Increases to the Transfer Tax Rate for Properties Over $10 Million: Economic Impact Report

CITY & COUNTY OF SAN FRANCISCO

Office of the Controller

Office of Economic Analysis

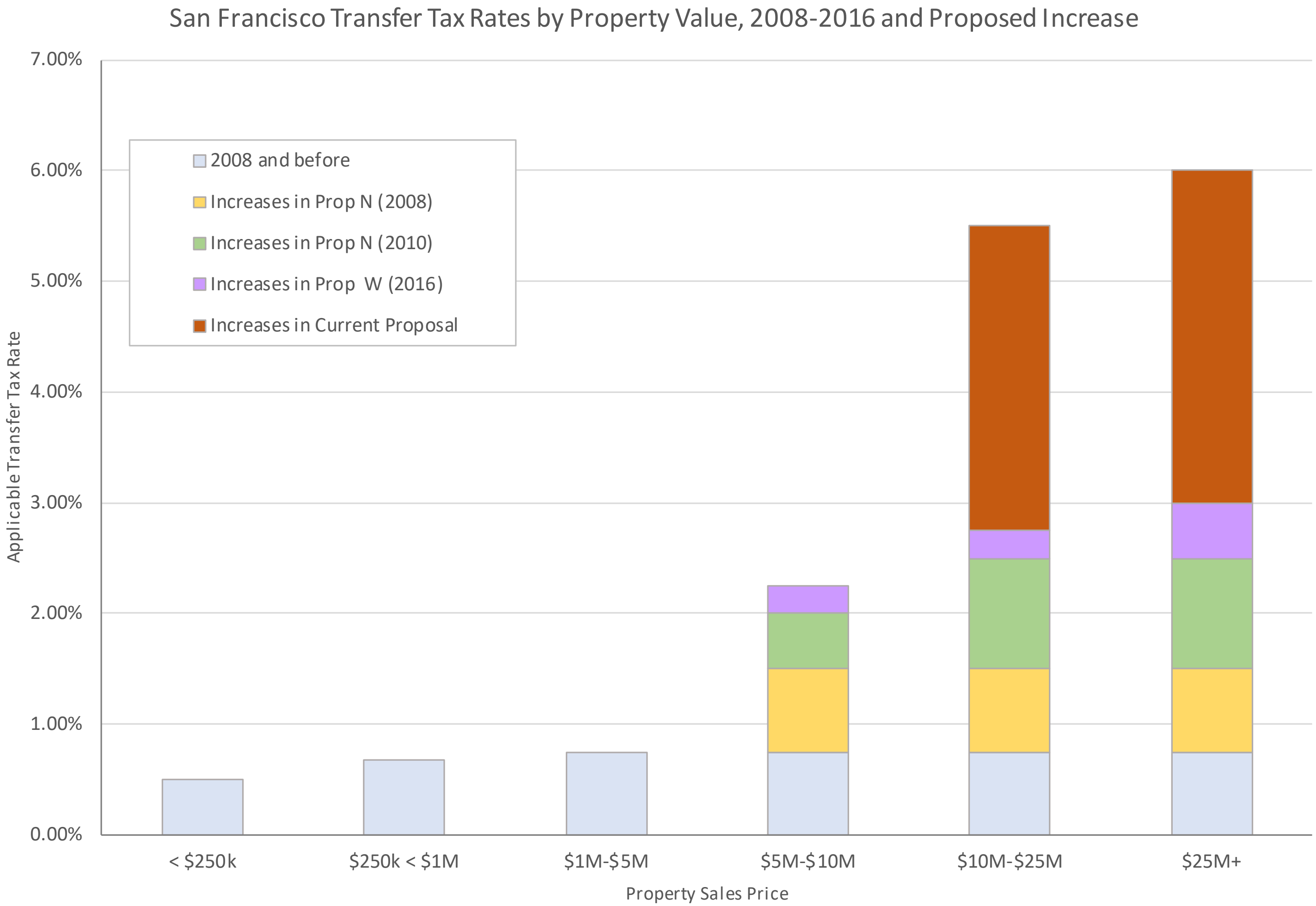
9.23.2020

Introduction

- Like many cities, San Francisco imposes a Real Property Transfer Tax ("Transfer Tax") on the sale of real estate in the city. The tax, which is paid by the seller, is equal to a percentage of the property's sale price.
- Proposed legislation would raise the Transfer Tax rate on properties in the city that sell for more than $10 million. For properties selling for between $10 million and $25 million, the rate