

Memorandum

TO: Senator Joe Bolcom
 FROM: Jeff Robinson
 DATE: April 5, 2017
 RE: Sales/Use Tax Revenue Growth and Manufacturing Consumables

This memo is in response to your request for a review of the recent downturn in State sales/use tax collections as well as information concerning to what extent 2016 legislation expanding an existing sales/use tax exemption for manufacturing consumables (supplies and replacement parts) contributed to the downturn.

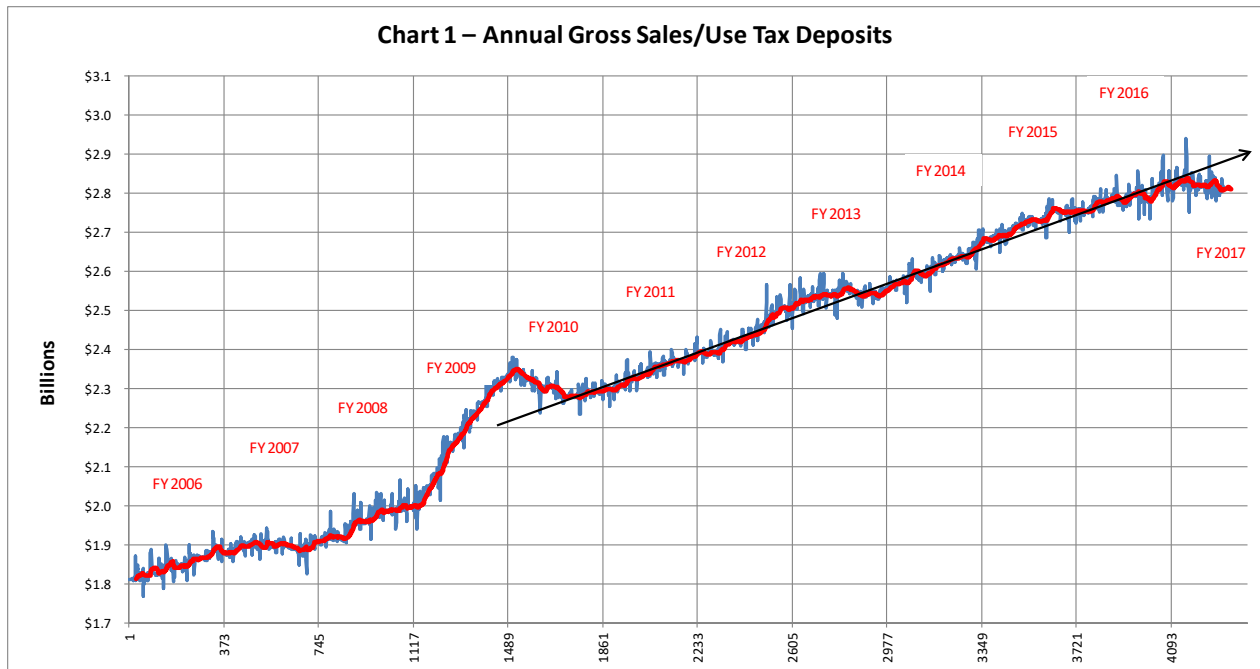


Chart 1 displays the annual moving total of gross Iowa sales/use tax General Fund deposits from FY 2006 through the end of March 2017. The graph shows a general steady upward trend. The sharp upturn in FY 2009 is due to an increase in the tax rate from 5.0% to 6.0% when the 1.0% local option school tax became a statewide tax. The downturn in FY 2010 is the result of the U.S. recession that began to impact Iowa tax revenue negatively in the fall of 2008. The black arrow depicts the general upward slope since late FY 2010. That upward trend

changed abruptly in early FY 2017 (August 2016) and the growth trend since that date has been moderately negative. The black arrow on **Chart 1** indicates that had the existing trend remained in place through all of FY 2017, the expected gross sales/use tax revenue would total \$2.9 billion. With the change in trend, gross sales/use tax revenue instead may equal about \$2.8 billion for the current fiscal year. This trend difference, a projected \$100 million, has contributed to the downturn in overall General Fund revenue as well as the downward revisions to the Revenue Estimating Conference projections for FY 2017 and FY 2018.

