Tax on Technology Companies to Fund Housing & Homeless Services: Economic Impact Report

Office of Economic Analysis

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Introduction

- The proposed legislation would impose a supplemental tax on the payroll expense of technology companies doing business in San Francisco, and reduce the business registration fees of businesses with less than $1 million in gross receipts within in the city.
- The supplemental tax, known as the "Homelessness and Housing Impact Technology Tax", would be set at a rate of 1.5% of an affected business's payroll in San Francisco, and would be imposed in addition to the Gross Receipts and Payroll Expense taxes now paid by businesses in the city.
- Although the tax is being proposed for the November 2016 ballot, the tax and fee changes would not go into effect until 2018.
- The proposed tax would be dedicated to housing and homeless services. As a dedicated tax, it would require approval by two-thirds of the voters to be adopted.
- The Office of Economic Analysis (OEA) has prepared this report because it has determined that the tax could have a material impact on the city's economy if it was adopted.

Rate, Tax Base, Applicability, and Timing of the Proposed Tax

- The proposed tax would be levied at the rate of 1.5% of a technology company's payroll expense in San Francisco.
- "Payroll expense" is defined in the proposed tax exactly the same way it is defined in the City's existing Payroll Expense Tax, except none of the current exclusions, such as those for stock options, may apply to the proposed tax.
- Any technology company with less than $1 million in San Francisco gross receipts would be exempt from this proposed tax. Such businesses would still benefit from the reduction in business registration fee.
- The tax would go into effect on January 1, 2018. Small businesses would begin paying the reduced business registration fee in Spring, 2018.

Current and Proposed Annual Business Registration Fees

For Wholesale and Retail Trade, and Certain Services

Gross Receipts	Current Fee	Proposed Fee
$0 to $100,000	$75	$45
$100,001 to $250,000	$125	$75
$250,001 to $500,000	$200	$125
$500,001 to $750,000	$400	$250
$750,001 to $1,000,000	$600	$350

For All Other Businesses

Gross Receipts	Current Fee	Proposed Fee
$0 to $100,000	$90	$45
$100,001 to $250,000	$150	$75
$250,001 to $500,000	$250	$125
$500,001 to $750,000	$500	$250
$750,001 to $1,000,000	$700	$350

Definition of a Technology Company

- The proposed tax defines "technology company" as a company doing business in San Francisco that receives any gross receipts from any of five technology business activities, defined in the North American Industrial Classification System (NAICS).
- The definition of technology company in the legislation is broader than the definition used by government statistical agencies, which classify businesses by their ***primary*** activity. Even companies operating in the city whose primary activity is not technology would owe the proposed tax, if they received ***any*** sales, at any location, from a business activity described by those NAICS codes.
- The tax is paid against the full amount of payroll expense incurred by an affected company within San Francisco, even if no San Francisco employees work in any of the technology business activities covered by the tax.
- The applicable technology business activities are:
  - Computer & Peripheral Equipment Manufacturing (NAICS 3341)
  - Software Publishing (NAICS 5112)
  - Data Processing, Hosting, and Related Services (NAICS 5182)
  - Internet Publishing & Broadcasting and Web Search Portals (NAICS 51913)
  - Computer Systems Design and Related Services (NAICS 5415)

Policy Background: Stock Options and Payroll Tax Exclusions

- In 2004, the City amended[*] the Payroll Expense tax to include "property issued or transferred in exchange for the performance of services (including but not limited to stock options)".
- Early-stage technology companies particularly utilize stock options, which are opportunities for employees to purchase company stock at a discount, if it becomes successful in the future.
- If a company's stock options become particularly valuable, the City's taxation of them can create an incentive to move out of San Francisco. No other city in the Bay Area taxes stock options.
- The recognition that the taxation of stock options creates an incentive for early-stage companies to leave the city was a motivation for two payroll tax exclusions[ǂ] passed by the City in 2011. Both exclusions allowed early-stage technology companies to avoid some tax on stock options.
- As discussed earlier, the new tax would not allow any exclusion of stock options.

[*] Ordinance 26-04
[ǂ] The Central Market Payroll Tax Exclusion (Ordinance 68-11) and the Pre-IPO Stock-Based Compensation Exclusion (Ordinance 87-11)

