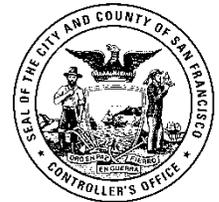


Review of the Impact of the Central Market Payroll Tax Exclusion



October 27, 2014



City and County of San Francisco

Office of the Controller - Office of Economic Analysis

Review of the Impact of the Central Market Payroll Tax Exclusion

October 27, 2014

Main Conclusions

In 2011, the City created a payroll tax exclusion for businesses operating in the Central Market Street / Tenderloin Area. The policy allows businesses to exclude from taxation all additional payroll above the payroll in their base year, generally either 2011 or their first year in the Area. The businesses are responsible for continuing to pay the payroll tax on their base year payroll.

In 2013, 15 businesses used the exclusion, reducing their payroll tax liability by \$4.2 million in that year. This report was written because of a requirement in the legislation that the Controller's Office report on the effects of the exclusion after three years.

The report reviews the change in a number of economic indicators within the Area during the period that the exclusion has been in effect. To provide context, changes in the same indicators in the rest of the city, during the same period, were also calculated. Among the findings are:

- Businesses within the Area paid \$7.6 million more in payroll tax in 2013 than they did in 2010. While some increase would be expected because of the economic recovery, the Area generated \$7.1 million more in payroll tax than it would have, if it had grown at the same rate as the rest of the city from 2010 to 2013. This new revenue represents the base year payroll tax of businesses which took the exclusion, as well as the full payroll tax of businesses in the Area which did not take the exclusion. Based on average wage information for the city, this \$7.1 million in payroll represents approximately 3,000 jobs.
- Also based on payroll tax filings, there were 61 more businesses in the Area in 2013 than there were in 2010. Again, some increase would be expected, but there were 32 more than there would have been if the number of businesses in the Area grew the same rate as the rest of the city from 2010 to 2013.
- Taxable sales, which reflect the health of neighborhood-serving retail businesses, grew more slowly in the Area than the rest of the city from 2010 to 2013—a 10% increase as opposed to a 25% increase in the rest of the city. Had taxable sales in the Area grown at the same rate as the rest of the city, an additional \$90,000 in sales tax would have been generated.
- An examination of trends in commercial rent, residential asking rents, and housing values in the Area revealed that, while increases have been rapid since the exclusion took effect, similarly rapid increases were seen in the rest of the city, and there was no appreciable difference between the Area and the rest of the city in the growth of commercial and residential rents, and housing prices.

In assessing the role of the exclusion in creating these trends, the report concludes that it likely was the primary reason for the relatively greater of growth in businesses within the Area.

For the city as a whole, the net fiscal impact hinges on whether the exclusion prevented the businesses which took it from moving out of the city. To the extent that it did, the payroll tax growth within the Area represents new revenue for the City, and the foregone payroll tax from the exclusion is revenue the City would never have received, and thus the net effect would be beneficial to the City.

Conversely, to the extent that it did not retain businesses in the city, and only incentivized them to move into the Area as opposed to staying elsewhere in the city, the payroll tax growth in the Area would not represent new revenue to the City, the foregone payroll tax from the exclusion would represent a real fiscal cost, and the net fiscal impact would be negative.

The possibility that a local business tax exclusion could prevent businesses from moving out of the city is magnified by the fact that San Francisco's payroll tax includes stock-based compensation, which can be significant for young technology companies approaching an initial public offering, or other sale of stock. Every major company that used the exclusion is a relatively young technology company. It may therefore be reasonable to assume that at least some of them remained in the city because of the exclusion, but it is impossible to determine with certainty for any particular company.

Regardless of whether the exclusion created a net fiscal benefit or cost for the city as a whole, its impact on the overall city economy was likely quite limited. Depending on how many businesses were retained in the city by the exclusion, it would be responsible for between 0% to 5% of the job growth the city has seen since 2010. Moreover, it is very likely that any business that was retained in San Francisco by the exclusion would have otherwise moved to a nearby city, had it not been enacted. For this reason, the impact of that job growth on other changes in the local and regional economy, such as rising housing prices, would likely have occurred in any event.

INTRODUCTION

The Central Market Payroll Tax Exclusion

In 2011, the City created a payroll tax exclusion for businesses operating in the Central Market Street / Tenderloin Area. At that time, businesses in San Francisco with over \$250,000 in payroll paid a 1.5% tax on their payroll expense in the city.

The exclusion defined a zone, covering most of the Tenderloin and Market Street from Fifth Street to Eleventh Street. It allows a business to exclude from taxation all additional payroll above the payroll in its "base year", generally either 2011 or its first year in the Area. The business is responsible for continuing to pay the payroll tax on its base year payroll.

The exclusion thus reduces the amount of payroll that would be subject to the tax, and is effectively a tax incentive for a business to locate or remain within the Area.

The Office of Economic Analysis (OEA) has prepared this report in response to a requirement in the legislation that the Controller's Office "perform an assessment and review of the effect of the Central Market Street and Tenderloin Area payroll expense tax exclusion on the Central Market Street and Tenderloin Area."

