Establishing a Progressive Payroll Expense Tax: Economic Impact Report

Item #100756

Office of Economic Analysis

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Overview

- The proposed legislation creates three major changes in San Francisco's business tax:
  1. a new tax on gross receipts from commercial rent, phased in from 2011 to 2013, to a final rate of 1.895%. Commercial landlords with gross receipts under $200,000 per year would be exempt from the commercial rent tax.
  2. a standard tax credit of $1,500 to all businesses. The credit does not reduce tax liability to less than zero.
  3. the creation of a progressive payroll tax structure, with a reduced tax rate on payroll for workers earning less than $85,000 per year.
- The lower-bracket rate is phased-in by formula, based on the revenue raised by the rent tax. This analysis is based on a lower bracket rate of 1.3% in 2013 and subsequent years.
- The upper bracket rate is 1.5%, the same as the current rate.

Background

- San Francisco's 1.5% payroll tax has been the subject of economic policy debate for many years.
- A recent Controller's Office study found that progressive payroll / commercial rent tax hybrid would be more efficient, equitable, and stable than the current payroll-only tax.
- This legislation is based on that study, although the commercial rent tax rate, and the revenue gain for the City, are both higher than the progressive payroll option detailed in the report.

Estimated Fiscal Impact: Key Points

- The rent tax is expected to generate approximately $73 million per year. This estimate is uncertain, as the City has not charged a commercial rent tax in the past.
- The standard payroll tax credit is expected to cost the City approximately $12 million per year.
- The legislation uses a formula to allocate 45% of this net revenue gain (rent tax less tax credit cost) to reducing the lower bracket payroll rate in the following year. The remaining 55% is kept for the General Fund.
- The General Fund increase is estimated at approximately $34 million per year, but this is uncertain and depends on the value of the rent tax.
- The Controller's Office estimates the resulting lower-bracket rate would be approximately 1.3%.

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Estimated Fiscal Impact: Budget Basis

Tax Year	Rent tax rate	Rent Tax Revenue	Tax Credit	Tax Credit Revenue	Cumulative Change in Payroll Tax Revenue	Net Budget Impact
2010	0.000%	$0.0	$0	$0.0	$0.0	$0.0
2011	0.632%	$24.5	$500	-$4.1	$0.0	$20.4
2012	1.263%	$49.0	$1,000	-$8.1	-$9.2	$42.9
2013	1.895%	$73.5	$1,500	-$12.2	-$18.4	$54.1
2014	1.895%	$73.5	$1,500	-$12.2	-$27.6	$44.9
2015	1.895%	$73.5	$1,500	-$12.2	-$27.6	$33.7
2016	1.895%	$73.5	$1,500	-$12.2	-$27.6	$33.7

Impact on Specific Businesses: 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 1.3%	$0	(exempt)
- Deduction	$1,500	
Progressive Payroll Tax	$0	
+ 90% of Rent tax passed through, @1.895%	$307	
Total Progressive Payroll Tax + Rent Increase	**$307**	
Gain (Loss) vs. Current Tax	**($307)**	

A small graphic design firm, with two employees, is exempt from the current payroll tax, and would be exempt from the progressive payroll tax as well.

However, they would likely see their occupancy costs rise, as commercial landlords will likely pass through the bulk of the rent tax. The firm's rents might rise by about $300 per year, or 0.05% of gross receipts.

Impact on Specific Businesses: 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 1.3%	$2,925
- Tax Credit	$1,500
Progressive Payroll Tax	$4,800
+ 90% of Rent tax passed through, @1.895%	$1,791
Total Progressive Payroll Tax + Rent Increase	**$6,591**
Gain (Loss) vs. Current Tax	**$159**

A dental office with ten employees would now pay the payroll tax, and, like all current business payers, would pass less in tax, because of the standard credit and the lower rate on payroll below $85,000.

Although the dental office's rents would rise, the net impact would be a slight savings of about $150, or 0.01% of gross receipts.

