Memorandum

DATE: November 12, 2010

TO: The Honorable Mayor and Members of the City Council

SUBJECT: Sales Tax Overview

Your November 17th agenda includes an informational briefing entitled Sales Tax Overview. The briefing materials are attached for your review.

If you have questions or need additional information, please let me know.

Jeanne Chipperfield
Chief Financial Officer

Attachment

C: Mary K. Suhm, City Manager
Thomas P. Perkins, Jr., City Attorney
Deborah A. Watkins, City Secretary
Craig Kinton, City Auditor
C. Victor Lander, Judiciary
Ryan S. Evans, First Assistant City Manager
Jill A. Jordan, P.E., Assistant City Manager
A.C. Gonzales, Assistant City Manager
Forest Turner, Assistant City Manager
Helena Stevens-Thompson, Assistant to the City Manager

“Dallas – Together, we do it better!”
Purpose and Outline

- Overview of sales tax is provided for informational purposes
  - No action is required

- Outline
  - State Law – tax rate and taxable items
  - Taxable vs. non-taxable sales
  - Historical trends
  - Forecasting model
  - Geographic and demographics
  - Internet sales
  - Summary
Tax Rate

- Sales tax is governed by and capped by State law
- Dallas is at maximum sales tax permitted under State law which is 8.25%
  - State levies 6.25% tax
  - Local jurisdictions are allowed to levy up to 2% tax
    - Cities
    - Counties
    - Transit authorities
    - Special purpose districts created to generate revenue for a specific reason such as for crime control, libraries, emergency services

- In Dallas, sales tax includes
  - 6.25% - State
  - 1.0% - City’s general fund
  - 1.0% - Dallas Area Rapid Transit
General Fund Revenue Sources (FY10)

- Property Tax, 43%
- Sales Tax, 20%
- Charges for Services, 13%
- Franchise Revenue, 10%
- Fines, 4%
- Other, 10%

Source: City of Dallas, Office of Financial Services
Taxable Items

- Only the sale or lease of tangible personal property or the sale of taxable services as defined by State are subject to sales tax.
- Not all sales are taxable - taxable sales are a subset of gross sales.
- Sales tax revenue comes from much more than retail activity, because most industries (categorized below; examples in appendix) have at least some portion of their sales that are subject to sales tax.
- Retail and wholesale trade accounts for about 34% of Dallas’ sales tax revenue.

<table>
<thead>
<tr>
<th>Category</th>
<th>Industry</th>
<th>Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail Trade</td>
<td>Admin Support, Waste, Remediation</td>
<td>Transportation &amp; Warehousing</td>
</tr>
<tr>
<td>Wholesale Trade</td>
<td>Professional, Scientific, Technical Services</td>
<td>Health Care &amp; Social Services</td>
</tr>
<tr>
<td>Information</td>
<td>Other Services (Except Public Administration)</td>
<td>Public Administration</td>
</tr>
<tr>
<td>Utilities</td>
<td>Arts, Entertainment, Recreation</td>
<td>Educational Services</td>
</tr>
<tr>
<td>Accommodations &amp; Food Service</td>
<td>Real Estate, Rental, Leasing</td>
<td>Agriculture, Forestry, Fishing, Hunting</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>Mining-Quarrying, Oil &amp; Gas Extraction</td>
<td>Mgmt of Companies &amp; Enterprises</td>
</tr>
<tr>
<td>Construction</td>
<td>Finance &amp; Insurance</td>
<td>Other and Nonclassifiable</td>
</tr>
</tbody>
</table>
Taxable Sales

- Economic growth does not always translate into sales tax revenue growth.

- For example, between 2002 and 2009, fastest growing gross sales in City were in industries that only account for 7.3% of sales tax revenue in City:
  - Real estate, rentals and leasing industry – 833%
  - Finance and insurance – 608%
  - Health care and social services – 519%
  - Educational services – 123%

- The fastest-growing industries in terms of taxable sales from 2002 to 2009 account for only 3.6% of Dallas’ sales tax revenue and were:
  - Mining-quarrying-oil & gas extraction – 71%
  - Agriculture-forestry-fishing-hunting – 54%
  - Finance and insurance – 51%
  - Arts-entertainment-recreation – 38%

Note: Data for briefing from State Comptroller unless otherwise Specified
Taxable Sales