The report has four parts. The first reviews the details of the legislation and provides a map of the Central Market Street and Tenderloin Area, as defined therein. The second reviews reports by the Offices of the Treasurer, Assessor, and City Administrator. The third presents analysis of a number of indicators of economic activity in the area. Trends within the neighborhood are compared to city-wide trends, to provide a frame of reference. The final section considers the extent to which the exclusion has had neighborhood-level and city-wide fiscal and economic impacts.

The following indicators are reviewed:

- Payroll tax
- Number of payroll tax-paying establishments
- Sales tax
- Property tax
- Transfer tax
- Commercial rent
- Residential rent
- Housing values

Details of the Legislation

The exclusion allows businesses that move into the Area to exclude any payroll within the area above a base year value. The exclusion therefore creates an incentive to add new employment in the Area, by making that the payroll on that employment tax free.

In order to qualify, a business must pre-qualify through the Office of Economic and Workforce Development, and agree to participate in the City's First Source Hiring Program. A business utilizing the exclusion that has more than \$1 million in payroll must enter into a Community Benefit Agreement (CBA) with the City Administrator.

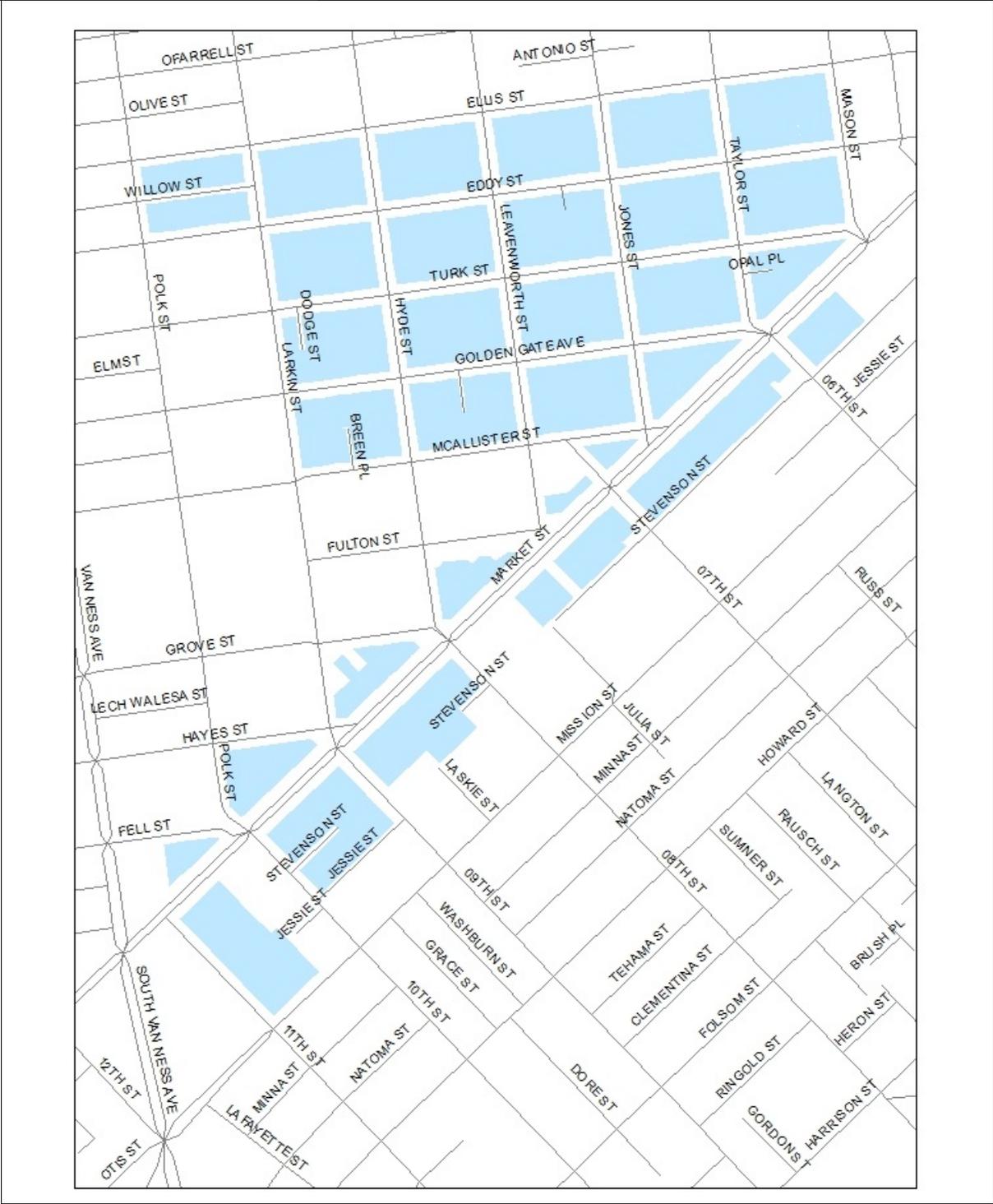
The legislation allows any company to utilize the exclusion for a maximum of six years. The legislation expires eight years after its effective date, in 2019.

