City and County of San Francisco

Office of the Controller – Office of Economic Analysis

Temporary Revision of Payroll Tax Expense: Economic Impact Analysis

Item #090228

Office of Economic Analysis

February 10, 2010

Introduction

- Proposed policy will allow businesses to pay, in 2010, the lesser of their 2009 or 2010 payroll tax liabilities.
- In 2011, they will be able to pay the lesser of their 2011 or 2009 payroll tax liabilities.
- In effect, the policy gives firms a tax break on net new payroll, effectively encouraging local hiring during the recession.
- The proposed policy will have a strong positive impact on local hiring, albeit at a steep cost to the City's General Fund.
- The policy is a targeted tax cut that mirrors the President's New Jobs Tax Credit, which is supported by a wide range of economists.

Important Aspects of the Policy

- No business affected by the policy will pay less in payroll tax than they did in 2009.
- Reduction in labor costs will stimulate some job creation.
- However, many businesses would add employment even without the tax incentive. The City would lose payroll tax growth that it would otherwise have received for tax years 2010 and 2011.
- Because the City cannot run a fiscal deficit from one year to the next, the lost revenue would necessitate reductions in City staffing and services, like any revenue shortfall.

Economic Context

- As of December 2009, there were 41,700 unemployed residents of San Francisco, 22,900 more than there were in December 2007.
- Approximately 36,000 jobs have been lost in the City during that time.
- During the recession the city's unemployment rate, currently 9.4%, has exceeded any recorded for San Francisco dating back to 1990.
- Seasonally-unadjusted unemployment has declined for several months in San Francisco. However, the President's Budget assumes national unemployment will remain at 8% until 2013.

