ECONOMIC POLICY / BRIEFING PAPER

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Taxing Sales
Comparing the Origin-Based and Destination-Based Models

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June 2012

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About the Author:

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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 the buyer's location. This report compares the two models.

The differences between the two are both conceptual and practical. In the United States, the key conceptual differences involve federalism. In the destination-based model, the federal government's role is, at most, to give consent to state collaboration. In the origin-based model, the federal government must pre-empt state sovereignty to ensure that states comply with the model.

The impact of moving to an origin-based model

The main body of this paper compares the *concept* of the destination- and origin-based models for a state-imposed sales tax. What the United States has today reflects state decisions to adopt the destination-based model for sales across state lines.

Thus, two comparisons can be made. One is between the two concepts, origin based and destination based. The other is between the world we have (destination based) and the world we would have if the United States moved to an origin-based tax. While the rest of this paper compares the concepts, this section compares the practical implications of moving from the destination-based model already in place to the origin-based model.

With the current destination-based sales tax, each state sets its own sales tax rate. Five states have a 0 percent sales tax (Alaska, Delaware, Montana, New Hampshire, and Oregon). Residents of these states, unlike the residents of other states, do not face a "use tax" on purchases made from out of state. States impose a use tax on goods used, stored, or consumed in the state where tax has not been paid through the sales tax. Most use tax applies to purchases made from out of state. While sellers collect sales tax on behalf of purchasers, buyers are responsible for making use tax payments. For purchasers in states without a sales or use tax, both in-state and out-of-state purchases are free of state sales tax.

For residents of the no-sales-tax states, the origin-based sales tax would be a new tax. Under an origin-based system, residents of these states would begin to pay sales tax when making purchases from out of state. A resident of Montana, for example, who previously had no obligation to pay a sales or use tax on merchandise ordered over the Internet from a seller in Indiana, would now pay the 7 percent Indiana state sales tax.

For residents of the states that currently have a sales tax, the origin-based tax would mean a continuing obligation to pay sales tax, but at a different rate. Consider the case of buyers and sellers in Kentucky and Tennessee. Kentucky has a 6 percent sales tax; Tennessee's average rate is 9.45 percent (this includes the state's 7 percent sales tax and the average local rate of 2.45 percent, as calculated by the Sales Tax Clearinghouse, http://thestc.com/STrates.stm). For Kentucky residents, the origin-based sales tax would mean a tax increase on purchases from Tennessee. For Tennessee residents, it would mean a reduction in sales tax for purchases from Kentucky.

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 be 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 tempers 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

	Origin Based	Destination Based
Tax rate	Tax rate in effect in the *seller's* state. Buyers may owe use tax to their state (depending on scope of federal pre-emption.)	Tax rate in effect in the *buyer's* state.
What is taxed	Follows rules in the seller's state.	Follows rules in the buyer's state.
Tax diversity: one state taxes a product/service, the other does not	If taxed in seller's state but not buyer's state, seller pays tax. If taxed in buyer's state but not seller's state, buyer may owe use tax (depending on scope of federal pre-emption).	If taxed in seller's state but not buyer's state, no tax collected by seller and no tax owed by buyer. If taxed in buyer's state but not seller's state, no tax collected by seller but buyer may owe use tax.
State receiving tax revenue	Seller's state receives sales tax amount. If federal pre-emption does not prohibit use tax, buyer's state may require use tax, thereby producing revenue for buyer's state through double taxation.	Buyer's state receives sales tax amount.
Use tax	Uncertain. If not pre-empted by federal law, could be used to counter incentives to buy out of state.	Neutralizes incentives to buy out of state.
Imports	Not taxed.	Taxed at rate of buyer's state and according to rules of that state.
How states could not cooperate	Impose use tax on out-of-state sales.	Impose origin-based sales tax.
Impact of not cooperating	Double taxation on purchasers in state.	Double taxation on sales to out-of-state buyers.

Use Tax

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 differentials. Whether the purchaser buys from an in-state seller or out-of-state seller, the tax rate is the same. While sellers collect the sales tax, the use tax requires purchasers to assess the tax, file returns, and remit the tax. Compliance by individuals is low. Compliance by businesses is much higher.[1]

In an origin-based model, a state that continued to impose a use tax would undermine the sales tax differential. The tax benefit to a buyer who makes a purchase from a seller in a state with a lower sales tax or no sales tax would disappear if there were a use tax. At best, the use tax would neutralize the sales tax differential, allowing the location neutrality of the destination-based sales tax to persist. This would occur only where the seller's state had no sales tax or no tax on that item or service. If the seller's state imposed an origin-based sales tax, purchasers in use tax states would face a higher overall tax rate because they would pay both the seller's state's sales tax and their own state's use tax. Thus, without federal pre-emption of state use taxes, the origin-based model would allow states to exploit the use tax to create incentives to buy in state.