The Central Market / Tenderloin Area

For the purposes of this report, the Central Market and Tenderloin Area ("the Area") is defined as the parcels shown in Figure 1. The map also includes certain large commercial properties on Market Street that are not eligible for the exclusion, namely 1145, 1155, 1275, and 1455 Market Street. These properties are also considered to be part of the Area for the purposes of the analysis in this report.

FIGURE 1

Central Market Street and Tenderloin Area



OTHER CITY REPORTS

Treasurer's Annual Reports

The legislation directs the Office of the Treasurer & Tax Collector to submit annual reports to the Board of Supervisors to provide "aggregate information on the dollar value of the Central Market Street and Tenderloin Area exclusions taken each year, the number of businesses taking the exclusion and the change in the number of businesses located in the Central Market Street and Tenderloin Area of the City."

On June 20, 2014, the Tax Collector provided his report for 2013. That report included the number of companies approved for the exclusion, and the effective payroll tax foregone as a result of the exclusion, for the three years 2011, 2012, and 2013. That information is summarized in Table 1 below. In 2013, \$4.2 million payroll tax was foregone because of the exclusion, and a total of \$6.1 million was foregone over three years.

TABLE 1		Payroll Tax Foregone as a Result of the Exclusion, 2011-2013	
<u>Year</u>	<u>Businesses Approved for the Exclusion</u>	<u>Payroll Tax Foregone (\$ million)</u>	
2011	2	\$0.0	
2012	14	\$1.9	
2013	11	\$4.2	

Source: Office of the Treasurer & Tax Collector

Some businesses were qualified for the exclusion for more than one year. According to the Treasurer's Office, 19 different businesses have received the exclusion at least once over the three year period.

It is likely that the amount of payroll tax foregone under the exclusion will rise when the Treasurer's report for 2014 is issued next year. Based on the Community Benefit Agreements (see Table 2 below), it is public information that the social media company Twitter utilized the exclusion in 2013. On November 7, 2013, Twitter made an initial public offering (IPO) of its stock, which valued the company at \$25 billion¹.

On May 6, 2014, the lock-up agreement that limited the ability of Twitter's insiders to sell their stock holdings to the

¹ Olivia Oran and Gerry Shih, "Twitter shares soar in in frenzied NYSE debut", *Reuters*, November 7, 2013. Accessed October 22, 2014, <http://www.reuters.com/article/2013/11/07/us-twitter-ipo-idUSBRE99N1AE20131107>.

public was reported to have expired². On that date, 82% of Twitter's equity was reportedly able to be sold, and the sharp decline in the stock's price on that date suggests that some of Twitter's insiders did sell some of their holdings.

Employee gains from the sale of employer stock-based compensation are considered taxable payroll under the City's payroll tax. If Twitter were to exclude payroll expense that resulted from employees selling stock after the expiration of the lock-up agreement, it would appear as excluded payroll for 2014, not 2013, the year of the IPO. The OEA has no way of knowing how much foregone revenue this might represent, but given the size of Twitter's IPO, it could have a notable effect on the amount of foregone payroll tax reported by the Treasurer in future years.

The extent to which foregone payroll tax revenue represents an actual revenue loss to the city is an issue addressed in the concluding section of this report.

Assessor-Recorder's Reports

The legislation also directs the Office of the Assessor-Recorder to report to the Board "any identifiable increases in property value resulting from businesses' location, relocation or expansion to or within the Central Market Street and Tenderloin Area."

In August, 2014, the Assessor-Recorder submitted a report for 2013 which did not attribute any increase in secured property tax to the exclusion, as none of the businesses receiving the exclusion owned any secured property within the Area. The Assessor's report did note that the businesses receiving the exclusion paid \$855,864 in business personal property tax (on business equipment). This tax was not affected by the payroll tax exclusion.

City Administrator's Reports

The legislation also directs the Office of the City Administrator to submit an annual report to the Board that sets forth "any and all Community Benefit Agreements that have been entered into with the Office of the City Administrator of Workforce Development during that year".

The City Administrator's website lists those businesses that entered into CBAs in each year of the exclusion. Those companies are listed in Table 2 below.

² "Twitter skids nearly 18% as lock-up period expires", Reuters with CNBC.com, May 6, 2014. Accessed October 22, 2014, <http://www.cnbc.com/id/101645678>.

TABLE 2**Community Benefit Agreements Established with Businesses Receiving the Exclusion**

Year of CBA	Business
2012	Zendesk
2013	21 Tech
2013	One Kings Lane
2013	Twitter
2013	Yammer
2013	Zendesk
2013	Zoosk

Source: Office of the City Administrator

The details of the CBAs themselves are available from the website of the City Administrator³. Each of these agreements is unique and reflects an agreement between each company and the City Administrator, incorporating the feedback of a Citizen's Advisory Committee created for that purpose.