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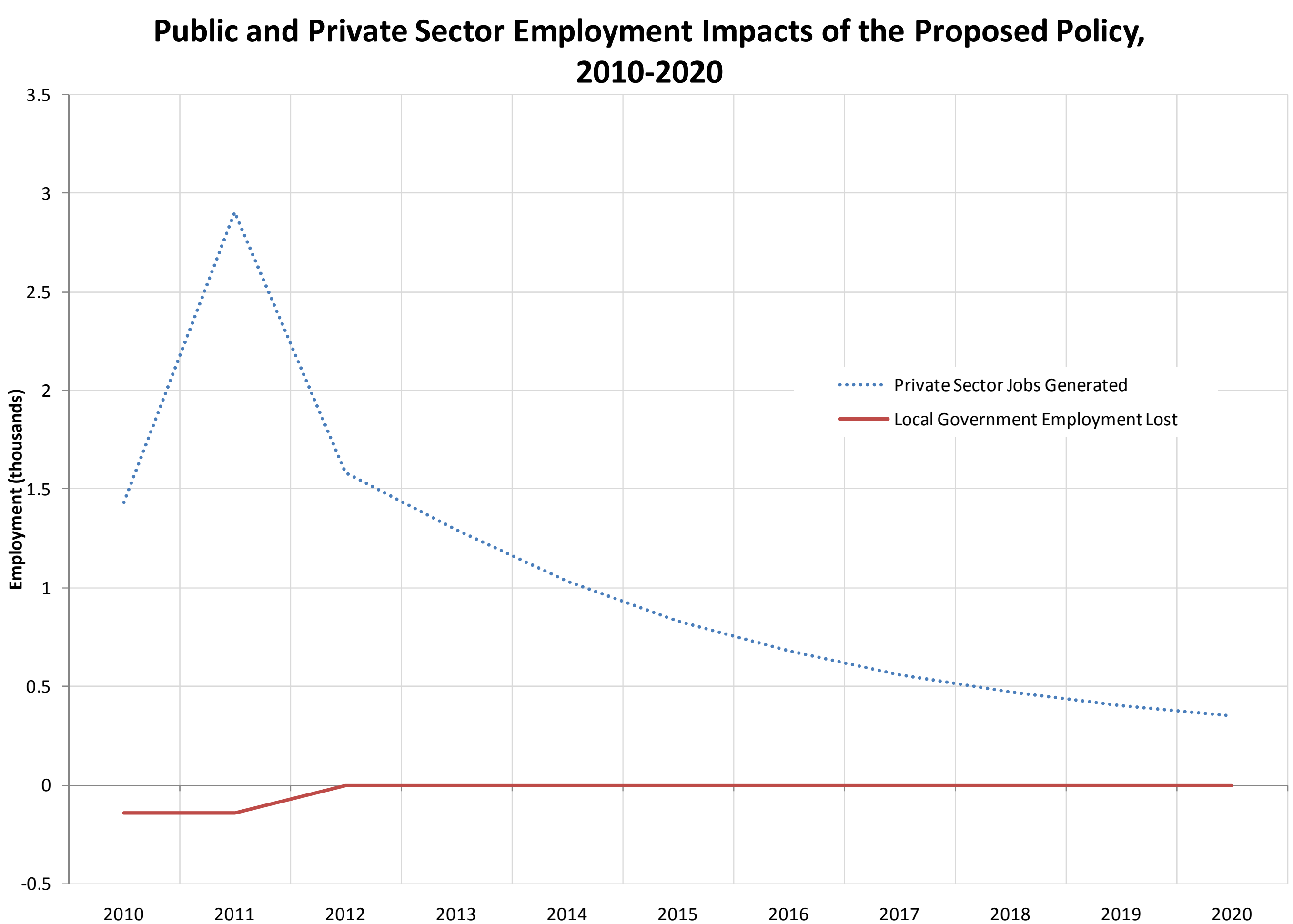
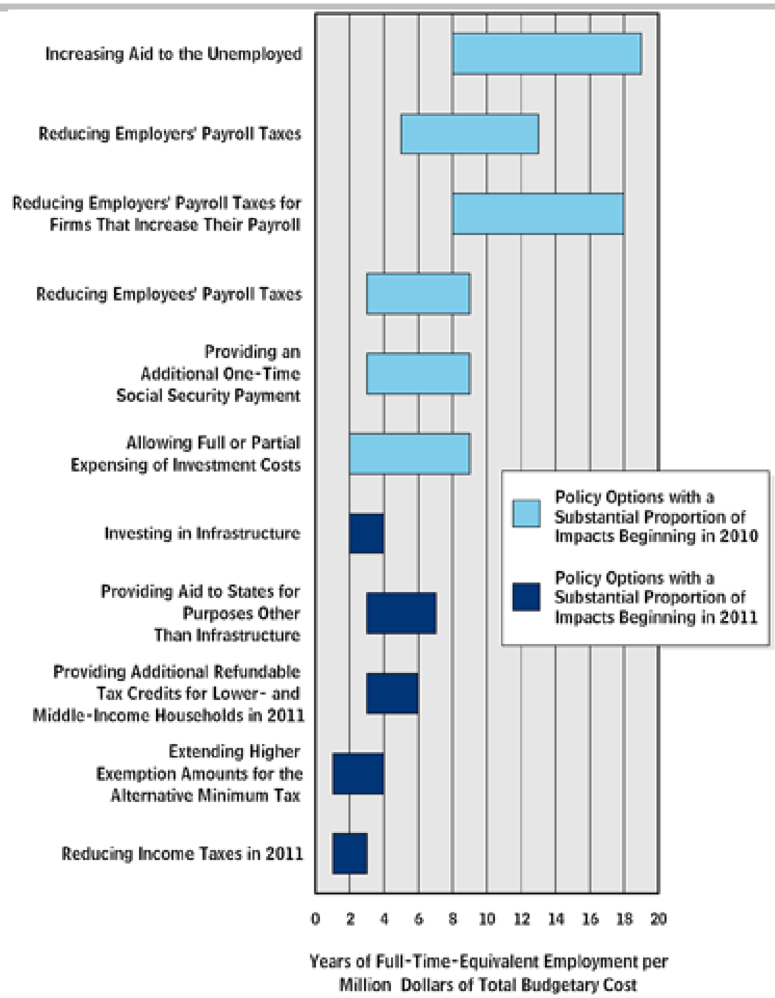
Summary of Impacts

