City and County of San Francisco

Office of the Controller - Office of Economic Analysis

Payroll Expense Tax Exclusion in Central Market Street and Tenderloin Area:

Economic Impact Report

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March 15, 2011

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Main Conclusions

San Francisco levies a 1.5% payroll expense tax (or "payroll tax") on all businesses that operate in the city and whose annual payroll expense exceeds $250,000. The proposed legislation would establish a zone, south and west of the financial district, within which businesses could exclude new payroll from the payroll tax for up to six years. In other words, businesses with premises in the area would be responsible for paying only their base year payroll tax, and could increase their payroll without additional tax for up to six years.

The proposed legislation can be understood as a variation on the policy of enterprise zones. These policies have been criticized for using tax revenues to subsidize business location in a depressed area, without stimulating a genuine process of long-term economic development that can survive the expiration of the subsidy. Unlike traditional enterprise zones, however, the possibility that Twitter might move to the Central Market area would likely increase its attractiveness to other businesses, leading to job and tax revenue growth after the expiration of the legislation.

Twitter is growing rapidly and reportedly needs a new location. It is said to be choosing between the San Francisco Mart building, at Market and 10th Street, or locations in San Mateo County. Analysis of rent, commuting, labor, and tax costs suggests that San Francisco's higher business tax could create a significant incentive for Twitter to leave the city. San Francisco's payroll tax covers all compensation to employees, including stock options. Twitter is currently valued in secondary markets in excess of $7 billion, after being valued at only $250 million in February 2009. The compensation associated with its stock options could be sizable in the future, and the accompanying payroll tax could reach into the tens of millions of dollars. If that is the case, it would appear to make a San Francisco location more expensive for the company than an alternative in San Mateo County.

Because of this, the legislation was analyzed based on the assumption that Twitter would leave the city if it was not enacted, and would move to the SF Mart if it was. Under these two scenarios, the long-term payroll tax growth associated with the formation of an technology industry cluster in the Central Market area outweighs the payroll tax growth that could reasonably expected to occur without Twitter, by approximately $2.7 million per year on average over twenty years. In addition, the legislation can be expected to lead to higher job growth and property values in the area, which will also increase sales, hotel, utility user, property, and transfer tax revenues.

This research suggests that two changes to the proposed legislation could reduce risks of an adverse economic impact, and increase the benefit to the General Fund while maintaining its economic benefits. In addition, two related policy ideas are offered for the consideration of decision-makers.

1. Requiring multi-location businesses to apportion their payroll, such that they are only eligible to exclude net new payroll within the area.

2. Removing large commercial properties, other than the SF Mart, from the area. If the large properties were excluded, the net payroll tax gain for the City would rise to an estimated $5.5 million a year, as the City would no longer lose the payroll tax growth that would happen at these properties naturally.

3. As a policy idea that is not directly tied to the proposed legislation, the City could structure a parcel tax on vacant commercial property, which would not apply to occupied commercial property. This would encourage owners of vacant commercial property to be flexible on rent, and thereby maximize occupancy and employment in the city. This tax could not be included in the proposed legislation, as it would have to be submitted to the voters pursuant to Proposition 218. Nevertheless, it is mentioned here as a future policy consideration.

4. Finally, this analysis suggests that an important variable in the fiscal and economic success of the proposed legislation is Twitter's decision to locate in the Central Market area instead of moving out of San Francisco. In turn, Twitter's potential future payroll tax liability associated with its stock options appears to be the largest cost factor weighing against a San Francisco location. The City should consider modifying the payroll expense tax, to reduce the incentive for successful technology companies to move out of San Francisco.

INTRODUCTION

Summary of the Proposed Legislation

San Francisco levies a 1.5% payroll expense tax (or "payroll tax") on all businesses that operate in the city and whose annual payroll expense exceeds $250,000. Currently, the tax applies to approximately 9,000 businesses and generated $345 million during fiscal year 2009-10. After the Property Tax, the payroll expense tax is the second-largest revenue source in the City's General Fund.

The proposed legislation would establish a zone, south and west of the financial district, within which businesses could exclude new payroll from the payroll tax for up to six years. In other words, businesses with premises in the area would be responsible for paying only the payroll tax in their base year, and could increase their payroll without additional tax for up to six years. A business's base year is defined in one of three ways, depending on where the business was located on the effective date of the policy.

1. For businesses that are already located in the area, on the effective date, the base year is 2010.
2. For businesses located elsewhere in San Francisco that move to the area after the effective date of the policy, the base year is the year prior to their move.
3. For businesses located outside of San Francisco that subsequently relocate to the area, the base year is their first year in San Francisco.

The legislation expires after eight years. A business can select up to six years of its choosing to utilize the exclusion.

