets higher rents, and they experience a net savings.

Both commercial banks and the small graphic design firm are exempt from taxes, and can be expected to pay more in rent. The rent burden for the commercial bank is no more than 0.01% of the business's gross receipts with either option. The biggest beneficiary of the group is the dentist's office, which is large enough to pay payroll tax under the current system, but receives a large reduction in tax due to the credit in both proposals.

TABLE 14 **Summary of the Pro Forma Analysis**

	Progressive Payroll: Gain/Loss vs. Current as % of gross receipts	Gross Receipts: Gain/Loss vs. Current as % of gross receipts
Graphic Design Firm, 2 employees	-0.04%	-0.04%
Dentist's Office, 10 employees	0.07%	0.33%
Hardware Store, 18 employees	0.01%	0.06%
Restaurant, 30 employees	0.03%	0.08%
Grocery Wholesaler, 58 employees	0.01%	-0.02%
Software company, 75 employees	-0.01%	0.12%
Hotel, 350 employees	0.07%	0.04%
Commercial Bank, 700 employees	-0.01%	-0.01%
Corporate Headquarters, 2000 employees	0.04%	0.03%

[5] For the corporate headquarters, it is shown as a percentage of payroll costs.

ECONOMIC IMPACT OF THE TWO PROPOSALS

Understanding the Economic Impact of Local Business Taxes

The previous chapters have focused on the impacts of the two proposed business tax alternatives to the City's finances, and to industry sectors and individual businesses in San Francisco. A broader, though related, concern, is the impact of different business taxes on the broader economy.

Like much of the debate concerning taxes, many aspects of the economic impact of local business taxes appear more complicated than they actually are. At the outset, it may be helpful to make four points about the economic impact of tax changes.

First, the economic impact of altering business taxes does not depend on how fair the current tax is already deemed to be. In the business tax debate in San Francisco, there are those who point to the City's already-high business tax burden as an argument against raising taxes further. On the other hand, there are those who point to cuts in social services, together with rising demand, and argue that the more affluent individuals and organizations in the City have a responsibility to contribute more.

Both of these points concern questions of fairness and equity, and while they are an important part of the broader policy debate about taxes, they do not directly pertain to economic outcomes. To put it simply, the economic impact of a tax *change* is largely independent of the current tax rate. Lowering the business tax rate will reduce the cost of doing business in San Francisco and stimulate job creation in the private sector; this will happen regardless of whether the rate is already relatively high or relatively low. Similarly, reducing local government spending will contract the public sector and the businesses that depend on the spending of the City and its employees; this contraction is also independent of the current rate, and how fair it is deemed to be.

Second, the economic impact of taxes is not directly tied to the relative importance of taxes, versus other factors, in guiding business location and investment decisions. The role of local taxes in attracting or driving out local businesses is intensely debated. The 2001 Crapo report[6], for example, argues that Philadelphia's payroll tax was the primary reason that the city lost a major portion of its manufacturing employment during the 1970s.

On the other hand, it is sometimes argued that local business taxes are too insignificant to be the decisive factor

[6] John R. Crapo, "The Impact of the Payroll Tax in San Francisco", Published by the San Francisco Chamber of Commerce, June 2001.

swaying business location decisions, and that other cost factors such as labor, rent, and access to markets and suppliers are more significant.

According to this line of reasoning, a local business tax increase is unlikely to significantly affect job creation because other factors are more important. There are merits to both sides of this argument, but again, a change in tax policy does not have to be the single largest impact to still have a noticeable economic impact.

Third, the economic impact of a new tax policy, like any other policy, does not depend on the overall state of the economy. A tax increase may feel particularly painful when the economy is in a recession, but this does not mean that the economic impact of the policy *per se*—the number of jobs it costs, for example—is necessarily worse at that time.

On the other hand, during good times a tax increase can be justified by the argument that the economy will continue to grow despite the tax increase. This may be true, but it is not the same as arguing that the tax increase had no negative impact on its own terms.

Fourth, taxes are one means by which government services are paid for, by residents and businesses. In principle, a complete economic analysis requires linking the analysis of tax changes to changes in the government spending that the tax supports. If the tax pays for investments in local business inputs that create value for the economy in the long term—like education, infrastructure, public health, and amenities that improve the quality of life—then the tax increase could increase competitiveness and create a positive economic impact in the long run.

In practice, however, linking a tax change to the long-term impact of its expenditure is extremely challenging. For example, almost all of San Francisco's business tax revenue is allocated to the City's General Fund. As discussed in an earlier chapter, the General Fund has experienced a substantial growth in revenue over the past ten years. The City has not, however, generally invested these funds into infrastructure that would generate long-term economic development. Fundamentally, the impact of changes to tax rates is simply not connected to political decisions about how to adjust budgets. As a practical matter, then, the impacts of a tax increase have to be analyzed independently of the long-term impacts of the expenditure on competitiveness.