Policy Background: 2012 Shift from Payroll To Gross Receipts

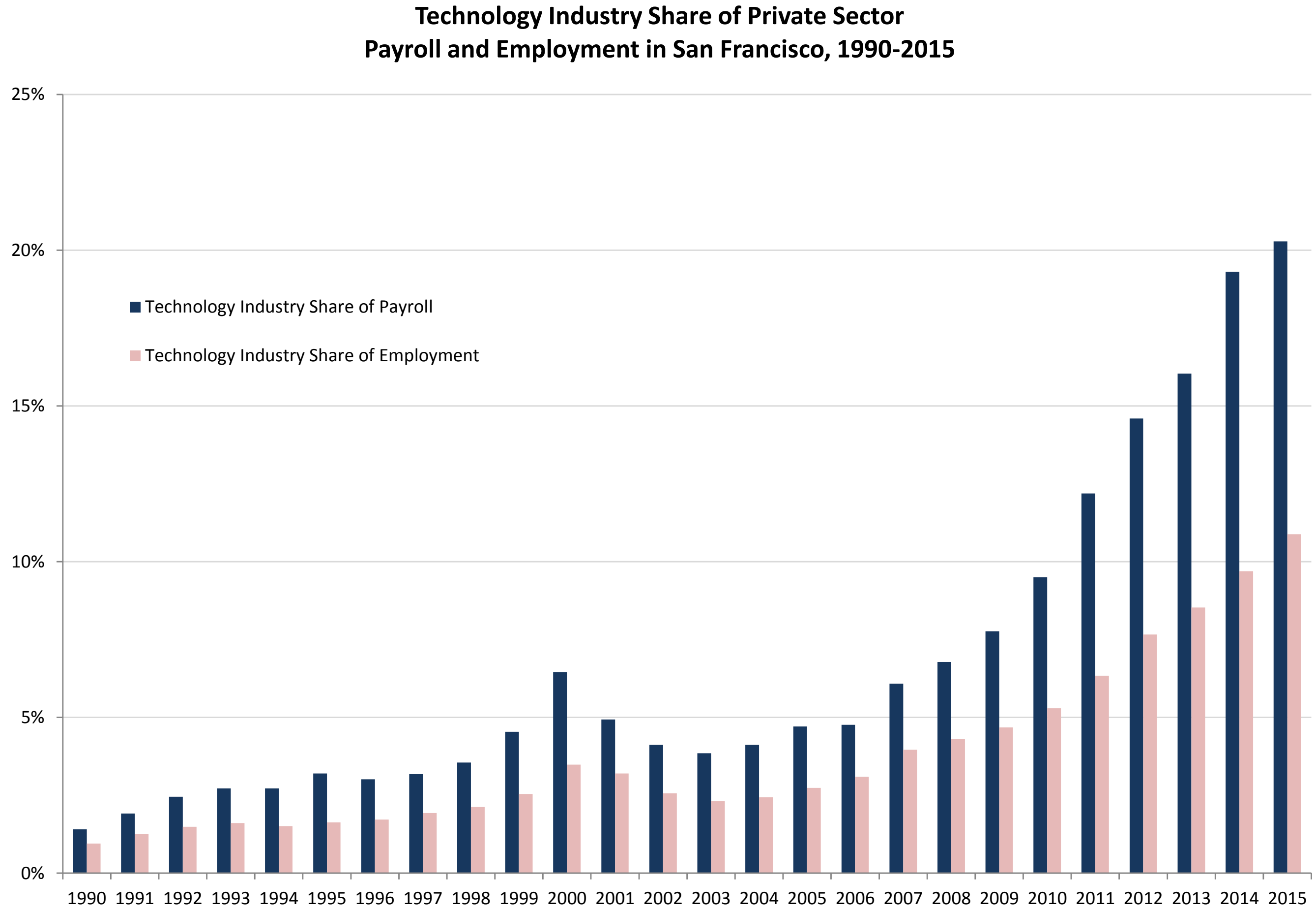
- In 2012, San Francisco approved the introduction of a new business tax on Gross Receipts*, and a phase-out of the Payroll Expense Tax, which the City has levied on businesses for several decades.
- The new tax was designed to phase in gradually over the 2014-18 period, while the Payroll Expense Tax is phased out in a way that is revenue-neutral to the City and business taxpayers.
- At the end of the phase-in period in 2018, the City will have either fully phased-out, or greatly reduced, the Payroll Expense Tax.
- The proposed tax would only go into effect after the phase-in is completed. If enacted, the City could potentially have three business taxes: a Gross Receipts Tax, a residual Payroll Expense tax, and the new tax on technology companies.

* Proposition E in 2012.

Revenue Impacts of the Proposal

- The Controller's Office has estimated that the proposed tax will generate between $70 million and $140 million per year, based on economic statistics produced by the federal Bureau of Labor Statistics (BLS). This is approximately 20% of the City's existing business tax, from its Gross Receipts and residual Payroll Expense taxes.
- As discussed earlier, the proposed tax would apply to more companies than those identified as technology companies in BLS statistics . The tax counts a company with any technology sales as a technology company, while the BLS classifies a company based on its primary business activity.
- For this reason, the Controller's estimates likely understate the actual revenue the tax will generate. However, there is no better source of economic data with which to make a revenue estimate.
- The proposed reductions to the business registration fee for small businesses are expected to reduce revenue by $5.3 million per year. This estimate is more robust than the tax revenue estimate can be.

