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THE SCHEME TO STREAMLINE SALES TAX INCREASES

By George A. Pieler

Do we want a new national system for raising sales taxes, unconstrained by accountability to voters? If not, it's time to start worrying.

In October the so-called Streamlined Sales and Use Tax Agreement (SST) came into effect for 19 states that have agreed to coordinate and harmonize their sales tax definitions, audit, reporting, and compliance procedures.[1] In its present form the SST is strictly voluntary for businesses that choose to register under it and remit sales and use taxes under its framework. The chief objective of that framework is to induce or coerce companies to remit to the states taxes on mail-order and Internet sales that presently escape liability under the Supreme Court's interpretations of the Commerce Clause and Compact Clause of the U.S. Constitution.

In fact, those constitutional constraints on states seeking to collect taxes on out-of-state sales make the SST at present voluntary, not compulsory. The SST is manifestly *designed* to be compulsory, however, and will become so if legislation proposed by North Dakota Senator Byron Dorgan (S. 2153) and Wyoming Senator Mike Enzi (S.2152) is enacted into law. These bills, introduced in December 2005, are nearly identical except for how they construct a small business exemption from the SST rules.[2] Both would give the SST the backing of federal law, as indeed is called for by the Compact Clause (contained in Article I, section 10 of the Constitution): "No State shall, without the Consent of Congress…enter into any Agreement or Compact with another State."[3]

It is no surprise that North Dakota Senator Dorgan is a leading proponent of the SST, since it was North Dakota's attempt to tax out-of-state mail order sales that was rejected by the Supreme Court in the *Quill* case (1992). *Quill* made clear that Congress could define a proper taxable "nexus" between a state and an out-of-state seller, but that absent such a definition states could not reach out on their own to tax sales by a "remote seller" lacking an adequate physical presence in the taxing state. While the SST is promoted as a way to close an alleged Internet sales loophole that supposedly hurts bricks-and-mortar retailers, it's really an effort to take up the *Quill* challenge by pressuring Congress to set up a structure for taxing out-of-state sellers.

WHAT IS THE PROBLEM?

To judge the merits of the SST, first we have to examine precisely what problem it is meant to solve. Senator Enzi says, "If Congress continues to allow remote sales to go uncollected and electronic commerce continues to grow as predicted, other taxes—such as income or property taxes—will have to be increased to offset the lost revenue." Note the Senator's presumption that states are due *X* amount of revenue from sales taxes, and that anything that reduces *X* requires compensation from other revenue sources. This is an unusual theory of revenue collection, to say the least. The proper question should be, as courts have recognized, whether a taxing jurisdiction has right and property authority over a class of economic activity it seeks to tax. Taxation is one of the key elements of sovereignty, which is why tax treaties between the U.S. and nations with which it has economic relations become very complex and often messy.

For the sake of argument, however, let's assume that using the SST to close a revenue gap in the states is a proper concern of public policy. Where do we find that revenue gap? Like the national government, the states' revenue collections respond most directly to the overall direction of the national economy (with obvious local deviations; e.g., one would expect Louisiana's tax revenues to decline in the wake of Hurricane Katrina). The November 25, 2005 *New York Times* reported, "After four years of tight budgets and deepening debt, most states from California to Maine are experiencing a marked turnaround in their fiscal fortunes, with billions of dollars more in tax receipts than had been projected…"

This picture is rounded out by a January 2006 report by Chris Edwards of the Cato Institute. Edwards documents overall state revenue growth from 2000 to 2005, showing a decline in the pace of revenue growth in 2001 and 2002 (coinciding with the end of the '90s tech boom and the aftermath of 9/11). In 2000, 2004 and 2005, however, Edwards shows state revenue growth approaching 8 percent a year. Note that at no time in this period did state revenues decline; they grew modestly even in 2001 and 2002, and robustly in every other year. This makes it hard to discern the kind of state revenue crisis implied by Senator Enzi.

A THEORETICAL PROBLEM?

If state-level revenue collections cannot justify the SST initiative, the issue driving the initiative must be conceptual or theoretical in nature. Senator Dorgan suggested this when he stated the "Quill decision said that states and localities could not require sellers to collect sales tax on remote sales until the states and localities have first dramatically reduced the complexity and burden of collecting sales taxes." Indeed, the hope of simplifying compliance with existing taxes is the reason the National Retail Federation has embraced the SST. NRF official Maureen Riehl says the amount of sales tax is not the issue, but rather the "unfair" advantage electronic sellers have over bricks-and-mortar sellers who must collect sales tax.

Of course if the "amount" of sales tax were not at issue, Senator Enzi's comments would be irrelevant. Further, if the level of sales tax revenue were not in part driving the SST, the SST agreement would have some provision for capping or limiting sales tax revenue so that consumers and businesses would be held harmless from the negative economic impact of boosting sales tax liabilities nationwide. However, no such limitation is suggested by the SST, which does no more than simplify state sales tax rates and harmonize definitions and collections procedures.

Even if old-fashioned retailers may be disadvantaged by sales tax collections, relative to mail order and Internet retailers, that is not a new problem. There are plenty of arguments on the other side: shipping costs can offset the tax advantage to remote sellers, and many shoppers use Internet retail outlets to research products and services but buy locally. Anyway, if the tax differential is such a huge problem, why is the only solution to "harmonize" tax burdens in an upward direction?

The real danger of the SST's national sales tax system is that it is highly prone to driving up sales tax rates, at the same time limiting tax exemptions that could cushion the economic blow. Delegating that tax-hiking power to a politically unaccountable board, as the SST does, is bad government and bad economics. A more logical, economically productive (and revenue-effective) response would be the supply-side response: cut the sales tax as much as possible so it doesn't make that much difference which sellers are liable for revenue collections.

The SST simply may be a theoretical answer to a nonexistent question. Before jumping onto the tax harmonization bandwagon—the increasingly popular mantra for big-government advocates in Europe, the UN, and the United States—the states and Congress should carefully examine what policies best promote national economic growth. More taxes, even those backed by elegant theoretical constructs, are seldom the answer.

[1] States that have agreed to participate in the SST program are Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, New Jersey, North Carolina, North Dakota, Oklahoma, South Dakota, West Virginia, Arkansas, Nevada, Ohio, Tennessee, Utah, and Wyoming. The last six are "associate states," meaning they have not yet amended their own laws in full compliance with the SST system but intend to do so.

[2] The Enzi bill creates a small business exemption for all businesses with sales (including sales by affiliates) of $5 million or less nationwide in the preceding year. The Dorgan bill instead creates a process for defining such an exemption, utilizing a rulemaking procedure under the direction of the Small Business Administration.

[3] There is of course some uncertainty about what constitutes an "agreement or compact" under this clause, and in *US Steel v Multistate Tax Commission*, 434 US 452, the Supreme Court found that a commission created by states in order to assess and properly assign tax liabilities among taxpayers with a presence in more than one state, did not violate the Compact Clause even though it had no congressional imprimatur. The Court applied a standard of whether the "compact" in that case had the tendency to increase the power of states vis-à-vis the federal government; however the decision was controversial at the time (1978) and only one Justice who ruled on the case, John Paul Stevens, remains on the Court today. The SST proponents may therefore not wish to chance a legal dispute under the Compact Clause.

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