SALES TAX

BROADENING SALES TAX BASE CAN REDUCE OVERALL TAX BURDEN

TEF IOWA POLICY REPORT

Title

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Abstract and Policy Recommendations

Many economists, policy advisors, and lawmakers are contemplating what changes to the state's sales tax law may enable Iowa to achieve significant, sustainable tax reform. Reducing reliance on the income tax through ending Iowa's many sales tax exemptions could help not only reduce individual and corporate tax rates but create the right environment for tax reform that improves the state's overall tax climate, while providing relief to families and businesses.

Changes to the sales tax will not only help alleviate individual and corporate income tax burdens, but modernize Iowa's tax code and create a tax system that is beneficial to future generations. Tax laws need to adapt to a changing economy while also being pro-growth, promoting entrepreneurship and job creation. If these end goals are at the forefront of tax reform discussions, Iowa will be on the path to greater prosperity.

There are several broadly accepted standards and observations about sales taxes by both economists and public finance experts. These principles are found throughout this paper and should be the guiding forces for any Iowa tax reform including the sales tax.

1. An ideal sales tax is imposed on all final consumption, both goods and services;
2. An ideal sales tax exempts all business inputs to avoid tax pyramiding;
3. Sales taxes should be destination-based, meaning that tax is owed in the state and jurisdiction where the good or service is consumed;
4. The sales tax is more economically efficient than many competing forms of taxation, including the income tax, because it only falls on present consumption, not saving or investment;
5. Because lower-income individuals have lower savings rates and consume a greater share of their income, the sales tax can be regressive, though broadening the base to include additional consumer services (much more heavily consumed by higher-income individuals) represents a progressive change;
6. The sales tax scales well with ability to pay because it grows with consumption and is, therefore, more discretionary than many other forms of taxation; and
7. Consumption is a more stable tax base than income, though the failure to tax most consumer services is leading to a gradual erosion of sales tax revenues as services become an ever-larger share of consumption.[1]

Introduction

In 1934, Iowa imposed its first income and sales taxes to provide property tax relief.[2] Today, Iowa has not only high property taxes, but also high income and sales tax burdens. High individual and corporate tax rates are problematic as they punish productivity and economic growth. Both individual and corporate income taxes are more harmful to economic growth than the sales tax.[3] High tax rates on capital can be some of the most harmful, because they discourage productivity, hiring, and overall investments in the business.[4]

Sales taxes, or taxes on consumption, are considered the least harmful in comparison to income and corporate taxes. This does not mean that a state should have a high sales tax, because this too would be harmful for economic growth. States should work to establish a tax code that has low rates combined with simplicity and transparency. This would in turn create certainty and stability.

In 2018, the Iowa legislature passed the first major income tax reform legislation in two decades. That tax reform began the process of lowering both the individual and corporate income tax rates and broadened the sales tax base by requiring sales tax be paid on e-commerce and other digital services. The 2018 law did not change the 6 percent state sales tax rate.

In terms of income tax relief, the 2018 law lowered the top individual rate from 8.98 percent to 8.53 percent in 2019. The top rate will be lowered further to 6.5 percent in 2023 (or later) only if two stringent revenue triggers are met. In addition, the top corporate rate will be reduced from 12 percent, the highest in the nation, to 9.8 percent in 2021. Even with these planned reductions, Iowa's income tax rates will still be high in comparison to the rest of the country.

Iowa's General Fund also relies heavily on income taxes for funding. Since 1993, individual and corporate income taxes have a combined average of

TABLE 1: Top Income Tax Rates

State	Top Individual Income Tax Rate
South Dakota	No income tax
Illinois	4.95%
Missouri	5.90%
Iowa (2023 rate)	6.50%
Nebraska	6.84%
Wisconsin	7.65%
Iowa (current)	8.53%
Minnesota	9.85%

State	Top Corporate Income Tax Rate
South Dakota	No income tax
Missouri	6.25%
Nebraska	7.81%
Wisconsin	7.90%
Illinois	9.50%
Minnesota	9.80%
Iowa (2021 rate)	9.80%
Iowa (current)	12.00%

64 percent of General Fund revenues, while the sales tax has been averaging 32 percent of revenues (Figure 3, page 12). Iowa's dependence upon income taxes for revenues further demonstrates the need for tax reform. Income taxes are the most harmful for economic growth and they tend to be less stable, especially during economic downturns.

Iowa has some of the highest tax rates in our region and this makes the state less competitive. Iowa is competing not only in a global economy, but also with 49 other states for both businesses and jobs. The Tax Foundation has noted that "even in our global economy, states' stiffest competition often comes from other states."[5]

"This means that state lawmakers must be aware of how their states' business tax climates match up

against their immediate neighbors and to other regional competitor states," argues Jared Walczak, Director of State Tax Policy at the Tax Foundation.[6] The Tax Foundation ranks Iowa as one of the worst states for business tax climate. In the *2020 State Business Tax Climate*, Iowa ranks 42 out of 50[7]. The index measures each states' corporate, individual, sales, property, and unemployment tax rates. While being ranked 15th in sales tax is okay, an expansion of the base and simplification of the code could make that ranking even better. Aside from the sales tax, Iowa is ranked low in the other categories:

- Corporate tax: 48 out of 50
- Individual tax: 42 out of 50
- Sales tax: 15 out of 50
- Property tax: 35 out of 50
- Unemployment: 35 out of 50[8]

"Generally speaking, high state tax rates repel businesses and high-income taxpayers, with businesses and workers both moving from high-tax to low-tax states and taking their skill sets, tax dollars, and investment capital with them," argued economists Rea Hederman, Andrew Kidd, and James Woodward.[9]

In Tax Education Foundation of Iowa's recent study authored by Hederman, Kidd, and Woodward, *A Better Path Forward for Iowa Tax Reform*, the benefits of reducing income taxes were stated very clearly: "Lowering corporate and individual income taxes benefits state economies through more business investment, more job creation, and more take-home pay for families. Lower corporate taxes reduce the cost of doing business, which allows employers to reinvest tax savings in their employees (higher wages) and their company (workforce and equipment improvements). Likewise, lower household income taxes allow families to keep their hard-earned income and save or spend it as they see fit. Both tax reductions foster economic growth through saving, spending, and private investment."

Iowa needs income tax relief and the sales tax can be part of the overall tax reform discussion. By broadening the sales tax base, more revenue can be generated, which in turn can be used to lower individual and corporate tax rates, or even the sales tax rate itself.

This paper will explore many aspects of raising additional revenue through broadening the sales tax base, but by no means is this a guide for how to increase the tax burden on Iowans. Nor is this an endorsement for additional government spending. New revenue obtained from either broadening the sales tax base or even increasing the sales tax rate should not be used for additional government spending.

TEF Iowa's goal with this policy study is to serve as an educational guide to all stakeholders, informing them as the debate on taxes continues, with an eye toward reducing the burden of Iowa's high-income tax rates.

What is a sales tax?

A sales tax is considered an *ad valorem tax*, that is, a percent of the price of the item is added to the final purchase amount when the item is purchased. For example, if you purchase a shirt for $15.99 with a sales tax rate of 7 percent, your total bill will be $17.11 due to the tax.

