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WELLS FARGO SECURITIES

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Retail Shopping Transformation and Local Fiscal Health

Some of the same forces that are moving retail sales onto the internet are driving the disappearance of many brick and mortar stores. Technological changes that make buying online seamless, whether desktop or mobile, as well as preferences for more urban, walkable lifestyles contribute to the shrinking of physical retail. Tighter household budgets in locations that have lost manufacturing jobs also contribute.

Lost manufacturing jobs and dead malls beget lower sales, income and property taxes — they're all connected. We argue that the recently enacted limitation on the SALT and property tax deductions are further economic stressors on these communities.

In other locations, malls are being re-purposed and re-vitalized. One model might include call centers in former anchor store spaces (buy from home, but call your mall for help?), or sports centers, educational institutions or multi-use apartment, retail and entertainment. Even a tear-down and "greening" has proven to increase surrounding commerce and property values. The greater need for warehousing and distribution centers is also driving re-use in empty mall space and parking lots.

Since peak pre-recession December 2007, general merchandise employment actually is up modestly, by 28,000. However, clothing and accessories retailing jobs are down 207,000 and furniture and furnishings retailing jobs are down 178,000. Over the past year, some of the job losses seem to have accelerated. Between December 2016 and December 2017, employment in store-based general merchandise fell about 90,000, clothing and accessory stores lost 29,000 jobs and furniture and furnishings dropped 7,000 jobs. Meanwhile, non-store retail (where on-line shopping takes place) is growing steadily, adding 17,000 jobs YoY and 116,000 since 2007. Overall, technological change and shifting tastes are driving a new business model in how we shop, pay for and consume retail products.

Sales Tax Collections and Quill

The inability to collect sales taxes on much of the universe of electronic purchases has been near and dear to states and local governments for some time. The "Marketplace Fairness Act" passed the Senate with bipartisan support but never made it through the House. However, on Jan. 12, 2018, the U.S. Supreme Court granted a petition from the state of South Dakota to revisit how sales taxes have been collected since 1992. This revisit is on the docket for the current term that ends in April. We might see a decision on this before summer 2018.

In 1992, the Supreme Court found that mail order or electronic sale of goods required the seller to have a physical presence ("nexus") in the state for sales taxes to be collected (Quill Corp. v. North Dakota, 504 U.S. 298 (1992)).

Explaining why it agreed to revisit the Quill decision, the court wrote the following:

"The legal and practical developments of the past 25 years strongly recommend revisiting that judgment. Quill has grown only more doctrinally aberrant, and has been roundly criticized by members of this Court, including Justices Kennedy, Thomas, and Gorsuch. But while its legal rationales have imploded with experience, its practical impacts have exploded with the rapid growth of online commerce. Today, States' inability to effectively collect sales tax from internet sellers imposes crushing harm on state treasuries and brick-and-mortar retailers alike...Given these changes...it is unwise to delay any longer a reconsideration of the Court's holding in Quill."

The question that the court will try to answer is: "Should this Court abrogate Quill's sales-tax-only, physical-presence requirement?" The current case is named after three online-only retailers: *South Dakota v Wayfair, Newegg and Overstock*, (case number 17-494).

In a Dec. 8, 2017 report, the Government Accountability Office (GAO-18-114) estimated that between $8 billion and $13 billion sales taxes could have been recovered by state and local governments in 2017 if these taxes had been collected for remote sales to consumers.

While a number of states have passed legislation that attempts to collect on-line sales taxes, the National Conference of State Legislatures is currently recommending that states wait to submit new legislation until the Supreme Court decides.

Over-Malled

As the internet grabs an increasing share of retail sales, there is less foot traffic through the many malls in the United States. Compared with other developed countries, the U.S. has four times more retail square footage per capita than Japan and France, six times more than England, nine times more than Italy and 11 times more than Germany. As an anchor department store closes in a mall, smaller retailers lose foot traffic. In fact, some lease arrangements allow smaller retailers to break their lease when an anchor leaves.

In addition to Amazon, newer retailers are choosing to have an online-only presence, for example, Casper (mattresses), Wayfair (furniture and furnishings), Newegg (electronics) and Overstock (odd lot goods). Others such as Bonobos (clothing) and more recently Warby Parker (eyeglasses) have a "showroom" business model with a small brick and mortar footprint, but goods actually are bought and delivered through internet purchase.

