Rio Grande Foundation

P.O. Box 2015
Tijeras, NM 87059
505 286-2030
www.riograndefoundation.org

Why New Mexico Should Reject The Streamlined Sales Tax Agreement

July 2003

By Matthew Mitchell
Research Economist, Rio Grande Foundation

Contents

Executive Summary

Like statehouses across the country, the New Mexico state legislature will soon decide whether the state should join an interstate sales tax compact. Called the "Streamlined Sales Tax Agreement," the compact is a radical departure from conventional tax policy. Because it permits the formation of an interstate tax cartel, there is good reason to believe that it would lead to more harm than good. The state should not join the Agreement.

Ostensibly designed to simplify interstate commerce and level the playing field between on-line and 'bricks and mortar' retailers, the Agreement would require signatory states to follow certain rules in taxing sales. More importantly (ominously), it would allow states to tax businesses outside their borders. For the first time in history, states would possess the authority to tax a transaction based on the consumer's rather than on the producer's location. By allowing states to tax a transaction based on where the consumer lives rather than on where the producer sells, the Agreement would violate one of the sacred precepts of American democracy: It would amount to taxation without representation. In addition, its enforcement would entail costly compliance and a potentially dangerous invasion of consumer privacy. Finally, by allowing states to establish an interstate tax cartel, the Streamlined Agreement would lead to inefficiently high taxes and less economic growth. Having misdiagnosed the true source of the seeming inequity in retail taxation, the Agreement's proponents offer a cure that is worse than the ailment.

Seeming Inequity in the Status Quo

One might wonder what prompted anyone to propose an interstate sales tax agreement in the first place. The main issue involves e-commerce and an inequity in current state tax codes. If I, as a New Mexico resident, buy a copy of Adam Smith's *Wealth of Nations* from my local bookstore, the transaction is subject to New Mexico's Gross Receipts Tax. If, however, I buy the book from Seattle-based Amazon.com, the transaction escapes taxation. Why? New Mexico's Tax and Revenue Department has so far been unwilling to collect the tax from me as the buyer.[1] Meanwhile, the courts have held that *at least for now*, the state is not permitted to collect from Amazon as the seller. In two separate rulings the Supreme Court has held that—under the current tax regime—states can only tax transactions involving firms with a physical 'nexus' in their state.[2] Since Amazon.com has no stores or employees in New Mexico, the state cannot tax the company.

---

[1] Though the New Mexico resident who purchases from an out-of-state seller is technically liable to pay New Mexico's Compensating Tax, state law bars the Taxation and Revenue Department from taking action to compel him or her to pay. See §7-9-7.1 of New Mexico Statutes. In recent testimony before the Blue Ribbon Tax Reform Commission, Commission staffer James P. O'Neill reported that compliance is "a thorny issue." See O'Neill, p. 1.

[2] See *National Bellas Hess vs. Illinois* and *Quill Corporation vs. North Dakota*. The later ruling (*Quill*) does offer Congress and the states a way to avoid this rule. Please see section III below.

What about the state of Washington's Tax and Revenue Department? They *may* tax my Amazon.com transaction, but like most states (including New Mexico) *they choose not to tax exports*.[3]

However it comes about, the current tax arrangement seems unfair to the local 'bricks and mortar' bookstore. Though both on and off-line retailers face taxes such as corporate and personal income, capital gains and input taxes, only the 'bricks and mortar' retailer must pay a transactions tax when its product is bought. This puts it at a seeming disadvantage.

The "Streamlined" Solution

In March of 2000, legislators from a number of states met in hopes of forming an interstate sales tax agreement.[4] Proponents of the agreement claim that they have found a way to level the playing field between off and on-line retailers. To wit: They want to give states the power to tax any retailer—no matter where he or she is based—that sells to an in-state buyer. In order for states to achieve this unprecedented, destination-based taxing power, the Agreement relies on a caveat in the latest Supreme Court ruling on the subject. Speaking for the unanimous court in Quill Corporation vs. North Dakota, Justice Stevens wrote:

> No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions….Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes."[5]

Essentially, the court said that under the *current* system, it is too much to expect a company to understand and comply with the tax laws of all the jurisdictions where their customers may live. *However*, if Congress and the state legislatures act to simplify the taxes, then company compliance will not be so difficult and states will be free to tax away.

In order to simplify sales taxes, the Agreement initially entailed three main stipulations:

- All the states were to adopt a uniform definition of products.
- All the states were to adopt a uniform tax base.
- Each state was to set its own sales tax rate, but that rate would prevail throughout the state, denying local governments the ability to set their own optional rate.[6]

---

[3] See §7-9-57 and §7-9-57.1 of New Mexico Statutes for the sections exempting exports.

[4] See Streamlined Sales Tax Project (SSTP).

[5] See *Quill Corporation vs. North Dakota*, Sect. IV.

[6] See Pound.