In economic terms, a sales tax is a consumption tax because it is levied when someone "consumes" or buys a product. Sales taxes are levied at both the state and local level and commonly exempt certain items from taxation. Each state has autonomy over its sales tax. This means each state exempts different items and each state has a slightly different structure than the others. This can vary from some states choosing not to levy a sales tax at all while others rely on the sales tax as their main source of state tax revenue. Some states have a significant number of exemptions where others have very few. As of 2019, 45 states and the District of Columbia collect a statewide sales tax while local sales taxes are collected in 38 states.[10] The federal government does not levy a sales tax and has left this to the states as a revenue source.

What is NOT a sales tax

Some confusion can arise when the discussion transitions to a value-added tax (VAT) or an excise tax. These are different types of taxes, and while they have similar features, they do not operate as a sales tax would.

More than 130 countries use value-added taxation around the world. A VAT is assessed and collected on the gross margin at each point in the manufacturing, distribution, and sales process of an item. This is in direct contrast to a sales tax which ideally should only be assessed and paid by the consumer at the very end-stage. There are no states that levy a VAT.

The other tax confused with a sales tax is the excise tax. Unlike the sales tax, the federal government frequently uses the excise tax on items such as gasoline, alcohol, and tobacco. The excise tax was first used and is still used today to alter people's behavior by way of taxation. Therefore, excise taxes are commonly referred to as "sin taxes" because they are levied on items policymakers deem unfavorable. In practice, an excise tax is based strictly on quantity; the consumer pays a flat amount per item.

Another difference is that VATs and excise taxes lack transparency because they are commonly included in the final price of the item, whereas a sales tax is applied at the final sale and itemized on the receipt.

History of Iowa's Sales Tax

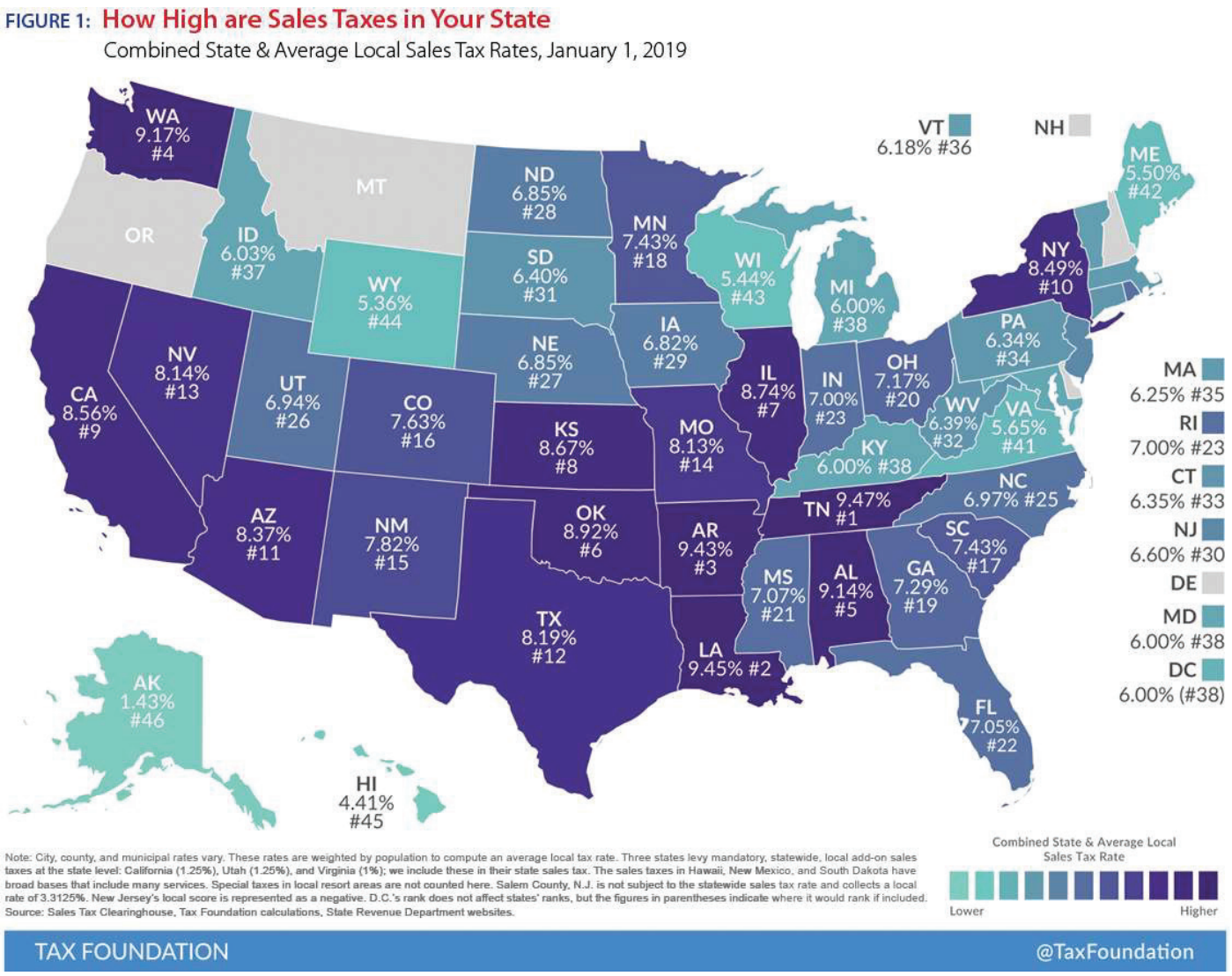
From a national perspective, the sales tax was created during the Great Depression in the 1930s when property tax revenue, the main revenue source for states at the time, dropped considerably. In 1934, Iowa enacted the first sales and income tax for the purpose of reducing the burden of property taxes. Overtime, Iowa's sales tax rate has gradually grown from 2 percent in 1934 to its current level of 6 percent which was reached in 2008. The 2008 increase of 1 percent was for the purpose of replacing "local sales and services taxes for school infrastructure purposes."[11] This statewide sales tax is known as SAVE (Secure an Advance Vision for Education), which directs the funds to school infrastructure spending and property tax relief. SAVE was recently extended during the 2019 legislative session.

TABLE 2: Iowa State Sales Tax Rate Changes Since Inception

Year	Sales Tax Rate
1934	2%
1955	3%
1957	2%
1967	3%
1983	4%
1992	5%
2008	6%

Exemptions within the sales tax code include the sales of certain foods, prescription drugs, medical devices, farm and industrial machinery, and manufacturing inputs. The most recent sales tax reform occurred in 2018 when the legislature modernized the sales tax code to include various forms of digital commerce. Iowa has also implemented a sales tax holiday that runs during the first weekend of August.[12] For that one weekend each year, shoppers in Iowa do not have to pay sales tax on clothing and footwear that is less than $100.[13]

The sales tax was originally structured to focus on the final retail sale of any item of tangible personal property or goods. During the Great Depression, Iowa's economy, as well as the rest of the country's, was primarily goods-based. However, since the early 1950s, services have been an increasingly larger part of our nation's economy. This has become a problem because as Iowa's economy has changed along with the rest of the country, many services sold to the consumer are still not subject to sales tax (see Appendix 1, page 17). The exclusion of so many services means that



as the service sector grows, the amount of revenue the sales tax can generate is being eroded.