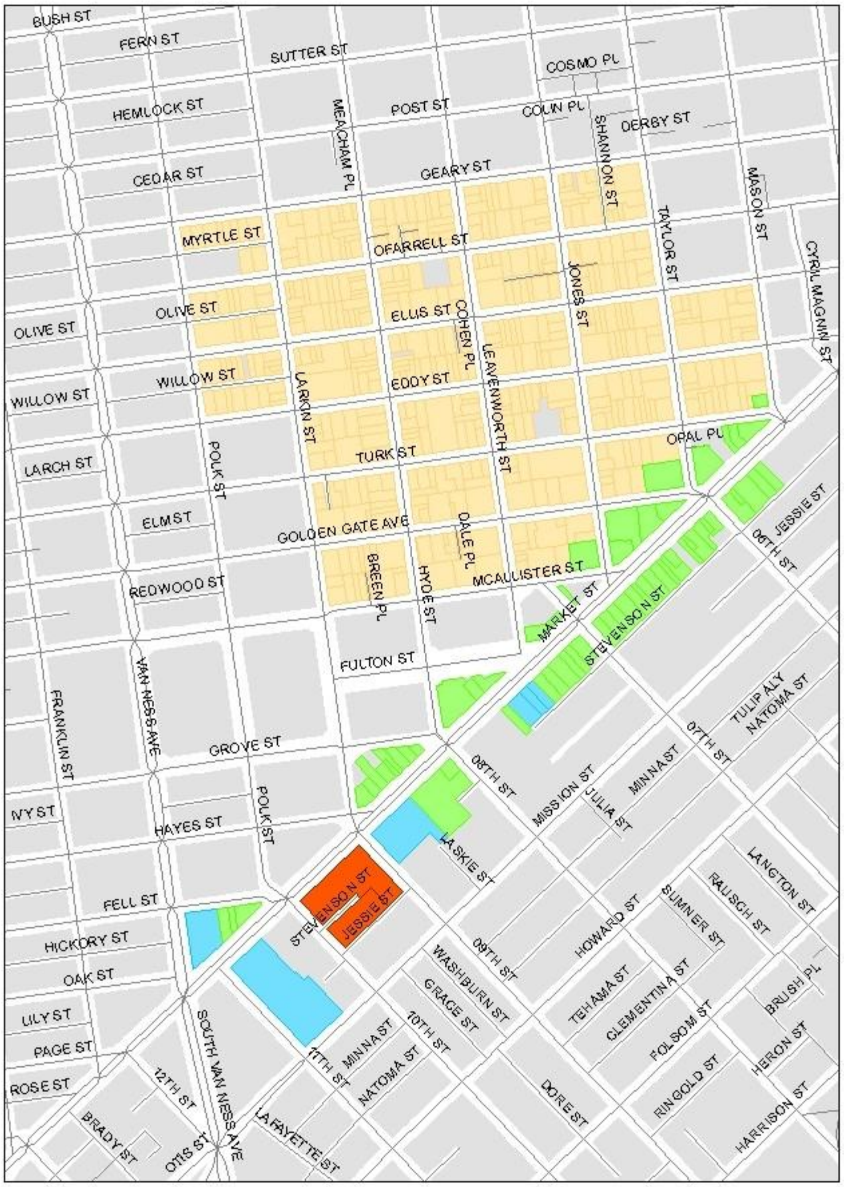
For many years the area, particularly along Market Street from 5th to 8th street, has experienced notably lower levels of commercial occupancy and activity than other sections of Market Street.

The City has recently undertaken a series of initiatives in an attempt to stimulate commercial development in the corridor, ranging from a small business loan fund, to streetscape improvements, to technical assistance to arts organizations. The proposed legislation can be viewed as an additional policy measure to encourage business location and employment growth within the area.

Map of the Central Market Street and Tenderloin Area

The area consists of most properties along Market street from Fifth street southwest to Van Ness Avenue. In addition, most properties in the Tenderloin area bounded by McAllister Street, Polk Street, Geary Street, and Mason Street are included, as indicated in Figure 1.

FIGURE 1	Map of the Proposed Central Market and Tenderloin Area



Source: Legislation Text

For reasons that will be detailed later in this report, it is useful to highlight four distinct sub-areas in the Central Market Tenderloin Area:

1. The San Francisco Mart building, 1455 Market Street, highlighted in red above. Twitter, the social media company now located on Folsom Street, is reportedly considering relocating to this property[1]. The Mart had previously served as a wholesale

[1] John Cote, "Mid-Market tax break plan in works to lure Twitter," San Francisco Chronicle, February 8, 2011, A-1.

furniture showroom until the mid-2000s, but is currently 95% vacant. It is envisioned for retail/office uses in the future, although it has not served those functions in the past, and would require significant renovations to accommodate those uses. The main Mart building fronting Market Street has 805,000 square feet[2].

2. Other large commercial buildings on Market Street largely southeast of 8th street to Van Ness. These properties constitute the bulk of the potential new employment to the area, and the majority of the space will be vacant and seeking tenants in the next 1-2 years. These properties include:

    a. 1155 Market Street, where the San Francisco Public Utilities Commission is now based. The PUC will be vacating in the next 1-2 years, for a new building on Golden Gate Avenue. The building has approximately 160,000 square feet.

    b. 1145 Market Street, which also hosts the SF PUC, the San Francisco Health Services System, other City agencies, and private tenants. CoStar reports that the building is currently 85% leased, and contains 145,000 square feet.

    c. 1275 Market Street, owned the State Compensation Insurance Fund (SCIF). SCIF has announced plans to vacate the building[3]. The building has approximately 350,000 square feet.

    d. 1455 Market Street, until recently owned and occupied by the Bank of America. It is also expected to entirely vacate in the next year. The building has approximately 1 million square feet of office space.

    e. 30 Van Ness, at the corner of Market and Van Ness, which is owned and occupied by the City and County. The building contains approximately 150,000 square feet.

2. Other commercial properties along Market Street, largely northwest of 7th street, highlighted in green. In general these are smaller office or non-office properties which are unlikely to host large numbers of new employees. Many of the smaller commercial properties have no tenants and have been vacant and blighted for many years.

[2] Source: CoStar market reports.

[3] J.K. Dineen, "State Fund move creates Civic Center Pain", San Francisco Business Times, December 9, 2010.

3. Parcels in the Tenderloin, highlighted in light orange. The majority of the commercial tenants in the area are smaller, neighborhood-serving businesses, or public or non-profit sector organizations. None of these types of tenants would be affected by the proposed legislation, as the payroll tax does not apply to small businesses, non-profit organizations, or government organizations.

POLICY BACKGROUND

Tax Incentives and Job Creation: Enterprise Zone Policies

The proposed legislation can be understood as a variation on the policy of enterprise zones. First proposed in the late 1970s to stimulate the commercial redevelopment of blighted areas in Britain and the U.S., they generally involve reducing the tax burden of businesses who locate jobs within an economically-depressed area.