The 2016 General Assembly expanded the list of tax-exempt purchases available to Iowa businesses. The expansion was included in [HF 2433](#) (Internal Revenue Code Update and Manufacturing Consumables). Sections 8 through 10 of that Act added supplies and replacement parts to the list of items exempt from the Iowa sales/use tax when utilized as part of a manufacturing process. The change was effective beginning July 1, 2016. The estimated [fiscal impact](#) for sections 8 through 10 on FY 2017 gross sales/use tax revenue was estimated to be \$25.6 million.¹

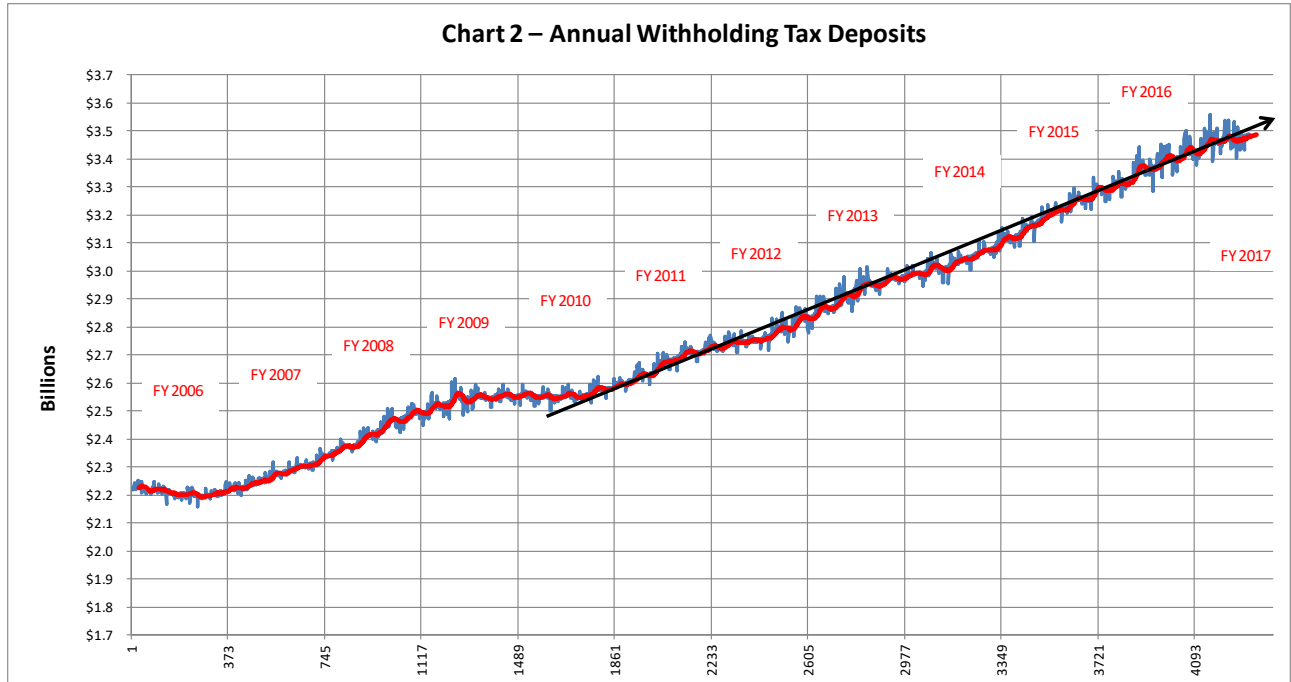
If the projected fiscal impact of the expanded sales use tax exemption was accurate, \$17.1 million of the fiscal year-to-date sales/use tax downturn can be attributed to that law change. However, the FY 2017 downturn appears to be considerably greater than \$17.1 million, and by the end of June 2017 the divergence from the former trend line may reach \$100 million.

One potential explanation for the recent sales/use tax downturn is an underestimated fiscal impact of the sales/use tax exemption for manufacturing supplies and replacement parts. For proposed legislation in previous years, estimates of the impact of exempting manufacturing supplies and replacement parts from the State sales/use tax had been much higher.