Technology's Expanding Role in San Francisco's Economy



During this decade, the Technology sector has transformed San Francisco's economy. The sector's share of the city's total private sector payroll and employment has more than doubled in the five years from 2010 to 2015.

By 2015, technology was three times as important as it was in 2000, at the height of the original dot-com boom.

Any tax focused on this industry will therefore have a significant effect on the future of the city's economy, and City revenues.

Evaluating Tax Policies: the EASE Principles

Major tax proposals are often evaluated according to a multi-faceted set of criteria that address their impacts on the economy, City administration and budgeting, and equity. These principles are sometimes summarized with the acronym EASE:

- **E**fficiency – what are the economic costs and benefits of the proposal?
- **A**dministration -- how does the proposal affect the City's cost of administering the tax?
- **S**tability – does the proposal increase or decrease the stability of the City's tax revenues?
- **E**quity – does the proposal make the tax system more equitable?

Efficiency: What are the Economic Costs and Benefits?

- Like any tax, the proposed supplemental payroll tax would create economic costs and benefits within the city's economy.
- We project the proposed tax would affect the economy in the following ways:
  - By increasing the cost of labor for technology companies, it would tend to reduce the number of workers employed by that sector, and the wages they earn.
  - The reduction in technology sector employment and wages would create negative multiplier effects in the local economy, such as reduced demand for business services, business travel, and building services that support technology companies.
  - To the extent the reduction of employment in the city reduces the desire of technology workers to live in the city, the tax will lead to lower demand for housing and consumer goods such as retail goods, personal services, and restaurants and bars.
  - On the other hand, as mentioned earlier, the tax is dedicated to homeless services and affordable housing. That government spending creates a stimulative effect in the local economy.
  - Furthermore, is likely that investment in homeless services improves the economic prospects of homeless people, and therefore in the long term reduces social service costs born by the public sector. However, the OEA is unable to quantify those benefits for this report.