Research on the impacts of enterprise zones has been mixed[4]. While the general principle that reducing the business tax burden can encourage private-sector job growth is fairly uncontroversial among economists, this does not necessarily mean that zone-based policies create jobs, and the policy has been criticized on several grounds[5].

In some cases, tax incentives have been shown to be insufficient to stimulate growth in areas that have suffered severe economic downturns, due to deindustrialization, for example. Since it was precisely this problem that they were originally developed to rectify, it led many to conclude that tax incentives alone have a limited capacity to transform depressed areas and local economies. Since this research concerned national-level taxes which are far more costly to businesses than San Francisco's 1.5% payroll tax, it suggests locally-funded enterprise zones may have even more limited effect, in isolation[6].

On the other hand, when applied to less-depressed areas, enterprise zones are also subject to the criticism that they provide a tax subsidy to business location decisions that would have happened anyway[7]. In that context, a tax incentive that applies to specific areas can be understood as a form of commercial rent subsidy, particularly when it applies to existing occupiable space that does not require extensive investment or redevelopment. Reducing the business tax burden at a specific location increases the desirability of the site for businesses, and the increased competition for the site tends to raise rents. The public investment, in such cases, benefits property owners and does not create jobs.

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[4] See for example, Alan H. Peters and Peter S. Fischer, *State enterprise zone programs: have they worked?* (Kalamazoo: Upjohn Institute, 2002).

[5] It must be pointed out that most enterprise or empowerment zone policies target the tax incentives to employees who are unemployed or have barriers to employment. This is not the case with the current policy, which likely increases its effectiveness in job creation *per se*, though obviously not for the workers who are targeted in enterprise zone policies.

[6] Neumark and Kolko (2010), for example, found that California's state enterprise zone program have no effect, on average, on job creation. See David Neumark and Jed Kolko, "Do enterprise zones create jobs? Evidence from California's enterprise zone program", Journal of Urban Economics 68 no.1 (2010) 1-19.

[7] Recognizing this, policy evaluations of enterprise zones focus on—and are highly sensitive to—the choice of "control areas". These are economically-similar areas that did not receive a tax incentive, and whose employment changes are used to establish a benchmark for those areas that do.

The economic function of the industrial and commercial real estate markets is to ensure the utilization of built infrastructure by establishing market rents that businesses want to pay and property owners can accept to offset their capital costs. The introduction of a "market-closing" tax subsidy is only warranted, according to this line of reasoning, when a significant market failure exists that has caused significant underutilization of infrastructure for an extended period of time.

Other objections to enterprise zones address the efficacy and role taxes play in affecting business decisions and the overall process of urban economic development. Enterprise zones have also been criticized for encouraging business location but not creating "real" economic development in the targeted areas. Consequently, when the subsidies expire, businesses lose the incentive to locate in the area, jobs decline again, and the area reverts to a *status quo ante* situation[8].

By contrast, in areas that attract businesses without a subsidy, business location and expansion decisions often invite businesses and residences to follow suit, in a clustering process. As the area succeeds at attracting businesses, more businesses and workers want to be there. According to this logic, tax incentives alone are insufficient to initiate this clustering dynamic, and yet without clustering, the long-term economic benefits of tax incentives will not materialize.

This research on enterprise zones suggests that the job-creation benefits of geographically-focused tax incentives can be maximized, and their negative consequences minimized, by targeting the policy in three primary ways:

1. Avoid using tax incentives as a stand-alone policy, in areas where they are too small to have a real effect.
2. Limit tax incentives to areas where a significant market failure exists, as evidenced by a history of high vacancy rates and underutilized infrastructure.
3. Utilize tax incentives only when there is a significant likelihood of attracting businesses that can catalyze a genuine, sustained process of local economic development once the subsidies expire.

Special Characteristics of the Central Market Area

In some respects, the Central Market and Tenderloin area has some of the characteristics that could lead to a successful enterprise zone strategy, if the policy is targeted with sufficient care.

In the first place, as discussed above, the tax incentive is not

[8] See, for example, Suzanne O'Keefe, "Job creation in California's enterprise zones: a comparison using a propensity score matching model", Journal of Urban Economics 55 no. 1, (2004): 131. This generally positive assessment of the short-term employment impacts of enterprise zones concluded that the long-term impacts are negative

the only policy initiative the City has undertaken to encourage investment and economic activity in the area. Secondly, there are many properties in the area that have remained vacant for many years, either because the structures themselves need a large amount of new investment to be occupiable, or because of lack of demand from tenants. The existence of such areas suggests that growth in most properties in the Central Market area won't "happen anyway".

However, by far the most significant element in the potential impact that could occur in the area is the attraction of Twitter. The company has become one of the leaders in social media, which has been one of the fastest-growing segments in the information technology in recent years. In only three years, Twitter's valuation—the implied value of all of its stock—has risen to $3.7 billion in December 2010[9]. It has recently been reported that the company has turned down an acquisition offer in the $8-10 billion range, suggesting the company believes its true value will eventually exceed that figure[10].

Based on published media reports, Twitter is planning to vacate its existing space on Folsom Street because it wishes to expand its workforce. Based on information provided to the OEA by the Office of Economic and Workforce Development, Twitter is interested in leasing approximately 400,000 square feet of real estate over the next five years. Depending on the layout of the space, this could support 2,000 – 2,500 jobs. The average compensation in Twitter's industry in San Francisco is approximately $100,000 per year, about 35% higher than the average private sector salary in San Francisco of $73,000.[11]

There is no other large private sector company in the Central Market/Civic Center area, and certainly not one that is likely to add 2,000 jobs in the next several years. Moreover, because of Twitter's importance in the rapidly-growing field of social media, its growth is highly likely to generate a cluster of businesses in the same field.