- Policy will create a net 1,430 jobs in 2010 and 2,900 jobs in 2011.
  - Represents 5-8% of total jobs lost in San Francisco since December, 2007.
  - This number includes the projected losses of public sector employment due to the revenue shortfall associated with the policy.
  - Assumes an April 1 2010 start date and no induced employment prior.
  - Will also create an annual average of 890 jobs 2012-2020, after the policy expires.
- Over the next two years, the net revenue impact to the City will be a loss of approximately $72 million. Over ten years, the cost will fall to $42 million, because of ongoing tax revenue from new job generation.
- Average cost per job is $16,500 in 2010 and 2011.
- The potential impacts of the City revenue decline on public services, and indirectly on the economy, is not considered, because the City could adjust to that impact in many ways.

Employment Impacts, 2010-2020



CBO Assessment of Federal Stimulus Options



Other than direct aid to the unemployed, a recent Congressional Budget Office analysis found that reducing payroll taxes for expanding businesses was the most cost-effective policy to stimulate job growth, ahead of all other types of tax cuts, infrastructure investment, and other non-infrastructure public spending.

Why a Targeted Tax Reduction is a More Effective Policy Than a Simple Tax Cut

- Payroll tax reductions can stimulate employment by reducing the effective cost of labor to businesses.
- However, if the stimulus does not directly incentivize job creation, it may not overcome the loss of public sector employment that the subsidy's revenue would pay for.
- Reducing the tax subsidy to only *new* payroll at expanding ensures that more of the subsidy goes to businesses that actually will increase payroll, and is therefore a more efficient tax policy.

Options to Reduce the Cost of the Policy

- The proposed policy can be re-scaled to reduce its cost. The net employment increase of the policy will be proportionally reduced as well.
- Three ways to scale the policy include:
  - By capping the maximum tax credit per business.
  - By reducing the percentage of new payroll tax excluded.
  - By restricting the policy to small businesses.

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Reducing the Policy Cost by Capping the Maximum Tax Credit

Maximum Credit	Two-Year Cost	Net Two-Year Job Gain
Current: no maximum	$72 million	4,330
$10,000 per business	$33 million	1,995
$5,000 per business	$21 million	1,300
$2,500 per business	$12 million	710
$1,000 per business	$5 million	325

This approach favors job creation in small businesses, without explicitly excluding large businesses. It does so by limiting the total size of the credit, which will usually mean more of a small business's new hires would be covered.

Reducing the Policy Cost by Limiting the Total Payroll of Eligible Businesses

Maximum Payroll	Two-Year Cost	Net Two-Year Job Gain
Current: no maximum	$72 million	4,330
$50,000,000	$57 million	3,540
$25,000,000	$47 million	2,865
$10,000,000	$36 million	2,190
$5,000,000	$26 million	1,515

This approach explicitly restricts the program to businesses below a certain level of payroll, but allows these businesses to exclude all new payroll from their tax.

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Reducing the Policy Cost By Reducing the Percentage of Tax Exempted

Net New Payroll Exempted	Two-Year Revenue Loss	Net Two-Year Job Gain
Current: 100%	$72 million	4,330
75%	$53 million	3,245
50%	$36 million	2,165
25%	$18 million	1,080
10%	$7 million	430

This approach opens the policy to all businesses without a cap, but instead of exempting 100% of new payroll from the payroll tax, it exempts only a fraction. Both the cost of the policy, and the effective reduction in labor costs which generate the job growth, are reduced in proportion.