Economic Impact of Switching to the Progressive Payroll Option

The Controller's Office uses a computer model called the REMI model to estimate the economic impact of proposed legislation. Complex policies, like these tax policies, can involve a mix of changes, some of which are positive for the economy, and others of which are negative. The REMI model allows these effects to be individually modeled and displayed, which can help make clear why the overall economic impact is what it is.

The net economic impact of the switch to progressive payroll involves a trade-off between positive and negative economic effects. Positive effects include:

- Lowering the cost of labor by lowering the payroll tax rate for the lower bracket, and introducing a new tax credit. Lowering labor costs promotes job creation and spending in the local economy.
- Raising local government revenue, which also increases spending in the local economy.

The primary negative effect is:

- Higher commercial rent, which is expected to rise as commercial property lessors pass the gross receipts tax on to their tenants. Higher rents discourage business attraction and retention in San Francisco, tending to reduce employment and spending in the city.

The projected economic impact, over the next twenty years, of each of these three individual changes is illustrated in Figure 6 below. A fourth line, representing their combined effect, is just the sum of the three individual impacts. The figure shows that the policy shift will have an initial benefit of approximately 250 jobs in the first year, rising to over 1,000 jobs by 2030.

The progressive payroll tax option generates a positive economic impact because the benefit of cutting labor costs to the economy outweighs the harm of rising rents.

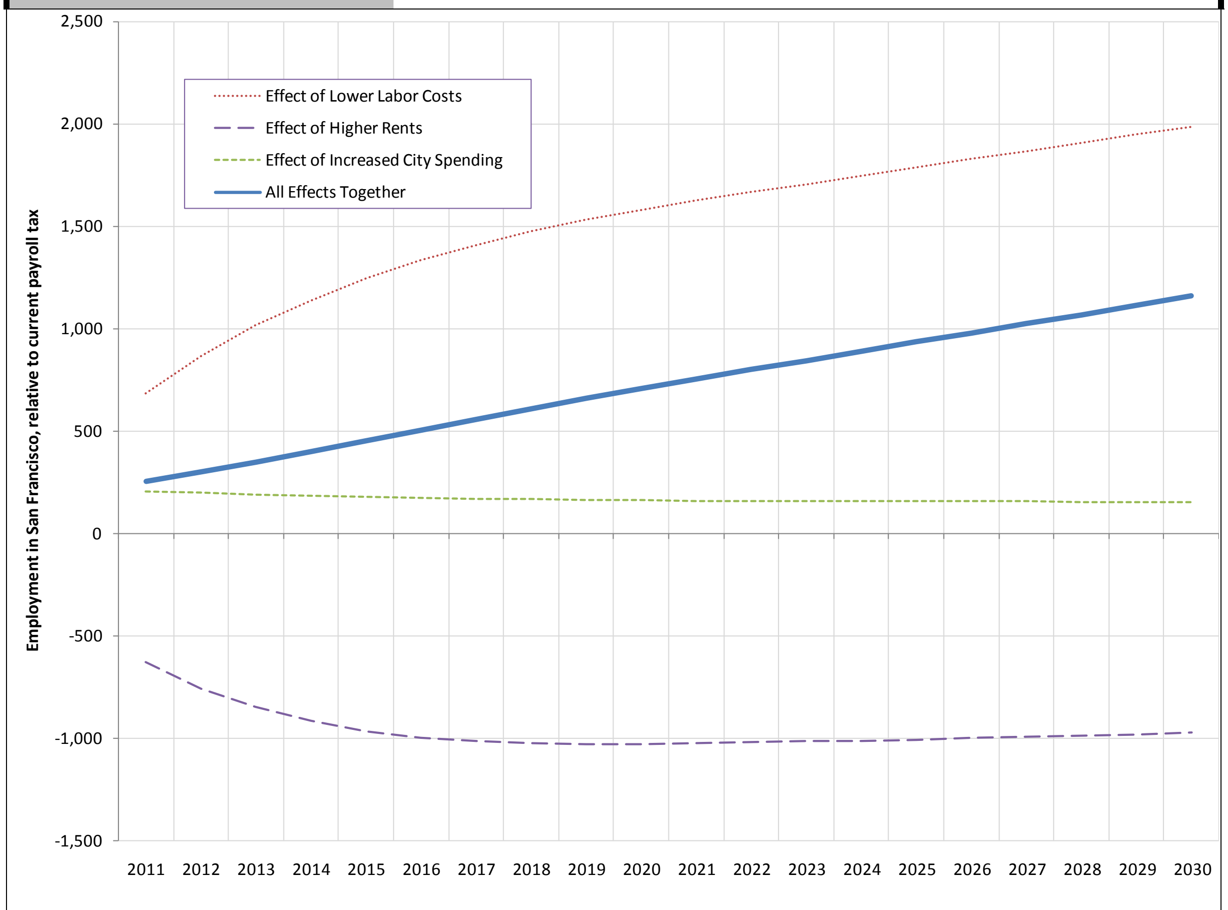
While the payroll tax is assessed against businesses, and causes them to hire fewer people than they otherwise would, it also likely causes San Francisco workers to accept lower salaries than they otherwise would, and therefore depresses earnings among workers in the city. If a jobseeker found that any potential employer in San Francisco was less likely to hire them because of the payroll tax, they would be more likely to accept some of that burden by accepting a lower salary.

