OFFICE OF THE CONTROLLER
CITY AND COUNTY OF SAN FRANCISCO

Ben Rosenfield
Controller

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Deputy Controller

MEMORANDUM

TO: The Honorable Board of Supervisors

FROM: José Cisneros, Treasurer
Ben Rosenfield, Controller
Ted Egan, Chief Economist

DATE: July 12, 2023

SUBJECT: **Business Tax Letter of Inquiry**

Introduction

In October 2022, Supervisor Rafael Mandelman requested that our offices study how the City's business tax system is being challenged by recent trends towards remote work. The several taxes that the City imposes on businesses, including the Gross Receipts Tax, the Homelessness Gross Receipts Tax, the Commercial Rents Tax, and the Overpaid Executives Tax, comprise the City's second-largest source of tax revenue, after Property Tax.

The analysis that we conducted points to several areas of emerging risk in these revenue streams. The report covers the following topics:

- Summary of Findings
- San Francisco's Economic Growth Trends
- Changes in City Tax Revenue
- Remote Work and Business Taxes
- Remote Work and Taxes on Commercial Property Activities
- Progressive Taxation and Concentration Risk
- The Office Market and San Francisco's Tax Competitiveness

Summary of Findings

During the 2010s, the rapid growth of the tech industry, and the entire city economy, fueled growth in City tax revenues, particularly from business taxes.

The City, which started the decade with the highest business tax burden of any city in California, further raised that burden with several rate increases and new taxes.

None of these changes stopped San Francisco from being one of the fastest growing cities in the country during the 2010s, although it did deepen three sources of risk in the City's finances.

First, the City's business tax revenue increasingly comes from a smaller handful of large taxpayers, mainly in the technology sector. These businesses could potentially reap substantial tax savings by locating in other Bay Area tech centers. With the persistence of hybrid work, most of them are currently reducing their office space needs in the city, and elsewhere.

Secondly, the City is increasingly reliant on taxes on the leasing and sale of commercial office properties. Remote work has led to a reduced volume of transaction of these properties, and there is some evidence of a marked reduction in property values. Both trends lead to revenue weakness for the City.

Finally, both structural changes in the city's economy, and policy choices to make the tax system more progressive, has had the effect of raising overall revenue volatility by concentrating revenue in a few payers. This runs counter to a long-standing City policy goal of minimizing volatility by broadening the tax base.

Background: San Francisco's Economic Growth Trends

The two decades prior to the COVID-19 pandemic brought unusually strong economic and population growth to San Francisco. In inflation-adjusted dollars, the total value of goods and services produced in the city more than doubled from 2001-2021[1]. The 2011-2021 decade was particularly strong; the city's GDP grew by 7.0% annually during that time.

The city's population grew as well, though not nearly as quickly. Before the pandemic prompted a major decline, the city's population had grown at a 1.0% annual rate between 2004-2019. This was the city's fastest pace of population growth since the 1940s.

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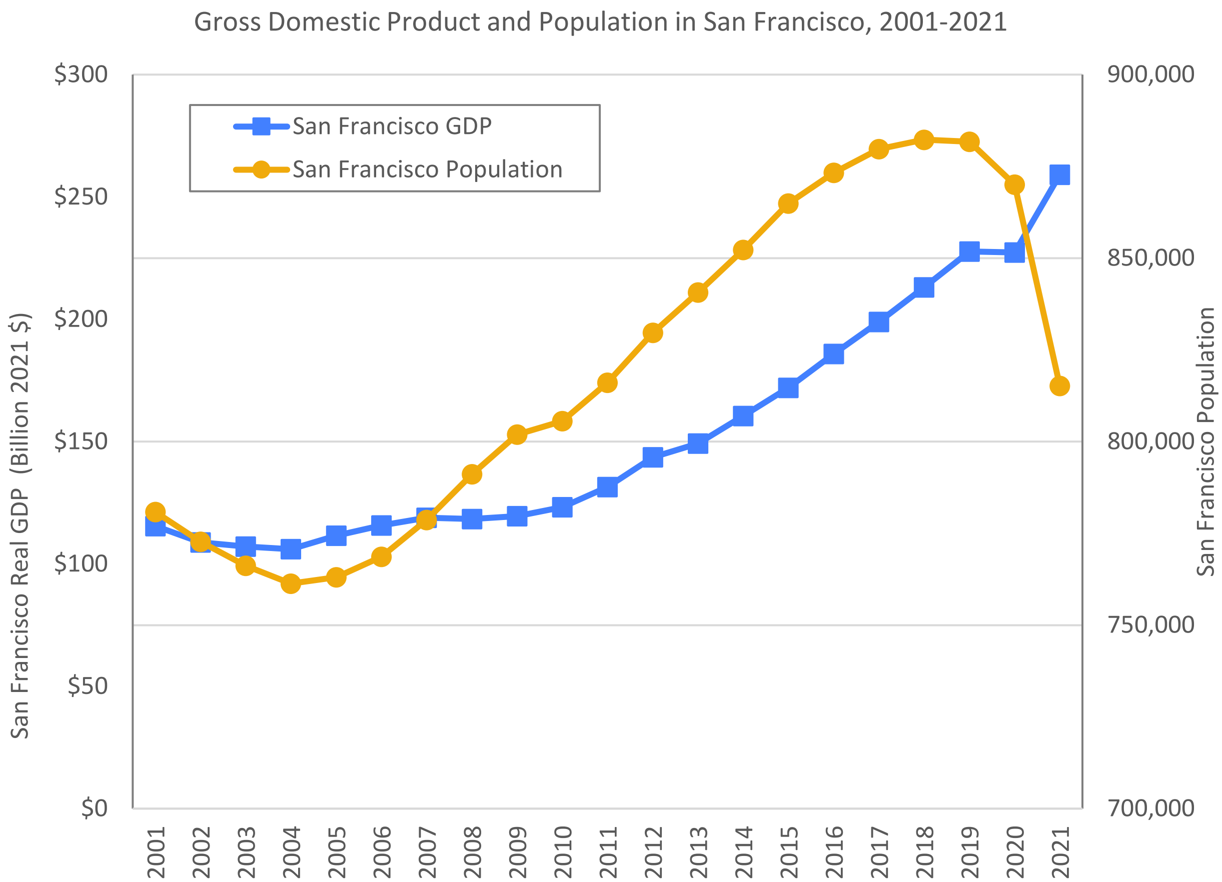
[1] Unless otherwise noted, years in this report refer to calendar and not fiscal years.