would rise from 2.75% to 5.5%. For properties selling for over $25 million, the rate would rise from 3% to 6%.
- The proposal is being submitted to the voters at the November 2020 election, and requires a simple majority vote to pass. As a general tax, its revenues can be spent for any governmental purpose.
- The Board of Supervisors has resolved to spend the revenue from the proposal on affordable housing and rent relief*; however this resolution is not binding on the City's budget process.
- 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.

* Resolution 365-20

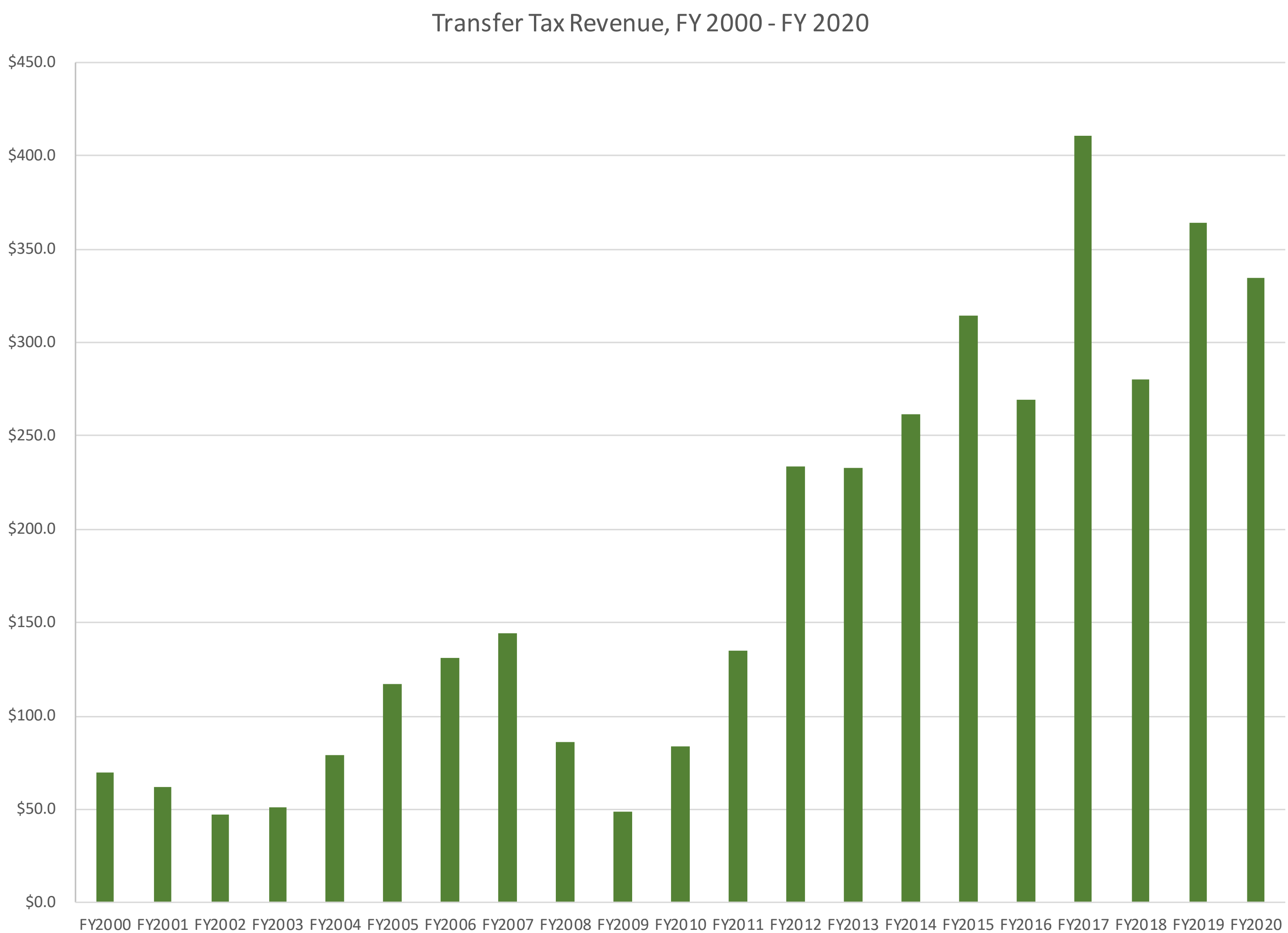
The City's Transfer Tax Rates Since 2008