Impact on Specific Businesses: 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 1.3%	$8,580
- Tax Credit	$1,500
Progressive Payroll Tax	$8,430
+ 90% of Rent tax passed through, @1.895%	$3,837
Total Progressive Payroll Tax + Rent Increase	**$12,267**
Gain (Loss) vs. Current Tax	**($1,017)**

A hardware store with 18 employees would pay significantly less tax directly, but could expect a rent increase that offsets their tax savings about approximately $1,000 per year, or 0.01% of gross receipts.

Impact on Specific Businesses: 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 1.3%	$10,530
- Tax Credit	$1,500
Progressive Payroll Tax	$10,380
+ 90% of Rent tax passed through, @1.895%	$4,264
Total Progressive Payroll Tax + Rent Increase	**$14,644**
Gain (Loss) vs. Current Tax	**($1,144)**

A restaurant with 30 employees would pay significantly less in taxes, since nearly all of its payroll would fall into the lower bracket.

However, restaurants tend to be in higher-rent space, and their higher rent costs could lead to a net cost increase of approximately $1,100 per year, or 0.04% of gross receipts.

Impact on Specific Businesses: 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 1.3%	$32,240
- Tax Credit	$1,500
Progressive Payroll Tax	$40,040
+ 90% of Rent tax passed through, @1.895%	$5,969
Total Progressive Payroll Tax + Rent Increase	**$46,009**
Gain (Loss) vs. Current Tax	**$491**

Because wholesalers tend to have lower-paid employees, and low rent costs, these firms stand to benefit from the proposed legislation.

However, the gain is extremely small in the context of the size of the business: approximately $500 per year, or 0.0008% of gross receipts.

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Impact on Specific Businesses: 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 1.3%	$29,250
- Tax Credit	$1,500
Progressive Payroll Tax	$129,000
+ 90% of Rent tax passed through, @1.895%	$15,350
Total Progressive Payroll Tax + Rent Increase	**$144,350**
Gain (Loss) vs. Current Tax	**($9,350)**

A software company with 75 employees would be somewhat more under the progressive payroll tax proposal. Most of its payroll is in the upper bracket and would be taxed at the present rate of 1.5%, and it would also pay higher rent as the commercial rent tax is largely passed-through to them.

The net increase in costs could total $9,350, or about 0.03% of gross receipts.

Impact on Specific Businesses: 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 1.3%	$163,215
- Tax Credit	$1,500
Progressive Payroll Tax	$175,890
+ 90% of Rent tax passed through, @1.895%	$0
Total Progressive Payroll Tax + Rent Increase	**$175,890**
Gain (Loss) vs. Current Tax	**$26,610**

Most hotels in San Francisco own rather than rent their space, and would be significant winners under the progressive payroll tax proposal.

A large, 350 employee hotel would pay over $25,000 less, saving approximately 0.05% of gross receipts.

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Impact on Specific Businesses: 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 1.3%	$0	(exempt)
- Tax Credit	$1,500	
Progressive Payroll Tax	$0	
+ 90% of Rent tax passed through, @1.895%	$104,462	
Total Progressive Payroll Tax + Rent Increase	**$104,462**	
Gain (Loss) vs. Current Tax	**($104,462)**	

Commercial banks are exempt from all local taxation, and would continue to be exempt under the progressive payroll legislation.

However, they would pay higher rents, likely exceeding $100,000 per year, or 0.02% of gross receipts.

Economic Impact Factors

- Lower payroll costs: Lowering the payroll tax on workers below $85,000 will reduce the cost of hiring in San Francisco, creating jobs and boosting local spending.
- Higher occupancy costs: Commercial rent tax will raise occupancy costs and make San Francisco a less competitively-priced office location.
- Government spending: Increased City revenue will generate multiplier effects and maintain City services.
- The aggregate economic impact of the legislation is the combination of these individual effects.