While these agreements are designed to provide tangible benefits to the Area's residents, their variety makes them difficult to evaluate as a group. Accordingly, this report makes no attempt to quantify the value of the CBAs in monetary terms.

³ The 2012 agreement can be found at <http://www.sfgsa.org/modules/showdocument.aspx?documentid=8285>. The list of 2013 agreements may be found at: <http://www.sfgsa.org/index.aspx?page=6544>.

ECONOMIC CHANGES IN THE AREA

Approach

This section reviews economic trends in the Central Market and Tenderloin area during the period the exclusion has been in effect. The section uses, to the greatest extent possible, a consistent approach to studying trends. The change in an indicator within the Area, during the exclusion period is compared to the change in the same indicator in the rest of the city, where the exclusion did not apply.

This approach can provide important context. In comparison to simply examining trends within the neighborhood, it allows a correction for both cyclical factors, such as the post-2011 economic recovery, and city-specific factors, like San Francisco's unusually rapid growth in technology industry employment, housing prices, and commercial rents. Comparing change in the Area to change in the rest of the city allows more of a focus on the effect of the exclusion alone.

The comparison is not perfect, however, because the Area is not the city in microcosm. A common approach in policy analysis is to identify a comparable area that was not subject to the policy, as a "control group", and then compare the performance of the area which received the policy (the "treatment group") to the control group. The difference in performance between the two groups can then be attributed to the policy.

We relied on the rest of the city as a control group, because it was difficult to identify a comparable neighborhood in San Francisco to the Central Market / Tenderloin Area. The area in question houses a large share of the city's non-profit social service providers. It has many low income residents, and many small retail and industrial businesses in small, older buildings. It possesses several million square feet of office space, as well as commercial storefronts along Market Street which had experienced abandonment for many years. While there are neighborhoods across San Francisco that are similar in some respects, in our opinion there is none that could serve as a basis for direct comparison.

Secondly, data limitations exist for some of the indicators we examine in this section, which inhibit a fine-grained comparison of two neighborhoods. Instead, we use the rest of the city as the control group, recognizing the limitations of the comparison, and use caution in attributing all differences to the exclusion.

Payroll Tax Revenue in the Area

Because the City levies a payroll tax against most of the larger businesses in the city, payroll tax information is a good way to assess both the economic and fiscal impacts of the exclusion on the Area and the city.

Since 2010, the Office of the Treasurer & Tax Collector has been tracking the payroll tax of businesses on an address-by-address basis. Prior to that year, payroll tax was only tracked at the level of the business as a whole, and not disaggregated to individual establishments.

The Treasurer's Office provided us with reported payroll expense paid by address, which were then associated with the Assessor's Parcel Numbers (APN) eligible for the exclusion. Businesses with less than \$250,000 of payroll are exempt from the payroll tax, and their growth is therefore not reflected in this analysis.

TABLE 3		Payroll Tax, Central Market / Tenderloin Areas and Rest of City, 2010-2013			
	2010 Payroll Tax	2013 Payroll Tax	Change, 2010-2013	% Change, 2010-2013	
Central Market / Tenderloin Area	\$1.2	\$8.8	\$7.6	648%	
Rest of City	\$337.5	\$496.6	\$159.1	47%	

Source: Office of the Treasurer & Tax Collector

Table 3 indicates that payroll tax in the Central Market and Tenderloin Area grew much more rapidly than in the City as whole: a 648% three-year increase within the area, compared to a 47% increase in the rest of the city.

Businesses in the Area paid \$7.6 million more in payroll tax in 2013 than they did in 2010. While some of this growth would be expected because the city's economic recovery, the Area generated \$7.1 million more in payroll tax revenue than it would have if it had had grown at the same rate as the rest of the city during the three years.

This growth occurred notwithstanding the fact that many of these companies used the exclusion to reduce their payroll tax. The growth consists of the base year payroll of new companies to the Area who took the exclusion, and the full growth of payroll of companies in the Area who did not take the exclusion.

**Payroll Tax-Paying
Businesses in the Area**

The payroll tax data discussed above can also be used to provide a count of businesses, as a measure of business growth in the Area during the exclusion period. Again, to provide context, the growth rate in businesses in the rest of the city are also provided in Table 4. Businesses with less than \$166,000 in payroll were not required to file a payroll tax return between 2010 and 2013, so this sample does not include those small businesses.

Table 4 indicates that the growth in businesses in the Area from 2010 to 2013 was slightly over twice the rate of growth in the rest of the city: 49% for the Area, compared with 23% for the area as a whole. The Area gained 61 businesses; 32 more than it would have if it grew at the same rate as the rest of the city.