Iowa voters also approved a change in the state sales tax in 2010 when the Natural Resources and Outdoor Recreation Trust Fund was approved. The Amendment called for the first 3/8ths of $0.01 of any sales tax increase to be dedicated to the Trust Fund. At this time the statewide sales tax has yet to be increased for this purpose.

Iowa's Local Taxes

"In Iowa, there are several locally imposed taxes that are so closely related to certain state taxes that both the local and state taxes are administered together."[14] Municipalities in Iowa can, with voter approval, implement a local option sales tax that consists of a "1 percent tax in addition to sales tax that is imposed by counties, cities, or unincorporated areas in a county."[15] Iowa's average sales tax is 6.82 percent, reflecting the fact that most cities have imposed the local option sales tax. The local option sales tax is collected by the State and then it is redistributed back to localities based on a formula, which is weighted 75 percent for population and 25 percent the sum of local property taxes levied.

School districts, with approval of voters, can also levy a school district income surtax, which is not to be more than 20 percent of the state income tax liability. Cities and counties may also impose hotel

and motel taxes and a local vehicle tax. Finally, a county can impose a surtax on income for five years, which will be dedicated for emergency medical services.

Economics of the Sales Tax

Every tax has an economic impact, but some have more than others. In the United States, governments pay for their services through revenue generated by taxing three primary economic bases: income, consumption, and wealth. Not all taxes work the same way, and each has a different impact on the economy. However, in all three types, the size of the tax base is critical to the revenue generation of the tax because there are economic, social, and political limits on the ability to adjust the statutory rates. In this section, we will focus on the economic aspects of the sales tax, or the tax on consumption.

Sales Tax Base

Simply put, a tax base is the total amount of items that a government can tax. This is where the discussion of exemptions comes into play. For example, if there were zero sales tax exemptions, then the base would include every transaction that takes place within that taxing jurisdiction. When an exemption is introduced, that item is no longer subject to the tax, so the base gets smaller. Economists call this an "erosion of the base."

A common agreement among economists and public finance scholars is that a well-structured sales tax should extend to all final consumer transactions, whether goods or services, but exclude business-to-business inputs.

However, most states fall far short of this ideal. While there is an economic argument for an exemption of business inputs, other exemptions are made based on political justifications, not a true economic rationale.

Exempting goods and services arbitrarily makes expanding the sales tax base difficult. While it is preferable to have fewer sales tax exemptions, it would also be correct for opponents to say that including some additional products or services in the sales tax base while excluding others can also seem arbitrary, and is an example of "picking winners and losers."

Though policymakers may intend to make the sales tax less burdensome for their constituents by supporting exemptions, in practice, narrowing the base requires higher sales tax rates to raise the same amount of revenue and adds more complexity to the tax code.

Though it is a counterintuitive idea, the fairest sales tax for taxpayers and tax-collecting businesses is one that only exempts business inputs and includes all final consumer goods and services. This policy enables the lowest possible tax rate to be collected on goods and services and has the simplest rules for compliance.

Sales Tax Breadth

The sales tax breadth is a way of measuring or calculating what percent of the economic base is subject to the tax. For example, when states started levying a sales tax in the 1930s, the tax applied to almost all items a person would purchase, creating a high sales tax breadth. Today, many states have chosen to exempt multiple items from the sales tax, which reduces the breadth, Iowa included. The Tax Foundation argues that Iowa's sales tax base is broad in comparison to other states, but "it remains too narrow to grow with today's service-oriented economy."[16]

In addition to certain tangible items now being exempt from the tax compared to the base of decades prior, the U.S. economy has changed from a manufacturing-based economy to a service-based economy. This has led to Americans purchasing more services than goods as a percentage of their overall consumption. In the first quarter of 2019, services accounted for approximately 70 percent of

personal consumption expenditures in the United States, whereas goods were only 30 percent.[17] Iowa's economy has followed a similar trend, as seen in Table 4.[18]

If Iowa does not take this economic change into account, this will lower the breadth of the sales tax automatically. Because the reduction in breadth reduces the revenue potential of the tax, many states have chosen to increase their sales tax rates in order to maintain constant revenues, rather than adjusting their base/breadth. Iowa is no exception.

Many economists involved in state-based policy use the late Indiana University Professor John Mikesell's standard measure of sales tax breadth, which is defined as the ratio of the implicit sales tax base to the state's personal income.[19] As of Fiscal Year 2017, Iowa had a sales tax breadth of 37 percent, which ranked 22nd highest in the nation. However, neighboring South Dakota, which applies a very broad-based sales tax, has the second-highest breadth in the nation at 62 percent, as shown in Table 5.[20]

While a higher sales tax breadth is a good thing as it applies to the taxation of the final sale of consumer goods and services, this measurement also includes goods and services that may be business inputs. Therefore, while policymakers should seek to expand the sales tax breadth by eliminating unjustified sales tax exemptions, it is important to

TABLE 4: Total Personal Consumption Expenditures in Iowa

	2018	% of total
Total personal consumption expenditures (in millions)	**122,913.7**	
GOODS	43,051.7	35%
Durable goods	14,061.2	11%
Motor vehicles and parts	5,705.4	5%
Furnishings and durable household equipment	2,910.9	2%
Recreational goods and vehicles	3,519.2	3%
Other durable goods	1,925.7	2%
Nondurable goods	28,990.5	24%
Food and beverages purchased for off-premises consumption	9,783.5	8%
Clothing and footwear	2,958.5	2%
Gasoline and other energy goods	5,419.9	4%
Other nondurable goods	10,828.6	9%
SERVICES	79,861.9	65%
Household consumption expenditures (for services)	74,936.8	61%
Housing and utilities	19,813.0	16%
Health care	20,715.9	17%
Transportation services	3,220.5	3%
Recreation services	5,041.5	4%
Food services and accommodations	7,077.3	6%
Financial services and insurance	10,105.9	8%
Other services	8,962.7	7%
Final consumption expenditures of nonprofit institutions serving households	4,925.1	4%

Source: Bureau of Economic Analysis

know that it is also possible for a sales tax to have too great of a breadth. For example, while South Dakota's sales tax includes a wider range of consumer services, which is consistent with the consensus of public finance scholars, the tax also includes a significant number of business inputs. The next section will explain the economic problems with taxing business inputs, and why it should be avoided.

TABLE 5:
Iowa and Neighboring States' Sales Tax Breadth

State	Sales Tax Breadth	National Rank
South Dakota	62%	2
Wisconsin	38%	19
Iowa	37%	22
Nebraska	34%	27
Minnesota	33%	30
Missouri	32%	32
Illinois	28%	34

Source: Tax Foundation; 1st = most breadth

Tax Pyramiding

As stated elsewhere, the ideal sales tax should include all final consumer transactions, whether goods or services, but exclude business-to-business inputs.

This is good and economically sound tax policy, not because businesses deserve special treatment, but because failure to do so results in what is called "tax pyramiding."