- Declining share of taxable sales: 31% in 1992 to 19% in 2009
  - Proportion of goods verses services in economy has decreased for decades
  - Internet has facilitated or maybe accelerated growth of novel services to compete for household dollars
  - Business transactions have “thinned” with more activity taking place on-line
Taxable and Non-Taxable Sales
(% of Gross Sales)

- 2002:
  - Not Taxable: 75.8%
  - Taxable: 24.2%

- 2009:
  - Not Taxable: 80.8%
  - Taxable: 19.2%
## Taxable Sales by Industry

<table>
<thead>
<tr>
<th>Type of Industry</th>
<th>2002</th>
<th>2009</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail Trade</td>
<td>$6,070,459,589</td>
<td>27.0%</td>
<td>$6,194,075,334</td>
</tr>
<tr>
<td>Information</td>
<td>$5,326,175,189</td>
<td>23.7%</td>
<td>$4,428,644,112</td>
</tr>
<tr>
<td>Utilities</td>
<td>$2,383,700,880</td>
<td>10.6%</td>
<td>$2,298,120,036</td>
</tr>
<tr>
<td>Accommodations &amp; Food Service</td>
<td>$1,774,202,402</td>
<td>7.9%</td>
<td>$2,061,842,057</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>$1,775,366,831</td>
<td>7.9%</td>
<td>$1,463,735,789</td>
</tr>
<tr>
<td>Wholesale Trade</td>
<td>$1,243,047,608</td>
<td>5.5%</td>
<td>$1,291,224,030</td>
</tr>
<tr>
<td>Construction</td>
<td>$768,858,409</td>
<td>3.4%</td>
<td>$1,012,378,818</td>
</tr>
<tr>
<td>Admin Support, Waste, Remediation</td>
<td>$943,755,461</td>
<td>4.2%</td>
<td>$914,985,054</td>
</tr>
<tr>
<td>Professional, Scientific, Technical Service</td>
<td>$637,162,028</td>
<td>2.8%</td>
<td>$584,710,641</td>
</tr>
<tr>
<td>Other Services (except Public Admin)</td>
<td>$418,635,630</td>
<td>1.9%</td>
<td>$437,839,790</td>
</tr>
<tr>
<td>All Other Industries</td>
<td>$1,177,396,793</td>
<td>5.2%</td>
<td>$1,309,856,931</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$22,518,760,820</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>$21,997,412,592</strong></td>
</tr>
</tbody>
</table>
Sales Tax Revenue Historical Trend for City of Dallas

Source: City of Dallas, Office of Financial Services
Historical Trend – Recession Dates

- Gross sales and taxable sales are affected by national and international economics
- National Bureau of Economic Research, a private organization maintains the following dates for the three recent national recessions
  - July 1990 to March 1991
  - March 2001 to November 2001
  - December 2007 to June 2009
- End of a recession does not necessarily mean the economy is growing strongly, rather that most major indicators are no longer falling
Forecasting Model

- Forecasting of sales tax is difficult due to volatile nature and numerous variables involved.
- Office of Economic Development developed a sales tax forecast model that generates short and medium-term forecasts.
- Model uses quarterly historic data from 1990.
- A large selection of statistics were evaluated to include in the model.
- The final model includes four variables that together provide the best predictive ability:
  - City of Dallas unemployment rate (source: U.S. BLS)
  - Occupied retail space in the city (source: Costar)
  - Actual sales tax revenue from two quarters prior (source: TX Comptroller)
  - Special seasonal variable – accounts for fourth quarter holiday shopping season
- Model explains 95.9% of historic sales tax revenue behavior in Dallas.
Forecasting Model Inputs

- Model variables have the following effect on quarterly revenue:
  - Dallas unemployment rate – every percentage point change in city’s unemployment rate changes quarterly revenue by $1.2m
  - Occupied retail space – every 1,000,000 square foot change of occupied space changes revenue by $0.8m
  - Past sales revenue – each $1m change in revenue two quarters prior changes current quarter revenue by $0.4m
  - Fourth quarter (Oct-Dec) seasonal variable – revenue will be $2.5m higher in fourth quarters
Forecasting Model Performance
(Quarterly Sales Tax Allocation)

The model closely tracks actual sales revenue
Forecasting Process

- The input variables must themselves be forecast based on:
  - Ongoing economic conditions
  - Predictions of other government and private forecasters
  - Professional judgment