Individual consumers would be unlikely to be affected by the disincentive because they have low rates of use tax compliance. However, corporations, and especially larger corporations, which comply at a higher rate than individuals, would be more likely to act on the incentive to buy in state under an origin-based model that allowed states to continue to impose a use tax.

Imports

Under the origin-based model, no state sales tax would be due on imports, as their origin is outside any state.

In the European Union, the Value-Added Tax (VAT), imposed by all EU members, is generally destination based for imports to each country ("distance sales"). For sellers who do relatively small amounts of business in a particular country in a given year—most commonly up to €35,000, or $45,500—the tax is origin based.[2] For imports, which are analogous to "remote sales" or sales from sellers in one European country to buyers in another, the European Commission's VAT Directive requires EU countries to impose the VAT in the country where the good arrives. This is not necessarily the country through which the good first enters the EU. For example, goods that enter the EU through Poland but are destined for the Netherlands are taxed in the Netherlands.[3]

The United States could impose an origin-based sales tax for domestic sales and a destination-based sales tax for imports. However, administering two systems at the same time would increase the burden and complexity of tax compliance. An advantage of moving to the origin-based model, which frees buyers from compliance obligations, would be lost, as buyers would still have to maintain records to comply with tax obligations on imports.

A federal sales tax on imported goods is one way to keep imports from escaping any sales tax under the origin-based model. The tax rate could be the average, tax-base-weighted sales tax rate across all states with sales tax. Receipts from the federal sales tax could be distributed to states and localities in proportion to their volume of domestic sales. A new bureaucratic structure would be required to administer the federal sales tax, as would a 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 involved in filing 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 pre-emption 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 pre-emption 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

Issue	Origin Based	Destination Based
Federalism burden	Pre-empt state law.	Historically, none. Federal consent required to allow states to impose tax collection obligation on remote sellers.
Federal government's role	Define key terms such as "origin." Possible role in collecting sales tax on imports.	None.
Incentives	Buy from the state with lowest tax. Incentive to buy in state if state has use tax. Incentive to buy foreign products, not domestic, if no sales tax on imports.	Neutral, if use tax is collected. Incentive to buy out of state with imperfect use tax collection.

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 relatively high sales tax rate could decide to have a lower tax or no tax on goods whose shipping cost is a small share of total price, but maintain its sales tax on other goods and services. Clothing might be an example. (States already engage in this category-specific competition through sales tax holidays, such as no sales tax or reduced sales tax on clothes during the back-to-school season.) Strategic responses could leave the state’s general sales tax rate unchanged but provide more numerous exemptions.

Exempt Sales Compliance

Moving from a destination-based to an origin-based sales tax would mean shifting the compliance burden for exempt sales. States exempt classes of business-to-business sales to avoid having a "tax on a tax" as goods move to final consumers, which would occur if goods were taxed at the time of wholesale sale and again at retail. For example, sales for resale, such as by wholesalers to retailers, are exempt. The shift would mean a new compliance burden for those who make exempt purchases across state lines. Under the destination-based model, purchases from remote sellers, that is, sellers in other states, are not taxed at the point of sale. Rather, they are taxed by charging the purchaser a use tax. With sellers collecting sales tax on all sales of goods subject to tax, purchasers would have to file sales tax exemption certificates with all sellers, not just those who are in state. If business purchasers did not file the exemption certificate, they would find themselves paying sales tax on a previously untaxed sale. Either result would represent a new burden on businesses that buy from out-of-state sellers. Table 3 shows how sales tax and use tax is collected for consumer and businesses purchases.

Table 3. Sales and Use Tax Collection: Consumer and Business Purchases

Destination-Based Model

Consumer Purchases		Business Purchases	
		Non-Exempt Purchase	Exempt Purchase
Same-state sellers	Seller collects.	Seller collects.	Buyer presents exemption certificate.
Out-of-state sellers	Buyer pays use tax.	Buyer pays use tax.	None.