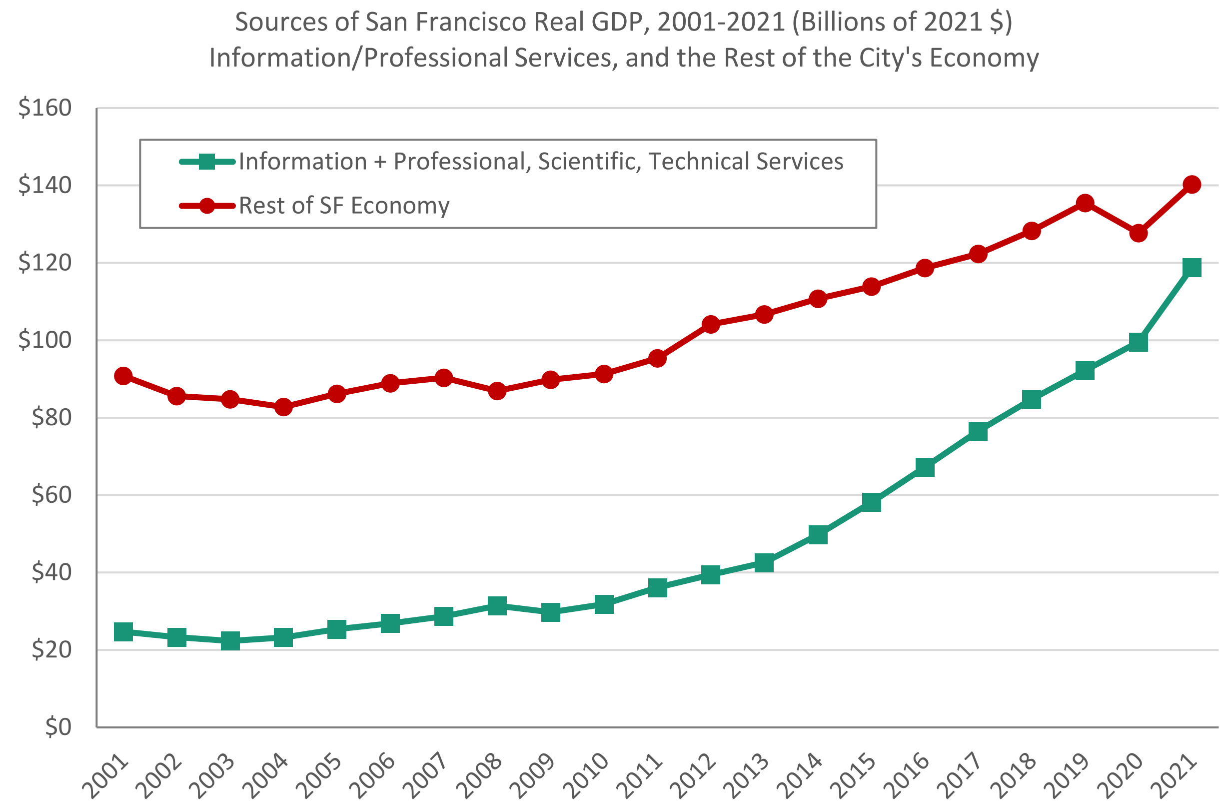


Source: Bureau of Economic Analysis

Important structural changes occurred within the city's rapidly-growing economy. From 2011-2021, the technology sector[2]'s GDP in the city grew by 12.7% per year, more than 3 times faster than the 3.9% average growth rate of the rest of the city's economy during that time. By way of contrast, the State of California's average GDP growth rate during this period was 3.4%.

As of 2021, the Information and Professional, Scientific, and Technical Services sectors made up 46% of the city's total GDP, up from 21% in 2001.

[2] In state and federal economic statistics, internet, software, and IT services companies are classified within the Information and Professional, Scientific, and Technical Services sectors.