TABLE 4		Establishments Reporting Payroll Expense, 2010 & 2013			
	2010 Businesses	2013 Businesses	Change, 2010-2013	% Change, 2010-13	
Central Market / Tenderloin Area	124	185	61	49%	
Rest of City	13,776	16,908	3,132	23%	

Source: Office of the Treasurer & Tax Collector

**Sales Tax Revenue
within the Area**

Sales tax data can provide another perspective on relative changes in business activity within the area and the rest of the city. The City's General Fund receives 1% of taxable sales at San Francisco businesses, and the Controller's sales tax database can be used to understand taxable sales trends in areas within the city. Unlike the payroll tax, sales tax is required to be remitted by any businesses with taxable sales, so even very small businesses are included in this database.

The City does not have access to taxable sales information on an address-by-address basis. We have no way to accurately attribute the sales of a multi-locational business to its various locations within the city. Accordingly, in order not to bias the results, businesses with more than one location in San Francisco were removed from this analysis. In addition, any business in the Area that remitted sales tax, but did not serve retail customers within the Area, was excluded from the sample.

Table 5 below indicates while taxable sales in the Area grew from 2010-13, it grew more slowly than the rest of the city. The Area saw 10% growth in taxable sales over the three years, compared with 25% for the rest of the city.

TABLE 5		Taxable Sales by Businesses with a Single Establishment in the City, 2010-2013 (\$ million)			
		2010 Taxable Sales	2013 Taxable Sales	Change, 2010-13	% Change, 2010-13
Central Market / Tenderloin Area					
	Tenderloin	\$32.6	\$42.3	\$9.6	30%
	Market Street	\$28.6	\$25.3	-\$3.3	-12%
	Area Total	\$61.2	\$67.6	\$6.4	10%
	Rest of City	\$7,222	\$9,019	\$1,796	25%

Source: Board of Equalization / Muni Services LLC

Property Tax and Transfer Tax in the Area

Within the Area, taxable sales in the Tenderloin grew faster than the rest of the city – 30% compared to 25%. However, businesses along Market Street, taken as a whole, experienced an absolute decline in taxable sales between 2010 and 2013, despite the city's overall strong economic recovery.

The Area generated approximately \$90,000 less sales tax than it would have if its sales tax base had grown at the same rate as the rest of the city between 2010 and 2013.

The Controller's Office has tracked the assessed value of properties in the Area, from fiscal year 2010-11 to through fiscal year 2013-14. The assessed value for a fiscal year applies as of July 1, so the FY 2010-11 figure represents assessed property values approximately 10 months before the exclusion went into effect. The figures for fiscal year 2013-14 refer to values on July 1, 2013. General Fund property tax revenue from these properties represents a fixed percentage of their assessed value.

During the period that the exclusion has been in effect, the Area has seen the construction of several hundred new housing units. The majority of these have not been enrolled by the Assessor, meaning the lower, pre-construction assessed value of the parcel is still in effect. Several thousand units are currently under construction or in the process of securing approvals. For this reason, the property tax revenue reported here is an underestimate of the assessed value of what has already been built.

Trends in the General Fund component of the Property Tax from the Area, and the rest of the city, are shown in Table 6. It indicates that growth in property tax revenue in the Area grew at nearly the same rate as the rest of the city over the three years: 10.7% in the Area compared with 10.8% in the rest of the City.

However, the not-yet-enrolled properties are of sufficient value that if they had been included, property tax in the

Area would likely have surpassed the citywide growth rate. Given the recently-completed and in-progress construction, the Area's property tax revenue can be expected to exceed current totals in the next few years, with growth in the Area very likely to outpace the citywide average.

TABLE 6		General Fund Property Tax Revenue from the Central Market / Tenderloin Area, and the Rest of the City, FY 2010-11 and FY 2013-14 (\$ million)		
	Property Tax, FY 2010-11	Property Tax, FY 2013-14	Percent Change	
Central Market / Tenderloin Area	\$8.2	\$9.1	10.7%	
Rest of City	\$1,053.7	\$1,167.3	10.8%	

Source: Controller's Office, Office of the Assessor-Recorder

When real estate in the city is sold, the seller is responsible for paying the Real Property Transfer Tax on the sales price. The Assessor-Recorder's Office has tracked Transfer Tax revenue within the Area. Fiscal year totals are provided in Table 7, from FY 2009-10, the fiscal year before the exclusion went into effect, through FY 2013-14, which covers sales through June, 2014.

While Table 7 shows large Transfer Tax totals from the Area in FY 2010-11 and FY 2012-13, generating \$7.6 million in revenue during just those two years, it is difficult to place these revenues into context. Transfer Tax is a highly volatile revenue stream even for the city as a whole. The Area's Transfer Tax revenue has fluctuated to an even greater extent over the five years examined, and we are unable to establish a baseline level.

While there have been sizable property transactions, resulting in millions of dollars of transfer tax revenue, we cannot exclude the possibility that that at least some of this revenue would have been realized without the exclusion.

