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Taxing Sales

Comparing the Origin-Based and Destination-Based Models

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Origin-Based and Destination-Based Sales Tax Models

A sales tax can be either origin or destination based. In the origin-based model, the tax is the tax rate and rules in the seller's location, and in the destination-based model, the tax rate and rules are those in

Features and Incentives

The origin- and destination-based approaches are substantially similar when buyer and seller are in the same state or in different states with the same sales tax rate. In these cases, the sales tax rate is the same under both models. The two approaches can have different results when buyer and seller are in different states with different sales tax rates.

The different rates mean a difference in price for the purchaser, and in a market system, buyers respond to such differences. This price difference reflects tax policy, not differences in input costs or efficiency. Table 1 compares the mechanics and features of the two models.

The economic analysis of taxation describes tax laws that lead to a change in behavior to provide examples of how tax policy produces distortion and loss of economic efficiency. The price is different not because one seller is more or less efficient, but because the seller is located in a state with a higher or lower sales tax rate.

Students of political economy see differences in tax rates as an opportunity for tax competition between governments. If the difference in tax rates is large enough, or purchase decisions sufficiently sensitive to price differences, purchasers will switch to sellers in a state with a lower sales tax rate. Sellers who thereby lose sales have an incentive to mobilize to encourage their state to lower its tax rate on the product or service they sell.

The range of responses to political pressure to lower a state's sales tax in an origin-based model includes:

- Lower the sales tax on all goods and services to which the sales tax applies.
- Lower the sales tax on those goods and services that can easily be sold across state lines, but leave the sales tax unchanged on goods and services that cannot easily be sold across state lines (such as restaurant meals).
- Make strategic moves to export the state's sales tax burden. In a political economy model, rational state politicians seek to export the tax burden to citizens of other states and countries. This allows politicians to deliver political rewards without imposing costs on their electorate. An example of this behavior is New Hampshire's rooms and meals tax, an exception to New Hampshire's "no sales tax" stance, but a tax more likely to be paid by those from out of state than a general sales tax. An origin-based sales tax would create a new means for politicians to export the tax burden to residents of other states. Politicians would face incentives to try to leverage the strength of companies in their states. For example, Washington State, which has a sales tax but no income tax, could remove exemptions for capital goods to tap the substantial out-of-state and out-of-country sales of Microsoft and Boeing. While the risk that businesses would leave the state would temper state efforts to tax goods sold out of state, voters would otherwise prefer tax regimes that export the tax burden to taxpayers in other states and countries.

The analysis up to this point has assumed that there is no cost to moving goods and services across state lines. Distance between buyer and seller and the nature of the product temper the impact of sales tax differences. The impact is greater where the sales tax difference has a greater influence on total cost. For some products, such as sand and gravel, additional shipping costs would outweigh sales tax savings, but sales tax differences would have a larger impact on the sale of luxury goods, for example, where shipping is a smaller share of total cost.

Table 1. Mechanics and Features of Origin- and Destination-Based Models

UseTax

Each state with a destination-based sales tax imposes a use tax on purchases made from sellers who do not collect the state’s sales tax. The use tax neutralizes sales tax diffe

administer the federal sales tax, as would new federal policy on what goods are subject to sales tax and what are exempt. A large share of imports are for resale, a category usually exempt from state sales taxes, and thus there would be a large amount of paperwork involving exemption certificates, relative to the amount of tax revenue.[4] Policymakers might thus decide that the compliance cost is too high and imports might remain untaxed.

Fiscal Federalism

The origin- and destination-based models are two models of fiscal federalism. Each requires different roles for the federal government.

As Table 1 shows, the two models create different incentives for states to cooperate. The origin-based model can be undermined by a state that imposes a use tax. Undermining the destination-based model would mean adopting an origin-based sales tax. This would make goods and services more expensive in destination-based states, as buyers would pay both the origin-based sales tax of the seller's state and the destination-based sales tax of the buyer's state. States have no incentive not to cooperate with the destination-based model, which, unlike the origin-based model, is self-reinforcing. Given that historical forces produced a destination-based sales tax in the United States, this explains why no state has moved to an origin-based sales tax. The origin-based model requires an outside force—the federal government—to force state cooperation.

In the destination-based model, the federal government has at most a coordinating role, giving its consent to state efforts to cooperate. An origin-based model requires federal preemption of state sovereignty.

Because sales taxes in the United States came about as state initiatives, their features reflect decisions made by states at the time they were adopted. Tax competition had implications for the design of the first general state sales taxes. (Kentucky and Mississippi appear to have been the first states to impose a sales tax, in 1930).[5] Had Mississippi, as a pioneer, adopted an origin-based sales tax, it would have disadvantaged Mississippi businesses.

Consider what would have happened to an office supply dealer who operated in northern Mississippi, just south of Memphis, if Mississippi had opted for an origin-based sales tax. The dealer's customers in Memphis would have begun to see the Mississippi sales tax on their invoices. Market forces would have meant two choices for the supplier: either reduce his prices below the price charged by Tennessee-based suppliers, or lose the sale to them. If the market was competitive, meaning prices had been pushed down to the cost of inputs, lowering prices would have meant losing money on Tennessee sales. The market would have told the Mississippi supplier to stop selling in Tennessee. In either case, reducing prices or stopping sales, the result would have been the same: the origin-based sales tax in Mississippi would have meant lower sales by Mississippi firms to buyers in Tennessee.