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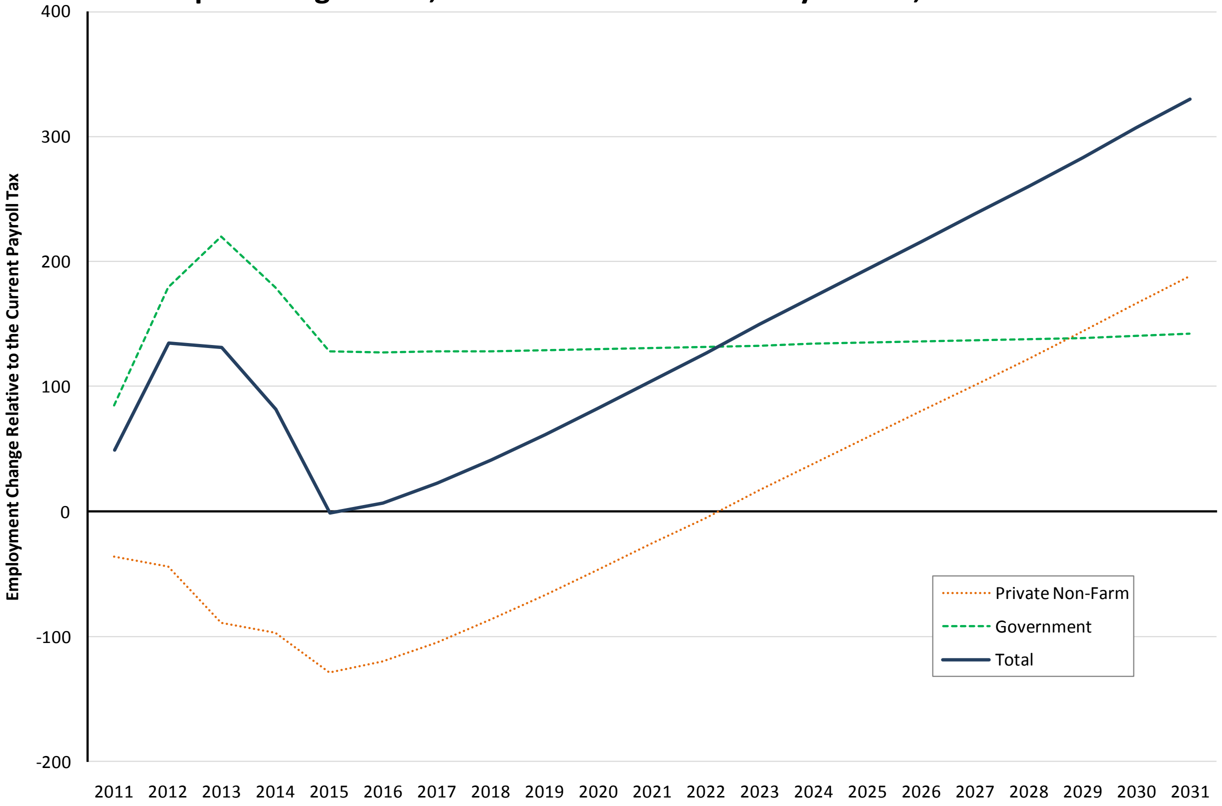
Economic Impact Assessment: Twenty-Year Employment Impacts

Public Sector, Private Sector, and Total Employment Impacts of the Proposed Legislation, Relative to the Current Payroll Tax, 2011-2031



The legislation will cause private sector employment will to decline, relative to the current payroll tax, until 2022, and then rise. The average private sector job impact is 6 jobs, or essentially zero, over twenty years.

However, the tax revenue raised by the legislation supports public sector employment. The total (public + private) job impact is projected to be positive every year except 2015, at the end of the phase-in.