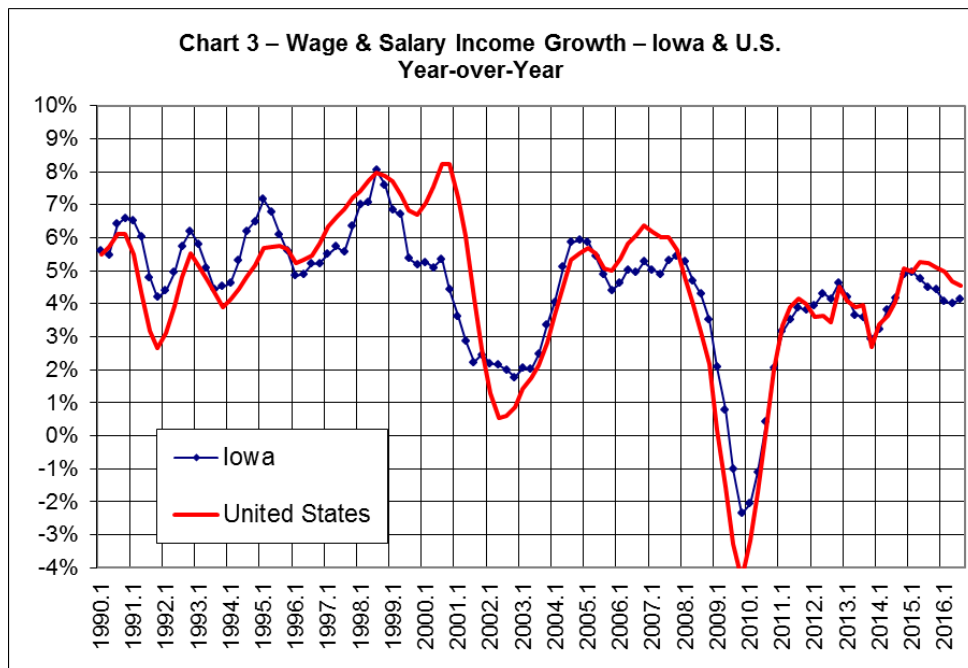
Economic Conditions as an Explanation for the Sales/Use Tax Downturn

Iowa Withholding Tax: It is possible the downturn is the result of an overall decline in economic activity. The deposit of individual income tax revenue can be a good indicator of overall economic health. Year-over-year employment and wage growth produces withholding deposit growth, and that in turn provides a look at the overall condition of the State's business climate. However, the deposit of Iowa individual income tax withholding payments has maintained growth throughout FY 2017, with the same general upward trajectory shown since the end of FY 2010. The black arrow on **Chart 2** depicts this situation.

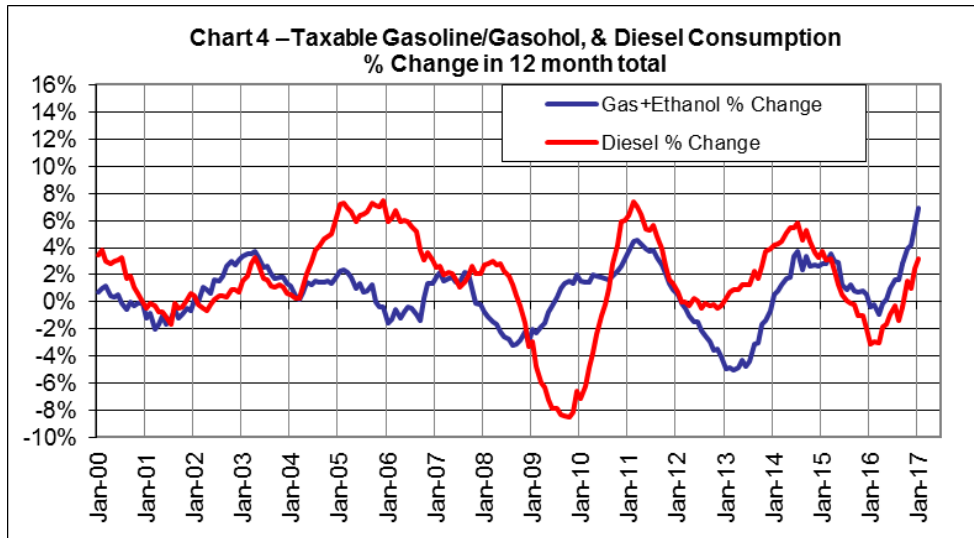
¹ The FY 2017 impact on gross sales/use tax revenue includes the impact on the State General Fund (\$21.3 million) and the local option sales tax dedicated to school infrastructure (\$4.3 million). Revenue raised by the local option sales tax for local governments was projected to experience an additional \$3.6 million revenue reduction as a result of the expanded tax exemption. This local option tax is not included in State gross sales/use tax revenue.