- Staff generate multiple scenarios for management to consider

- Scenarios are alternative futures that are assigned a probability of occurring

- May 2010 forecasts
  - Baseline scenario with slow growth in major economic indicators (67%)
  - Recession scenario (33%)
  - The recession scenario predicted $17 million less revenue through 2015 compared to the baseline scenario

- Final forecast is influenced by current conditions, statistical models and professional judgment

- Conditions and forecasts improved over the summer leading management to adopt a conservative, flat sales tax estimate for the 2011 budget

- Staff evaluate new methods and information for relevance and applicability on an ongoing basis
  - Mid-year updates are made when necessary for budget management purposes
Forecasting – Ratio Method

- FY11 budget is based on a ratio forecast methodology that was confirmed through the model developed by Office of Economic Development.
- Forecast of year-end sales tax revenue uses year-to-date actual receipts.
  - Each calendar month account for approximately the same share of annual revenue from year to year.
  - Uses averages from the last five years.
  - Assumes current year revenue pattern will follow the historic trend.
- Annually City Auditor reviews upcoming fiscal year revenue projection and methodology.
Forecasting – Ratio Method
Forecasting Methodology - FY11 Budget

- For FY11 Budget, sales tax revenue is forecast at $204.8m
  - Second largest revenue source for the general fund
  - Accounts for about 20.5% of revenue for general fund

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<table>
<thead>
<tr>
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<tbody>
<tr>
<td>FY08 Actual</td>
<td>$228.8m</td>
</tr>
<tr>
<td>FY09 Actual</td>
<td>$206.9m</td>
</tr>
<tr>
<td>FY10 Actual</td>
<td>$204.7m</td>
</tr>
<tr>
<td>FY11 Budget</td>
<td>$204.8m</td>
</tr>
</tbody>
</table>
Geographic Pattern of Sales
(Based on Point of Sale)

- Total sales in Dallas reflects the concentration of commercial activity.
- Northern and western Dallas’ retail and industrial corridors are the areas generating most of the city’s sales.
- This pattern does not reflect the source of the income that generates the sales.
- These sales are to all individuals, including customers that may reside in other parts of the city, outside the city or even outside the state.
% Change in Sales Activity
(Based on Point of Sale)

- Total sales activity has changed in the city
- Increases are likely due to increased commercial and retail activity
- Decreases may be due to loss of local customers or the removal of large tax payers (through closure or relocation)
The dollar change in sales activity matches the percent change pattern with scattered pockets of increasing and decreasing sales by ZIP code.
Dallas ZIP Demographics

- Dallas ZIP codes present a range of socioeconomic characteristics
- Many of these factors drive retail and other spending behavior
- Non-Dallas residents also contribute to sales tax revenue and Dallas residents spend some income in other jurisdictions

<table>
<thead>
<tr>
<th></th>
<th>Average of all Zips</th>
<th>Min of all Zips</th>
<th>Max of all Zips</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Household Expenditure</td>
<td>$55,264</td>
<td>$23,868</td>
<td>$137,771</td>
</tr>
<tr>
<td>Retail Expenditure</td>
<td>$23,487</td>
<td>$10,472</td>
<td>$57,783</td>
</tr>
<tr>
<td>Median Age</td>
<td>34.5</td>
<td>27.5</td>
<td>44.7</td>
</tr>
<tr>
<td>Owner Occupied Housing Units</td>
<td>41.8%</td>
<td>5.6%</td>
<td>77.1%</td>
</tr>
<tr>
<td>Median Household Income</td>
<td>$46,041</td>
<td>$16,922</td>
<td>$126,828</td>
</tr>
<tr>
<td>Average Vehicles Per Household</td>
<td>1.6</td>
<td>1.1</td>
<td>2.4</td>
</tr>
<tr>
<td>Per Capita Income</td>
<td>$31,132</td>
<td>$8,500</td>
<td>$94,338</td>
</tr>
<tr>
<td>Average Household Size</td>
<td>2.7</td>
<td>1.5</td>
<td>3.8</td>
</tr>
<tr>
<td>Education Total (Bachelors or higher)</td>
<td>28%</td>
<td>4%</td>
<td>73%</td>
</tr>
<tr>
<td>Total Population</td>
<td>29,457</td>
<td>267</td>
<td>75,022</td>
</tr>
</tbody>
</table>

Source: ZIP demographic and spending statistics from Alteryx Demographics Now
Socioeconomic Factors Driving Household Spending