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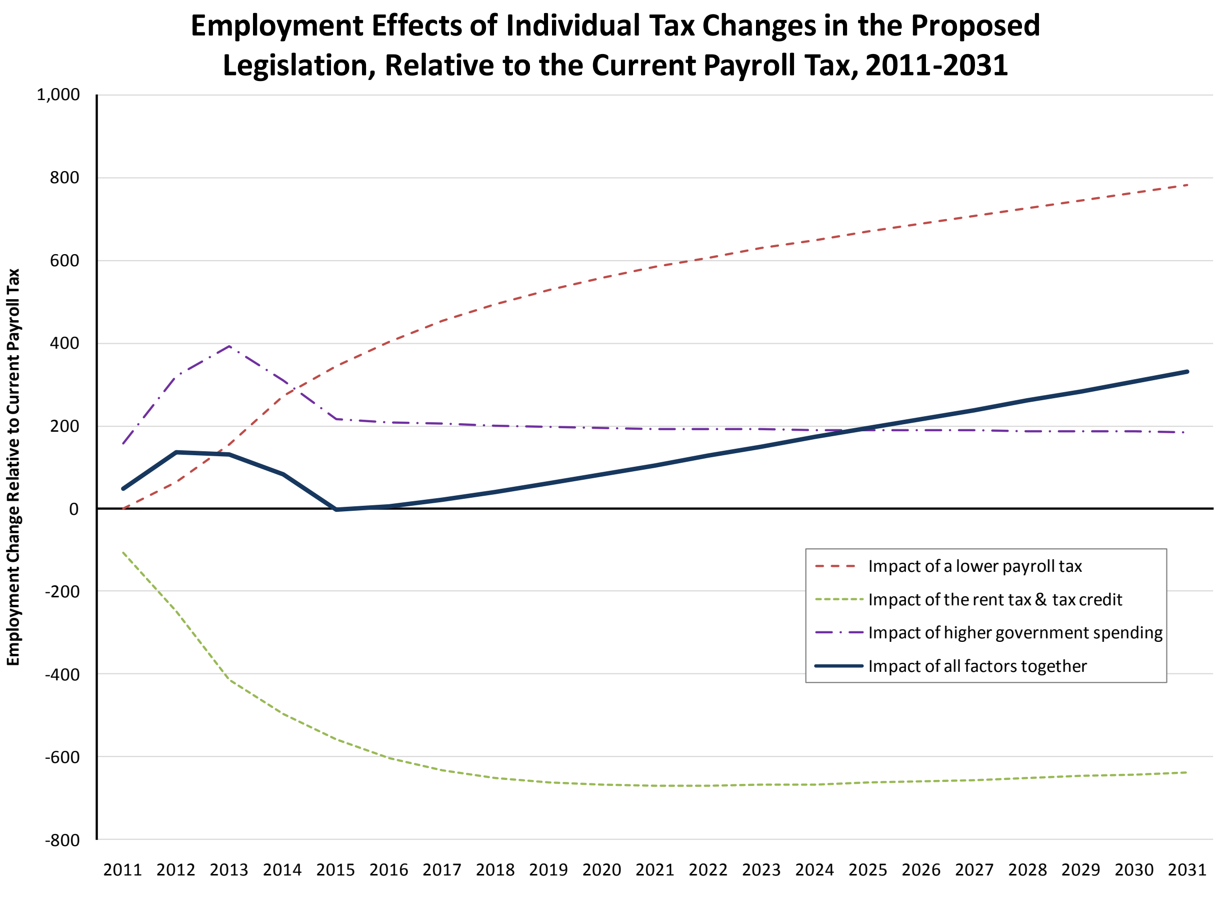
Economic Impact Assessment: Employment Effects by Factor



The overall job impacts of the legislation can be broken down by its individual tax and revenue items.