TABLE 7**Real Property Transfer Tax from the Central Market / Tenderloin Area, and the Rest of the City, FY 2009-10 to FY 2013-14**

	FY2009 -10	FY2010 -11	FY2011- 12	FY2012 -13	FY2013- 14
Central Market / Tenderloin Area	\$0.0	\$3.0	\$0.7	\$4.6	\$0.0
Rest of City	\$83.7	\$132.2	\$232.9	\$228.1	\$225.2

Source: Office of the Assessor-Recorder

**Commercial Rents
Adjacent to the Area**

To examine trends on commercial rents, data for the Area and the City as a whole, was provided by the commercial brokerage firm Cushman & Wakefield. Cushman & Wakefield ensured that the office buildings used to define the submarket were consistent throughout the study period. Unlike the tax data, the office market data is up-to-date, and this section includes data through the third quarter of 2014.

This data is also not specifically focused on the area, but rather the Mid-Market/Civic Center sub-market as defined by Cushman and Wakefield. However, it covers all of the major office properties in the area, except government buildings that have no private sector tenants. Properties that include public and private sector office tenants are included. Very small office and retail spaces, particularly in the Tenderloin, are not included; given their size, however their inclusion would not be likely to affect the Area trend.

Table 8 below shows the 2010-2014 trend for average asking rents in the Mid-Market and the entire city, for all classes of office space combined. Both the submarket and the city experienced similar large increases in asking rent over the four-year period. The increase in the Mid-Market submarket was marginally greater: a 73% increase, compared to a 71% increase for the city as a whole.

TABLE 8**Average Asking Direct Rent per Square Foot, Mid-Market Submarket and the City as a Whole, 2010 & 2014 (All Classes)**

	2010 Average Rent	2014 Average Rent	Change, 2010-14	% Change, 2010-14
Mid-Market Submarket	\$27.46	\$47.57	\$20.11	73%
Entire City	\$33.56	\$57.41	\$23.85	71%

Source: Cushman & Wakefield.

Note: 2010 totals are the averages of four quarterly figures; 2014 totals are the average of the first three quarters.

**Residential Rents
Adjacent to the Area**

The growth in business activity could affect the desirability of the Area as a residential location, as workers in the new businesses, preferring to live near their jobs, bid up residential rents and housing prices nearby.

To investigate this issue, we examined asking rents at a fixed set of apartment buildings that rented units both in 2010 and 2013. This data was provided courtesy of RealFacts, a real estate information company that tracks asking rents for vacant units at individual properties. The OEA was given access to quarterly asking rents at a consistent set of 59 residential properties across the city. The addresses of these properties are known, so it was possible to determine if they were within a ¼ mile, or ½ mile, buffer of the Central Market / Tenderloin area. To provide context, the map of the buffers is shown in Figure 2.

FIGURE 2

Quarter-Mile and Half-Mile Buffers around the Central Market/Tenderloin Area



Data on asking rents was available from the third quarter of 2011, the first full quarter after the exclusion was passed, until the second quarter of 2014. The average increase was calculated for properties within $\frac{1}{4}$ mile of the Area, $\frac{1}{2}$ mile of the area (including those properties within $\frac{1}{4}$ mile), and in the rest of the city beyond the $\frac{1}{2}$ mile buffer around the Area.

The number of sample properties within the buffers and the rest of the city, and the growth rates of asking rents, are shown in Table 9 below.

TABLE 9**Average Increase in Asking Rents, Apartments within ¼ mile and ½ mile of the Area, and the Rest of the City, 2011Q3 – 2014Q2**

	Number of Properties	Average Rent Increase, 2011 Q3 - 2014 Q2
Within 1/4 mile	9	23%
Within 1/2 mile	14	22%
Rest of City	34	26%

Source: RealFacts LLC

Table 9 indicates that average asking rents at sample apartments within the ¼ mile and ½ mile buffers grew somewhat more slowly than asking rents in the rest of the city. Within ¼ miles of the Area, rents grew 23% over the time period. Expanding the buffer to ½ mile incorporated 5 additional properties and slightly lowered the growth in rents to 22%. However, asking rents at the 34 properties located beyond the ½ mile buffer increased by an average of 26% during the period.

Because of the small sample size, these results should be interpreted with caution. The differences in growth rates are not statistically significant. The most accurate interpretation would be that on the basis of the best evidence known to the OEA, there is no evidence that rents near the Central Market / Tenderloin Area grew faster than rents across the rest of the city, despite the growth of businesses within the Area.

Housing Values Adjacent to the Area

A second way to examine the potential effect of business growth within the Area on housing prices is to look at the for-sale market. Like apartment rents, housing prices have risen rapidly in the city since 2010.

Our data for this analysis comes from Zillow, which utilizes housing sales data to create estimates of each house's value. Zillow aggregates information into neighborhoods it has defined. The Area lies within two neighborhoods for which Zillow provides monthly average housing values: Van Ness/Civic Center, which covers the Van Ness corridor from Gough to Polk north to California St., and along with the north side of Market St. to McAllister. Zillow's South of Market neighborhood covers the south side of Market from 5th St. to the Central Freeway, following US-101 to 16th St., I-280 and Mission creek. The changes in average housing values in those two areas, compared to the rest of the city, are detailed in Table 10.