If the tax is levied on business inputs, then the tax will be embedded in the final price of the good or service several times over. Figure 2 provides a very simple example. If sales tax is applied to the raw timber purchased by a sawmill, and then is applied to the lumber the cabinetmaker purchases, and then applied to the cabinets purchased by the home store, and finally applied on the new cabinets purchased by a customer – the sales tax is embedded four times into the final price of the cabinet. While this is a simplified example, it illustrates that this pyramiding of the sales tax ultimately increases the cost of doing business, and more times than not, also increases the final cost for the consumer.

FIGURE 2:
Illustration of Tax Pyramiding on a Cabinet

Tax pyramiding is particularly burdensome in industries with long production lines and with many components, such as agriculture-based products and manufacturing. The economic consequence is that businesses will try to avoid these taxes and change their operational structure in ways that would not be otherwise economically efficient. In addition, tax pyramiding undermines one of the benefits of transparency provided by the retail sales tax over the VAT or the excise tax. When states tax business-to-business transactions, the embedded taxes are already in the final price of the product, unbeknownst to the consumer.

Regressive Tax

Many refer to the sales tax as a regressive tax, which is an accurate description, especially when applied to items like groceries and medication. By definition, a regressive tax is when a tax takes a larger percentage of income from low-income

earners rather than from high-income earners because it is levied uniformly to all situations. This is the direct opposite of a progressive tax which takes a larger percentage from high-income earners, such as the graduated income tax, that is applied at a higher rate the more income you earn.

For example, if someone only makes $25,000 per year and they buy $2,500 in taxable goods during that same year, they are paying sales tax on 10 percent of their total earnings. If someone makes $50,000 per year and they buy the same $2,500 in goods, they are only paying sales tax on 5 percent of their earnings. Although the tax is the same rate in both scenarios, the person with the lower income is paying a higher percentage of their income, which makes the tax regressive. Other taxes that are considered regressive are user fees and property taxes.

However, it must be noted that sales tax exemptions can exacerbate the regressive effects of sales taxes. Under current law, Iowa exempts many services from the sales tax base. Yet, a greater proportion of services are consumed by wealthier households versus low-income households. Because these sales are exempt, the sales tax rate paid on taxable goods consumed by low-income taxpayers must also be higher to collect the same revenue, making the regressive impact of the tax greater.
Many citizens and policymakers assume that an ambitious expansion of the sales tax base must necessarily make the state tax system more regressive or more costly for low-income taxpayers. If Iowa were to use revenues raised from an expansion of the sales tax base to reduce income tax rates and the sales tax rate the overall tax climate for lower-income taxpayers could be improved.

Tax Shift

Many who debate changes to the sales tax argue that it could result in a tax shift. By definition, a tax shift is when there is a redistribution of a tax burden from one entity to another. In the private sector, this is illustrated by a producer shifting the cost of the tax onto the consumer.
In the case of government and the sales tax, many states have broadened the sales tax base to reduce the regressive nature of the sales tax by including services. They use this revenue to either reduce the sales tax rate or to reduce other tax rates, such as income or property tax. This negates the idea of a "shift" because the taxpayer is receiving a reduction in their tax burden somewhere else in the code.

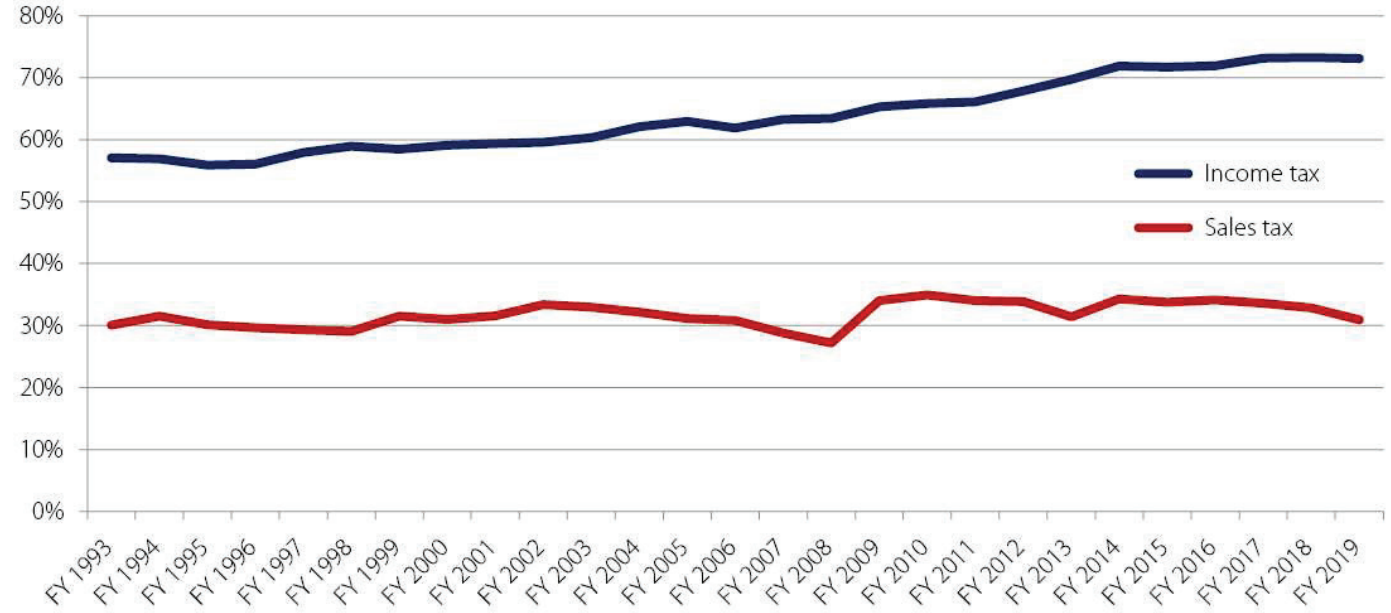
The only way Iowa would be guilty of conducting a "tax shift" is if they broadened the sales tax base and or increased the rate with no other tax changes. In other words, if the legislature either broadened the sales tax base or increased rates only for additional government spending with no corresponding tax rate reductions, it would end up resulting in a tax shift.

The result of this would be "shifting" of the revenue burden from one tax onto another. For example, many states have broadened their sales tax base in order to reduce the income tax. In Iowa's case, some have argued and proposed that the revenue generated from broadening or raising the sales tax should be used to reduce the income tax rates. In that case, there is a redistribution of tax revenue from one tax to another, but the net impact for many taxpayers is neutral because there is an accompanying cut. That is why sales tax changes are so commonly included in comprehensive tax reform packages.

Iowa's Sales Tax in the Current Environment

As noted earlier in this paper, Iowa voters passed an amendment to the state Constitution in 2010 which created the Natural Resources and Outdoor Recreation Trust Fund. The Amendment calls for the first 3/8ths of $0.01 of any sales tax increase to be dedicated to the Trust Fund. Proponents of certain water quality efforts continue to advocate for an increase of the sales tax for the purposes of funding the Trust Fund. At the same time, some advocates for mental health funding are asking that

FIGURE 3



more money be spent to meet Iowa's mental health needs. An argument exists that the sales tax could be increased a full penny to provide additional funding for natural resources, mental health, and other spending initiatives.

