# Tax on Businesses With Disproportionate Executive Pay: Economic Impact Report

CITY & COUNTY OF SAN FRANCISCO

Office of the Controller

Office of Economic Analysis

10/14/2020

# Introduction



- Proposition L on San Francisco's November 2020 ballot is a proposed tax on businesses, based on the ratio of the salary of their highest-paid managerial employee, to the median salary of their San Francisco employees. This is termed the "executive pay ratio"
- A business whose ratio exceeds 100:1 would be subject to tax on their San Francisco gross receipts*. The tax, which would increase as the ratio increases, would be paid in addition to other business taxes imposed by the City, including the Gross Receipts Tax.
- The tax requires a simple majority vote to pass. As a general tax, its revenues can be spent for any governmental purpose.
- The Office of Economic Analysis (OEA) has prepared this economic impact report after determining that the proposed changes could have a material impact on the city's economy.

* Or its San Francisco payroll expense, if it current pays the City's Administrative Office Tax in lieu of the Gross Receipts Tax

# Background and Definitions



- In 2015, the Securities and Exchange Commission (SEC) required publicly-traded companies to report the ratio of the compensation of its chief executive officer (CEO), to the median compensation of its employees.
- This public information has been used to estimate similar tax payments in other cities, for example in Portland, Oregon.
- In Portland, the tax only applies to publicly-traded companies, however the tax proposed for San Francisco would also apply to private companies with a sufficiently-high executive pay ratio.
- The proposal does not rely on the SEC-reported ratio. Instead, businesses are required to report the ratio of their highest-paid managerial employee (whether the CEO or not), to the median compensation of its San Francisco employees.
- Compensation for part-time and part-year San Francisco employees would be included in the ratio, but that compensation would be converted to an annualized, full-time-equivalent basis before the median compensation is determined.

# Proposed Tax Rates by Executive Pay Ratio



- The table below indicates the rates that would apply for different executive pay ratios. Gross Receipts tax-paying businesses would pay the indicated rate, multiplied by their San Francisco gross receipts. Administrative Office Tax-paying businesses would pay the indicated rate, multiplied by their San Francisco payroll expense.
- Businesses with an executive pay ratio below 100:1 would pay no tax.

| Executive Pay Ratio | Gross Receipts Tax Rates for Gross Receipts Tax Payers | Payroll Expense Tax Rates for Administrative Office Tax Payers |
|---|---:|---:|
| Less than 100:1 | 0% | 0% |
| Between 100:1 and 200:1 | 0.100% | 0.4% |
| Between 200:1 and 300:1 | 0.200% | 0.8% |
| Between 300:1 and 400:1 | 0.300% | 1.2% |
| Between 400:1 and 500:1 | 0.400% | 1.6% |
| Between 500:1 and 600:1 | 0.500% | 2.0% |
| More than 600:1 | 0.600% | 2.4% |