Since 2008, voters have approved three increases to the Transfer Tax: Prop N in 2008 and 2010, and Prop W in 2016. All three raised rates on properties that sold for over $5 million, and made no change on properties selling for less than $5 million.

The current proposal would double rates on properties over $10 million, while having no effect on less-expensive properties. The proposed rate increase is larger than the earlier measures, on a smaller set of properties.

Transfer Tax Revenue History



As shown in the chart to the left, Transfer Tax revenue has been highly volatile over the past twenty years. Partly this is due to the city's economic cycles, and the rate increases described on the previous page.

However, the revenue stream is inherently volatile, and increasingly dependent on sales by the largest properties,

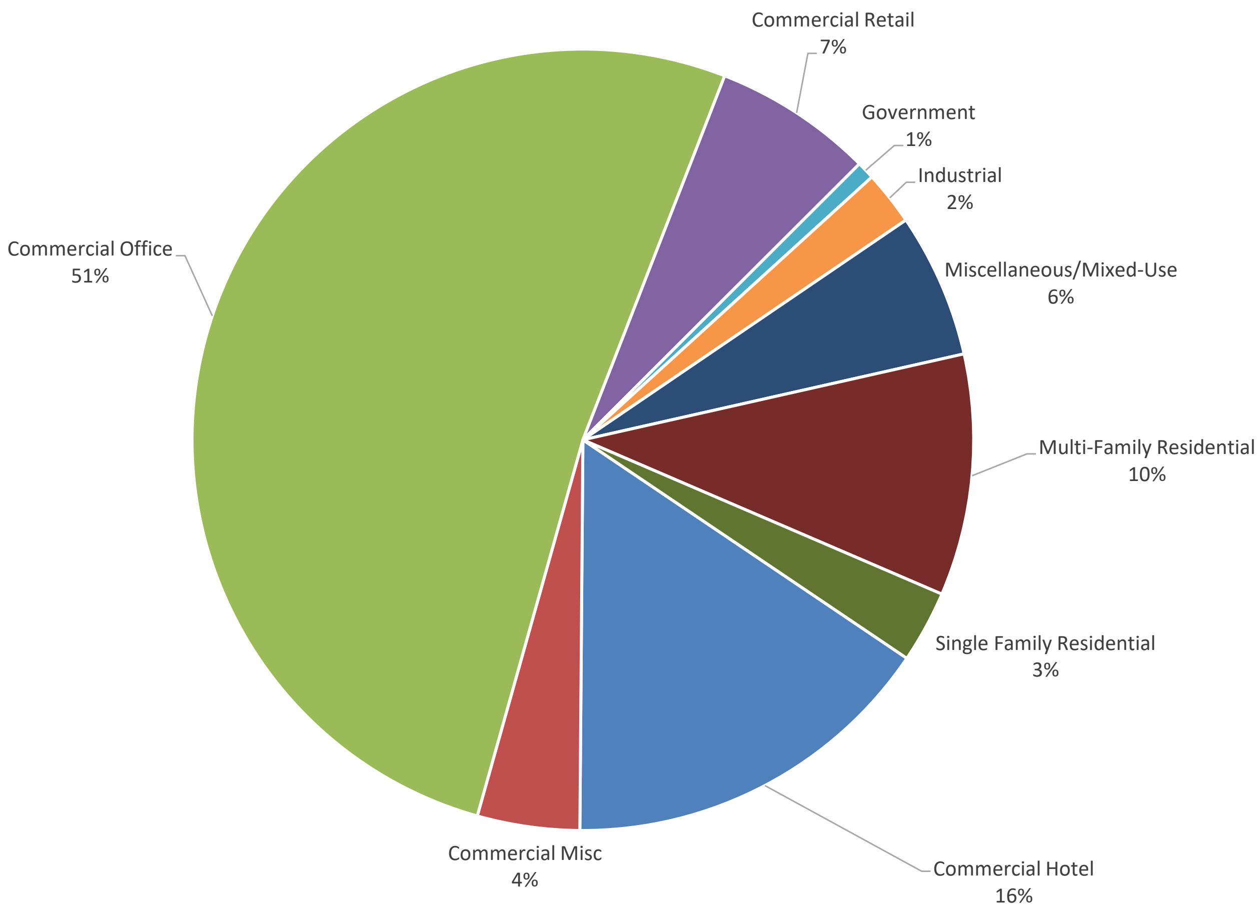
Although properties above $10 million represent a very small share of sales in a typical year, they represent a large and growing share of total revenue, equal to about 72% in fiscal year 2019-20.