If those scenarios came to fruition, there is a possibility that the sales tax would be as high as 8 percent in communities where a local option sales tax is in place. Although the sales tax is considered less harmful than the income tax, it does not mean that a high sales tax rate will not have economic consequences.

In addition to those who have turned towards sales taxes as a source of new spending, others have considered sales tax as a way to reduce the state's reliance on income taxes. One of the ideal policies that should be explored for much-needed income tax reform is an expansion of the sales tax base as a tool for lowering income tax rates.

A review of Iowa's sales tax collections over time shows that there is the potential for a greater reliance on the sales tax. Despite increases to Iowa's sales tax rate, the sales tax has not become a more effective revenue source for the state. As shown in Figure 3, Iowa is relying more heavily on income tax than sales tax. The sales tax has been at a relatively consistent average of 32 percent of the state's revenue since 1993, while the individual and corporate income taxes have combined to average 64 percent, including 73 percent in each of the past three years.[21]

It is clear that since the early 1990s, changes in consumer behavior have caused the state to lean more and more heavily on income tax collections to fund Iowa's budget, especially as untaxed services assume an ever-greater share of personal consumption. One consequence of this changing consumer trend is that the existing sales tax base is taxed at a higher rate than would otherwise be necessary. Another consequence is that the income tax, and its anti-growth impact, has emerged as the dominant state tax.

Sales Tax in Tax Reform in Other States

Other states, namely North Carolina and Utah, have experienced the same divergence between their sales and income tax as Iowa. North Carolina addressed this problem by broadening the base of their sales tax to include services and many exempted goods. In exchange, their overall tax code was reformed to encourage entrepreneurship,

economic growth, and job creation.[22] As a result, for the five years immediately following tax reform, North Carolina has seen revenue surpluses in each year, with a surplus amounting to 3 percent of state revenue in 2019, or $700 million above projections along with record job growth.[23]

Utah's legislature, similarly, just passed sweeping changes to their tax code that lowers the income tax rate and broadens the sales tax base to address the overreliance on income tax and takes advantage of many of the untaxed services in the state.[24] Utah is currently experiencing economic growth and the state leadership wants to see this trend continue, which is the rationale for reform of the sales tax.

In 2018, Kentucky also enacted tax reform that created a net increase in revenue, which was a necessary change to address the state's growing pension problem and the lack of diversified revenue sources. Kentucky broadened the sales tax base by including many services, using the new revenue to create a lower flat-rate personal and corporate income tax which also had fewer exemptions.

Iowa's tax reform in 2018, along with tax reform efforts in North Carolina, Utah, and Kentucky has resulted in these states broadening their sales tax bases to make their states more friendly to investment through comprehensive tax reform.

Competitiveness

Kentucky, North Carolina, and Utah have all found that taxing services and broadening their sales tax base does not hurt their economic competitiveness with other states. Iowa would be well served to consider further sales tax base broadening and simplifying of the sales tax code. At the same time, Iowa must be prudent that any sales tax reform options, whether base broadening or even a rate increase, must result in actual tax rate reductions. Broadening the sales tax base could result in either lowering income tax rates or using the revenue to lower sales tax rates themselves.

In Table 6, a hypothetical situation is calculated to illustrate the amount of sales tax available if there were zero exemptions. We understand in this situation that business inputs would be taxed, which we do not support. However, since the exact figure is almost impossible to calculate with all the varying exemptions in the tax code, this shows that the maximum collections from a sales tax with zero exemptions are around $7.4 billion. In 2018, there were $2.4 billion in sales taxes collected by the state, which equates to only 32 percent of the maximum available. If the Legislature were to remove many, if not all, of these sales tax exemptions on services that are not business inputs, then a significant amount of revenue could be generated to offset Iowa's high-income tax rates.

TABLE 6: Hypothetical Sales Tax Revenue

	2018	6% State Sales Tax Applied
Total personal consumption expenditures (in millions)	**122,913.7**	**$7,375**
GOODS	43,051.7	$2,583
Durable goods	14,061.2	$844
Nondurable goods	28,990.5	$1,739
SERVICES	79,861.9	$4,792
Household consumption expenditures (for services)	74,936.8	$4,496
Final consumption expenditures of nonprofit institutions serving households	4,925.1	$296

Source: Bureau of Economic Analysis

There are other criteria that policymakers can use if they cannot reach a consensus on sales tax reform that includes all final consumer goods and services in the sales tax base.

A comparison to other states can provide an assessment of whether Iowa faces a competitive disadvantage by levying a sales tax on a good or service. However, this process must be viewed with appropriate skepticism. After all, most states do not

currently levy sales taxes in accordance with sound tax policy principles, and some states are continuing to narrow their sales tax bases.

Still, these criteria will show that Iowa has much room for improvement. For example, there are numerous services that one of Iowa's neighboring states tax that Iowa currently exempts, or exempts in certain circumstances. Each of these could clearly be included in a reform plan without any economic objection. These include boat storage, veterinary services, lobbying, and chartered flights with a pilot. (See Appendix 1, page 17)

As mentioned in the section on regressivity, the taxation of groceries, prescription and nonprescription drugs and other staples is a major area for objections to sales tax reform. However, it is also a significant source of foregone revenue. Right now, there are 5 states that do not levy a sales tax at all and only 9 additional states that have chosen to exempt all three of these categories from the sales tax. (See Appendix 2, page 23)

TABLE 8: State Count on Taxation of Groceries and Drugs

Item	Number of States
Groceries	16 states*
Prescription Drugs	1 state*
Nonprescription Drugs	36 states

* Some only levy a local tax or a tax rate lower than the state rate.

While many are accustomed to referring to a sales tax on groceries as a tax on "food," in practice, many food products Iowans consume daily are already subject to sales tax. Prepared meals and beverages at restaurants and fast food establishments are taxed in Iowa, as are food products purchased at grocery stores that are heated, such as a rotisserie chicken. Iowa currently exempts all unprepared groceries and prescription drugs, while taxing nonprescription drugs.

It should be noted that while levying a special, lower state or local sales tax rate on groceries is a possible compromise with the potential to raise revenue, it does add complexity to the tax code. Preferably, policymakers should levy the same uniform sales tax rate on all goods and services. By ending more exemptions, state and local governments will have more revenue to arrive at the lowest possible rate.

To see more details on how other states tax particular goods and services, please reference the tables found in the Appendix 1 and 2.

Revenue Impact of an Income Tax Rate Change

Because this paper recommends reducing Iowa's state income tax rate as part of comprehensive tax reform, it would be essential for policymakers to be able to assess the cost of these changes. When a tax rate is changed, economists calculate how much the tax will either increase or decrease the government's revenues. There are two very different types of calculations that exist, "static scoring" and "dynamic scoring." When static scoring is used, it assumes that the tax change will have no impact on the economic behavior of the individuals that are affected. Dynamic scoring adds to the calculations the predictable impact tax changes will have on economic behavior.