Source: Bureau of Economic Analysis

Changes in City Tax Revenue

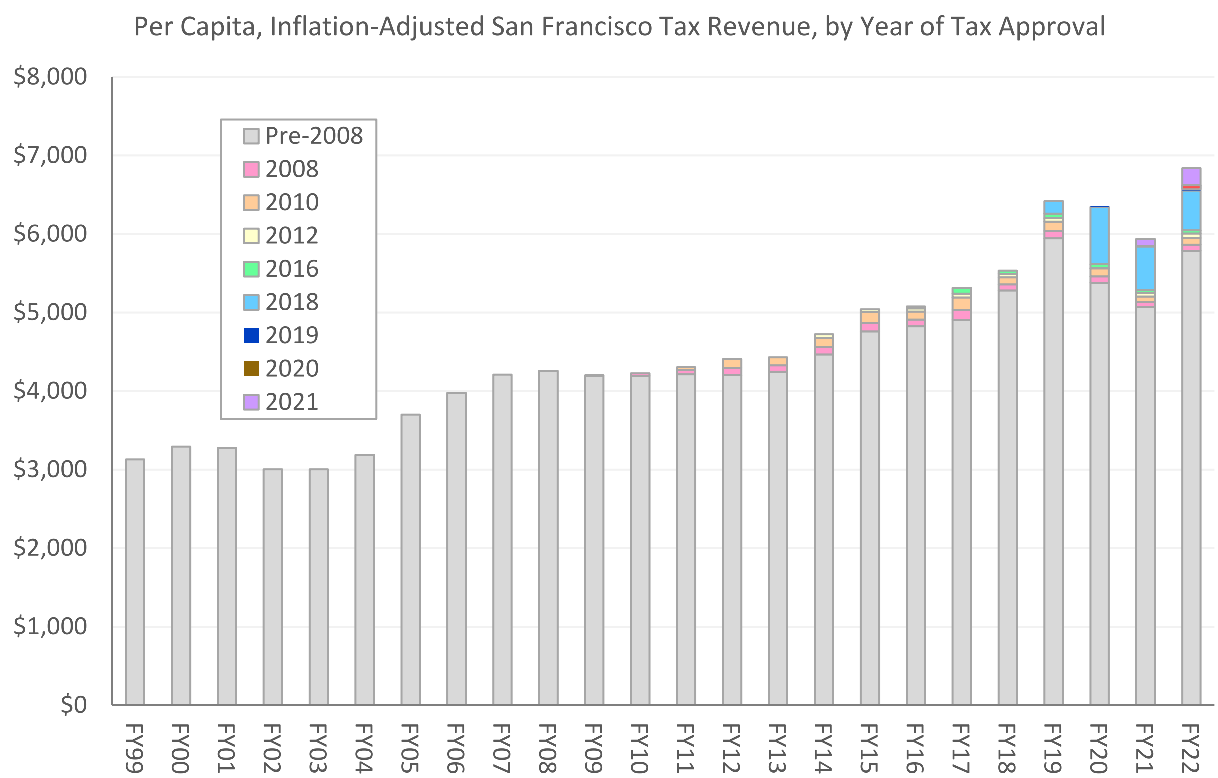
This record of strong economic growth has led to substantial growth in City tax revenue. Per capita tax revenue in San Francisco has more than doubled in twenty years, after adjusting for inflation. The City received $3,003 in tax per resident in fiscal year 2002-03 (in 2022 dollars). In the most recent fiscal year 2021-22, tax revenue per resident was $6,838.

Economic growth has been just one source of revenue growth for the City. San Francisco voters also approved several tax increases since 2008, which have contributed to tax revenue. Under California's Proposition 218, all local tax increases must be approved by voters.

In 2008 and 2010, two increases to the Real Property Transfer Tax were approved. In 2012, voters approved a change to the City's business tax that introduced a new Gross Receipts Tax, while beginning a phase-out of the old Payroll Expense Tax. That shift did not lead to new revenue, but the measure also included a $32 million increase in the business registration fee.

In 2016, another increase to the Transfer Tax was approved. In 2018, voters approved two new business taxes – one on commercial rents, and another, to fund homelessness services, on the gross receipts of large businesses. In 2019, a Transportation Congestion Mitigation Tax was adopted, and in 2020, voters approved an additional increase to the Gross Receipts Tax (Prop F) and an additional Transfer Tax increase. All of these new revenue sources are reflected in the chart below.

While the pre-2008 taxes account for most of the City's tax revenue, the post-2008 taxes comprised 15% of the total by fiscal year 2020. In 2020 voters also approved an Overpaid Executives Tax, which went into effect in 2022, and is not reflected in the chart[3].



Source: Office of the Treasurer and Tax Collector / Controller's Office

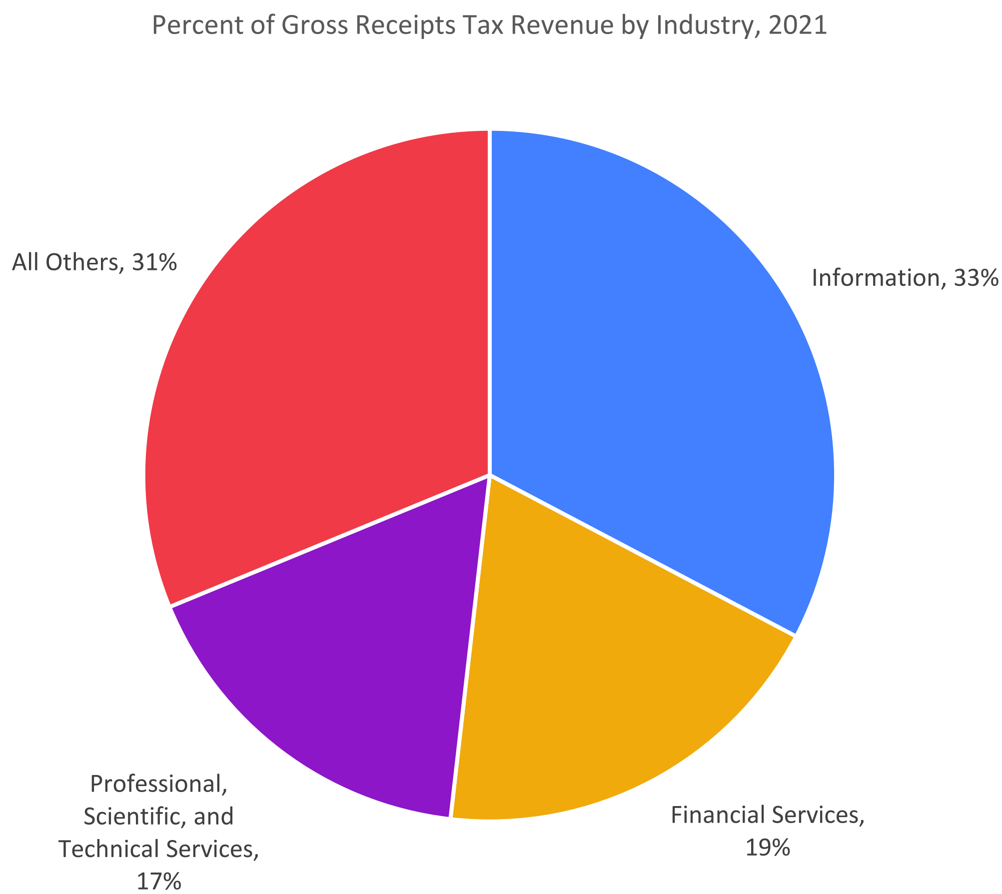
[3] Voters approved other taxes as well, though their revenue is small and not reflected on the chart. These include the Sugary Drinks Tax (2016), the Cannabis Business Tax (2018), and the Commercial Vacancy Tax (2020).