If this cluster development happens in the wake of a potential Twitter relocation to the area, it would make it very unlikely that Central Market would revert to a *status quo ante* situation after the proposed legislation expires. The new presence of other technology companies and related businesses could, by themselves, make the area a more desired business location that it is now, with our without the proposed tax incentive.

None of this is to say that the proposed legislation would be

[9] Amir Efrati, "Profit Elusive, but Twitter gets $3.7 Billion Value" Wall Street Journal, December 15, 2010.

[10] Spencer E. Ante, Amir Efrati and Anupreeta Das, "Twitter as Tech Bubble Barometer", Wall Street Journal, February 10, 2011.

[11] Bureau of Labor Statistics, *Census of Employment and Wages* for San Francisco County. Twitter's industry classification (NAICS) code is 5182.

decisive in Twitter's decision to locate in the Central Market or to expand outside of San Francisco. While this question is vital in assessing the potential impact of the legislation, the OEA does not possess any inside information on the subject. The publically-available data bearing on this question will be reviewed in the next section.

Twitter's Situation

If Twitter does elect to move out of San Francisco, it would not be an unprecedented move for a company of its size. San Francisco has a history of struggling retain its larger businesses, while its small business sector has become an increasingly large share of total employment.

Recently-acquired data from the National Employment Time Series, which tracks individual businesses across locations and time, confirms this. Proportionally more San Francisco businesses moved out of the city during the last economic upswing, than from other Bay Area counties, while more businesses have left. As Table 1 indicates, 3.6% of all businesses in San Francisco in 2003 moved out during the economic upswing from 2003-8, the highest figure among the five largest Bay Area counties.

TABLE 1 **Rates of Business Move-outs, San Francisco and Other Bay Area Counties, 2003-8**

	San Francisco	Alameda	Contra Costa	San Mateo	Santa Clara
# of Establishments, 2003	65,569	87,111	56,086	48,315	105,980
# of businesses moved out, 2003-8	2,393	2,235	1,593	1,528	1,952
as % of 2003 total	3.6%	2.6%	2.8%	3.2%	1.8%

Source: NETS/Edward Lowe Foundation

Employee Stock Options and San Francisco's Payroll Tax

As stated in the introduction, San Francisco taxes payroll expense at 1.5% for businesses with total employee compensation above the small business exemption amount. Payroll expense includes all compensation to employees, including stock option grants.

It is common practice in the information technology industry to compensate employees with stock options. These options grant the right to purchase a specific number of shares in the company at a specific price, called the *strike price*. The shares come from among those internally held by the company itself, as opposed to those held by outside investors. A common practice for an early-stage, privately-held company is to grant its employees options at a low strike price, in the hope that the company will rise in value as it grows. Employees have the right to *exercise* the options, meaning they pay the strike price and receive shares that are usually equal or close to the market price of the stock at that time.

For example, the option may be structured such that if an employee is granted 10,000 options at a strike price of $1, and the company goes public, the employee has the option to exercise the option. If he or she does so at an exercise price of $50/share, the employee pays the company $1 x 10,000 or $10,000, and receives shares worth $50 x 10,000 or $500,000. After exercising the options, the employee receives shares that he or she can either hold or sell. The company's equity is reduced by $490,000, and the employee's equity is increased by the same amount.

The widespread practice of granting options in the technology industry stems from the belief that offering stock creates a greater incentive for employee performance than salary compensation, and from the belief that it allows the company to reduce its risk. Stock options create a liability for the company only if the company is successful, and the market value of the shares rises.

Twitter has received five publically-reported rounds of outside investment (see Table 2). During those rounds, the implicit market value of the company has risen from approximately $20 million to $3.7 billion. In each round, a share of the company is sold to private investors. An estimate of the total amount of the company held by outside investors can be adding up the share of the company that is sold in each round. Based on media reports, roughly half of Twitter is owned by outside investors, suggesting that the remainder is still owned by or optioned to company founders and employees.

TABLE 2 **Twitter's Reported Funding Rounds**

Date		Investment ($M)	Valuation ($M)	% of Equity
Jul-2007	1	$1	$20	5%
May-2008	2	$15	$80	19%
Feb-2009	3	$35	$250	14%
Sep-2009	4	$100	$1,000	10%
Dec-2010	5	$200	$3,700	5%
			Total:	53%

1 Michael Arrington, "Twitter Gets Their Venture Round", TechCrunch, July 26, 2007. Value is estimated.
2 Michael Arrington, "Twitter Announces Their Funding, Calls Itself A Communication Utility", TechCrunch, June 24, 2008.
3 Mark Hendrickson, "Twitter Raises $35 Million Series C From Benchmark and IVP", TechCrunch, February 13, 2009.
4 Brad Stone, "Twitter Confirms New Funding", New York Times, September 25, 2009
5 Spencer E. Ante, Amir Efrati and Anupreeta Das, "Twitter as Tech Bubble Barometer", Wall Street Journal, February 10, 2011.

Twitter's actual payroll expense tax liability depends upon its market value at the time employees exercise their options, and this is highly uncertain. At the time of writing, Twitter's stock options are being traded on a secondary market[12] at a company valuation of $7.3 billion. Twitter has reportedly rejected takeover rumors at a valuation of $10 billion, suggesting the company believes it would be worth more in the future[13].

As the only city in California to levy a payroll expense tax, San Francisco is the only city that imposes a local tax on stock options. The differences in business tax liability between San Francisco and other Bay Area locations are magnified for companies that grant stock options that are likely to be valuable in the future. If Twitter moved to the City of South San Francisco, for example, it would pay that city $15 per employee per year, or $37,500 a year for 2,500 employees.