For example, when Oregon increased its income tax rate, the state expected to have more revenue–this is a static scoring scenario because the behavior of citizens was not taken into consideration. What happened in practice was that people moved out of state and Oregon collected LESS revenue, even with the higher rate. If dynamic scoring had been conducted, then the behavior of these citizens would have been measured, and the revenue projection probably wouldn't have been as high.

A Better Path Forward for Iowa Tax Reform provides an overview of four possible tax scenarios that each take into consideration an increase in sales tax revenues and a decrease in income tax revenues. The annual increase in economic activity projected by those scenarios ranged from $250 million to $610 million.

Expanding the sales tax base would result in new state revenue. While reducing both the individual and corporate income tax rates would cause the state to forgo some revenue, it could be recouped by new economic activity that would not otherwise be realized under the state's current high tax rates.[25]

Conclusion

A major aspect of the 2018 state tax reform consisted of modernizing the sales tax by broadening the base. Further base broadening of Iowa's sales tax would not only create a more simple and fair tax structure, but also provide additional revenue to be used to lower tax rates. The sales tax should apply to all final consumption to follow the tax principle of "economic neutrality." Neutrality ensures that the tax will not interfere with economic decision-making any more than is necessary. More commonly, this is known as not picking winners and losers. It is not the role of the tax code to favor golf lessons over a new pair of shoes.

There have been several broadly accepted standards and observations about sales taxes by both economists and public finance experts that are worth restating:

1. Sales taxes should be imposed on all final consumer purchases of goods and services alike while exempting business inputs to avoid double taxation through tax pyramiding;
2. The sales tax is more economically efficient than many competing forms of taxation, including the income tax, because it only falls on present consumption;
3. Because lower-income individuals have lower savings rates and consume a greater share of their income, the sales tax can be regressive, though broadening the base to include additional consumer services and reducing the tax rate represents a progressive change; and
4. Consumption is a more stable tax base than income, though the failure to tax most consumer services is leading to a gradual erosion of sales tax revenues

Policymakers should approach any sales tax reform with caution. Whether broadening the base or even raising the sales tax rate, policymakers must ensure that revenues gained from any sales tax reform be applied to actual tax rate reduction, whether that is the sales or income tax.

In order to ensure Iowa has a more competitive economic climate, it is preferable that any new sales tax revenue be utilized to lower income tax rates. Iowa's high-income tax rates discouraged economic growth and productivity. Iowa can learn from states such as Utah and North Carolina, who have lowered tax rates and, in the process, created economic growth. The sales tax can be part of a greater conversation for a more pro-growth tax reform that will place Iowa taxpayers first while promoting entrepreneurship and job creation. If these end goals are at the forefront of tax reform discussions, Iowa will be on the path to greater prosperity.

Many economists, policy advisors, and lawmakers are contemplating what changes to the state's sales tax law may enable Iowa to achieve significant, sustainable tax reform. Where the disagreement comes is what the scope of those changes should be, and how much revenue should increase or decrease as a result of those changes. Hopefully, this policy study shed some light on the discussions and can help guide policymakers in making the best decision for reform.

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Appendix 1: Tax treatment of services, Iowa and surrounding states

Service	Iowa Tax Status	Iowa Notes	IL	MN	MO	NE	SD	WI
Basic Sales Tax Rate	6%		6.25	6.875	4.225	5.5	4.5	5
								E= (Generally) exempt from sales tax
Agricultural Services								
Veterinary services (both large and small animal)	Non-Taxable	Pet grooming service is taxable.	E	E	E	E	4.5	E
Horse boarding and training (not race horses)	Non-Taxable		E	E	E	5.5	4.5	5
Industrial and Mining Services								
Metal, non-metal and coal mining services	Non-Taxable	Excavation, without more, is a taxable service, but excavation for mining is normally an exempt service performed in connection with new construction.	E	E	E	E	4.5	E
Seismograph & Geophysical Services	Non-Taxable		E	E	E	E	4.5	E
Oil Field Services	Non-Taxable		E	E	E	E	4.5	E
Typesetting service; platemaking for the print trade	Non-Taxable		E	6.875	E	5.5	4.5	5
Construction	.		.	.	.	.	.	.
Gross Income of Construction Contractors	Non-Taxable		E	E	E	E	2	E
Transportation Services	.		.	.	.	.	.	.
Income from intrastate transportation of persons	Non-Taxable		E	E	4.225	E	4.5	E
Income from taxi operations	Non-Taxable	Limousine service is taxable	E	E	E	E	4.5	E
Storage	.		.	.	.	.	.	.
Automotive storage	Non-Taxable		E	E	E	E	4.5	5
Food storage	Non-Taxable	Taxable if it is the storage of raw agricultural products, unless the warehouse ships the raw agricultural product out of Iowa.	E	E	E	E	4.5	E
Cold storage	Non-Taxable	Taxable for raw agricultural products.	E	E	E	E	4.5	E
Marina Service (docking, storage, cleaning, repair)	Non-Taxable	Boat repair is taxable	E	E	E	E	4.5	5
Marine towing service (incl. tugboats)	Non-Taxable		E	E	E	E	4.5	5
Utility Service - Industrial Use	.		.	.	.	.	.	.
Interstate telephone & telegraph	Non-Taxable		7	6.875	E	E	4.5	5
Electricity	6%	Processing and agricultural production exempt.	5	6.875	4.225	5.5	4.5	5
Water	6%	Processing and agricultural production exempt.	E	6.875	4.225	5.5	E	E
Natural gas	6%	Processing and agricultural production exempt.	5	6.875	4.225	5.5	4.5	5
Other fuel (including heating oil)	6%	Processing and agricultural production exempt.	6.25	6.875	4.225	5.5	4.5	5
- Residential Use								
Interstate telephone & telegraph	Non-Taxable		7	6.875	E	E	4.5	5
Electricity	Non-Taxable		5	6.875	E	5.5	4.5	5
Natural gas	Non-Taxable		5	6.875	E	5.5	4.5	5
Other fuel (including heating oil)	Non-Taxable		6.25	6.875	E	5.5	4.5	E
Sewer and refuse, residential	Non-Taxable		E	T	E	5.5	4.5	E