Remote Work and Business Taxes

As of 2023, the City's largest business tax is the Gross Receipts Tax, which generates about $800 million per year in revenue for the City.

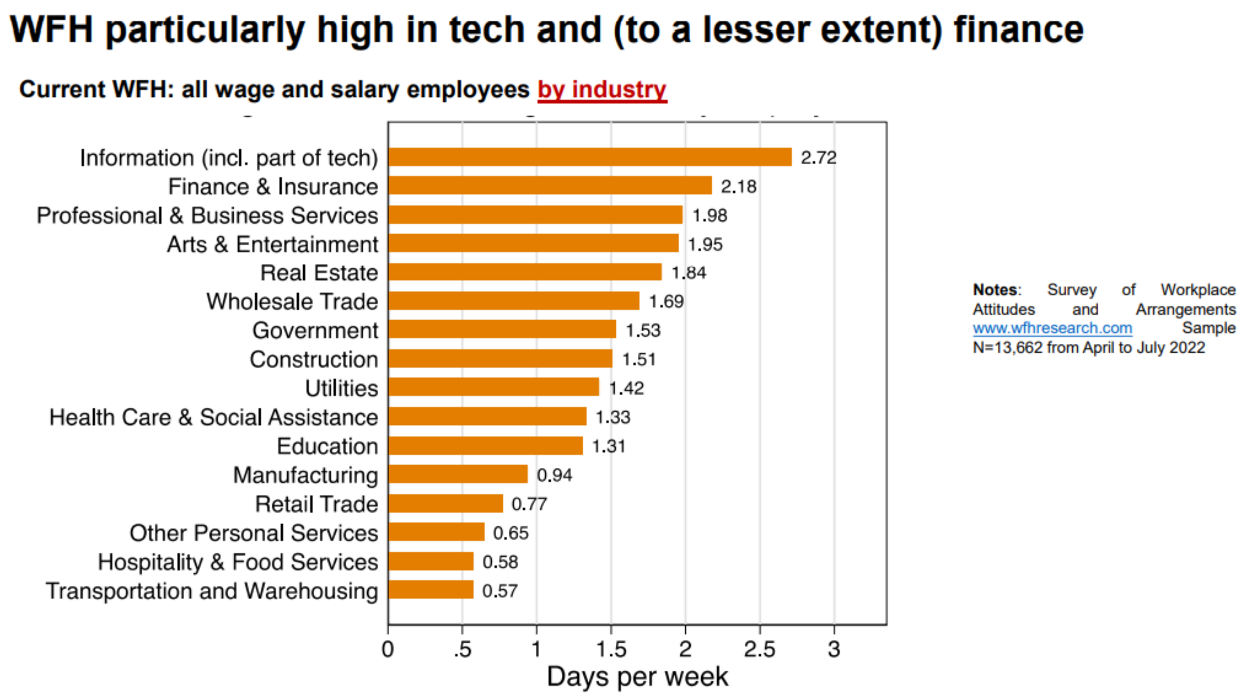
Both the Gross Receipts Tax and Homelessness Gross Receipts Tax are heavily weighted towards three industries in the city: Information, Financial Services, and Professional, Scientific, and Technical Services. As noted earlier, the growth of Information and Professional, Scientific, and Technical Services far outpaced the rest of the local economy.

Together, these three industries owed 69% of the City's Gross Receipts Tax, and a higher share of the Homelessness Gross Receipts Tax. Because of the City's disproportionate reliance on tax revenue from these industries, significant changes in how they operate can have an outsized fiscal impact on City government.



Source: Office of the Treasurer and Tax Collector / Controller's Office

During the pandemic, non-essential office workers were required to work from home. Unlike most other activities that were curtailed at that time, in-office work has not returned to levels seen before 2020. National surveys of remote work behavior conducted by Stanford researchers found that three industries: Information, Finance & Insurance, and Professional and Business Services – lead this trend within the U.S. economy.