The latter point was designed to ease compliance. Without it, an e-commerce company would have to know the tax rates and policies of the over 7,500 taxing jurisdictions in the U.S.[7] But as Colorado Governor Bill Owens points out recently, “Efforts to achieve simplicity and uniformity were undercut by efforts to preserve some semblance of local control. [The drafters of the Agreement] were therefore forced to reject the idea of one-rate per state and allow municipalities to establish varying rates.”[8]

Though the rule requiring uniform in-state rates was dropped, the rule allowing states to tax vendors without a physical presence remains.

Why the Solution is Worse Than the Problem

Breaking the physical presence precedent would entail a number of dangers. Its costly administration would require significant invasions of privacy. It would also violate our country’s federal arrangement and would amount to taxation without representation. Finally, without the physical presence rule, states would have the power to form a taxing cartel. Each of these dangers is discussed in turn.

Invasion of Privacy

In order to verify the location of every customer in every transaction, the agreement would have third party collection agents develop software to track each transaction, calculate the appropriate tax and remit it to the appropriate jurisdiction. The collection agency would, of course, keep a portion of the tax as its fee. At the very least, these organizations would have detailed information on the buying patterns of consumers. At worst, they would have access to sensitive financial information (i.e., credit card numbers). Personal finances and purchases would no longer be private and opportunities for identity theft would abound.

Costly Administration

It will be a difficult task to build and maintain a database to track 7,000+ tax codes. Seeing that every interstate transaction complies with these codes will not be cheap. The Streamlined proponents claim that under the plan, the liability for the correct sales tax calculation and collection will rest with the state, not with the vendor. Even if states succeed in freeing vendors from bearing the compliance cost (which is doubtful), they cannot remove the costs altogether. It will be expensive to administer a destination-based tax system and states will pass that cost along to the taxpayer through one tax or another.

Taxation Without Representation

Taxing a company without a physical presence in a state is taxation without representation. It gives states the power to reach outside their borders and tax companies who share no part in the local elective process.

---

[7] This number is widely cited. See Owens and the SSTP website.

[8] See Owens.

This significant diminution of states' rights would clear the path for taxes that violate the "benefit principle." This important tenet of tax theory requires that taxes be levied only on those who benefit from the public spending. Amazon.com enjoys none of the benefits of State Road 18 between Lovington and Hobbs. Nor do the company's employees make use of Coyote Creek State Park.[9] Why should they have to pay for these services if they don't use them? Perhaps another example will hit closer to home. In 1997 (the last year for which data are available), there were 1,447 New Mexicans working for e-commerce firms.[10] Why should these people pay for a park in Iowa or a statue in Oregon? Why should they pay for the salary of a Texas legislator that they didn't elect?

Interstate Tax Competition

To make matters worse, there is reason to believe that people would not only pay for services they don't use, but they would pay dearly. One of the felicitous results of our federal system is that each state faces a natural limit on its tax rate.

Imagine that New Mexico residents are free to buy tortillas from both New Mexico and Texas vendors. When they buy from in-state vendors, New Mexicans incur New Mexico's tax rate and when they buy from Texan vendors they incur Texas' tax rate.[11] Now imagine that the New Mexican government chose an exorbitantly high tax on tortillas, say $100 per pack. New Mexico's state coffers would receive little or no revenue because most people would gladly buy from a Texas vendor and incur the more-reasonable Texas tax. It is obvious that there is a tax rate beyond which further tax increases would actually reduce tax revenue. If the state values revenue, it will not raise taxes beyond this natural point.

This means that the tax codes of each state must compete with the codes of others, promoting economic growth.[12] New Mexico competes with Texas to attract economic activity (and a larger tax base). To attract people, each state attempts to provide the best quality services, such as education, at the lowest tax price. This interstate competition in services provided at the best tax price is one reason decentralized (federal) government is more efficient than centralized (monopolistic) government.

The Tax Cartel

The Streamlined Agreement, however, would allow governments to cheat the natural constraint of competition by forming an interstate tax cartel. The Agreement would force the New Mexico tortilla buyer to pay a tax to the New Mexico department of revenue whether the tortillas are bought at a local store or on-line. When New Mexicans are denied the opportunity to shop around for lower tax rates, the New Mexico

---

[9] Those truly committed to decentralized government might point out that these local spending projects do not benefit the Farmington state taxpayer any more than they do the Seattle taxpayer.

[10] See U.S. Bureau of the Census, 1997.

[11] This is basically the current system. Texas, like most states, chooses to set its export rate at zero.

[12] Given New Mexico's singularly high tax rates and correspondingly low economic performance, one is tempted to conclude that this is a competition the state is losing.

government will find citizens ready to endure a higher rate before they forgo consumption. The government will find that a higher tax rate can be imposed without a significant drop off in revenue. (The situation is similar to that of the monopolist who charges high prices because consumers have nowhere else to turn.) Like competition in markets, competition among governments in quality of services provided at the best tax price is good. Businesses and individuals who don't like New Mexico's services and taxes may choose to move their economic activity to another state, providing natural discipline to the government of New Mexico.