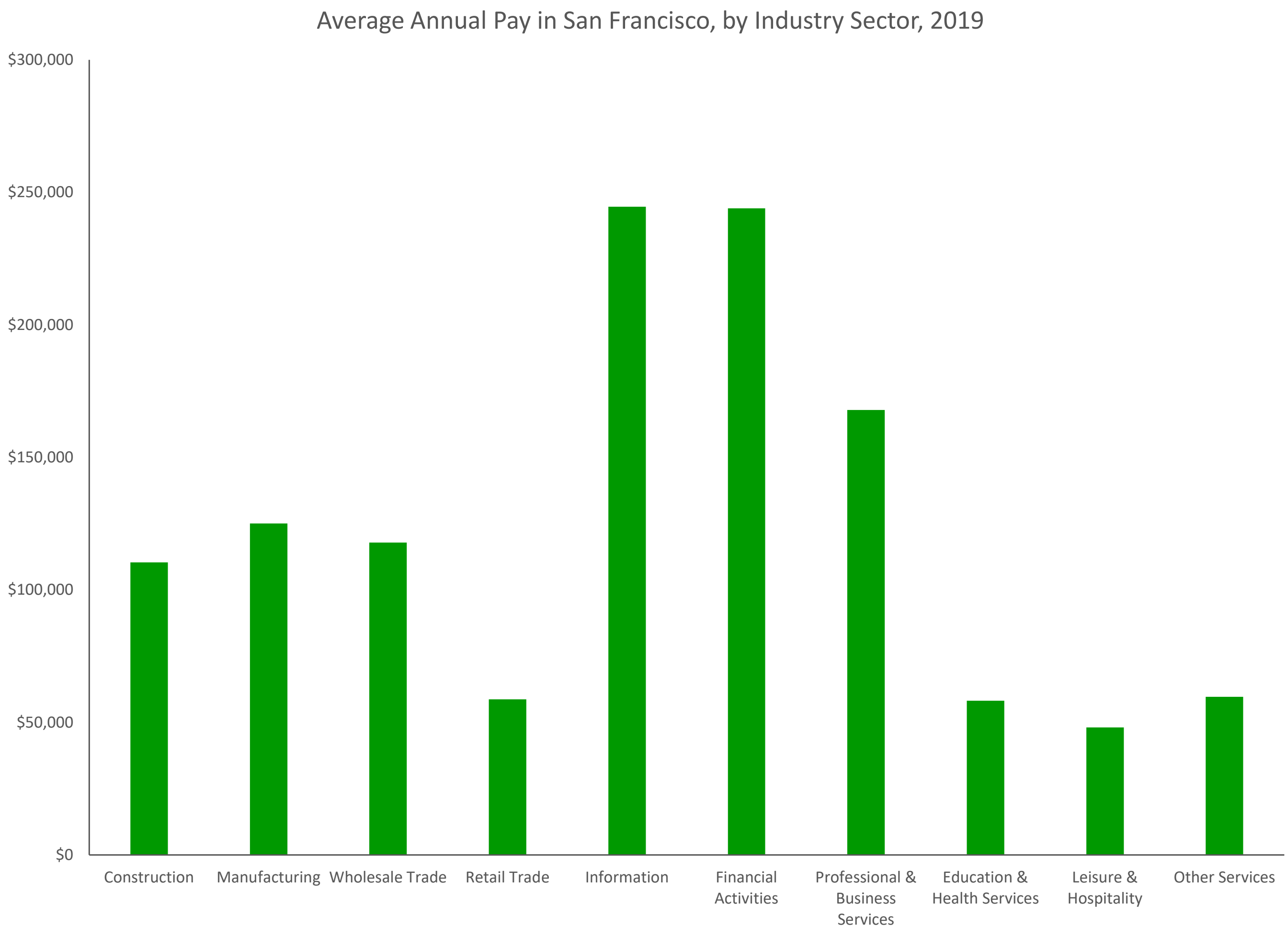
# Proposed Rates in Context



- The highest tier of the City's current Gross Receipts Tax ranges from 0.160% to 0.650%. Gross Receipts Tax payers could pay anywhere from an additional 0% to 375% of its Gross Receipts tax liability, depending on its industry and its executive pay ratio.
- Administrative Office tax-paying businesses currently pay 2.9% of their payroll expense to the City in business taxes. These businesses could pay an additional 0% to 83% of their business tax liability, depending on their executive pay ratio.
- However, based on available evidence from 2019 compensation, most impacted businesses are projected to pay in the lower rate ranges of 0.100% and 0.200%. Executive compensation is highly volatile, however, and businesses may see substantial variation in their tax rate from one year to the next.

# San Francisco Area Median Salaries by Industry






A review of average wages by industry in San Francisco can provide some insight into how many businesses are likely to be subject to the tax. As shown in the chart to the left, average wages range from about $48,000 to $245,000 per year. If these are typical of median wages paid by companies in these industries, this data suggests that, in the lowest-paid industry, a company's highest-paid executive would need to earn at least $4.8 million annually for the tax to apply.