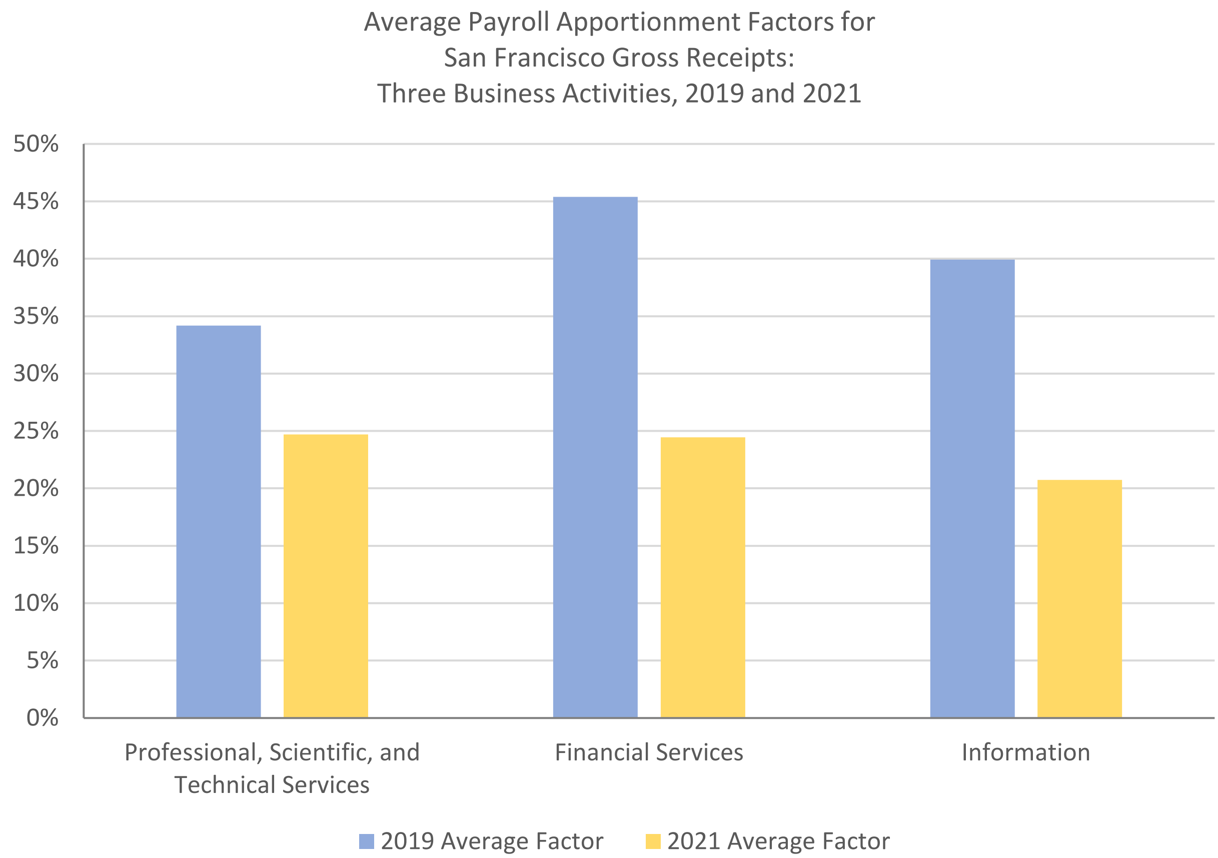


Source: Barrero, Jose Maria, Nicholas Bloom, and Steven J. Davis, 2021. "Why working from home will stick," National Bureau of Economic Research Working Paper 28731.

Working from home can have a direct effect on how much tax a business owes the City. For most office-using industries, both the current Gross Receipts Tax, and its predecessor, the Payroll Expense Tax, depend partly on the share of a business's payroll expense which is incurred within San Francisco. Local governments are only constitutionally permitted to tax activities that are "fairly apportioned" to their locality.

This percentage, called a "payroll apportionment factor", is reduced when employees who used to work in San Francisco offices, instead work remotely from home outside of the city. On the other hand, the factor is increased when San Francisco residents, who formerly commuted out of the City, instead work at home.

The pandemic had a measurable impact on payroll apportionment factors. For the three industries that pay most of the City's Gross Receipts Tax, average payroll apportionment factors declined substantially between 2019 and 2021. The average factor for Professional, Scientific and Technical Services declined by about a quarter. The factor for Financial Services and Information both declined by nearly half.



Source: Office of the Treasurer and Tax Collector / Controller's Office

As a way of providing perspective on the fiscal impacts of remote work on the City, it is possible to compare the actual Gross Receipts Tax base in 2021 to what it would have been if apportionment factors had not declined during the pandemic. For the three industries that we have been discussing, the major declines in apportionment factors just discussed have major financial implications.

If their payroll apportionment factors had not declined, businesses in these three industries would have owed $484 million more in Gross Receipts Tax and Homelessness Gross Receipts Tax, combined, than they did owe.

It is important to note that this figure is not a real budgetary loss. At no point did the City's revenue from those two taxes decline by that amount. However, the figure can be viewed as a fiscal impact of remote work – revenue that the City was not owed, because office employees are spending less time physically working in San Francisco[4].

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[4] This analysis assumes that San Francisco could have accommodated the new employment associated with that growth in gross receipts, if remote work had not become prevalent. However, according to data from the Bureau of Labor Statistics, employment at San Francisco-based establishments in these three industries grew by only 1.8% between 2019

Industry	Foregone Tax Revenue From Reduced Apportionment Factors ($M)
Financial Services	$230
Information	$151
Professional, Scientific, and Technical Services	$103
Total, Three Sectors	$484

Source: Office of the Treasurer and Tax Collector / Controller's Office

Remote Work and Taxes on Commercial Property Activities

The City's new and increased taxes on commercial property activity also serve to create new revenue risks, given the persistence of remote work. Each of the four Transfer Tax increases which the voters have approved since 2008 have been focused on the largest properties, which are mostly office buildings. The Commercial Rents Tax covers almost all commercial properties, but office properties pay the higher rate, and generate most of the revenue.