The Community Opportunity to Purchase Act

- In 2019, the City adopted the Community Opportunity to Purchase Act (COPA), which requires sellers of certain multi-family housing and vacant properties in San Francisco to first offer the property to qualified non-profit organizations.
- For several years, the City, through its Small Sites program, has overseen the acquisition of multi-family properties and subsidized the rents of their low-income tenants.
- COPA also exempts, until 2024, any COPA sale from the higher Transfer Tax rates that normally apply to properties selling for more than $5 million. The tax rate for COPA sales is 0.75%.
- Because of this exemption, the proposed rate increase will strengthen the incentive for sellers of multi-family and vacant properties to sell them to non-profits through COPA, and thus avoid the higher tax rate.
- It is possible that the proposal could increase the supply, and/or reduce the cost of providing, affordable housing through Small Sites and similar programs. As with any tax exemption, COPA sales would also reduce the new revenue generated by the proposal.

Affected Properties by Property Class

Aggregate Sales Price by Property Use, San Francisco Properties Selling for Over $10 Million, 2010-16



Office buildings make up 51% of the value of properties that typically sell for over $10 million in San Francisco.

Hotels and motels account for 16%, and retail properties account for 7%.

Properties that are generally eligible for the COPA exemption described on the previous page include multi-family residential and mixed use buildings. These make up 16% of the Transfer Tax base.

Single family residences make up 3% of the total.

Economic Impact Factors

- The proposal will create both positive and negative impacts on the city's economy. The overall economic impact of the proposal depends on the relative strength of these positive and negative factors.
- On the positive side, the proposed tax increase will increase Transfer Tax revenue, which will lead to higher government spending, which will expand the economy and generate positive multiplier effects in the city's economy.
- While it will likely reduce property values and this would, in time, reduce Property Tax revenue, the impact of this reduction would be minor, and is not considered in this report.
- As discussed earlier, the proposal would also increase sellers' incentive to participate in a COPA sale, and this could have the effect of lowering the City's cost of providing affordable housing through its Small Sites and similar programs. However, the extent to which this occurs depends on decisions made by non-profits and their financial partners, including the City, and cannot be forecast with certainty.

Economic Impact Factors (continued)

- On the negative side, an increase to the Transfer Tax also will effectively reduce the value of properties selling for over $10 million, by reducing the seller's after-tax proceeds.
- It will also create a disincentive to sell properties. A buyer of an expensive property could, for example, avoid the financial impact of the higher rate by holding the property for twice as long. Any slowing of the pace of property sales would shrink the tax base and tend to reduce tax revenue. This effect is also difficult to estimate, however, and is not considered in this economic impact analysis.
- Additionally, a higher Transfer Tax rate will also discourage property investments that would raise property value. This will generate negative multiplier effects throughout the local economy.
- Because of this effect on investment decisions, it is helpful to distinguish between the impacts on parcels that have the potential for further development, as opposed to stable properties that do not. This distinction is discussed on the following pages.