Other data from the Bureau of Labor Statistics indicates that the median salary for "Chief Executives" in the San Francisco area is $236,060 per year. Even in the lowest paid industry, an executive would have to earn at least 20 times this area median for the tax to apply.

For this reason, very few companies are expected to pay the tax each year.

# Economic Impact Factors



- The proposed tax would create both negative and positive impacts on the city's economy. The net economic impact, which will be detailed later, depends on the relative strength of the two factors.
- On the positive side, the tax will generate General Fund revenue for the City, which will generate positive multiplier effects through the local economy, by raising public sector employment, wages, and payments to contractors and aid recipients.
- On the negative side, the business tax will likely reduce private sector employment and investment in the city. Notwithstanding a business's earnings and ability to pay the tax – which will probably be correlated to executive compensation and the executive pay ratio – the proposed tax will increase the already-wide difference in the cost of doing business in San Francisco, compared to other locations. The loss of employment and spending will create negative multiplier effects in the city's economy, as fewer employees and residents will lead to reduced spending at other local businesses.

# Revenue Uncertainty and Volatility



- The Controller's Office has estimated that impacted businesses could pay between $60 million - $140 million annually.
- While revenue estimates are often challenging for new taxes, three aspects of this tax make the revenue estimate highly uncertain, and will also likely contribute to a very high level of volatility in the tax.
- First, as discussed earlier, very few companies are likely to be subject to the tax, because of the relatively high wages in the Bay Area.
- Second, based on a review of executive compensation from 2017-2019, it appears to be highly volatile and dependent on stock-based compensation, whose value fluctuates with the stock market.
- Third, the tax rates are highly progressive. Companies with a ratio exceeding 600:1 will pay at 6 times the rate of companies have a ratio of 100:1 to 200:1. This will likely mean that the majority of the tax's revenue will come from a very small number of companies – and not necessarily the same companies from one year to the next.

# Estimated Revenue by Industry



- The table below indicates the projected distribution of tax burden across industries in the city, and that industry's share of total city employment in 2019.
- The Retail Trade, Financial Services, and Information sectors are projected to bear a disproportionate share of the tax burden.

| Industry | Estimated Share of Proposed Tax Revenue | Share of City Employment, 2019 |
|---|---:|---:|
| Retail Trade | 23% | 7% |
| Financial Services | 23% | 8% |
| Information | 17% | 8% |
| Professional & Technical Services | 7% | 22% |
| Arts, Entertainment, Recreation | 6% | 2% |
| Accommodations | 6% | 3% |
| Wholesale Trade | 5% | 2% |
| Other | 13% | 50% |

# Economic Impact Assessment



- The OEA uses the REMI model to estimate the net economic impact of City policy changes.
- REMI estimates impacts by creating an economic forecast for the city, assuming policy changes are made, and then comparing that to a baseline forecast in which no policy changes are made.
- The economic impact of the proposed tax was modeled in REMI, assuming the following changes to the economy:
- A $100 million (the midpoint of the revenue estimate) increase in local government spending;
- A $100 million increase in local production costs for businesses in San Francisco, distributed by industry according to the table on the previous page.

# Conclusions



- Based on the REMI model simulation, the proposed tax would cost the city economy approximately 615 jobs, and lead to a decline in the city's GDP of approximately $60 million.
- These changes would occur in the context of estimated City GDP of $183 billion and employment base of 985,000, in 2018.
- Job losses would occur across the economy, but would be concentrated in retail trade, financial services, and accommodations, which would account for 37% of the total.
- In addition to economic impact, taxes are also often evaluated on the basis of their equity, administrability, and stability.
- In terms of equity, the tax likely does align well with a business's ability-to-pay, since executive compensation generally does correlate with overall business income and performance.
- On the other hand, the tax is likely to be significantly more unstable than other City revenue sources, because of the small number of payers, and the volatility of stock-based compensation.

# Staff Contacts



Ted Egan, Ph.D., Chief Economist
ted.egan@sfgov.org