Remote work appears to be placing stress on the city's office market, and this increases the risks associated with taxes that are based on office leasing and sales activity. As noted below, office vacancy rates are rising across the country, and particularly in San Francisco. Uncertainty about property values has lowered the number of transactions of these properties, which has limited the City's Transfer Tax revenue. One office transaction that has recently been completed in the city resulted in an estimated 80% decline in market value from pre-pandemic levels[5]. The City can expect weakness and volatility in both Transfer and Commercial Rents Taxes, even after the office market stabilizes, if remote work leads to a permanent reduction in property values.

Although Property Tax is a State tax and San Francisco voters cannot alter its rate, remote work is also likely to have an impact on both commercial and residential Property Tax revenue, as noted in earlier research by the Controller's Office[6].

and 2021. This is far below the growth rates of previous years, and not difficult for even a tight office market to absorb. These employment figures include people working in-person and remotely.

[5] "SKS Real Estate said to be buying 350 California St. in San Francisco", San Francisco Business Times, May 8, 2023.

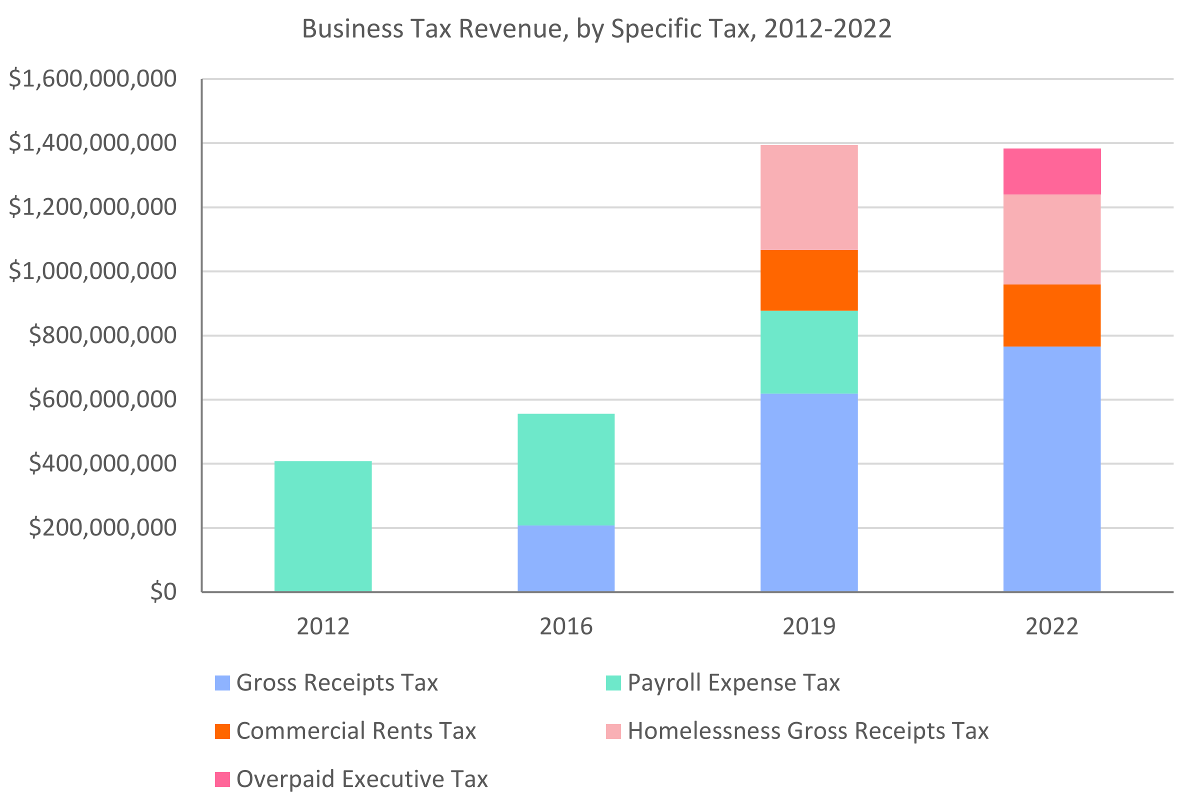
[6] Controller's Office, Response to Letter of Inquiry Regarding Downtown Commercial Property, October 2022.

Progressive Taxation and Concentration Risk

As the number of taxes affecting businesses in the city has increased, so has their progressivity. In 2012, before the Gross Receipts Tax was approved, the City's primary source of business tax revenue was a flat, 1.5% tax on payroll expense.

By 2016, the City had begun to phase-out the flat Payroll Expense Tax, and phase-in a progressive Gross Receipts Tax, which featured higher rates for larger businesses. The Homelessness Gross Receipts Tax, approved in 2018, is more progressive. The Commercial Rents Tax, while featuring a flat 3.5% rate for office rents, has exemptions or lower rates for other types of commercial property, and draws most of its revenue from downtown office owners and their tenants.

A new Overpaid Executive Tax was first paid in 2022, meaning the City had 3 progressive business taxes, while the burden of the fourth, the Commercial Rents Tax, fell heavily on the same businesses and their landlords[7].



Source: Office of the Treasurer and Tax Collector / Controller's Office

[7] The City also levies a progressive Business Registration Fee on all registered businesses in San Francisco, though its revenue is relatively small.

