Assessment of Proposed Business Tax Changes

Prepared for

City and County of San Francisco
Office of Economic Analysis
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Prepared by

Matthew Newman
Tim Gage
The Blue Sky Consulting Group

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Sacramento
5714 Folsom Blvd, #127
Sacramento, CA 95819

Phone: 1.510.654.6100

Emeryville
6475 Christie Ave, #175
Emeryville, CA 94608

www.BlueSkyConsultingGroup.com

Introduction

The Blue Sky Consulting Group was engaged by the Controller's Office of Economic Analysis to assess the likely fiscal and economic effects of two proposed business tax changes under consideration as alternatives to the current payroll tax. Specifically, we examined the proposals developed for a progressive payroll tax and a business gross receipts tax, and reviewed the methodology, assumptions, and data sources relied upon by the Office of Economic Analysis for projecting the fiscal and economic effects of these proposals. This report presents the findings of this assessment.

Our Assessment of the Fiscal Effects

In general, our assessment is that the estimates prepared by the Office of Economic Analysis for projected revenues for each of the two tax options (progressive payroll and gross receipts) appear reasonable. Projecting revenues is an inherently uncertain process, particularly where relatively large changes are proposed (as with the business gross receipts tax option and the commercial rent tax component of both proposals). Nevertheless, we believe that the estimates prepared reflect a sound methodology, rely on reasonable assumptions, and incorporate the best available data.

Based on our review and assessment of the fiscal impact estimates, we believe that, under either the progressive payroll or the gross receipts option, current (payroll) tax payers would pay roughly the same amount as they do under the current system, with the additional revenue generated coming largely from businesses that do not currently pay business taxes (although the precise extent of the shift to new tax payers is subject to some uncertainty, specifically as it relates to the extent to which commercial landlords are able to pass on the rent tax to tenants). Therefore, it is our assessment that both tax options would result in a broadening of the tax base.[1]

Because the progressive payroll tax option reflects an evolution of the current business tax rather than a wholesale new approach, the fiscal and economic changes of this proposal relative to the current system are likely to be quite modest. Similarly, the estimates of the fiscal and economic effects are likely to be more accurate and subject to less uncertainty.

The business gross receipts tax represents an entirely new taxation system, and so carries with it the potential for bigger changes relative to the current system. Therefore, the estimates associated with this tax are subject to somewhat more uncertainty, although the extent of potential economic benefits, based on the output from the REMI model, are somewhat greater.

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[1] We note that, however, both of these options would increase the complexity associated with administration of the business tax, for both tax payers and the city. We did not specifically examine the impact of these administration and compliance issues.

Both options include a component for a commercial rent tax. Although the commercial rent tax is smaller than either the progressive payroll or business gross receipts components of the two proposals, we believe that the estimation methodology for this tax is subject to the most uncertainty due to limited data. Nevertheless, the range of uncertainty, given the smaller size of this revenue source, is limited.

Our Assessment of the Economic Effects

With respect to the economic effects, our assessment is that the changes in both output and employment of either alternative with respect to the current system are likely to be quite modest and, according to the output of the REMI model used by the Office of Economic Analysis, are likely to be slightly positive.

Under the progressive payroll tax proposal, the current payroll tax would be reduced for lower wage workers and replaced with a tax on commercial rent. Reducing the payroll tax, especially on lower wage workers, will lead to a reduction in the cost of labor and, consequently, an increase in employment in the city. These gains will be offset to some extent by lower levels of economic activity stemming from increased costs for rent payments for San Francisco businesses and lower returns to investments in commercial property. In addition, some of the profits earned by out of town landlords will be recaptured (via the tax) and spent in the local economy by the city, which will stimulate economic activity.

Under the second option, the business gross receipts tax, the current payroll tax will be replaced by a business gross receipts tax and a commercial rent tax (as discussed above). By reducing the cost of labor, the elimination of the payroll tax likely will lead to an increase in local employment, although the extent of this increase is subject to some uncertainty. These gains will be offset to some extent by lower levels of economic activity stemming from the increased costs businesses face from the gross receipts tax. These economic effects are further complicated by the fact that a portion of the reduction in the payroll tax may be passed on to workers in the form of higher wages and consequently will reduce the labor cost savings for employers. To the extent that a portion of these gains for employers are passed on to workers in the form of higher incomes, some will be spent or invested in the local economy and some will be spent or invested outside of the city. In-city expenditures will act to stimulate economic activity. In addition, a portion of the business gross receipts tax will be paid by out of town visitors or by purchasers of exported goods and services. These payments represent new revenue to the local economy and so will tend to increase the level of economic activity.

Sorting out the effects of these various economic factors presents a significant challenge for economists. Little research into the economic effects of a gross receipts tax exists, although at least one study compared the economic effects of a payroll tax to that of a value added tax (VAT), which is similar to a gross receipts tax in some respects. This study found that “for an equal amount of revenue raised, the [economic] distortion is slightly less under a VAT than a payroll tax."[2] Nevertheless, economic theory and existing research alone cannot, by themselves, fully address the question of the economic impact of proposals such as those under consideration.

Especially in cases where a retrospective analysis of historical data is not a possibility, economists frequently turn to economic models, such as the REMI model utilized by the Office of Economic Analysis, in order to sort out the combined effects of multiple economic changes occurring simultaneously (as with this exercise). The results produced by these economic models are sensitive to the underlying structure of the model itself and to the input assumptions relied upon. The REMI model is a widely used model for conducting economic analysis at the local level, and is a reasonable choice for the current analysis. Similarly, we reviewed the assumptions relied upon by the Office of Economic Analysis, and believe that they are reasonable as well. Therefore, we believe that it is reasonable to rely on the results of the REMI model projections performed by the Office of Economic Analysis, which indicate that each of the two proposed business tax options would produce modest employment gains.

Basis for our Conclusions

In order to develop the assessments presented in this memo, we relied primarily on a review of the interim report entitled "Improving San Francisco's Business Tax: An Analysis of Two Alternatives" prepared by the Controller's Office of Economic Analysis office on May 11, spreadsheets containing the fiscal impact projection methodology and REMI model input and out put figures, and meetings and phone conversations with the office's chief economist, Ted Egan.

In order to complete our assessment, we carefully audited the spreadsheets, assessed the overall approach, and reviewed and evaluated the key input assumptions and data sources relied upon. We made several suggestions for improving the fiscal impact models, each of which was adopted by the Office of Economic Analysis and incorporated into the final results.

In addition, we examined the economic literature and analyzed the likely economic effects of each of the proposed tax changes. We also reviewed the input assumptions utilized by the Office of Economic analysis for the REMI model and analyzed the REMI output to determine if the projected economic effects appeared to be reasonable and to conform with what one would expect to find based on a review of the relevant economic literature.

Finally, we relied upon our own collective experience analyzing the fiscal and economic impacts of proposed tax policy and other public policy changes.

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[2] Toder, Eric and Rosenberg, Joseph, "EFFECTS OF IMPOSING A VALUE-ADDED TAX TO REPLACE PAYROLL TAXES OR CORPORATE TAXES." Urban-Brookings Tax Policy Center and the Economic Growth Program of the New America Foundation, 2010.