Revenue Impact of the Proposal

Given the importance of large properties in the Transfer Tax, and the size of the proposed rate increase, it is expected to have a large impact on revenue.

The chart to the left illustrates what the City's Transfer Tax revenue would have been, had the proposed rates been in effect since Fiscal Year 2017-18. The rates in the current proposal would have led to a 67% increase in revenue over those years.

The Controller's Office has projected that the proposal would have added between $13 million and $346 million annually over the last economic cycle, for an average increase of $196 million. Given the volatility of the revenue stream, and the possibility of deferring sales, future annual revenue may often not reach that level, however.

Additionally, as described earlier, revenue may be reduced by future COPA sales, which could then lead to lower housing burdens and reduced out-migration of low-income households from the city.

Stable Properties and Development Sites

- Property owners, like other owners of capital assets, make investment decisions based on their expected rate of return. These investments can range from simple maintenance decisions, to choices about rehabilitation and expansion, to large-scale redevelopment decisions. In each case, the owner would weigh the cost of the investment against the benefit, in terms of increased property value.
- Taxes that are levied against property values, like the Transfer Tax, reduce the after-tax benefit of those investments. On the margin, a tax increase can discourage property owners from making them.
- For owners of properties that are "stable", because their zoning controls do not allow for further development, the primary consequences of less property investment is reduced economic activity in industries that serve buildings and their tenants, such as real estate, construction, and building maintenance and repair.
- However, for parcels that do have the potential to support more residential or commercial space, the higher tax can have the effect of making some redevelopment plans less feasible, leading to more constrained real estate markets, higher commercial rents, and higher housing prices.

Estimating the Impact on New Development

- Recent OEA research has tried to quantify the impact on new development of new citywide fees and taxes*. This research can be utilized to estimate the impact of the proposed tax increase, on both residential and non-residential development.
- Economically, for a development site, a Transfer Tax increase feels like an impact fee, or other cost increase. It reduces the value added to the property by the redevelopment, and the financial return. The analytical challenge is to estimate how a given increase to the Transfer Tax, paid each time the property is sold in the future, would affect development decisions in the present.
- Based on information from the Assessor's Office and other sources, as described in the Appendix, the OEA estimates that the 3% transfer tax increase, which most development sites would face, would be financially equivalent to a $64/square foot impact fee on non-residential development, and a $32,850/unit fee on residential development. The impacts of these costs on the amount of development in the city are also detailed in the Appendix.

* See, for example, our reports on changes to the Inclusionary Housing fee (2017) and the Jobs-Housing Linkage fee (2019).

Economic Impact Assessment

- The OEA uses its REMI model of the San Francisco economy to estimate the impact of proposed legislative changes. The model calculates the combined impacts of policy changes. Based on the analysis discussed on the previous two pages, the following impacts were included in the REMI simulation of the policy:

1. An increase of $196 million annually in City government expenditures, associated with the projected revenue growth*
2. A reduction of $196 million in income to the real estate sector, as the tax burden will be borne by sellers of high-valued real estate.
3. A reduction of $193 million in annual commercial real estate investment, along with an increase of 0.31% in commercial rents, because of non-residential development made infeasible by the tax increase.
4. A reduction of $300 million in annual residential real estate investment, along with an increase if 0.17% in housing prices, because of residential development made infeasible by the tax increase†.

* This does not consider any benefits to housing affordability, or tax revenue reductions, due to COPA sales that may be incentivized by the proposal.
† Estimates under 3 and 4 only include the lost benefit of new market-rate housing and office development, and do not consider the lost subsidies from affordable housing funded or produced by those projects, or any other lost community benefits associated with the developments.