It is notable that, despite the adoption of higher Gross Receipts Tax rates in 2020, and a new Overpaid Executive Tax, overall business taxes owed to the City declined slightly between 2019 and 2022. In this new era of remote work, the City's business tax base is already eroding. Rate increases and new taxes are, to some extent, disguising the erosion from a budgetary perspective.

This dynamic is potentially risky, however. The City has become more reliant on the tax revenue paid by a smaller number of businesses. In 2012, with the flat Payroll Expense Tax in effect, the five largest businesses paid 7% of total tax revenue, and the largest 100 paid 34%.

By 2022, based on tax filings received as of May 8th, the largest five payers, comprising 0.04% of taxpaying businesses, contributed 24% of all business tax revenue. The largest 100, who make up 0.7% of taxpaying businesses, owed 58% of the total[8].

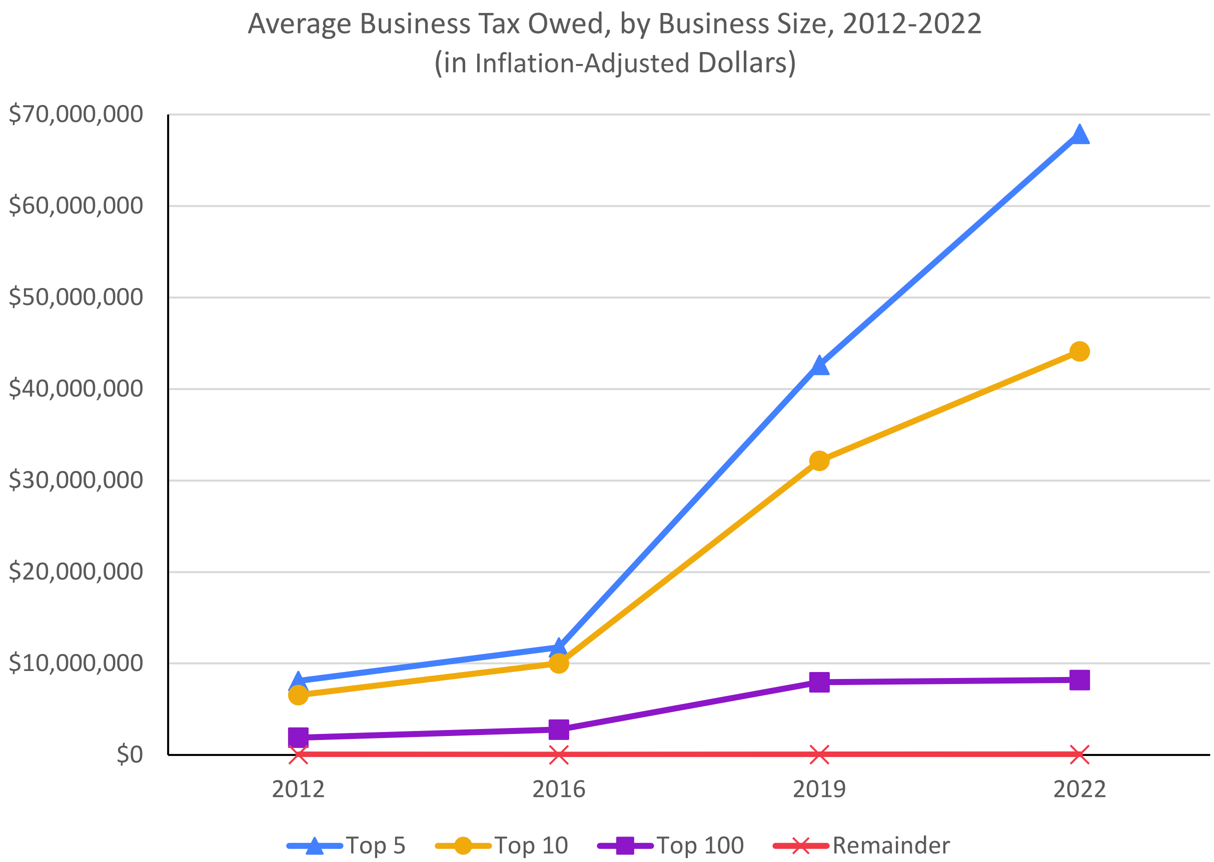
Amount (in millions) and Percentage of Business Taxes Owed, by Business Size, 2012 & 2022 (2012 revenue numbers adjusted for inflation)

	Top 5	Top 10	Top 100	All Others
2012	$30 (7%)	$48 (12%)	$138 (34%)	$270 (66%)
2022	$339 (24%)	$441 (31%)	$820 (58%)	$588 (42%)

Source: Office of the Treasurer and Tax Collector / Controller's Office

For context, the chart below illustrates the average amount of business tax owed by businesses in these size categories over the ten-year period from 2012 to 2022. The average amount owed by the five largest payers in the city grew from $8 million in 2012 (in inflation-adjusted dollars) to $68 million in 2022, an 8-fold increase. By contrast, the average business that was not in the top 100 saw its amount owed increase by only 1.3 times during the period, from $48,432 to $63,614 in inflation-adjusted dollars.

[8] Tax filing information is confidential, and the City is prohibited by law from identifying the largest companies.



Source: Office of the Treasurer and Tax Collector / Controller's Office

One reason for the increased concentration in the largest taxpayers is organic – these businesses simply grew their revenues faster than smaller businesses, on average. But a major reason – which we estimate accounts for about 50% of the growth in concentration – is because the City's business tax system became more progressive during that time.

Tax filings from 2022 reveal that the new Overpaid Executive Tax is by far the most top-heavy of all of the City's business taxes. The 194 companies that reported owing the tax (as of May 8th, 2023) owed a combined $142 million. The top 5 companies owed 64% of that total, for an average of $18.2 million each.