Wayfair, as we've mentioned, sells furniture and other home furnishings. Approximately 15% of the $70 billion U.S. furniture market has moved on-line according to IBIS World. Amazon too, has entered the furniture market. Counting all goods, between 2010 and 2016, Amazon's sales grew to $80 Billion from $16 billion ; 50% of U.S. households have Amazon Prime.

With the growth in internet-based ride-hailed transportation (Uber, Lyft, etc.) and the future potential for driverless cars, some analysts believe there is an excess of parking space around many malls. According to a joint report by Green Street Advisors and the Urban Land Institute, there are approximately 75 billion square feet of parking considered excess in today's economy, which could lead to devaluation of property.

On the positive side, internet orders still need to be sourced, packaged and sent to the customer and there is job growth at fulfillment centers — where more than 400,000 jobs have been added over the past decade. Whereas more than 3.5 million cashiers face obsolescence, jobs at fulfillment centers pay more than cashiering and in some cases offer career mobility. Aside from the obvious loss due to store closings, the drop in the need for cashiers is also due to technology — with self -checkout a growing feature in brick and mortar stores like Target and CVS. In that case, one employee can replace five, acting as a troubleshooter who can monitor numerous machines.

Closings Are Not Happening Everywhere

Derek Thompson penned "The 4 Reasons why 2017 is a Tipping Point for Retail" in the *Atlantic* (Nov. 16, 2017) and said: "The brick-to-clicks transformation will accentuate retail's regional inequality problem. Department store closings are already concentrated in the low-income suburbs of Kentucky, Ohio and Pennsylvania." A report by the Rockefeller Institute corroborates this view, finding Pennsylvania likely to have the most total store closings, followed by Ohio and Michigan. The *Wall Street Journal* too, commented with the article "Mall Closures Ripple Through Small Town America," Jan. 19, 2017. While it is common sense, places that have lost well-paying manufacturing jobs are more likely to have struggling shopping centers.

Of interest, small discount retailers are opening new stores aggressively in communities where there may have been closings of other stores. *Bloomberg Businessweek,* citing Dollar General, recently wrote about this phenomenon, with the story sub-title, "In the poorest towns, where even Wal-Mart failed, this little-box is turning a profit."

Spotlight on Ohio

We do a deeper dive into Ohio as a state that is high on the list of store closings. It is also a state, however, where resurgence is taking place. Columbus, Ohio is one such example, with its large finance, insurance, health and university employment sectors. The city is one that has always ranked highly on "lifestyle" assessments but more recently it has been an attractive destination for millennials. The city tore down a mall in the center of downtown and created a green space but added entertainment and food to the park as well. Anecdotally, there are reports of increased property values and commercial activity surrounding the park.

Older industrial cities in the state have used the historic tax credit, HTC to renovate downtown areas. For example, Dayton, Ohio plans to revitalize its 19th Ccentury arcade and was awarded $5 million in tax credits by the state in June 2017 and again $4 million in December 2017. The Dayton Arcade is a collection of nine buildings totaling more than 330,000 square feet. Initially the developers plan affordable housing for artists, building a 126-unit multi-family building using a Low Income Housing Tax Credit, LIHTC. The University of Dayton may locate some functions there as well. Elsewhere, Providence, R.I. turned Westminster Arcade, built in 1828, into micro apartments.

However, the new tax code changed the 20% credit from one year to amortizing over five years. Plus lower corporate tax rates reduce the benefit to the company taking the HTC.

The Pace of Recovery Is Very Regional

We pulled an employment table for Ohio, similar to the one we track each month for the nation as a whole. From peak pre-recession, it becomes clear that recovery in Ohio has been slower than for the country at large. (State-specific data are lagged a month. That's why there's December for Ohio but January for the U.S.)

At the state level the BLS does not separate non-store retail from stores, so the figures here are net of both. Nevertheless, while the net change in retail trade jobs 2007-2017 in the nation has been positive, in Ohio it is significantly down. Between 2016 and 2017 the retail trade category fell in Ohio, whereas the macro figures show a smaller drop in the country overall.