A Closer Look at Inequity

What about the 'bricks and mortar' bookseller from our earlier example? Does state sovereignty and tax competition necessarily come at the price of equity? No. Those who want to address the inequity in sales tax law should take a closer look at the source of the problem. As has already been noted, my copy of *The Wealth of Nations* purchased on Amazon.com can legally be taxed by the state of Washington if it so chose. What is more, Washington's reluctance to tax this export makes economic sense in the context of interstate competition discussed above. States are free to choose their tax bases and tax rates. Taxing producers who sell in-state while giving a break to those who sell out-of-state likely promotes economic growth via interstate competition. That same interstate competition will tend to keep tax rates lower for the "bricks and mortars" absent formation of the interstate cartel proposed by the "Streamlined Agreement."

What is clear is that the Streamlined Sales Tax Agreement misdiagnoses the cause of inequitable taxation. My Amazon.com purchase escapes taxation not because New Mexico is denied the ability to tax it, but because the state of Washington has *chosen* to give Amazon an edge over its 'bricks and mortar' counterparts.

Having misdiagnosed the problem, proponents of the Streamlined Agreement offer a cure that is more dangerous than the disease. They would undermine state sovereignty; erect a costly and invasive regime of compliance; burden the residents of one state with the bill for services enjoyed by those living elsewhere; and, perhaps most alarmingly, deny citizens the ability to shop around for lower taxes and allow states to impose monopolistic rates.

An Afterword: For those Interested in Historical Context

The Constitutional Convention of 1787 was organized at the behest of an earlier interstate convention, the Annapolis Convention. *That* meeting arose from heated interstate disputes over how states could tax one-another. It was in no small part due to these vituperative debates that the Constitutional Convention decided that states should be denied the power to tax one another without the consent of Congress. For over two hundred years, Congress has resisted any temptation to allow states that power. This has created a free-trade zone throughout the United States that has allowed the country to flourish. If Congress and the state legislatures adopt the Streamlined Agreement, this vital free-trade zone will be lost. State and national representatives would do well to abide by the tradition established with the *first* interstate tax agreement, the U.S. Constitution.

About the Author

Matthew Mitchell is research economist at the Rio Grande Foundation. He has also written for the Phoenix-based Goldwater Institute and Washington's Heritage Foundation. His articles have appeared in both Arizona and New Mexico newspapers and have received mention in the Heritage Foundation publication, *The Insider*. Matthew graduated with honors from Arizona State University in 2002. He holds a B.S. in economics and a B.A. in political science. Next fall, he will enter a Ph.D. program in economics at George Mason University.

Bibliography

Americans for Tax Reform. *The E-Freedom Coalition Proposal to the Advisory Commission on Electronic Commerce*. Washington, DC: November 10, 1999. http://www.atr.org/policybriefs/111099pb.html

Atkins, Chris. Testimony before the Iowa E-Commerce Task Force on behalf of the American Legislative Exchange Council. Des Moines, Iowa. October 4, 2001. http://www.alec.org/

Buchanan, James M. and Geoffrey Brennan. *The Power to Tax: Analytical Foundations of a Fiscal Constitution*. Liberty Fund: Indianapolis, Indiana, 1980.

Council on State Taxation. *Report Card on the Streamlined Sales Tax Implementing States' Agreement*. Washington, DC, October 11, 2002. http://www.statetax.org

Eads, Jim. *State Taxation of Electronic Commerce*. Testimony before the New Mexico Blue Ribbon Tax Reform Commission. Santa Fe, New Mexico, May 22, 2003.

Haynes, Ray. Testimony before the House Judiciary Subcommittee on Commercial and Administrative Law on behalf of the American Legislative Exchange Council. Washington, DC, Date unknown. http://www.alec.org/

Mitchell, Daniel J. *Why Congress Should Not Authorize A State Sales Tax Cartel*. Washington, DC: The Heritage Foundation, September 26, 2001. http://www.heritage.org/Research/Taxes/EM778.cfm

New Mexico Statutes, §7-9-57

New Mexico Statutes, §7-9-57.1

New Mexico Statutes, §7-9-7.1

National Bellas Hess vs. Illinois, 386 U.S. 753 (1967).

O'Neill, James P. *Compensating Tax*. Testimony before the New Mexico Blue Ribbon Tax Reform Commission. Santa Fe, New Mexico, May 23, 2003.

Owens, Bill. *Nine Problems with Taxing the Internet*. Center for the New American Century, 2003. http://www.cnaconline.org/

Pound, William. *State and Local Sales Tax Simplification*. Testimony before the New Mexico Blue Ribbon Tax Reform Commission. Santa Fe, New Mexico. May 22, 2003.

Quill Corporation vs. North Dakota, 504 U.S. 298 (1992).

Streamlined Sales Tax Project (SSTP), http://www.streamlinedsalestax.org/

US Bureau of the Census. 1997 Census, American FactFinder website: http://factfinder.census.gov