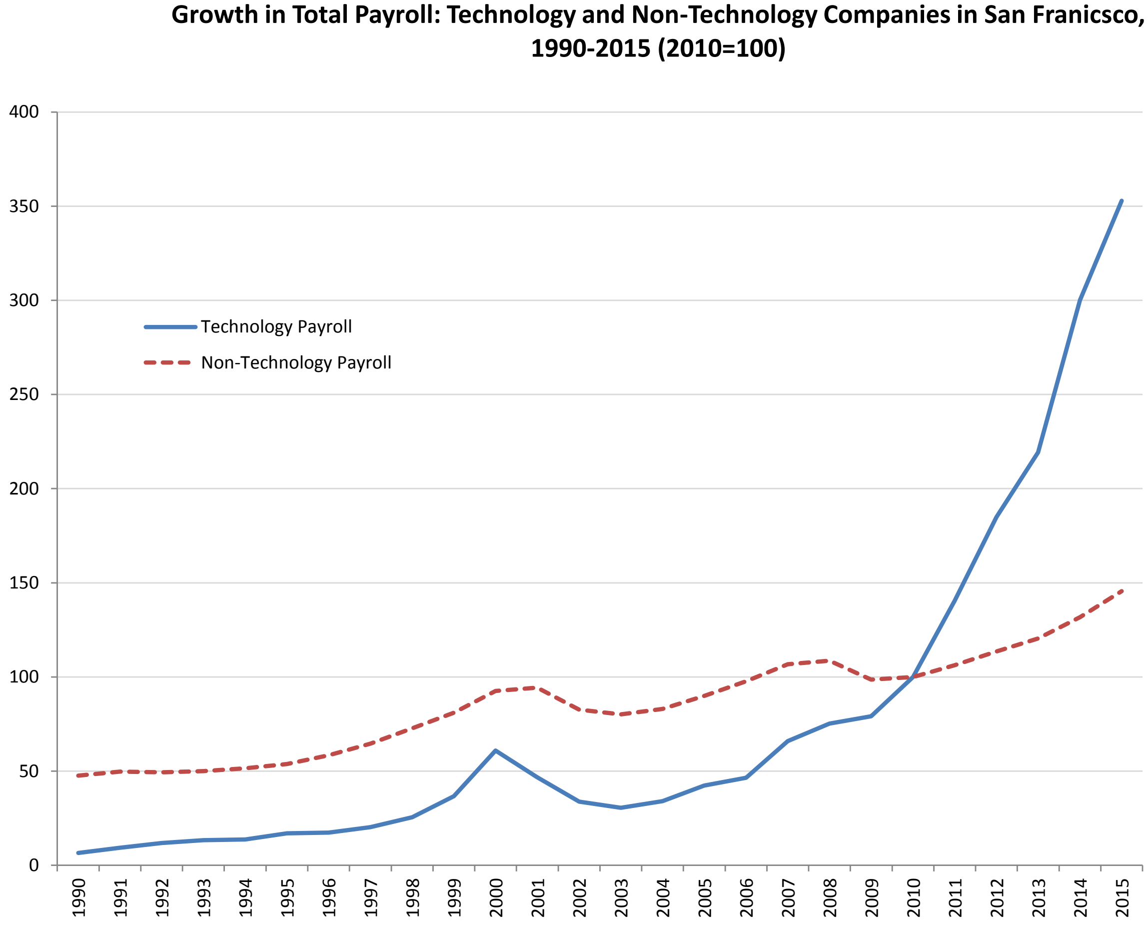
Economic Impact Assessment

- Using our REMI model of the San Francisco economy, the OEA simulated the impact of the following changes:
  - a 1.5% increase in payroll expense for the technology industries identified in the legislation.
  - a $115 million increase in City spending on housing and homeless services.
- The simulation modelling suggests that the proposed tax will result in:
  - A net loss of approximately 870 jobs over a twenty-year forecast period.
  - A decline in earnings in every sector except social services, with the greatest decline (0.6%) in the Information and Professional Services sectors.
  - A decrease in housing prices of 0.18%.
  - Despite the decrease in housing prices, real personal income (personal income adjusting for prices, including housing prices), is projected to decline by 0.13%, because of the decline in employment and wages.
- Because the decline in earnings will more than offset the decline in housing prices, housing will be less affordable, on average.
- This is possibly the case because some of the tax would fall on technology company employees, many of whom do not live in the city. Technology workers who live, but do not work, in the city would be unaffected. Hence their demand for housing would be unchanged by the tax.

Administration: The City's Costs of Administering the Tax

- Administration costs reduce the efficiency of a tax, because they represent the government's cost of collecting the tax revenue. The greater the administrative cost, the less funds are available for public services.
- The City's business tax administration costs have risen significantly since the adoption of the new Gross Receipts tax, both because of the need to prepare to administer an entirely new tax, and because the Treasurer's Office is administering two separate business taxes at the same time.
- After the phase-in period is completed, if the payroll tax is fully phased-out, administration are expected to decline, because only one business tax would be administered.
- If the proposed tax were adopted, the City would be administering two distinct business taxes for a indefinite period of time.
- Since the proposed tax would not go into effect until 2018 anyway, changing the Gross Receipts Tax in 2018, rather than introducing an entirely different tax, would minimize the City's administrative costs.

Stability: Does the Tax Facilitate Budgeting by Being Stable?



Stability is an important criterion for assessing a tax system because unstable revenues introduce uncertainty and inefficiency into the budget process, creating either greater budgetary risk, or a need for higher reserves.

The chart to the left indicates the growth of the total payroll of technology companies and the remainder of San Francisco's private sector, from 1990 to 2015. Technology payroll is three times more volatile than the rest of the city's private sector, so a tax on technology payroll will reduce the stability of the city's tax revenues.

Equity: Is the Tax Fair?

- The equity of tax proposals are often described in "vertical" or "horizontal" equity terms:
  - Vertical: Do those with the greatest ability to pay, pay the most tax?
  - Horizontal: Does the tax treat payers equally, when they have an equal ability to pay?
- The evaluation tax equity at a local level in California is somewhat challenging, because California cities are prohibited from taxing business or personal income, the clearest measure of "ability to pay".
- Instead, cities typically rely on proxies that more roughly reflect ability to pay, like business size. The City's Gross Receipts Tax, for example, charges higher rates for higher gross receipts tiers.
- The proposed tax is a flat 1.5% tax, but the growth and high wages of the technology sector suggests a high ability to pay. On vertical equity terms, therefore, the proposed tax likely makes the business tax system more equitable.
- Technology is not, however, the only industry that has been growing or the only industry that pays high wages. By not proportionally increasing the tax on other industries that may have a comparable ability to pay, the proposed tax is likely less equitable on horizontal terms.

Conclusions and Recommendations

- Because the technology industry has become such an important part of San Francisco's economy, the proposed tax would likely have a major impact on the future of the local economy, and City finances.
- While the Controller's Office has projected the tax could raise $70-$140 million, this is likely an underestimate, given the broad definition of "technology company" in the tax.
- While the tax would put downward pressure on housing prices in San Francisco, by limiting demand, our analysis indicates it would put greater downward pressure on earnings. For this reason, it would, on average, make housing less affordable in San Francisco.
- In addition, the proposed tax would reduce the stability of the City's business tax revenue, and increase administration costs.
- If the City wishes to raise an additional $120 million in business tax revenue in 2018, it may be more straightforward to simply adjust the Gross Receipts Tax rates at that time. Such an approach would minimize the economic harm of re-creating the payroll tax, promote greater revenue stability, and reduce the City's administrative costs.

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