Springfield

The city is an interesting example of the connection among job losses, mall closings and drops in income and property taxes. Water and sewer revenues had fallen as well. However, the city is also an example of a place that seems to be managing its situation well, from City Hall to the community at large. Springfield, located between Columbus and Dayton, is home to the Upper Valley Mall, now mostly shuttered. The mall was built in 1971 and went into receivership in 2014. Macy's and JCPenney closed in 2015 and the cinema closed in 2017. Interestingly, Dollar General, a discount retailer, shows at least five locations in and around the Springfield area with numerous current job postings. Also of interest, the city renovated a historic downtown building that is now housing a number of technology companies and providing jobs.

In Springfield, income taxes make up more than 50% of general government revenues and these revenues were down from the original budget due to a plant closing (Moyni, Inc.) in 2016. The population has fallen to 59,680 in 2016 from 64,480 in 2007 . Assessed property values too, fell from $902 million in 2007 to $762 million in 2016. From 2000 to 2014 median income dropped 27% in Springfield. The state has cut back on revenue sharing with local government, adding another fiscal stressor.

US Employment Changes by Select Industrial Category December 2007-January 2018 (000's)

Industry	Jan-18	Jan-17	Dec-07	% 2007-2018	# jobs 2007-2018	% YOY 2017-2018	# jobs YOY 2017-2018
Total Nonfarm	147,810	145,696	138,413	6.79%	9,397	1.45%	2,114
Total Private	125,482	123,383	116,037	8.14%	9,445	1.70%	2,099
Goods-producing	20,358	19,888	21,976	-7.36%	-1,618	2.36%	470
Private, Service providing	105,124	103,495	94,061	11.76%	11,063	1.57%	1,629
Retail Trade	15,877	15,913	15,570	1.97%	307	-0.23%	-36
Education and health services	23,427	22,957	18,924	23.80%	4,503	2.05%	470
Total Health Care*	15,888	15,594	13,103	21.26%	2,785	1.89%	295
Leisure and hospitality	16,248	15,906	13,550	19.91%	2,698	2.15%	342
Accommodation and Food Services	13,893	13,606	11,557	20.21%	2,336	2.11%	287
Total Professional and business services	20,694	20,246	18,051	14.64%	2,643	2.21%	448
Total Government	22,328	22,313	22,376	-0.21%	-48	0.07%	15

Source: Bureau of Labor Statistics, Establishment Data, seasonally adjusted and Wells Fargo Securities, LLC
*Includes ambulatory health care services, hospitals, and nursing and residential care facilities.

Ohio Employment Changes by Industrial Category December 2007-December 2017 (000's)

Industry	Dec-17	Dec-16	Dec-07	% 2007-2017	# jobs 2007-2017	% YOY 2016-2017	# jobs YOY 2016-2017
Total Nonfarm	5,542	5,503	5,418	2.29%	124	0.71%	39
Total Private	4,775	4,732	4,624	3.27%	151	0.91%	43
Goods-producing	919	903	996	-7.73%	-77	1.77%	16
Private, Service providing	3,856	3,829	3,630	6.23%	226	0.71%	27
Retail Trade	559	576	599	-6.55%	-39	-2.90%	-17
Education and health services	947	934	805	17.64%	142	1.39%	13
Total Health Care*	815	811	700	16.43%	115	0.49%	4
Leisure and hospitality	571	556	499	14.43%	72	2.70%	15
Accommodation and Food Services	483	478	433	11.43%	50	0.94%	5
Total Professional and business services	723	724	675	7.11%	48	-0.14%	-1
Total Government	767	712	795	-3.52%	-28	7.72%	55

Source: Bureau of Labor Statistics, Establishment Data, seasonally adjusted and Wells Fargo Securities, LLC
*Includes ambulatory health care services, hospitals, and nursing and residential care facilities.

According to a study of the loss of the middle class in certain areas, Pew Research Center found that of 229 metro areas studied, 119 were winners while 110 were losers, measured by income. Pew cited Springfield, Ohio (along with Goldsboro, NC) as the largest losers. (Pew Research Center, May 11, 2016, "America's Shrinking Middle Class: A Close Look at Changes Within Metropolitan Areas".)