Differences in tax liabilities between cities are important to business location decisions, but they are not the only consideration and cannot be considered in isolation. Commercial rent and tenant improvement cost differentials may offset tax differences, as may direct and indirect labor cost differentials. Intangible factors may also matter, but are hard to quantify by definition. If a business can access a broader labor force at lower wages in one city versus another, or workers incur lower commuting costs to one job site versus another, these costs factors can offset differentials in local taxes or commercial rents. Such tangible considerations are analyzed in the next section. Intangible factors, such as the branding value of a San Francisco location, are not analyzed in this report.

Commercial Rent Differentials

Based on published reports, the company is considering the SF Mart building in the Central Market area, and two locations in San Mateo County: the former Walmart.com building in Sierra Point in Brisbane, and the Centennial Towers in South San Francisco[14]. While the OEA does not have any information about Twitter's negotiations, or the Brisbane property, published asking rents for two of the properties on CoStar probably give a reasonably clear indication of the trade-off between Centennial Towers and the SF Mart.

The listed asking rents in the South San Francisco are actually considerably higher than those at the San Francisco Mart building, primarily because Centennial Towers is a new property, and includes thousands of free parking spaces. However, because of its greater age, and history of use as a furniture showroom and not an office building, the Mart will require expensive tenant improvements. These costs are generally borne by the tenants, and we have estimated them

[12] Sharespost.com

[13] Spencer E. Ante, Amir Efrati and Anupreeta Das, "Twitter as Tech Bubble Barometer", Wall Street Journal, February 10, 2011.

[14] Alexia Tsotsis, "Twitter Considers Moving Its Headquarters. To Brisbane, CA?" TechCrunch, January 13, 2011.

at $100/square foot, compared with $35/square foot in South San Francisco.

This brings the six-year occupancy costs in the two alternatives into closer alignment, although South San Francisco is still more expensive. As stated in the previous section, San Francisco's payroll tax covers all compensation to employees, including wages and salaries, stock options, and any other property or consideration. When only Twitter's business tax on its expected wages and salaries are considered, the two locations differ by $2.4 million over six years, as detailed in Table 3. San Francisco's higher business tax rate is offset by lower rents at the SF Mart location.

However, the future value of Twitter's stock options is unknown, but likely very large given their current value and the company's recent growth. Its future payroll tax liability for that form of compensation could be significant, perhaps reaching into the tens of millions of dollars over several years. If that is the case, the company's payroll tax would make a San Francisco location significantly more costly than a San Mateo County alternative.

TABLE 3 **Twitter's Estimated Building Occupancy and Tax Costs, San Francisco Mart and South San Francisco Location, Excluding Stock Options**

	Year 1	2	3	4	5	6	6-Year Total
Rent-SF Mart	$2.92	$2.92	$2.92	$2.92	$2.92	$2.92	
Monthly Rent - South SF	$4.25	$4.25	$4.25	$4.25	$4.25	$4.25	
Twitter's Anticipated Occupied Square Footage	200,000	300,000	400,000	400,000	400,000	400,000	
Annual Rent Payment - SF Mart ($M)	$7.0	$10.5	$14.0	$14.0	$14.0	$14.0	$73.6
Annual Rent Payment - South SF ($M)	$10.2	$15.3	$20.4	$20.4	$20.4	$20.4	$107.1
Tenant Improvements - SF Mart ($M)	$20.0	$10.0	$0.0	$0.0	$0.0	$0.0	$30.0
Tenant Improvements - South SF ($M)	$7.0	$3.5	$0.0	$0.0	$0.0	$0.0	$10.5
Total Annual Occupancy Costs - SF Mart ($M)	$27.0	$20.5	$14.0	$14.0	$14.0	$14.0	$103.6
Total Annual Occupancy Costs - South SF ($M)	$17.2	$18.8	$20.4	$20.4	$20.4	$20.4	$117.6
Business Tax excluding stock options - SF Mart ($M)	$1.6	$2.4	$3.2	$3.2	$3.2	$3.2	$16.6
Business Tax - South SF ($M)	$0.02	$0.02	$0.03	$0.03	$0.03	$0.03	$0.2
Occupancy Costs and Taxes - SF Mart ($M)	$28.6	$22.9	$17.2	$17.2	$17.2	$17.2	$120.2
Occupancy Costs and Taxes - South SF ($M)	$17.2	$18.8	$20.4	$20.4	$20.4	$20.4	$117.8
						SF Premium	$2.4

Sources: For asking rents: CoStar reports. For Twitter absorption: OEWD.
Assumptions:
Tenant improvements: $100/sf for the SF Mart, $35/sf for South SF location.
SF Business tax excluding stock options: Absorption divided by 190 sf/employee (equaling headcount) x $100,000 annual salary x 1.5%.

While this analysis cannot definitively indicate how Twitter perceives its options, if these numbers are roughly correct, it suggests that the proposed legislation would have a significant financial benefit for Twitter.

Asking rent data for the property on Marina Boulevard in

Brisbane is not available on Costar. However, that property is 25 years old and is unlikely to rent for more than the new Centennial Towers. To the extent that they rent for less than Centennial Towers, it only exacerbates the affordability gap that San Francisco faces because of its payroll tax.

Transportation Costs

There still may be other tangible and intangible factors that the company might consider in making its decision. Among the tangible factors is labor access and cost. The SF Mart and South San Francisco locations offer different levels of transportation service and accessibility to workers. Workers who commute to jobs in San Francisco are far more likely to travel by transit, biking, or walking. These modes of transportation offer much lower operating costs than driving to work, which most workers in San Mateo county do. However, those workers who do commute by car to jobs in San Francisco—and 35% of the city's IT workers are in that category—must generally pay for parking, which adds to that costs. In suburban office locations, parking is usually free.

Table 4 summarizes an analysis of census data from 2005-9. This data allows for the direct cross-tabulation of results of a survey that the census sends to 1% of U.S. residents each year. The sample is restricted to IT workers who commute to jobs in either San Mateo or San Francisco counties, and calculates the split of workers by mode of transportation, and their average one-way commuting time by mode. Operating cost / trip is estimated based on published monthly transit prices, and current monthly new auto lease, insurance, fuel prices.