- Household spending is an important determinant of sales activity in Dallas.
- Dallas households, however, spend income inside and outside their neighborhoods and inside and outside the city overall.
- At the ZIP code level, there is very little correlation between where spending power is concentrated and where actual sales take place (correlation = 0.26).
- A statistical analysis of the relationship between spending and socioeconomic variables by Dallas ZIP codes revealed the following:
  - Median household income and per capita income positively correlate to an increase in spending.
  - Average household size correlates to a lesser degree, given that a family's budget can only expand so much as the family grows.
  - Educational attainment tends to contribute to additional spending, but the results vary with different statistical models (limitations in the available data may explain this inconsistency).
  - Ethnicity and home ownership were not statistically associated with household spending.
Socioeconomic Factors Driving Household Spending

- Urban dynamics
  - As neighborhoods mature sales shift from taxable goods early on (furniture, clothes, toys) to non-taxable services at maturity (college, travel)
  - Mature neighborhoods will either reach an equilibrium or go into economic decline
  - Dallas has many renewing neighborhoods and the era of strong inner-ring suburb competition may be cresting as those communities also mature
  - Opportunities to attract more business activity overall to unique neighborhoods can help offset declining share of taxable economy
Internet Sales

- In early 2010, the Texas Comptroller estimated that the state is losing almost $600m a year in state and local sales taxes from online purchases which translates to about $4.6m per year for the City of Dallas.

- Rules related to internet sales
  - Texas sales tax, including local tax, is due on purchases made on the internet for delivery in Texas.
  - If the seller has a Texas location, Texas sales tax is due on the purchase.
  - If a Texas buyer purchases merchandise through the Internet from a seller located outside of Texas and uses the taxable item in Texas, then the Texas use tax on the purchase is due from the customer.
  - An out-of-state seller is not required to collect the Texas tax if the seller only conducts business in Texas from out-of-state by mail, telephone, or the Internet, but this seller can voluntarily collect the Texas tax from its Texas customers.
  - If the seller has Texas outlets, Texas salespersons, or otherwise comes into Texas to conduct business, such as soliciting sales, performing services, or making deliveries, an out-of-state seller must get a Texas permit and collect the Texas tax.
  - The Comptroller's office monitors out-of-state sellers to make sure they properly report and remit the tax they collect.
Summary

- Sales tax revenue is a significant revenue for the City’s general fund
- Sales tax is volatile and affected by the economy and numerous variables
- Staff will continue to monitor and report on sales tax on a monthly basis
Appendix
Appendix: Example Taxable Items

- The sales tax code and the administrative rules crafted by the State Comptroller are lengthy and complex. There are hundreds of clauses, exemptions and findings that affect the taxability of goods and services.

- Examples of taxable items in select industries:
  - Information – Newsletters, data retrieval, or mailing lists
  - Utilities – Residential consumption of electricity when the municipality has removed its default exempt status
  - Manufacturing – Hand tools, maintenance and janitorial supplies and equipment, or machinery or equipment used to maintain or store products
  - Construction – Maintenance on non-residential property, labor to repair, remodel or restore residential real property, and labor for new construction
Appendix: Example Non-Taxable

Examples of non-taxable items in select industries

- Administration Support/Waste Services/Remediation – Use of pesticides or regulated herbicides for mainly agricultural purposes, and the services of full-time peace officers privately employed as guards
- Professional/Scientific/Technical Services – Copyrights on photographs (in some instances), and the professional services of landscape designers and architects
- Arts/Entertainment/Recreation – Skydiving training for a person intending to be a skydiving instructor, and consignment sale by an exempt museum of artwork of less than $5,000 on one of the two days an exempt museum is allowed to make exempt sales
- Retail Trade: Items used by the disabled, such as walkers, bedside rails or talking clocks, and items sold during the sales tax holiday
- Mining/Quarrying/Oil & Gas Extraction - Labor to start or stimulate production or the labor to work on the formation outside a well
- Transportation & Warehousing – Charges by colleges, universities, and public schools for parking permits and decals for students
- Other Services (Except Public Administration) – Labor for motor vehicle repair, and qualifying sales made by groups such as PTAs
- Public Administration – Amusement services provided exclusively by a governmental entity
- Accommodation and Food Service – Baby food, fruit and vegetable juice made with more than 50% fruit and vegetable juice, or bakery goods not sold with utensils