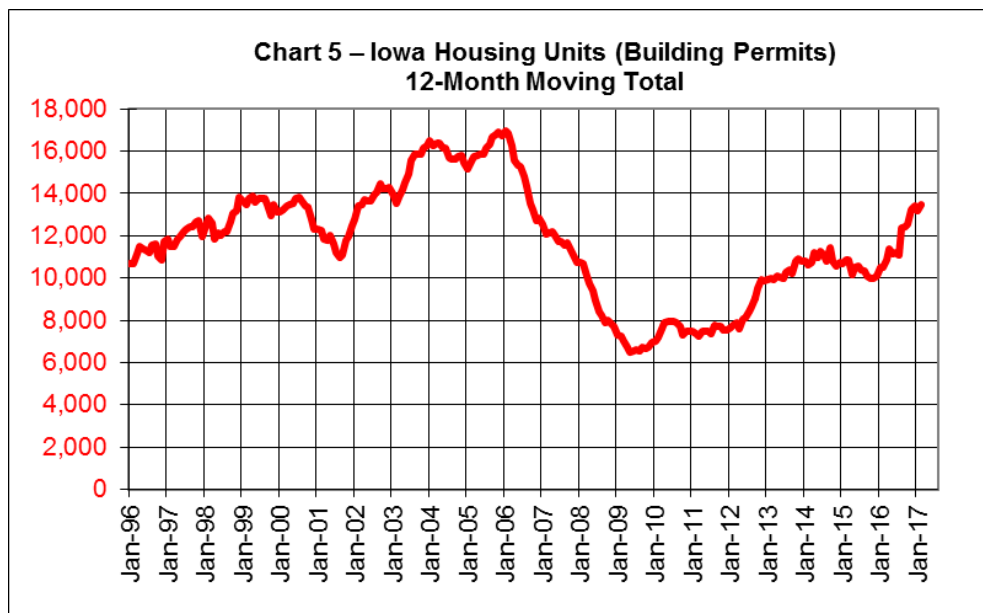
Iowa Wage and Salary Growth: Income growth is necessary for growth in taxable sales, and wage and salary income makes up more than 50.0% of Iowa personal income. **Chart 3** depicts the annual growth in Iowa wage and salary income. While the growth rate has come off its 5.0% post-recession high, Iowa wage and salary income growth remains at its average for the period since 2012.