TABLE 4 **Commuting Time and Operating Costs: Information Technology Workers commuting to San Francisco and San Mateo Counties**

	Work in San Francisco			Work in San Mateo County		
	% of commuters	Average commute time	Cost/Trip	% of commuters	Average commute time	Cost/Trip
Auto from within SF	14%	21	$11.80	11%	41	$9.74
Auto from outside SF	21%	47	$13.51	80%	31	$9.67
Transit from within SF	22%	30	$1.50	2%	60	$1.61
Transit from outside SF	31%	58	$5.60	3%	53	$1.07
Bike/Walk	11%	20	$0.02	3%	20	$0.02
All modes		40	$6.64		33	$8.93

Source: IPUMS/American Community Survey, 2005-9
See Appendix A for assumptions.

On average, San Francisco commutes offer lower out-of-pocket costs, but take more time. The city's average high time cost of commuting particularly discourages workers in high-wage industries, such as information technology. Even if workers do not value commuting time at only half the value of their hourly wage, total commuting costs is still a slightly higher percentage of worker salaries than it is in San Mateo county. This means that a San Francisco location—despite is centrality in the region, and despite the variety of transportation options that are available—does not necessarily translate into a competitive advantage in attracting information technology workers.

TABLE 5 **Commuting Time and Operating Costs: Information Technology Workers commuting to San Francisco and San Mateo Counties**

	San Francisco	San Mateo	Difference
One-Way Average Commuting Costs	$6.64	$8.93	$2.29
Annual Commuting Costs (480 trips)	$3,186	$4,288	$1,101
One-Way Average Commuting time (min)	40	33	-7
Annual Commuting Time (hours)	319	265	-53
Average Hourly Salary	$44.54	$50.08	$5.54
% discount for commute-time valuation	50%	50%	
Annual Time Cost of Commuting	$7,100	$6,647	-$453
Annual Total Cost of Commuting	$10,287	$10,935	$648
as % of annual salary	11.1%	10.5%	-0.6%

Source: IPUMS/American Community Survey, 2005-9

Table 5 also indicates that average wages for information technology workers are considerably less in San Francisco than they are in San Mateo county. This could, in theory, be an additional source of advantage associated with a San Francisco location. However, statistical analysis of individual worker information from the census data suggests that these wage differences can fully be accounted for by differences in education, age, and other variables that affect earnings.

IT workers in San Mateo are more likely to have a graduate degree, and be older, than their San Francisco counterparts. When those differences are accounted for, the impact of a San Francisco location *per se* on wages is statistically insignificant.

ECONOMIC IMPACT ASSESSMENT

Fiscal and Economic Impacts

The foregoing section focused on establishing the relative importance of business tax differences in the overall cost accounting of a San Francisco and a San Mateo County location.

It found that Twitter's business tax burden would be sufficiently large to outweigh the benefits of paying a lower rent in the SF Mart in the Central Market area. In addition, labor factors such as accessibility and costs do not appear to dramatically favor one location over another. Therefore, on balance, it appears that Twitter would stand to realize significant savings over the next several years by moving out of San Francisco.

This cannot be taken as conclusive proof that Twitter *will* leave San Francisco if the proposed legislation is not enacted, but the analysis that follows is based on the assumption that it will.

This section is focused on estimating the broader economic impact of enacting the proposed legislation, assuming that Twitter moves to the SF Mart in such a situation. The alternative scenario considered is one in which the proposed legislation is not enacted, Twitter leaves San Francisco, and the Central Market area continues as before.

The fiscal and economic impact of the legislation hinges on what one believes will happen to the large commercial properties Market Street between 7^{th} and Van Ness if Twitter does, or does not, come to the area. Commercial real estate owners in the area have seen stagnating public sector demand, and declining private sector demand, for many years.

In addition, a great deal of commercial space will be vacated in the near future. The new San Francisco Public Utilities Commission headquarters at 525 Golden Gate will be completed in Spring 2012, leading the PUC to vacate its premises at 1145 and 1155 Market Street. The State Compensation Insurance Fund is moving out of San Francisco, vacating its office building at 1275 Market beginning in September of this year. The Bank of America has recently sold its building at 1455 Market, and will reportedly vacate all of its employees soon. Just outside of the Central Market area defined in the legislation, the AAA tower at 100 Van Ness is almost entirely vacant. Between these properties and the San Francisco Mart, approximately 3 million square feet of office space in Civic

Center is due to become vacant in the next 18 months.

How and when this space becomes re-occupied is very much an open question, yet will vitally affect the ultimate impact of this proposed legislation. Whatever net new payroll growth that occurs in the companies that occupy vacant properties would be excluded from the payroll tax by the proposed legislation. This would apply to any business that moved to the area from outside the city limits of San Francisco, and to any net payroll growth at a current San Francisco business, for six years.

If property owners react to the heightened vacancy in the district by reducing asking rents in order to fill space at all costs, then many new businesses and jobs will move into these buildings. On the other hand, property owners with a longer-term perspective may elect to hold the line on rents, tolerate higher vacancy in the short term, and wait for higher rent-paying tenants to possibly appear in the future. In this case, there may be little new employment growth in the area.

Forecasting this is highly uncertain. But it does seem reasonable to assume that if Twitter – one of the largest technology companies in San Francisco – makes a decision to locate in the Central Market area, it will legitimize the area in the eyes of other technology companies. Since the technology industry is growing rapidly in the city at the moment, it seems reasonable to assume that if Twitter moves to the area, the area could recover occupancy to a typical 85% average occupancy rate in perhaps five years. Since, as discussed in the previous section, it seems unlikely that Twitter would remain in San Francisco if the proposed legislation is not enacted, this assumed absorption of space can be considered an impact of the legislation.