TABLE 10**Average Housing Values in Neighborhoods
Adjacent to the Central Market / Tenderloin Area,
May 2011 – August 2014**

Central Market / Tenderloin Area	Average Value, 5/11	Average Value, 8/14	% Change, 2010-13
Van Ness/Civic Center	\$474,500	\$733,600	55%
South of Market	\$543,000	\$843,700	55%
Area Total	\$508,750	\$788,650	55%
Rest of City	\$822,526	\$1,249,924	52%

Source: Zillow

The table indicates that there was slightly greater appreciation in housing values in the neighborhoods adjacent to the exclusion area: a 55% increase since May 2011, compared with 52% for the remainder of the city.

Both the residential rent and housing value analysis suggest there was no significantly greater appreciation in housing near the Area than there was in the rest of San Francisco. This suggests that the new business growth in the Area did not lead new employees to bid up nearby housing prices faster than the citywide rate.

IMPACT OF THE EXCLUSION

Introduction

The previous section analyzed how various fiscal and economic indicators have changed in the past three years, in both the Area and the rest of city. The approach of comparing the differences in growth in same indicator in the Area and the rest of the city, before and during the exclusion, minimizes the impact of other factors.

This section assesses the extent to which the exclusion may be responsible for these trends. First, it assesses the potential role of the exclusion in creating changes within the Central Market/Tenderloin neighborhood. Then, it considers the economic and fiscal impact of the exclusion on the city as a whole.

Neighborhood Impacts

The Central Market / Tenderloin Area experienced faster growth in the number of businesses, and their payroll, than the rest of the city. In 2013, the Area had 61 more businesses filing a payroll tax return than it did in 2010: this is 32 more than would have been expected if the neighborhood had grown at the same rate as the rest of the city during the three years. By contrast, only 19 businesses have taken advantage of the exclusion in any year. This suggests that the exclusion may have had a role in making the Area more attractive as a business location—even to businesses who did not take advantage of the exclusion.

The payroll tax revenue data similarly suggests that the Central Market / Tenderloin Area grew faster than the city during the first three years of the exclusion. Of the \$7.6 million in additional payroll tax paid by businesses in the Area, \$7.1 million is above and beyond what would have been expected if the Area had grown at the same rate as the rest of the city.

There is no way to know, from the address-based payroll filings, the employment represented by this employment. Judging by the CBA reports, the major employers in the Area are in the technology industry. Based on the 2013 average annual wages for such companies in San Francisco, the \$7.1 million payroll in the Area could represent a growth of approximately 3,000 jobs, beyond what could have been expected based on citywide growth.

Since the exclusion was the primary difference between the Area and the rest of the city during the years in question, it is reasonable to attribute these differences to the exclusion.

A second notable trend in the Area is the lack of any relative housing or commercial rent inflation, relative to the rest of the city. Certainly, a 23% increase in asking rent, 55% increase in housing values, and a 73% increase in

commercial are very rapid increases to experience in only three years. They are, however, no more rapid than what was seen across the city during the same time period.

To put it another way, the Area did not become more desirable, relative to the rest of the city, to either residents or commercial tenants. Much of the growth in business was accomplished by increasing the utilization of a few long-vacant buildings, such as the old Furniture Mart at 1355 Market Street.

A third notable aspect to the impact on the neighborhood was the significantly slower growth in sales tax revenue, relative to payroll tax. This is particularly true along Market Street – in the Tenderloin, sales tax revenue did outpace the citywide growth rate during the three years. However, during the period in question, businesses along Market Street did not experience the growth in retail sales that would have been expected from the addition of several thousand new jobs, to say nothing of the hundreds of new housing units that have been constructed in the Area in the past few years.

On balance, then, at the neighborhood level, it seems reasonable to conclude that the exclusion likely encouraged the greater-than-average rate of business and employment growth within the Area since 2011. This was accomplished without increasing residential rents, housing prices, and commercial rents beyond the rates experienced citywide. However, the slow rate of sales tax growth suggests that the ripple effects of the new technology industry employment in the Area have been more limited.

Citywide Impacts

The fiscal and economic impacts of the exclusion are different when viewed from the perspective of the city as a whole. The businesses that moved into the Area from elsewhere in the city clearly increased the tax revenue that was paid from within the Area. The citywide total is not as simple to tally, however.

On one hand, if a business took the exclusion to move from to the Area from another part of the city, leaving behind vacant space in that other location, then the exclusion would simply have been a subsidy for a business to relocate. This would create a fiscal cost to the city – the excluded payroll tax – but no citywide benefit. In its 2011 report on the potential economic impact of the exclusion when it was first proposed, the OEA highlighted research on the generally poor performance of local tax incentives, for precisely the reason that they create few if any jobs on a citywide basis, and expend rather than generate tax revenue on a net basis.