When the payroll tax is lowered, not only does hiring increase, but so do worker earnings and business profits. Workers tend to spend locally, and businesses tend to reinvest locally; both generate multiplier effects that ripple throughout the city's economy.

A gross receipts tax on commercial rent, on the other hand, is shared between the property owner and the business. The income that is lost to the business does diminish local reinvestment and harms the economy, but the income that is lost to the property owner is generally capital gains that would not be spent or reinvested locally. Therefore, the multiplier effects of this tax are less. The overall economic impact of this tax, while negative, is not as negative as the current payroll tax.

The model also shows a net job increase of approximately 200 per year because of the higher City revenue generated by the progressive payroll option. If the payroll tax was cut to make the policy completely revenue-neutral to the City, this economic impact would disappear, but the positive impact of reducing labor costs would be even more striking.

FIGURE 6 **Estimated Employment Impacts of Switching from the Current Payroll Tax to the Progressive Payroll Tax Option**



Economic Impact of Switching to the Gross Receipts Option

The economic impact of the gross receipts option is qualitatively different than the progressive payroll option. The total economic impact is the aggregation of four individual effects, two positive and two negative.

The positive impacts are:

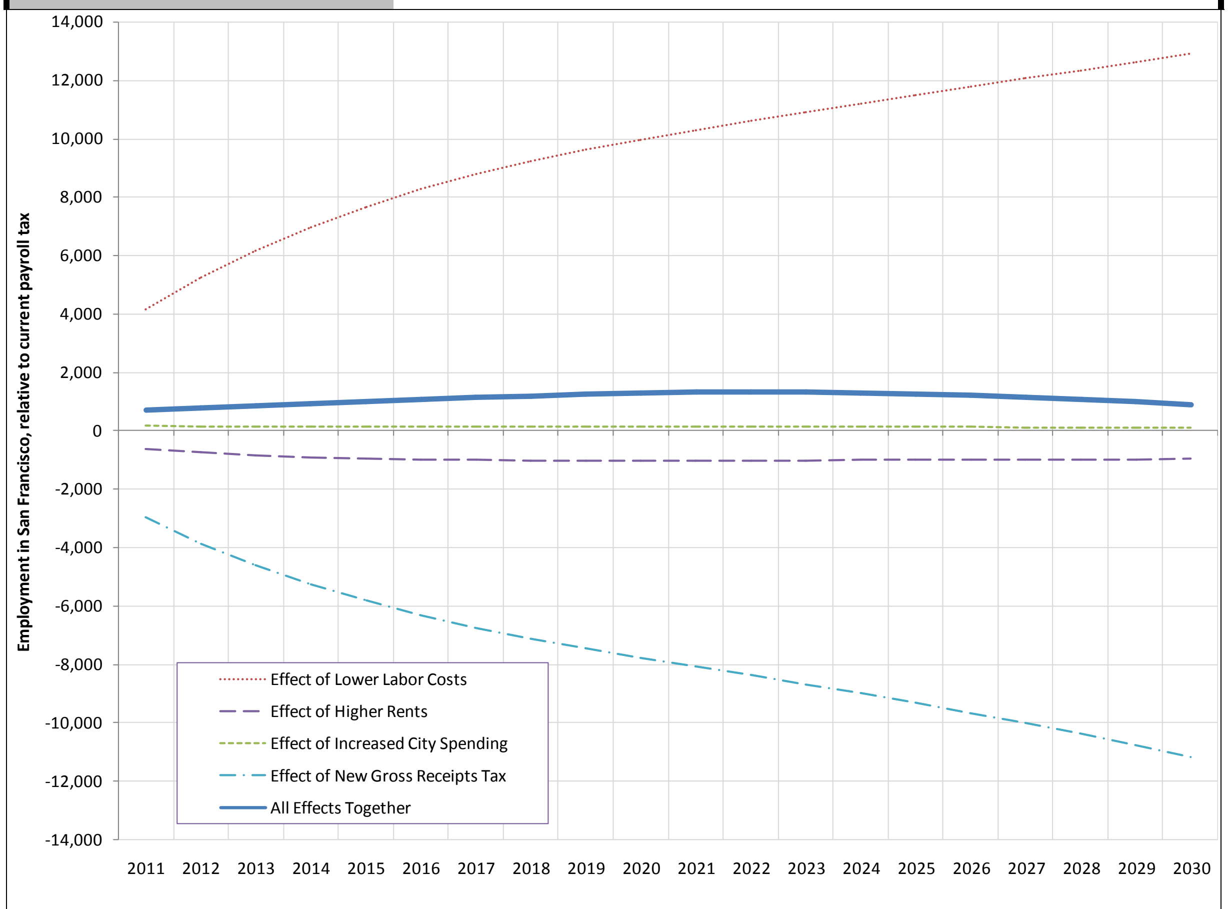
- Lowering the cost of labor by completely eliminating the payroll tax.
- Raising revenue for the City government.