If the proposed legislation is not passed, and Twitter chooses the South San Francisco location, it is less clear where demand for real estate in the area would come from. It seems reasonable to assume that it could take ten years for the 3-odd million square feet of space to be re-occupied to a slightly lower average occupancy rate of 75%. In addition, without a major private-sector magnet like Twitter, it seems unlikely that more than 50% of these future tenants would pay the payroll tax. Much of the employment base in the Central Market area now are government, non-profit, and small business employers, all of whom are exempt from San Francisco's business tax. If the area becomes the home of an information technology cluster, on the other hand, perhaps 90% of the employees would be in businesses subject to the payroll tax[15].

These assumptions are not based on any verifiable data sources, but if they are reasonably close to what might happen in both scenarios, the proposed legislation would both generate higher payroll tax revenue, and more employment, over a twenty year period.

The fiscal impact is positive, despite the fact that none of the properties are assumed to generate any payroll tax for the first six years, and even discounting future payroll tax revenue at 5% per year. This is because on year 7, in a Twitter scenario, the entire area would already be fully occupied with higher-wage employees, at a higher employment density, 90% of whom would be payroll-taxable. In a no-Twitter scenario, in year 7 the properties would still have significant vacancy, and their occupants would be lower-wage employees, similar to those in the Civic Center area now.

Given the uncertainty surrounding these assumptions, little weight should be given to the actual revenue and job estimates themselves, or the differences between the two scenarios. The primary point is that, under reasonable assumptions, the City's annual payroll tax revenue is nearly three times higher, over a 20-year period, with Twitter and the exclusion than without it. This strongly suggests that the proposed legislation, by catalyzing a new form of economic development in the Central Market area, will generate fiscal benefits for the City in the longer term.

By comparison, the job differences are slighter, and are exclusively attributable to the assumptions that office vacancy declines faster in the Twitter scenario, and that employment density is higher as well (assumed because rents will be higher in the Twitter scenario, and businesses will have a greater incentive to conserve space).

[15] At an average salary of $100,000, an internet business would need only three full-time employees to be too large for the City's small business exemption to the payroll tax.

TABLE 6	Fiscal and Economic Impact of the Proposed Legislation in the Large Commercial Properties

	With Twitter	Without Twitter	
Assumptions			
Years to absorb vacant space	5	10	
Maximum average occupancy	85%	75%	
Gross Square Feet / Employee	250	300	
% of employees payroll-taxable	90%	50%	
Average salary of payroll-taxable	$100,000	$75,000	
Years payroll tax is not excluded	14	20	
Impacts	With Twitter	Without Twitter	Difference
Average 20-year payroll tax revenue, discounted at 5% ($M)	$4.2	$1.5	$2.7
Average Annual Employment, 20 years	7,604	6,460	1,144

Because the job and payroll tax impacts are both positive, other City tax revenue impacts can be expected to be positive as well. Business-driven hotel tax revenue is roughly proportional to employment, and is particularly influenced by the presence of corporate headquarters. Commercial rents and property values will indisputably rise if Twitter is attracted to the area, which will lead in time to higher property tax and transfer tax revenues. More employment should also lead to higher utility and sales tax revenues.

It is important to stress that, but for Twitter moving to the area, the proposed legislation would probably have relatively little effect on the re-occupation of these properties, analogous to a very small enterprise zone incentive. The 1.5% savings on net new payroll in the vacant land represents approximately 15-25% of currently average commercial rents in the property. This means that businesses that would benefit from the proposed legislation would pay somewhat more to be located in the area, and that property owners would earn higher rents. It does not necessarily mean that more businesses will come to the area, more hiring will take place, or the occupation of the space will take place more quickly.

It is the attraction of Twitter to the area, and not the reduction of taxes, that is fundamental to the positive fiscal and economic impacts of the proposed legislation. The proposed legislation is not a “silver bullet” to all of the shortcomings of enterprise zone policies. But because it impacts a company that has the potential to create long-term economic development in the area, it can be expected to generate both higher revenues and more jobs over the long term.

Occupational Impacts

If Twitter moves to the Central Market area and forms the focal point of an information technology cluster, the jobs created in these companies will require significantly more education, on average, than the average San Francisco job. Approximately half of the adults in San Francisco's resident workforce have a four-year university degree, or more higher education. Half have some college education but not a four-year degree, a high school diploma, or less than a full high school education.

Office employment in San Francisco has become increasingly specialized in jobs requiring high levels of education for several decades. In the 2005-9 periods, according to Census data, 29% of all workers in San Francisco office industries had a graduate degree, and another 46% had a four-year degree. Only 16% of workers had only some college education, and only 10% had a high school education or less.

The corresponding distribution for the IT industries in San Francisco is even more heavily weighed towards the university-educated: 26% had graduate degrees, 58% had a four-year degree. Only 11% had some college, and only 5% had a high school education or less.

In the past, the Civic Center / Central Market area was one of the few employment centers in San Francisco that offered significant numbers of office jobs for those with less than a four-year education. These jobs, such as customer service support, payroll and other back office functions, bookkeeping and other clerical jobs, often require only a high school education yet offer greater career-path potential than many of the minimum wage jobs that are commonly held today by workers with a high school education.

These jobs have been leaving San Francisco for many years, though the U.S. outlook for many of these occupations is strong, and they form a significant amount of the office employment in other Bay Area locations. Several of the buildings in the Central Market area contained jobs of that type. San Francisco's inability to retain these jobs in the Central Market area, coupled with a growth of high-skill information technology jobs in the same area, suggests that the lower-skilled office jobs will disappear from the city permanently, barring some major future change in the city's competitiveness relative to other Bay Area locations.

