San Francisco's deal with Twitter sends city down slippery slope of tax breaks

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Big tax breaks for corporations make me suspicious. When San Francisco debated one to keep Twitter, my sympathies lay with critics of the deal.

But after the deal was approved, I took a closer look to see if it made sense. This produced two surprises for me.

The first: It does.

The second: San Francisco still made a terrible mistake. And in doing so, the city offers a cautionary tale to any other cities considering the wisdom of such incentives.

Here's why: The Twitter deal on its own makes rational economic sense. It keeps a fast-growing and high-profile company in San Francisco, one that promises to move to a part of the city that needs an economic jolt, while having no immediate impact on the city's budget.

But it has opened a Pandora's box. Other tech firms want the same break. And that could blow an even deeper hole in a city budget whose general fund is already reeling from a projected deficit of more than $306 million out of a $4.1 billion budget for the next fiscal year. For comparison, San Jose faces a budget shortfall of $115.2 million in its $934.6 million general fund for next fiscal year, with a slightly larger population.

"It starts you on the race to the bottom," said Jean Ross, executive director of the California Budget Project, which has extensively studied the impact of tax incentives on job creation and government budgets.

S.F.'s payroll tax

At the heart of this debate is San Francisco's unique-in-California payroll tax. The city levies a 1.5 percent tax on all pay, including compensation from cashing in stock options. That creates a problem: Companies might like to start in San Francisco, but once they expand, they leave and typically migrate down the Peninsula.

According to the San Francisco controller's office, 2,393 companies moved out of the city between 2003 and 2008. Compare that to the 1,952 that left Santa Clara County, which has almost 50 percent more businesses.

"San Francisco is a great place to start a company," said Ted Egan, chief economist in the controller's office, who produced the economic impact analysis on the Twitter deal. "But we have an experience where companies say it's not a great place to house 1,000 employees."

So it was no surprise when Twitter made noises about leaving. It looked at locations in South

San Francisco and Brisbane, where rents were higher but taxes were lower.

But Twitter also discussed moving into San Francisco's Mid-Market area, a long-standing blighted part of the city.

So San Francisco passed a deal that will freeze the payroll tax payment for any company that moves into this Mid-Market area for six years. The city is banking that Twitter can serve as an economic engine in a last-ditch attempt to turn that neighborhood around. It's not an unreasonable bet, since tech companies like to cluster around other tech companies.

To be clear: Twitter will be paying some taxes to San Francisco, an estimated $8 million over six years.

Without the exemption, if Twitter had stayed in the city it would have paid at least $16 million in payroll taxes during that time -- which doesn't include the much larger windfall if Twitter went public.

By comparison, if Twitter had, say, moved to San Jose, its total annual business tax would have been $25,000.

Additional measures

Why did Twitter take the deal? Even with the estimated $30 million it will take to fix up the company's new digs, it will still cost the company less in repairs, taxes and rent in that part of San Francisco than it would to lease in the other alternatives it examined.

If the story ended here, we'd have a win-win scenario. Alas, no.

That's because other companies understandably wanted similar deals.

And so, there are now two additional measures being considered by the city's supervisors. The first would exempt stock options issued before an IPO from the payroll tax for six years. This is understood to be aimed at Yelp and Zynga, the most likely candidates for IPOs in San Francisco.

In a city where there are only 13 tech companies that went public since 1997, this will have minimal impact on the city budget.

But the second proposal would exempt taxes on all stock options forever, something that would help companies already public, such as Salesforce. That's potentially a lot more money; Egan is hard at work calculating the impact this would have on the $350 million the city collects in business-related taxes.

Advocates say this will give San Francisco's economic image a much-needed tech-friendly sheen. I doubt it. But even if they're right, it could take years for the economic benefits to materialize. In the meantime, it would diminish revenue immediately, leaving the city even larger budget deficits now.

And Kim Walesh, San Jose's director of economic development, pointed out another consideration.

"They're sending a signal to the other companies that locate there that they aren't as special as the companies getting special treatment," she said.

So what started out with the best intentions has quickly spiraled into something more ominous. And San Francisco is going to need every ounce of its famous creative energy to find some way to pull out of the economic incentive nose-dive before it crash-lands.

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