Service	Iowa Tax Status	Iowa Notes	IL	MN	MO	NE	SD	WI
Finance, Insurance and Real Estate	.		.	.	.	.	.	.
Service charges of banking institutions	6%	Tax is imposed only on service charge relating to depositors' checking accounts.	E	E	E	E	E	E
Insurance services	Non-Taxable		E	E	E	E	4.5	E
Loan broker fees	Non-Taxable		E	E	E	E	4.5	E
Property sales agents (real estate or personal)	Non-Taxable		E	E	E	E	4.5	E
Real estate management fees (rental agents)	Non-Taxable		E	E	E	E	4.5	E
Real estate title abstract services	Non-Taxable		E	E	E	E	4.5	E
Tickertape reporting (financial reporting)	Non-Taxable		E	E	E	E	4.5	E
Services								
Personal Services	.		.	.	.	.	.	.
Debt counseling	Non-Taxable		E	E	E	E	4.5	E
Income from funeral services	Non-Taxable	The sale of taxable services and tangible personal property should be separately itemized.	E	E	E	E	4.5	E
Fishing and hunting guide services	6%	Commercial recreation is taxable.	E	E	E	E	4.5	5
Personal instruction (dance, golf, tennis, etc.)	Non-Taxable	Generally exempt except dance schools, dance studios and flying lessons are taxable.	E	E	E	E	4.5	E
Tax return preparation	Non-Taxable		E	E	E	E	4.5	E
Business Services	.		.	.	.	.	.	.
Sales of advertising time or space:								
Advertising agency fees (not ad placement)	Non-Taxable		E	E	E	E	4.5	E
Check & debt collection	Non-Taxable		E	E	E	E	4.5	E
Commercial art and graphic design.	Non-Taxable	Finished art and complete charge for tangible personal property are subject to tax.	E	6.875	E	5.5	4.5	E
Credit information, credit bureaus	Non-Taxable		E	E	E	E	4.5	E
Lobbying and consulting	Non-Taxable		E	E	E	E	4.5	E
Marketing	Non-Taxable		E	E	E	E	4.5	E
Packing and crating	6%	Packing material sold for use in agricultural, livestock, or dairy production is exempt. Packing material sold to retailers or manufacturers of the purpose of packaging or facilitating the transportation of tangible personal property sold at retail or transferred in association with the maintenance or repair of fabric or clothing is also exempt.	E	E	E	5.5	4.5	E
Private investigation (detective) services	6%	Excluding private detective services furnished by a peace officer with the knowledge and consent of the officer's law enforcement agency.	E	6.875	E	5.5	4.5	E
Process server fees	Non-Taxable		E	E	E	E	4.5	E
Public relations, management consulting	Non-Taxable		E	E	E	E	4.5	E
Secretarial and court reporting services	Non-Taxable	The sale of taxable services and tangible personal property should be separately itemized.	E	E	E	E	4.5	E
Security services	6%	Excluding private security services furnished by a peace officer with the knowledge and consent of the officer's law enforcement agency.	E	6.875	E	5.5	4.5	E

Service	Iowa Tax Status	Iowa Notes	IL	MN	MO	NE	SD	WI
Sign construction and installation	6%		E	E	E	5.5	4.5	5
Telemarketing services on contract	Non-Taxable		E	E	E	E	4.5	E
Telephone answering service	6%		E	E	E	E	4.5	5
Temporary help agencies	Non-Taxable	Machine operators are taxable.	E	E	E	E	4.5	E
Test laboratories (excluding medical)	6%	Excluding tests on humans or animals, and excluding environmental testing services.	E	E	E	E	4.5	5
Window cleaning	6%	Exempt if performed for home owner.	E	6.875	E	5.5	4.5	E
Computer:	.		.	.	.	.	.	.
Software - package or canned program	Taxable		6.25	6.875	4.225	5.5	4.5	5
Software - modifications to canned program	Generally Taxable *see notes*	Prewritten software is taxable, "however, if there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such modification/enhancement, the modification or enhancement does not constitute prewritten computer software." IA 423.1(38). There's an exemption for Commercial Enterprises .	6.25	E	4.225	5.5	4.5	5
Software - custom programs - material	Generally Taxable *see notes*	Prewritten software is taxable, "however, if there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such modification/enhancement, the modification or enhancement does not constitute prewritten computer software." IA 423.1(38). There's an exemption for Commercial Enterprises .	E	E	E	5.5	4.5	E
Software - custom programs - professional serv.	Generally Taxable *see notes*	Prewritten software is taxable, "however, if there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such modification/enhancement, the modification or enhancement does not constitute prewritten computer software." IA 423.1(38). There's an exemption for Commercial Enterprises .	E	E	E	5.5	4.5	E
Internet Service Providers taxable in Iowa	Non-taxable		E	E	E	E	4.5	5
Internet Service Providers-DSL or other broadband	Non-taxable		E	E	E	E	4.5	5
Information services	Generally Taxable *see notes**	New exemption may apply for Commercial Enterprises. Exemption includes specified digital products, prewritten computer software, and certain otherwise taxable services as long as purchased by a commercial enterprise.	E	E	E	E	4.5	E
Data processing services	Generally Taxable *see notes*	New exemption may apply for Commercial Enterprises. Exemption includes specified digital products, prewritten computer software, and certain otherwise taxable services as long as purchased by a commercial enterprise.	E	E	E	E	4.5	E
Mainframe computer access and processing serv.	Non-Taxable *see notes*	Depending on the particulars of the transaction, "mainframe computer access" maybe Infrastructure as Service which is non-taxable.	E	E		E	4.5	E

Service	Iowa Tax Status	Iowa Notes	IL	MN	MO	NE	SD	WI
Computer Online Services:	.		.	.	.	.	.	.
Online Data processing services	Generally Taxable *see notes*	New exemption may apply for Commercial Enterprises. Exemption includes specified digital products, prewritten computer software, and certain otherwise taxable services as long as purchased by a commercial enterprise.	E	E	E	E	4.5	E
Software - Downloaded	Generally Taxable *see notes*	New exemption may apply for Commercial Enterprises. Exemption includes specified digital products, prewritten computer software, and certain otherwise taxable services as long as purchased by a commercial enterprise.	6.25	6.875	E	5.5	4.5	5
Books - Downloaded	Generally Taxable *see notes*	New exemption may apply for Commercial Enterprises. Exemption includes specified digital products, prewritten computer software, and certain otherwise taxable services as long as purchased by a commercial enterprise.	E	6.875	E	5.5	4.5	5
Music - Downloaded	Generally Taxable *see notes*	New exemption may apply for Commercial Enterprises. Exemption includes specified digital products, prewritten computer software, and certain otherwise taxable services as long as purchased by a commercial enterprise.	E	6.875	E	5.5	4.5	5
Movies/Digital Video - Downloaded	Generally Taxable *see notes*	New exemption may apply for Commercial Enterprises. Exemption includes specified digital products, prewritten computer software, and certain otherwise taxable services as long as purchased by a commercial enterprise.	E	6.875	E	5.5	4.5	5
Other Electronic Goods - Downloaded	Generally Taxable *see notes*	New exemption may apply for Commercial Enterprises. Exemption includes specified digital products, prewritten computer software, and certain otherwise taxable services as long as purchased by a commercial enterprise.	E	E	E	E	4.5	5
Streaming Music/Audio Services new	Generally Taxable *see notes*	New exemption may apply for Commercial Enterprises. Exemption includes specified digital products, prewritten computer software, and certain otherwise taxable services as long as purchased by a commercial enterprise.	E	6.875	E	5.5	4.5	5
Professional Services	.		.	.	.	.	.	.
Accounting and bookkeeping	Non-Taxable		E	E	E	E	4.5	E
Architects	Non-Taxable		E	E	E	E	4.5	E
Attorneys	Non-Taxable		E	E	E	E	4.5	E
Engineers	Non-Taxable		E	E	E	E	4.5	E
Land surveying	Non-Taxable		E	E	E	E	4.5	E
Leases and Rentals	.		.	.	.	.	.	.
Bulldozers, draglines and const. mach., short term	Non-Taxable	The lease or rental of machinery and equipment is exempt when directly and primarily used for new construction. The dealer owes 6% sales or use tax on its purchase of such inventory.	T	6.875	4.225	5.5	4.5	5
Bulldozers, draglines and const. mach., long term	Non-Taxable	The lease or rental of machinery and equipment is exempt when directly and primarily used for new construction. The dealer owes 6% sales or use tax on its purchase of such inventory.	T	6.875	4.225	5.5	4.5	5