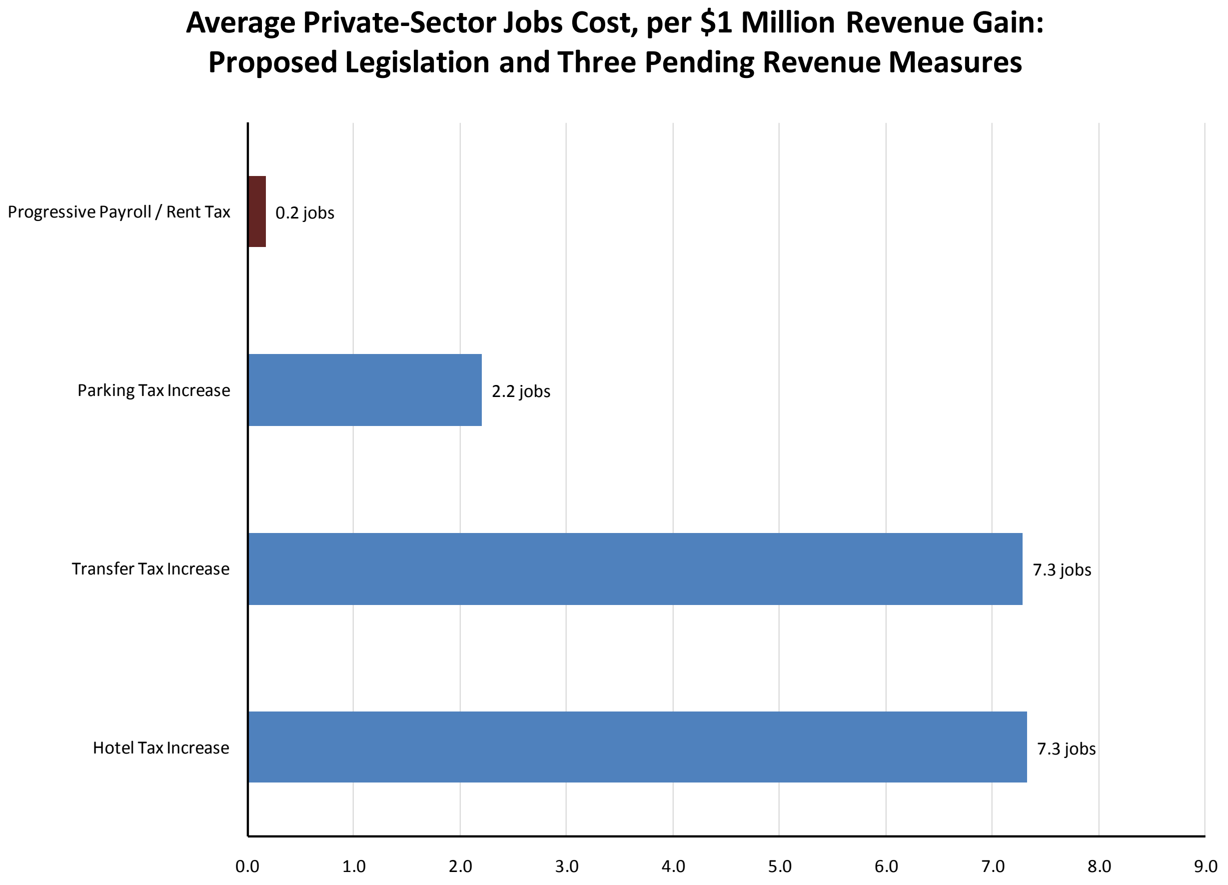
While the new rent tax & tax credit package would cost between 600-700 jobs per year, the lower payroll tax would create more jobs in the long run, after 2025.

In addition, the higher government spending will sustain about 200 jobs each year, in the public and private sectors, with more coming in the early years.

Economic Efficiency Relative to Other Tax Measures

- The private sector job cost of the proposed legislation can be compared to that of other tax proposals that have been introduced:
  - Real Property Transfer Tax Increase (100750)– will raise housing & occupancy costs, leading to wage inflation and reduced job growth in all industries.
  - 2% increase in the Hotel Tax – will be partly passed on to visitors, lowering occupancy, tourism spending, and tourism industry employment
  - Increase in the Parking Tax (100759)– will reduce consumer spending in San Francisco, reducing employment, mainly in retail trade.
- Detailed economic impact reports on transfer and parking tax measures are underway, and will be released shortly.

Estimated Private Sector Job Loss per $1 million in City Revenue Gained



The proposed legislation generates $35 million in revenue, at a net average cost of 6 private sector jobs over the next twenty years.

Given the precision of the OEA's REMI model, this is essentially a zero impact.

In comparison with the other tax measures that have been or may be introduced this year, the proposed legislation has by far the lowest negative private sector job impact.

Conclusions and Recommended Amendments

- The proposed legislation modifies the Progressive Payroll option in the Controller's report, to achieve greater revenue growth while minimizing private sector job growth.
- It is less damaging to the economy than other tax measures that have been introduced or discussed in 2010.
- Rent tax revenue estimates are highly uncertain. If the legislation is intended to raise $35 million in revenue, it might be advisable to modify the phase-in formula to ensure precisely that amount is generated.