On the other hand, if the exclusion prevented a business from moving outside of the city, then, by preserving the base year payroll tax, it effectively created a citywide as

well as a neighborhood fiscal benefit. Our 2011 report also highlighted the fact that the City's treatment of employee stock-based compensation as taxable payroll could create a very large local burden for a successful technology company in its IPO, potentially ranging into the tens of millions of dollars. While, in general, local taxes have been shown to have a weak impact on business location – either pro or con—San Francisco's taxation on post-IPO stock compensation is unique among cities. In our 2011 report, we investigated the relative business advantages of locating in San Francisco, and while there were several, we could find none that would outweigh a tax of tens of millions of dollars on a young business trying to attract new investors through an IPO.

Two of the companies that have received the exclusion and entered into CBAs – Twitter and Zendesk – have already had an IPO since the exclusion was passed. Every other CBA business is an early-stage technology company, potentially facing an IPO or other sale of stock in the near future. This suggests that the desire to shield post-IPO stock-based compensation from the payroll tax is likely a strong incentive to take the exclusion and locate within the Area, as no other type of larger business in the city has taken the exclusion. Consequently, it is reasonable to believe that at least some of these businesses would be at risk of leaving the city were it not for an exclusion of their stock compensation from the payroll tax.

It must be stressed, however, that not every new business in the Area has taken the exclusion. Companies such as Dolby, Square, and Uber have moved or will be moving into large office buildings in the Central Market Area that are not eligible for the exclusion, such as 1275 Market or 1455 Market⁴. The local business media referred to a "Twitter effect"⁵, because some businesses decided to locate in the Area without any tax incentive, simply to be part of the cluster of technology firms forming around Twitter, the largest technology business in the neighborhood.

This process is a second way the exclusion could create a citywide fiscal benefit. San Francisco's office space market is heavily supply-constrained. Office employment in the city increased by an average of 10,000 jobs per year between 2010 and 2013, according to Moody's Analytics. New office space in the city is capped at approximately 1 million square feet of space per year, which can accommodate somewhere between 4,000 and 6,000 jobs

⁴ J.K. Dineen, "Uber cruises into Mid-Market with headquarters lease", *San Francisco Business Times*, July 8, 2013.

⁵ Dan Schreiber, "'Twitter effect' takes hold of San Francisco's mid-Market area", *San Francisco Examiner*, September 4, 2011.

per year.

Given this demand for office space, if the exclusion, and the associated "Twitter effect", led to the full utilization of existing office space in the Central Market, it did not shift office vacancy to elsewhere in the city – it allowed the city to increase the amount of payroll-tax paying businesses, without new office construction.

Unfortunately, it is not possible to determine which specific businesses would have moved out of the city without exclusion, which only moved to the Area because of the presence of other companies, and which took the exclusion but would have remained in the city without it. For this reason, the citywide fiscal impact cannot be estimated with any confidence.

If one accepts that early-stage technology companies were at high risk of moving out of the city without the exclusion, then a positive fiscal outcome is more likely, because every CBA business fell into that category.

If, instead, one believes that businesses value a San Francisco location substantially more than one in San Mateo county, or that the technology cluster in the Central Market area would have happened naturally through pressures in the office market, notwithstanding the impact of the payroll tax, then the better assessment would be that the exclusion was subsidizing something that would have happened anyway, and the citywide fiscal impact would be negative.

Regardless of whether the exclusion was created a fiscal benefit or cost for the City, its impact on San Francisco's economy was likely quite limited. If the fiscal impact was negative, and the exclusion only encouraged the relocation of companies that would have been elsewhere in San Francisco, then the net economic impact from the citywide perspective would be negligible—simply a matter of moving jobs and spending around the city with little if any net gain.

On the other hand, if the exclusion retained every business that used it, the overall impact would still not be very large in a citywide context. As estimated above, the new payroll in the Area could represent approximately 3,000 jobs. The city as a whole has added more than 70,000 jobs, across all sectors, from 2010 to 2013⁶. Even if all of the growth in the Area represents new growth to the City, under the assumption that all of the businesses would have left without the exclusion, it would still represent less than 5% of the city's employment growth during the three years.

⁶ Employment Development Department, *Employment by Industry Data*

Moreover, if businesses had left San Francisco because of a local tax, there is no reason to believe they would uproot their labor force and leave the Bay Area. The impact of these 3,000 jobs on other aspects of the local economy, such as housing prices, would therefore have remained.

STAFF CONTACTS AND ACKNOWLEDGEMENTS

Ted Egan, Ph.D., Chief Economist

ted.egan@sfgov.org

Asim Khan, Ph.D., Principal Economist

asim.khan@sfgov.org

The authors thank Caroline Rooney of Cushman & Wakefield, Jamie Whitaker of the Controller's Office, Eddie McCaffrey of the Assessor-Recorder's Office, and Tajel Shah, Jeremy Wong, and Amanda Fried from the Treasurer & Tax Collector's Office, for providing data used in this report. The authors are solely responsible for any errors and omissions.