Service	Iowa Tax Status	Iowa Notes	IL	MN	MO	NE	SD	WI
Rental of hand tools to licensed contractors.	Non-Taxable	The lease or rental of machinery and equipment is exempt when directly and primarily used for new construction. The dealer owes 6% sales or use tax on its purchase of such inventory.	T	6.875	4.225	5.5	4.5	5
Chartered flights (with pilot)	Non-Taxable		E	E	E	E	4.5	E
Fabrication, Installation and Repair Services	.		.	.	.	.	.	.
Labor charges - repairs to interstate vessels	Non-Taxable	Exempt if the vessel is licensed, the service is used to repair or restore a defect in the vessel, the vessel is engaged in interstate commerce and will continue in interstate commerce once the service is completed, and the vessel is in navigable water that borders Iowa.	E	E	E	E	4.5	E
Installation charges by persons selling property	Non-Taxable	Electrical and electronic installation is taxable. Installation may also involve other taxable enumerated services. Installation is exempt if performed on or in connection with the new construction, reconstruction, alteration, expansion or in connection with industrial machinery installation.	E	6.875	E	5.5	4.5	5
Installation charges - other than seller of goods	Non-Taxable	Electrical and electronic installation is taxable. Installation may also involve other taxable enumerated services. Installation is exempt if performed on or in connection with the new construction, reconstruction, alteration, expansion or in connection with industrial machinery installation.	E	6.875	E	5.5	4.5	5
Custom processing (on customer's property)	Non-Taxable	Unless a taxable enumerated service.	E	6.875	E	5.5	4.5	5
Custom meat slaughtering, cutting and wrapping	Non-Taxable	Packing material sold for use in agricultural, livestock, or dairy production is exempt. Packing material sold to retailers or manufacturers fo the purpose of packaging or facilitating the transportation of tangible personal property sold at retailis also exempt.	E	E	E	E	4.5	E
Taxation of Cloud Computer Services New								
Software as a Services, Generally (Remote Access to Hosted Software)	Generally taxable	see notes for Remote Access to Hosted Software Business use/Business Custom Applications	E	E	E	E	4.5	E
Remote Access to Hosted Software - Personal Use	Taxable		E	E	E	E	4.5	E
Remote Access to Hosted Software - Business Use	Generally Taxable *see notes*	New exemption may apply for Commercial Enterprises. Exemption includes specified digital products, prewritten computer software, and certain otherwise taxable services as long as purchased by a commercial enterprise.	E	E	E	E	4.5	E
Remote Access to Hosted Business Custom Applications	Generally Taxable *see notes*	New exemption may apply for Commercial Enterprises. Exemption includes specified digital products, prewritten computer software, and certain otherwise taxable services as long as purchased by a commercial enterprise.	E	E	E	E	4.5	E
Infrastructure as Service, Generally	Non-taxable		E	E	E	T	4.5	E
Personal Cloud Storage/Backup	Non-taxable		E	E	E	T	4.5	E
Business Cloud Storage/Backup	Non-taxable		E	E	E	T	4.5	E

Service	Iowa Tax Status	Iowa Notes	IL	MN	MO	NE	SD	WI
Business Data Warehouses	Exemption exists for qualify Data center *see notes*	There is an exemption for qualifying Data Centers: The owner of a data center business, as defined in section 423.3, subsection 95, located in this state may make an annual application for up to five consecutive years to the department for the refund of fifty percent of the sales or use tax upon the sales price of all sales of fuel used in creating heat, power, and steam for processing or generating electrical current, or from the sale of electricity consumed by computers, machinery, or other equipment for operation of the data center business facility.	E	E	E	T	4.5	E
Ecommerce Site/Webserver Hosting	Generally Taxable *see notes*	New exemption may apply for Commercial Enterprises. Exemption includes specified digital products, prewritten computer software, and certain otherwise taxable services as long as purchased by a commercial enterprise.	E	E	E	E	4.5	E
Provision of Virtual Computing Capacity	Non-taxable		E	E	E	E	4.5	E

Appendix 2: State Grocery And Drug Sales Tax Exemptions

(As Of January 1, 2020)

State	State Tax Rate (Percentage)	EXEMPTIONS		
		Groceries	Prescription Drugs	Nonprescription Drugs
Alabama	4		*	
Alaska	none	--	--	--
Arizona	5.6	*	*	
Arkansas	6.5	0.125% (4)	*	
California (3)	7.25	*	*	
Colorado	2.9	*	*	
Connecticut	6.35	*	*	
Delaware	none	--	--	--
Florida	6	*	*	*
Georgia	4	* (4)	*	
Hawaii	4		*	
Idaho	6		*	
Illinois	6.25	1%	1%	1%
Indiana	7	*	*	
Iowa	6	*	*	
Kansas	6.5		*	
Kentucky	6	*	*	
Louisiana	4.45	* (4)	*	
Maine	5.5	*	*	
Maryland	6	*	*	*
Massachusetts	6.25	*	*	
Michigan	6	*	*	
Minnesota	6.875	*	*	*
Mississippi	7		*	
Missouri	4.225	1.225%	*	
Montana	none	--	--	--
Nebraska	5.5	*	*	
Nevada	6.85	*	*	
New Hampshire	none	--	--	--
New Jersey	6.625	*	*	*
New Mexico	5.125	*	*	
New York	4	*	*	*
North Carolina	4.75	* (4)	*	
North Dakota	5	*	*	
Ohio	5.75	*	*	
Oklahoma	4.5		*	
Oregon	none	--	--	--
Pennsylvania	6	*	*	*
Rhode Island	7	*	*	
South Carolina	6	*	*	
South Dakota	4.5		*	

State	State Tax Rate (Percentage)	EXEMPTIONS		
		Groceries	Prescription Drugs	Nonprescription Drugs
Tennessee	7	4% (4)	*	
Texas	6.25	*	*	*
Utah	6.1 (5)	3.0% (5)	*	
Vermont	6	*	*	*
Virginia	5.3 (2)	2.5% (2)	*	*
Washington	6.5	*	*	
West Virginia	6	*	*	
Wisconsin	5	*	*	
Wyoming	4	*	*	
District of Columbia	6	*	*	*

*-- indicates exempt from tax, blank indicates subject to general sales tax rate.

Source: Compiled by FTA from various sources.

(1) Some state tax food, but allow a rebate or income tax credit to compensate poor households. They are: HI, ID, KS, OK, and SD.

(2) Includes statewide 1.0% tax levied by local governments in Virginia.

(3) Tax rate may be adjusted annually according to a formula based on balances in the unappropriated general fund and the school foundation fund.

(4) Food sales subject to local taxes.

(5) Includes a statewide 1.25% tax levied by local governments in Utah. Effective April 1, 2020, food is fully taxable in Utah.

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2610 Park Avenue, Muscatine, Iowa 52761

tefiowa.org @tefiowa @tefiowa @taxediowa