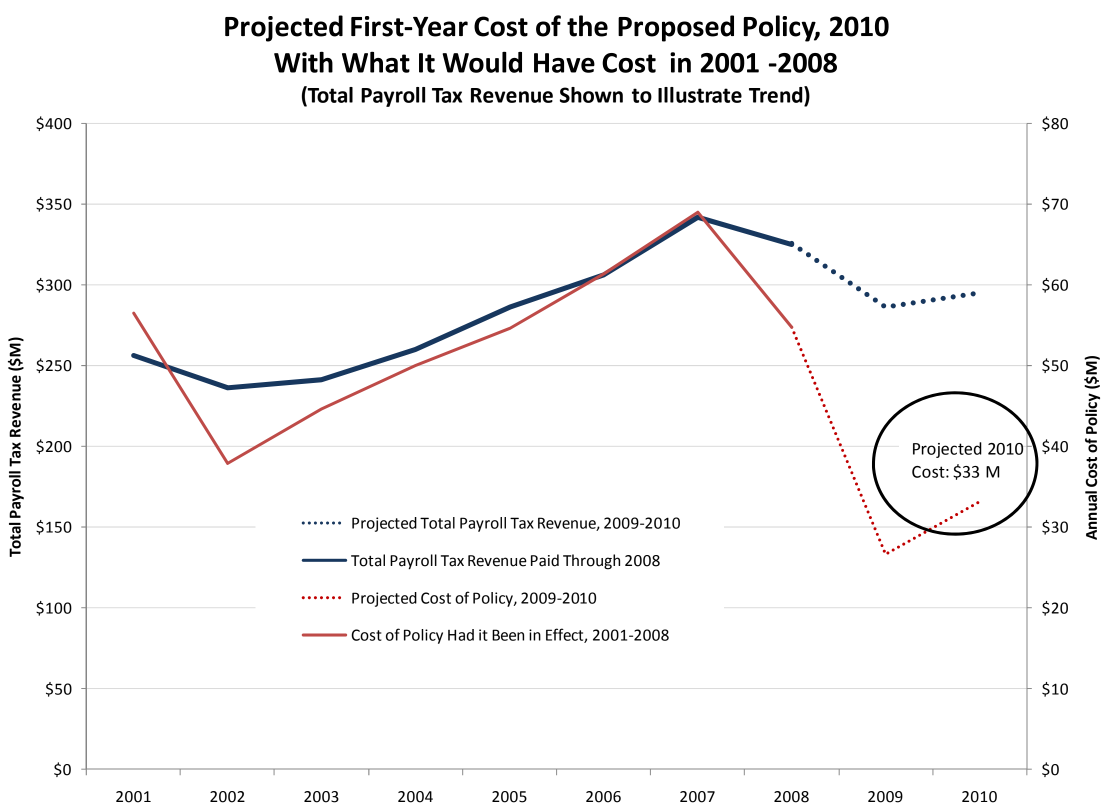
Conclusion

- The proposed targeted tax cut would have a strong positive impact on job creation in San Francisco.
- The policy would also make the City's serious current budget deficit worse, and likely lead to significant employment reductions in the City's workforce.
- At the federal level, the policy is favored by many economists and is among the most efficient tax policies for job generation.
- The incentive has a high cost as proposed, but can be scaled in one of several ways to reduce its cost to the City.

Appendix

- Estimating the Payroll Tax Revenue Loss
- Estimating Job Creation
- Estimating the Revenue Gains of the Jobs Created
- Estimates of Net Revenue