Economic Impact Results and Conclusions

- Based on these projected changes to the local economy, the REMI model forecasts that the net impact on the city's economy would be negative.
- The negative impact is almost entirely associated with the development that would be made infeasible by the Transfer Tax increase. Limitations to the growth of the city's housing supply will tend to inflate housing prices, while limitations to the growth of commercial real estate will limit job growth, and put downward pressure on wages.
- As a result, the real incomes of San Francisco households would decline, on average, because of the lower incomes and higher housing prices. San Francisco would become less attractive economically as a place to live. Consequently, the city's population would decline, with both fewer migrants moving in, and more residents moving out.

Economic Impact Results and Conclusions

- Specifically, the REMI model points to a loss of approximately 625 jobs, and a decline in the city's GDP of approximately $50 million. This is the net economic impact, considering both the positive and negative factors described on page 12.
- By way of context, the city had a GDP of $183 billion, and 985,000 jobs, in 2018.
- About half of the job loss would be concentrated in the construction and real estate industries, with the remainder spread across other sectors in the city's economy.
- Both the city's population, and per capita income, would decline as a result of the proposal. By 2030, the city would have 1,050 fewer people than it would otherwise, and per capita disposable income would be $100 less, in today's dollars.

Appendix: Commercial Development Impact

Office square footage	96,429,817	from SF Planning Land Use database
Average transfer price / square-foot	$909	Based on 2019 annual sales from REIS
Average frequency of turnover	19	Estimated from SF Assessor Data
Average annualized transfer tax payment as % of total	5.3%	1 / average frequency of turnover
Higher transfer tax rate	3.0%	Assuming new development is subject to 3% increase
Total transfer tax payment/SF	$27.3	3% of average sales price per sf
Annualized transfer tax payment	$1.45	Annualized per sf cost assuming 5.3% per year
discount rate	6.0%	Approximating a commercial cap rate in SF, 2019
escalation rate	4.0%	Approximate annual growth in commercial properties
constant-dollar discount rate	1.9%	
Present value of incremental transfer tax, per SF	$64	upfront cost equivalent to future transfer tax payments for 99 years
Tax as % of sales price	7.0%	$64 divided by sales price per sf - effective price reduction
supply impact of 1% effective price change	0.031	estimated elasticity of new office supply to effective price changes*
% reduction in commercial SF from incremental tax	0.220%	elasticity times the effective price reduction
Square footage lost from effective price decline	212,303	% reduction x existing office square footage
Value of investment lost	$193,007,353	SF lost x average sales price: investment measured by value
non-residential price effect	0.3145%	% reduction in supply / (elasticity of supply + elasticity of demand)

Appendix: Residential Development Impact

Total SF Housing Units	390,000	from SF Planning Land Use database
average units per transfer	71	Based on 2019 annual sales from REIS
transfer price / unit	$658,666	Based on 2019 annual sales from REIS
Average frequency of turnover	27	Estimated from SF Assessor Data
Average annualized transfer tax payment as % of total	3.8%	1 / average frequency of turnover
Higher transfer tax rate	3%	Assuming new development is subject to 3% increase
Total transfer tax payment	$1,409,546	3% of average sales price x number of units
Annualized transfer tax payment	$53,124	Annualized per sf cost assuming 3.8% per year
discount rate	6%	Approximating a commercial cap rate in SF, 2019
escalation rate	4.0%	Approximate annual growth in apartment property values
constant-dollar discount rate	1.9%	
Present value of incremental transfer tax	$2,343,373	upfront cost equivalent to future transfer tax payments for 99 years
Tax PV / unit	$32,851	PV divided by average number of units per project
Tax as % of sales price	5.0%	Per unit Tax PV / average sales price per unit
Supply impact of 1% effective price change	0.023	estimated elasticity of new residential supply to effective price changes*
Reduction in housing from higher tax	0.117%	elasticity times the effective price reduction
Units lost	456	% reduction x existing units
investment lost	$300,129,137	SF lost x average sales price: investment measured by value
housing price effect	0.1669%	% reduction in supply / (elasticity of supply + elasticity of demand)

Staff Contacts

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