The city has tightened its belt, reducing government headcount. Business activities, mainly water, sewer and storm water were in the red about $5.5 million in each of 2015 and 2016, mainly due to sewer rates not covering expenses. The city raised rates on each of water, sewer and storm water in 2016, which should help cover expenses and maintain balances. In addition, city voters passed a five and a half year income tax increase last November that is expected to produce a surplus. The city has renovated a number of buildings for office and technology companies and is building up its health and technology employment.

The Loss of the SALT Deduction Is Not Just About Coastal Blue States

Finally, on top of these stressors, we would like to point out that capping the SALT and property tax deduction could have a local impact in states like Ohio.

Ohio cities have income tax as do Indiana counties (Maryland counties too). Pennsylvania local governments have earned income taxes as well. Certainly, on a dollar basis, the coastal states will be sending more tax money to the federal government. However, a meaningful number of taxpayer/voters could be paying more under the new tax regime in other states where local income tax is prominent.

We pulled IRS state data to see where the combined state and local income tax plus property tax exceeded the new $10,000 cap. Then we looked at average total itemizations in three tax brackets to see where using the new, higher standard deductions might be preferable. (The standard deduction for single filers was doubled to $12,000 while those filing jointly could take a standard deduction of $24,000.) The hypothesis is that taxpayers who continue to choose itemization would pay additional tax on amounts above the $10,000 SALT deduction cap.

We must highlight the weaknesses in this analysis. First, the most current IRS data are from 2015, so the deductions may have been higher in 2017 (or not, if job losses were significant). Second, there are no data available that breaks out single filers from those filing jointly. Finally, some in the upper brackets might have to pay the alternative minimum tax (AMT) which was retained for individual filers in the new code. On the other hand, we did not factor in other items still available, like the higher child tax credit or medical expense deductions.

With these caveats in mind, we show rough figures for Ohio, Indiana, Pennsylvania and for comparison, Maryland, New York and the U.S. In Ohio, taxpayers in the $75,000-$100,000 income range who are single filers might continue to itemize if their total itemizations were above the new standard deduction of $12,000, but they could still benefit from the SALT. Filers above $100,000 income exceeded, on average, the $10,000 cap for income and property tax. Filers in the $200,000 - $500,000 income range might continue itemizing and the average taxpayer could be paying approximately $4,600 additional tax since they are above the SALT cap (assuming a 32% rate). In Indiana, some single filers might choose to itemize in ranges between $75,000-$500,000 but only those in the upper $200,000-$500,000 range might be paying more due to SALT. Pennsylvania's picture is similar, where single filers in the $75,000-$200,000 range may itemize while most in $200,000-$500,000 range would likely itemize. Above $100K, the average taxpayer in Pennsylvania, if they itemize, might pay more due to the elimination of SALT.

In Maryland, itemizers above $100,000 would likely continue to itemize and might pay more given their total income and property taxes exceed the cap. New Yorkers are in a similar situation with the addition of some in lower brackets paying up due to the loss of the SALT deduction. Some say that drafters of the new code intended to "punish" coastal blue states, but a range of taxpayers in other states where there is local income tax could also end up sending more of their income to the federal government next year.

Ohio Income and Property Tax Itemizations, 2015 ($000's)				
	Total Itemizers, all brackets	$75K-$100K	$100K-$200K	$200K-$500K
Number of itemizers	1,462,130	248,740	440,650	131,020
average dollars itemized*	$ 22,125	$ 17,812	$ 22,642	$ 39,453
State/local Income Tax				
number of itemizers	1,316,780	236,620	428,480	128,590
average dollars itemized	$ 7,192	$ 4,173	$ 6,855	$ 15,733
Property Tax				
number of itemizers	1,290,210	227,160	415,300	123,830
average dollars itemized	$ 4,215	$ 3,492	$ 4,499	$ 7,435
Total	$ 11,407	$ 7,665	$ 11,354	$ 23,168
*includes mortgage interest deduction, charitable contributions and other				
Source: IRS-SOI, State Data and Wells Fargo Securities				