Estimating First-Year Payroll Tax Lost from the Policy

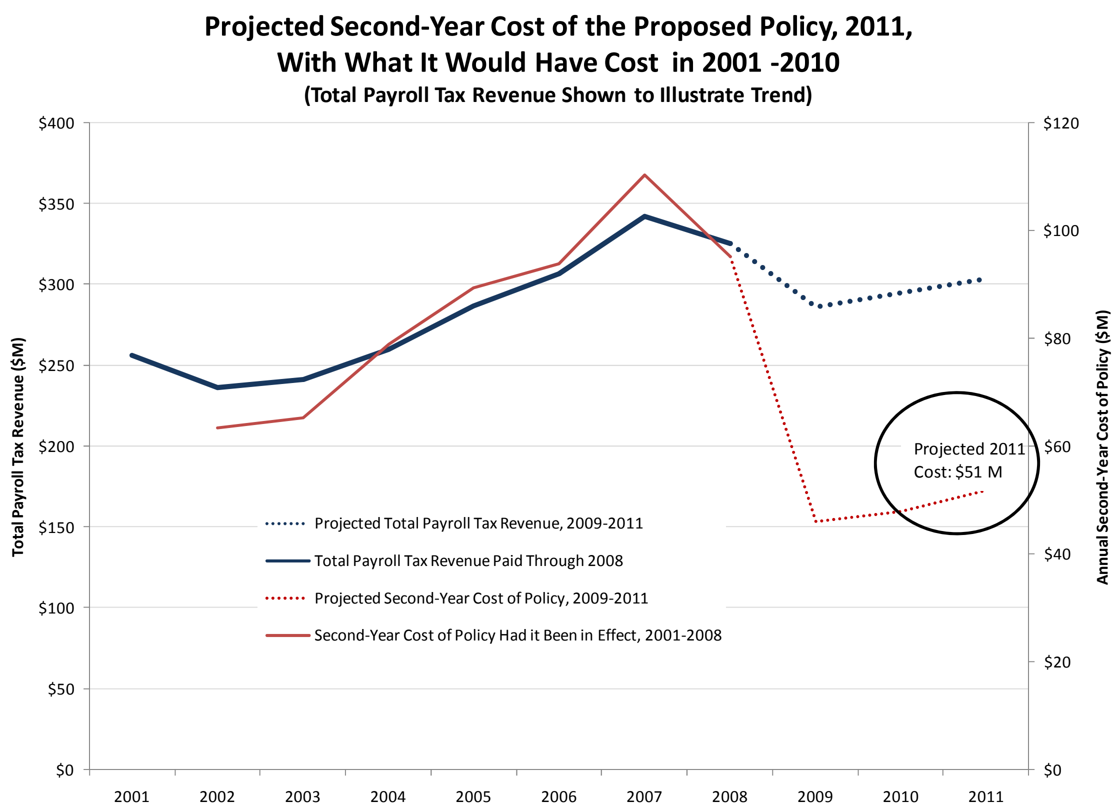


During the 2001-2004 recession, total payroll tax revenue declined, but the payroll tax from expanding businesses declined 4 times as fast. The total payroll tax paid by expanding businesses is the cost of the proposed policy.

The Controller's Office is projecting a 12% decline in payroll in 2009. If the same relationship holds as the last recession, that would lead to a 51% drop in expanders' payroll in 2009, followed by a 24% gain in 2010.

This would translate into a policy cost of $33 million in 2010, the first year of the policy.

Estimating the Second-Year Payroll Tax Loss from the Policy



In 2011, businesses will be eligible to pay based on their payroll from 2011 or 2009, whichever is lower.

If the two-year cut had been in effect over the last decade, the second year of the policy would have been significantly more expensive than the first year, because growing businesses would essentially receive two years of new payroll tax free.

If the same pattern of payroll decline and recovery occur in 2011 that we saw in the last recession, the second year of the policy will cost the City $51 million in payroll tax revenue.

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Estimating Job Creation from the Policy

- Estimating job creation involves two questions:
  - What percentage of the payroll tax base can take advantage of the incentive? This leads to an effective city-wide wage reduction?
  - How sensitive are employment changes to changes in wages? This depends on the elasticity of demand for labor in San Francisco, and can be modeled.