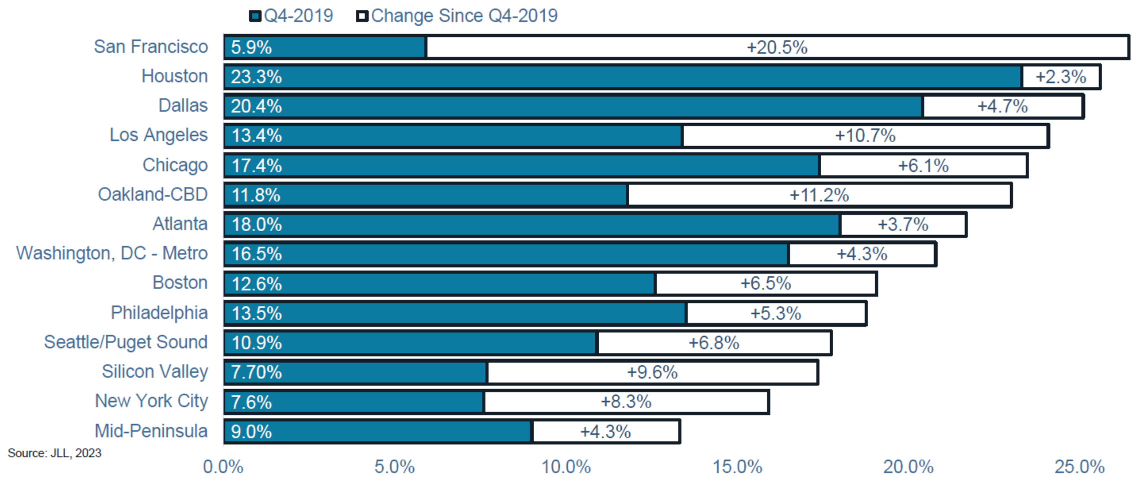
This increasing concentration has run counter to one of the City's goals of business tax reform in the past, which was to ensure revenue stability by broadening the tax base, and protecting it against adverse reactions by payers. As the table below indicates, most of the City's recent tax changes have increased the volatility of the overall tax base.

	Pre-2008 Taxes	Post-2008 Taxes
High Volatility	Pre-2008 Transfer Tax	Transfer Tax increases Overpaid Executives Tax Homelessness Gross Receipts Tax
Medium Volatility	Hotel Tax Sales Tax Utility User Tax	Commercial Rents Tax Gross Receipts Tax
Low Volatility	Property Tax	

The Office Market and San Francisco's Tax Competitiveness

Recent evidence from the office market may mean that the risks of a top-heavy tax structure may be growing. Reduced time in the office has led companies – especially technology companies – to reduce their leasing of office space. While office demand is down and vacancy is up in every major market, San Francisco has been particularly impacted. The city went from having the lowest office vacancy rate in the country, before the pandemic, to one of the highest in 2023. Notably, other Bay Area office sub-markets, which also provide space to the tech industry, and are also coping with the impact of remote work, have had much smaller increases in vacancy.

As the chart below shows, vacancy in the Silicon Valley submarket has increased by 9.6% since the start of the pandemic, compared with a 20.5% increase in vacancy in the city. The Mid-Peninsula market has seen even less of a shift – only a 4.3% increase in vacancy, which has led to an overall vacancy rate that is half San Francisco's.



Source: JLL

Although San Francisco's office vacancy rate leads the region, businesses searching for new space have many options within the region. According to Moody's/REIS, there were 41.2 million square feet of vacant office space in the Bay Area, 23% of which is in San Francisco. As businesses across the region consolidate their office needs, office owners and local governments are likely to be more aggressive at competing for office tenants.

Office Market	Vacant Stock, 2022
West Santa Clara County	9,729,000
San Francisco	9,366,000
East Santa Clara County	5,213,000
Outer East Bay	4,929,000
San Mateo County	4,681,000
Inner East Bay	4,669,000
North Bay	1,582,000
Marin County	998,000
Total	41,167,000

Source: Moody's / REIS

It is not clear how important San Francisco's taxes are in explaining its relatively weak post-pandemic office market. Other factors – such the weak recovery in transit ridership, which San Francisco heavily relies upon – likely also play a role.

To help gauge San Francisco's tax competitiveness within the Bay Area, we estimated what a large technology company, in the Information sector, would pay in local business taxes in San Francisco and the eight other Bay Area cities with significant employment in that sector. We did not consider the Overpaid Executive Tax, which no other city in California has, and which as noted above is highly weighted to the largest payers.

The results of that analysis indicate that the business would pay at least 20 times more in San Francisco than in each of the other locations, except for Oakland, where the margin is narrower.

Sector:	Information
Total Sales	$30 Billion
Local Sales	$30 Million
Local Employees	10,000
Local office space	4 million square feet
Payroll Factor	20%

City	Information Sector Employment	Business Tax Liability
San Francisco[9]	35,878	$39,886,480
Mountain View	21,798	$2,009,195
San Jose	13,872	$171,301
Sunnyvale	11,676	$28,122
Menlo Park	10,712	$8,000
Oakland[10]	5,967	$26,938,700
Santa Clara	4,700	$350,000
Palo Alto	4,409	$300,000
Redwood City	3,866	$6,276

Source: Controller's Office analysis of local tax ordinances

[9] Includes Gross Receipts Tax and Homelessness Gross Receipts Tax only.
[10] Assumes the taxpayer would be classified as a Media business, and 20% of total gross receipts were attributable to Oakland.