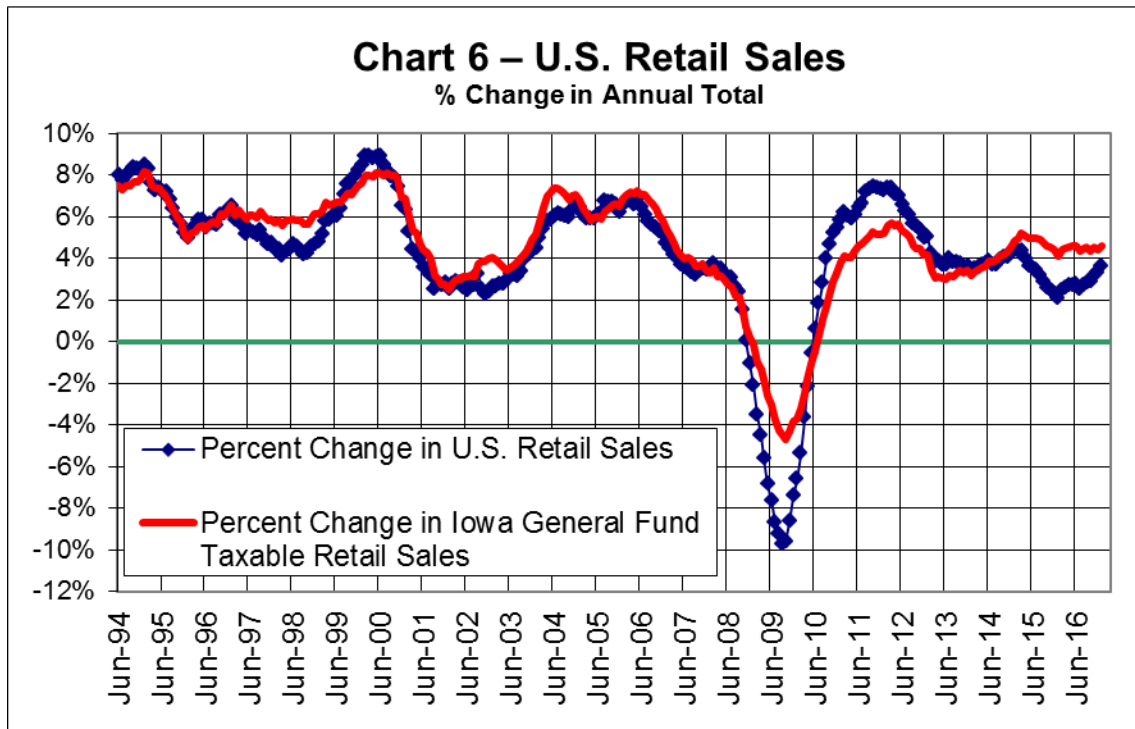
Taxable Fuel Sales: Declines in the rate of growth in taxable gallons of transportation fuel can indicate fewer goods moving to and from manufactures and retailers and a lessened need and desire of people to move about. Growth in the annual volume of taxable motor fuel sold, both gasoline/ethanol and diesel, indicates quite the opposite of an economic slowdown. Since early 2016, taxed gallons sold have shown a significant rate of increase, as shown in **Chart 4**.



Iowa Residential Building Permits: For the most part, the materials that go into building a new home (single or multifamily) are subject to sales/use tax, as are the additional furnishings needed to equip a new house. The U.S. Census Bureau provides monthly totals for housing building permits issued in each state, along with the number of new housing units associated with those permits. The housing unit statistics for Iowa all point to a significant level of improvement over the most recent 12 months.



U.S. Retail Sales: There is not a source that provides the level of retail sales within Iowa. The U.S. Census Bureau does provide monthly estimates of the level of retail sales in the U.S., along with a breakdown showing the retail categories of those sales. The blue line on **Chart 6** shows the annual growth in overall retail sales. The red line depicts retail sales without sales at grocery stores, gas stations, and vehicle dealers (all three of these locations would have significant sales that are not subject to the General Fund sales tax). The red line indicates that when using national data, a decrease in Iowa General Fund sales/use tax revenue would not be expected.



U.S. State Sales Tax Receipts: Anecdotal evidence suggests that many states are reporting lackluster sales tax growth. However, [U.S. Census Bureau](#) data covering sales tax revenue growth for all states indicates that sales tax revenue in the fourth quarter of calendar year 2016 grew 2.6%. Sales tax revenue in the third quarter grew 2.7%. Over those same two calendar quarters, Iowa gross sales/use tax revenue growth was 0.6%.

Conclusion

Iowa sales/use tax revenue growth has been flat to declining since August 2016 and that situation represents a break from the trend that had been in place since the end of the previous recession. If the latest trend continues, gross sales/use tax revenue will be down \$100 million from the level suggested by the previous trend by the end of FY 2017. The 2016 General Assembly expanded an existing manufacturing sales/use tax exemption to now include supplies and replacement parts. That law change took effect July 1, 2016, and that date coincides

closely with the change in sales/use tax growth trend. The fiscal impact of that law change on gross sales/use tax receipts was projected to be \$25.6 million for FY 2017.

A brief look at readily available economic data shows that Iowa should be expecting normal growth in sales/use tax revenue, as indicators of income and economic activity are stable, and in some cases, strong. The lack of an obvious economic downturn explanation for the change in sales/use tax revenue growth raises the possibility that the estimate for the manufacturing consumables law change was low, and the real fiscal impact was perhaps two to three times the \$25.6 million projected.