The negative impacts are:

- Adding the new tax on gross receipts, which raises the cost of doing business generally and discourages job creation and expansion.
- Higher commercial rent, as in the progressive payroll option.

Despite the fact that there are two negative effects, the overall economic impact of the switch to the gross receipts option is slightly higher. The average job benefit is about 700 jobs in the first year, rising to nearly double that in ten years.

FIGURE 7 **Estimated Employment Impacts of Switching from the Current Payroll Tax to the Gross Receipts Tax Option**



CONCLUSIONS AND NEXT STEPS

Summary of Findings

This report has attempted to advance the policy debate in San Francisco concerning business taxes. The City's current payroll tax system has been widely acknowledged to discourage job creation and economic growth. This research has suggested that San Francisco can improve its business tax system by incorporating common elements found in other large cities in California, such as the taxation of gross receipts.

Because its cost can readily be passed through to commercial tenants, a gross receipts tax on commercial rent would have the fiscal advantages of indirectly broadening the base of business taxpayers. Such a shift also helps to move the City's tax base away from a tax on labor costs, which discourages hiring and depresses spending in the local economy. Based on the best available economic data, the Controller's Office has constructed two alternative taxes that will both create revenue and generate a positive economic impact.

Moreover, by moving away from a pure payroll tax, the City would diversify the revenue streams within its business tax, which would promote stability.

Administration Concerns

While the two alternatives do seem to offer improvements on three of the EASE criteria: efficiency, stability, and equity, the challenge of administering a new tax system should not be underestimated. The addition of a gross receipts tax on commercial rent would involve administering two different types of business taxes simultaneously. A switch to the gross receipts option would involve classifying businesses into over ten sectors and applying a different rate to each. It would also place new administrative burdens on taxpayers. In a progressive payroll structure, they would be required to report additional detail to the City regarding their payroll in the upper and lower brackets, although this information is generally tracked for federal tax purposes. In a gross receipts system, they would have to understand the applicable definitions of gross receipts and any apportionment issues, and could have additional compliance costs.

The City's costs are difficult to quantify at this point, and may only become clear if and when actual legislation to change the business tax system is drafted. In practice, the Office of the Treasurer and Tax Collector absorbs the costs of administering taxes from the tax revenue. It is important to appreciate therefore that actual revenue from a new business tax system would be slightly less than what is outlined here.

Considerations for Implementation

The progressive payroll and gross receipts alternatives detailed in this report were designed based on the best available economic information. However, if decision-makers were to move forward with one of the proposals, it would create a revenue risk for the City. This is particularly true for the gross receipts option. Because the City has not taxed gross receipts for many years, it lacks the information necessary to accurately estimate revenue from a tax switch.

If the City immediately switched to new business tax to either rate structure discussed in this report, the City's actual revenue could vary by 10% or more. To minimize this risk, and to allow the business community and broader economy time to adjust, the Controller's Office recommends a phasing-in strategy. Under Proposition 218, voters are required to approve a tax rate ceiling—a maximum rate. The City is free to set a lower rate by ordinance, without voter approval, at any time.

Under the progressive payroll option, a phase-in approach could involve asking the voters to approve a maximum rate, such as 1.395%, and then phasing this rate in over a five-year period. If the rate in Year 1 were 0.25%, at the end of Year 1 the City would be able to predict with considerably greater accuracy how much revenue the rent tax would generate. In Year 2, it could then reduce the payroll tax rates to an amount equivalent, in tax payment terms, to the rent tax generated in Year 1. A similar true-up could be made in each subsequent year of the phase-in, so that after five years, the final 1.395% rent tax and the appropriate payroll tax rate would be achieved. Phasing-in under the gross receipts option would be more complicated.

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Comments on this draft report are welcome. Please send your comments to:

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