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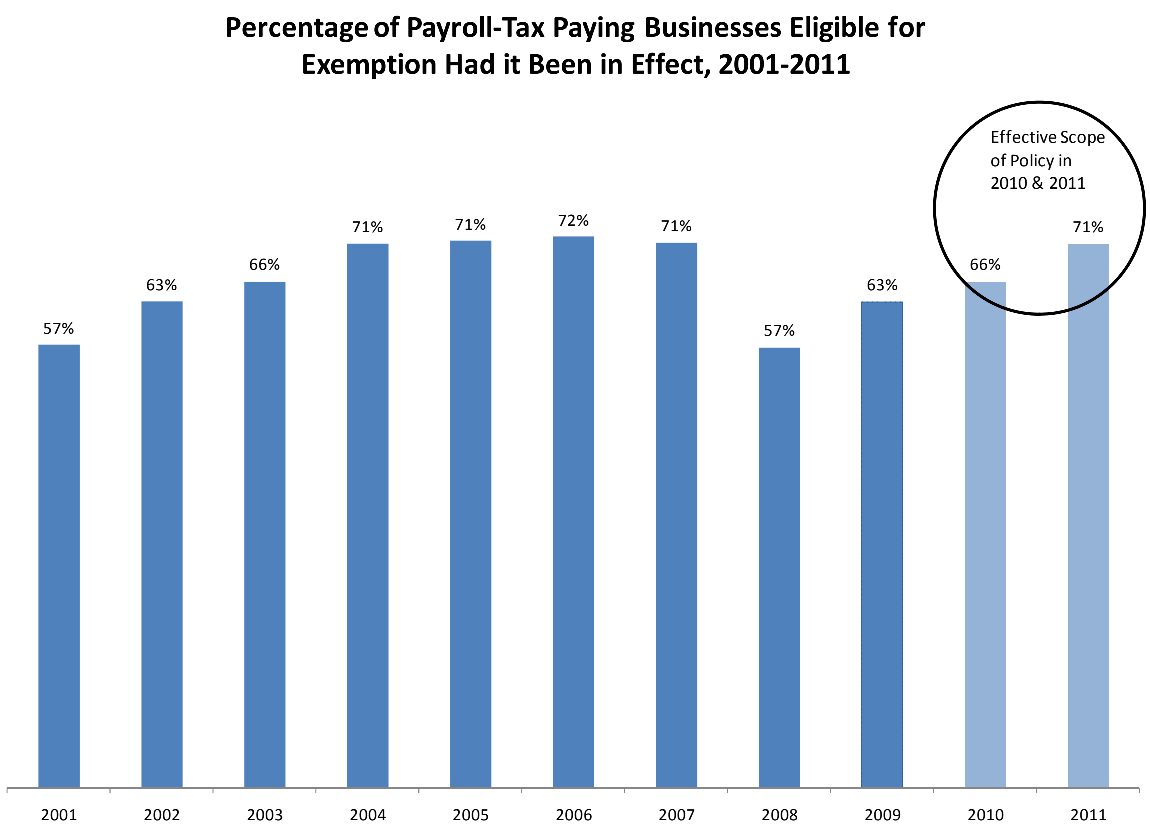
Percentage of Affected Businesses



Businesses whose total payroll is not expanding are not eligible for any payroll tax exemption under the policy. Consequently, the employment impact of the policy is somewhat less than it would be if it were a straight elimination of the payroll tax.

Nevertheless, based on past tax payment information provided by the Treasurer's Office, it is possible to estimate the percentage of businesses that could have benefited had the policy been in effect in the past.

For this report, it is assumed that the 2009, 2010, and 2011 are similar to the experience of 2001, 2002, and 2003.

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Effect of Lower Labor Costs on Employment

- The net impact of the policy is an approximately 1% reduction of labor costs to San Francisco payroll-tax paying businesses in 2010 and 2011.
- The OEA's REMI model of the city economy estimates that a 1% reduction in labor costs will generate a .24% increase in private sector employment in 2010, and a 0.4% increase in employment in 2011.
- These elasticities of demand for labor are typical in econometric studies of the job creation impacts of tax credits*.

* See, for example, Timothy J. Bartik and John H. Bishop, "The Job Creation Tax Credit", *EPI Briefing Paper #248*, Economic Policy Institute. October, 2009.

Estimating the Revenue Impact of Employment Induced by the Policy

- Each new job induced by the policy (which is *not* the same as each worker hired created by growing businesses) indirectly generates other tax revenue:
  - Commercial and Residential Property Tax
  - Hotel Tax
  - Sales Tax
  - Utility User Tax
  - Payroll tax for induced employment continuing after 2011.

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Summary of Ten-Year Revenue Impacts

	Payroll Tax Lost	Revenue Gain from Additional Employment	Net Revenue
Year 1	-$33,135,365	$5,205,186	-$27,930,179
Year 2	-$51,984,067	$7,923,662	-$44,060,405
Years 3-10	$0	$29,817,132	$29,817,132
Years 1-10	-$85,119,432	$42,945,980	-$42,173,453

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