Indiana Income and Property Tax Itemizations, 2015 ($000's)				
	Total Itemizers, all brackets	$75K-$100K	$100K-$200K	$200K-$500K
Number of itemizers	707,620	117,400	228,790	65,890
average dollars itemized*	$ 22,158	$ 18,224	$ 21,844	$ 36,511
State/local Income Tax				
number of itemizers	670,970	114,440	225,390	65,130
average dollars itemized	$ 6,593	$ 4,130	$ 6,443	$ 13,635
Property Tax				
number of itemizers	633,450	108,790	218,600	62,770
average dollars itemized	$ 2,309	$ 1,813	$ 2,366	$ 4,130
Total	$ 8,902	$ 5,943	$ 8,809	$ 17,765
*includes mortgage interest deduction, charitable contributions and other				
Source: IRS-SOI, State Data and Wells Fargo Securities				

Pennsylvania Income and Property Tax Itemizations, 2015 ($000's)				
	Total Itemizers, all brackets	$75K-$100K	$100K-$200K	$200K-$500K
Number of itemizers	1,782,370	287,620	583,300	198,100
average dollars itemized*	$ 24,162	$ 18,951	$ 23,506	$ 38,349
State/local Income Tax				
number of itemizers	1,570,630	260,630	551,090	193,260
average dollars itemized	$ 7,208	$ 4,132	$ 6,407	$ 13,359
Property Tax				
number of itemizers	1,593,770	262,520	551,960	188,410
average dollars itemized	$ 5,162	$ 4,171	$ 5,245	$ 8,148
Total	$ 12,370	$ 8,303	$ 11,652	$ 21,507
*includes mortgage interest deduction, charitable contributions and other				
Source: IRS-SOI, State Data and Wells Fargo Securities				

Maryland Income and Property Tax Itemizations, 2015 ($000's)

	Total Itemizers, all brackets	$75K-$100K	$100K-$200K	$200K-$500K
Number of itemizers	1,359,360	216,200	436,820	147,590
average dollars itemized*	$ 28,500	$ 22,238	$ 29,082	$ 48,678
State/local Income Tax				
number of itemizers	1,276,210	209,290	436,820	145,750
average dollars itemized	$ 9,793	$ 5,676	$ 9,424	$ 20,802
Property Tax				
number of itemizers	1,079,730	176,570	396,000	139,910
average dollars itemized	$ 4,399	$ 3,199	$ 4,443	$ 6,827
Total	$ 14,192	$ 8,875	$ 13,867	$ 27,629

*includes mortgage interest deduction, charitable contributions and other

Source: IRS-SOI, State Data and Wells Fargo Securities

New York Income and Property Tax Itemizations, 2015 ($000's)

	Total Itemizers, all brackets	$75K-$100K	$100K-$200K	$200K-$500K
Number of itemizers	3,328,790	537,780	1,064,070	393,580
average dollars itemized*	$ 36,702	$ 20,167	$ 27,659	$ 50,952
State/local Income Tax				
number of itemizers	2,921,520	486,820	1,001,990	384,340
average dollars itemized	$ 17,696	$ 5,772	$ 9,339	$ 23,071
Property Tax				
number of itemizers	2,394,320	368,380	836,540	318,830
average dollars itemized	$ 8,731	$ 6,522	$ 8,157	$ 12,694
Total	$ 26,427	$ 12,294	$ 17,496	$ 35,765

*includes mortgage interest deduction, charitable contributions and other

Source: IRS-SOI, State Data and Wells Fargo Securities

US Income and Property Tax Itemizations, 2015 ($000's)

	Total Itemizers, all brackets	$75K-$100K	$100K-$200K	$200K-$500K
Number of itemizers	44,671,840	6,926,330	13,936,090	5,070,550
average dollars itemized*	$ 28,173	$ 20,388	$ 25,645	$ 43,360
State/local Income Tax				
number of itemizers	32,956,930	5,420,540	11,445,760	4,206,680
average dollars itemized	$ 10,146	$ 4,293	$ 7,202	$ 17,316
Property Tax				
number of itemizers	37,538,300	5,977,660	12,631,450	4,655,100
average dollars itemized	$ 4,991	$ 3,794	$ 4,947	$ 8,155
Total	$ 15,137	$ 8,087	$ 12,149	$ 25,471

*includes mortgage interest deduction, charitable contributions and other

Source: IRS-SOI, State Data and Wells Fargo Securities

Additional information is available on request.

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