This example shows the nature of the choices states faced in the early days of state-level sales tax. Any state that adopted an origin-based sales tax would have disadvantaged in-state businesses. (While economic models often say that going first brings an advantage, there would have been a "first mover disadvantage" in this case.) Thus, the process by which the state-level sales tax began in the United States, as a series of individual decisions by states acting alone, explains why they opted for a destination-based, rather than an origin-based sales tax.

For the same reasons that states did not adopt the origin-based model originally, a state that changed to such a model would disadvantage itself unless it could convince all other sales tax states to change at the state time. The states' self-interest reinforces the existing destination-based model and helps explain why no state has changed from the destination- to the origin-based model.

Federal preemption could require all states that all sales tax states use the origin-based model. This step would be subject to constitutional challenge in the federal courts. The claim that the federal government has the constitutional authority to require state sales taxes to be origin based requires an expansive interpretation of the commerce clause. There would be little economic activity beyond the federal government's reach under a reading of the commerce clause that allowed the federal government to dictate the terms of a tax within a state.

A federal law that pre-empted state authority to impose destination-based sales taxes would also have to decide the fate of the use tax. Without federal pre-emption of use tax authority, states could undermine the potential for tax competition in the origin-based system. They could do this by imposing a use tax on all out-of-state purchases, subjecting them to double taxation, or by imposing a use tax when the seller's state has a lower sales tax rate, which would bring the rate paid by the purchaser up to the rate in the purchaser's state. Table 2 summarizes the federalism implications under the two sales tax approaches.

Table 2. Fiscal Federalism Issues in Origin- and Destination-Based Sales Taxes

Tax Competition

Inherent in the origin-based model is the potential for economic competition between states based on sales tax differentials. The destination-based model, on the other hand, produces no tax competition; the combination of sales and use taxes means that it makes no difference to the buyer whether purchases are made in-state or out-of state.[6] The buyer pays the in-state sales tax rate on in-state sales and the same rate, through the use tax, on purchases made from out of state.

Under the origin-based model, the sales tax rate in the seller's jurisdiction becomes one of the factors that influence the buyer's decision. Everything else being equal, a buyer will prefer to buy from a seller in the state with the lowest origin-based sales tax.

As noted earlier, many factors can keep everything else from being equal. Transportation costs can offset sales tax savings for some purchases. Purchases of heavy or bulky products, whose transportation costs are a large share of total costs, are less likely to be influenced by sales tax differentials.

States could act strategically to counteract sales tax differentials, though this would depend on the scope of federal pre-emption of their ability to design the features of their sales tax. A state with a

their corporate domicile, the state in which they are incorporated. If sellers were free to name the state of origin, many would name a no-sales-tax state such as Delaware without having to change the physical location of any economic activity. The result would be large changes in where sales originate for sales tax purposes.

The location problem has two possible solutions. One is to allow sellers who do business in multiple states to choose the state of origin for out-of-state sales. The other is to impose "rules of origin." To be workable, rules of origin would have to be nationally uniform. If each state had its own, sellers could be subject to multiple states' sales taxes on the same sale.

BACKGROUND: Why is the sales tax model an issue?

The sales taxes imposed by American states follow the destination-based model. This fact reflects how the sales tax arose in the United States.

While states had long taxed particular goods, they adopted general sales taxes applicable to broad classes of sales as a response to the fiscal crisis during the Great Depression in the 1930s. The structure of these taxes reflected the federalism of the US Constitution. While states have sovereign power to impose taxes within the state, the Constitution's "commerce" clause constrains state sovereignty. (Article I, Section 8 enumerates the powers of Congress, among which is "to regulate Commerce with foreign Nations, and among the several State and with the Indian Tribes.")

In structuring their sales taxes, states deferred to the federal government's power over commerce across state lines, imposing a sales tax on residents of the state and requiring sellers in their state to collect the tax. For sales from out-of-state sellers, states placed the burden of collecting and remitting the tax on buyers and called it a "use tax."

Litigation soon asked the federal courts to clarify who had to collect sales tax. In the earliest cases, the c interpreted the commerce clause to mean that states could not require out-of-state mail order catalog sellers to collect the sales tax due on sales to state residents unless the mail order company also had a physical p in the state. This meant that Sears, Roebuck & Co. and Montgomery Ward could be required to collect sales on catalog sales in all the states where they had stores, even if the goods were sent from an out-of-state warehouse.

More recently, the possibilities for remote sales have expanded far beyond mail order catalogs to includ 800 numbers, direct electronic data interchange between buyers and sellers, and the Internet. The judicial branch's interpretation of the commerce clause has meant that states cannot require sellers who use these new metho of remote sales to collect the state's sales tax unless the remote seller has a physical presence in the state.

Since 1999, a number of states have worked through the Streamlined Sales and Use Tax Agreement (SSUT simplify sales taxes. They want Congress to retain the destination-based sales tax and to give them the ability to require out-of-state sellers to collect their (destination-based) sales tax on sales to their respective states.

The origin-based sales tax model offers an alternative approach. In this model, the tax would not be owed by the purchaser, but by the seller, who would collect the sales tax that applies in the state. This tax would be imposed on both taxable sales to buyers in the same state as the seller and buyers who lived in other states (as, fo example, with Internet sales.)

In the origin-based model, the sales tax is a tax on sales made by the seller. In the destination-based model, the sales tax is a tax on purchases made by the buyer and collected by the seller.