To be sure, this is clearly not a case in which commercial property owners are actively displacing more established businesses in favor of technology companies who can pay a higher rent. The Bank of America, AAA, and SCIF buildings were all owned by the employer, and vacated on their own accord. Moreover, the low prices for which these buildings are selling suggests that they could be financed with extremely low rents. Yet their continuing high vacancy rates suggest that any tenants who could pay even those low rents simply aren't in the market. In the short term, and in the absence of a significant change in the city's competitive position, the choice in the Central Market may not between a Twitter-led information technology cluster and lower-skill office work. The choice may be between an information technology cluster, and vacant buildings.

Having said that, retaining a large technology headquarters like Twitter could have important workforce advantages in the future. San Francisco, as discussed earlier, has a reputation for incubating new businesses, and then failing to retain them as they reach a larger size. Yet it is precisely the smaller companies which rely most exclusively on the highly-skilled worker, since so much of their resources are focused on innovation and product development. Only once a company reaches a certain size is there the likelihood that it will bring in-house a wider range of office functions.

In addition, if Twitter continues to be a success, it would be in the company's interest to help organize a local workforce development system specific to its industry. Many of San Francisco's colleges, universities, and high schools have programs aimed at careers in the media and Internet industries. What such programs need to be successful is deep involvement from leading businesses in the industry.

RISK MITIGATION

Policy Considerations

This research suggests that two changes to the proposed legislation could reduce risks of an adverse economic impact, and increase the benefit to the General Fund while maintaining its economic benefits. In addition, two related policy ideas are offered for the consideration of decision-makers.

1. The legislation currently states that if a business has premises within the area, it is eligible to exclude its net new payroll. Because payroll tax is calculated and paid on a city-wide basis, not on a premises-by-premises basis, this creates a loophole in which a large local business could open a satellite location in the area, and deduct *all* net new payroll city-wide. This problem can be fixed by requiring multi-location businesses to apportion their payroll, such that they are only eligible to exclude net new payroll within the area.

2. Removing large commercial properties, other than the SF Mart, from the area would increase the benefits to the General Fund, while having only a minor impact on the economic benefits of the legislation. Including the SF Mart is vital to retaining Twitter in the city. Including the other properties, for which no large retention target has been identified, creates a marginal incentive at best, but still requires the City to forego the payroll tax revenue that would have happened there anyway as the buildings become re-occupied. As detailed in the previous section, the payroll tax impact of the proposed legislation is estimated to be a $4.2 million gain over the next twenty years. If the large properties (1145, 1145, 1275, 1455 Market and 30 Van Ness) were excluded, the gain would be an estimated $5.5 million a year.

3. The large amount of commercial vacancy that will appear in the area in the next few years highlights the economic importance of ensuring the maximum utilization of existing properties and infrastructure. While, as discussed in the previous section, property owners have a decision to make regarding how low to reduce rents to ensure occupancy, the economic and financial interests of the City are clearer. As a policy idea that is not directly tied to the proposed legislation, the City could structure a parcel tax on vacant commercial property, which would not apply to occupied commercial property. This would encourage owners of vacant commercial

property to be flexible on rent, and thereby maximize occupancy and employment in the city. This tax could not be included in the proposed legislation, as it would have to be submitted to the voters pursuant to Proposition 218. Nevertheless, it is mentioned here as a future policy consideration.

4. Finally, this analysis suggests that an important variable in the fiscal and economic success of the proposed legislation is Twitter's decision to locate in the Central Market area instead of moving out of San Francisco. In turn, Twitter's potential future payroll tax liability associated with its stock options appears to be the largest cost factor weighing against a San Francisco location. The City should consider modifying the payroll expense tax, to reduce the incentive for successful technology companies to move out of San Francisco.

APPENDIX A

This appendix lists the assumptions used in calculating average commuting costs by automobile by information technology workers in San Francisco and San Mateo counties.

Assumption	Value	Notes
Average auto speed in Traffic, SF-San Mateo	30	Google Maps: 94117 - San Mateo, CA (19.7 miles, 40 minutes in traffic)
Average auto speed in Traffic, SF-SF	12	Google Maps: 17th and Stanyan - 2nd and Bryant (5.0 miles, 25 minutes in traffic)
Average auto speed in Traffic, SM-SM	38	Google Maps: Sneath Lane - Foster City
Average auto speed in Traffic, East Bay-SF	20	Google Maps: College & Broadway Oakland - 2nd and Bryant (2/3) and San Mateo - 2nd and Bryant (1/3)
Auto & Insurance costs attributable to auto commuting	70%	
Auto & Insurance costs attributable to park-n-ride	15%	
Lease monthly costs	$259	Prius Northern California Lease deal, 3/2/2011
Lease upfront (to be amortized at 0%)	$2,999	Prius Northern California Lease deal, 3/2/2011
Calculated: Total Monthly lease costs	$342.31	
Average monthly insurance costs	$46.75	minimum monthly insurance costs with Progressive for new Prius
Monthly auto costs attributable to auto commuting	$272.34	
San Francisco monthly parking costs	$175	
San Mateo monthly parking costs	$0	
Average 1-way Driving Distance, SF-SF	4.2	Calculated based on assumed average speed and Census-reported time
Average 1-way Driving Distance, SF-SM	20.1	Calculated based on assumed average speed and Census-reported time
Average 1-way Driving Distance, SM-SM	19.6	Calculated based on assumed average speed and Census-reported time
Average 1-way Driving Distance, NonSF-SF	15.9	Calculated based on assumed average speed and Census-reported time
Average MPG	50	Prius Northern California Lease deal, 3/2/2011
Cost of Gasoline per Gallon	$3.80	
Repairs, registration, maintence taxes (per mile)	$0.07	
Depreciation per mile	$0.00	Vehicles are leased

STAFF CONTACTS

Ted Egan, Chief Economist (ted.egan@sfgov.org) (415) 554-5268

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