Origin-Based Model

Consumer Purchases		Business Purchases	
		Non-Exempt Purchase	Exempt Purchase
Same-state sellers	Seller collects.	Seller collects.	Buyer presents exemption certificate.
Out-of-state sellers	Seller collects seller's state's tax.	Seller collects seller's state's tax.	Buyer presents exemption certificate.

Origin-Based and Destination-Based Sales Tax: Trade-offs

Moving from a destination-based sales tax to one that is origin based brings trade-offs. Some problems get solved, others created.

Many of these problems result from federalism: each state setting its own rules adds complexity. The only way to simplify the sales tax is federal action—harmonizing a destination-based sales tax through an agreement such as the Streamlined Sales and Use Tax Agreement—or an assertion of federal authority involving a move to an origin-based tax.

Forty-Five State Rules. A destination-based sales tax places the burden of tax variations from state to state on sellers in the forty-five states with state sales taxes. A seller must know what is taxed in one state but not another.

A move to an origin-based sales tax would relieve sellers of the burden of being familiar with the rules that determine the sales tax base in each of the states where they have customers. As the highlighted cell in table 3 shows, it would also create a new burden on businesses buying across state lines, which would be required to show that they are exempt from the other state's origin-based sales tax. This would require knowing the nuances of what is and what is not an exempt sale in each of the states where the buyer makes purchases.

Location. Tax differences can fuel economic development. Locations with lower tax rates are rewarded with more economic activity, more jobs, and more investment.

With an origin-based sales tax, sellers who do business in multiple states might have flexibility to choose their origin state. For example, many corporations have Delaware—which has no sales tax—as 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. For example, if one state said that the shipping warehouse was the origin and a second said that the origin was the state where the product was made, a seller could be subject to origin-based sales taxes in both states.

An authority that had the ability to coerce recalcitrant states would be required. Some part of the federal government could be given responsibility to define rules of origin. An alternative would be a federal law that required states to follow rules set by some entity outside the federal government, either a new, single-purpose organization or some existing organization designated to set such rules.

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[1] An estimate of state use tax compliance by businesses comes from the state of Washington, which estimated that use tax paid equaled 74.5 percent of use tax owed. State of Washington Department of Revenue, "Department of Revenue Compliance Study," Research Report 2008-5, accessed March 7, 2012, http://dor.wa.gov/Docs/Reports/Compliance_Study/compliance_study_2008.pdf. Three investigators at the University of Tennessee, lacking a similar study for individual compliance, assumed a compliance rate of 5 percent. Donald Bruce, William F. Fox, and LeAnn Luna, "State and Local Government Sales Tax Revenue Losses from Electronic Commerce," April 13, 2009, http://cber.utk.edu/ecomm/ecom0409.pdf.

[2] See the column for "Threshold for Application of the Special Scheme for Distance Selling," in European Union, "Annex 1: Thresholds (March 2012)," accessed May 8, 2012, http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/traders/vat_community/vat_in_ec_annexi.pdf.

[3] European Commission, "Where to Tax?" accessed March 8, 2012, http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/vat_on_services/index_en.htm.

[4] Consumer goods are 22.9 percent of imports; larger categories are industrial supplies and materials (including crude oil and gasoline) and capital goods. "Imports of Goods by End Use Category and Commodity," in US Department of Commerce, "US International Trade in Goods and Services, December 2011," released February 12, 2012. A large share of consumer goods are likely imported for wholesale, not directly for consumers or businesses as "final sales," and thus they would likely not be subject to sales tax.

[5] William F. Fox, "History and Economic Impact," March 13, 2002, accessed March 7, 2012, http://bus.utk.edu/cber/staff/mnmecon338/foxipt.pdf.

[6] It could be argued that the administration of the sales tax creates an incentive for out-of-state purchases through imperfect enforcement of the use tax. However, imperfect enforcement is not competition between specific states, only competition between buying in state and out of state, regardless of where the out-of-state seller is. Also, there is limited competition, again through imperfect enforcement of the use tax, where an individual is willing to travel to a lower tax state to make a purchase. The cost of doing so is low for those who live along state borders but high for those who live far from a border with a lower (or no) sales tax state. Vermonters and suburban Bostonians can readily get to tax-free New Hampshire; those who live in San Francisco have a long way to go to get to Oregon.

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 States, 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 courts 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 presence in the state. This meant that Sears, Roebuck & Co. and Montgomery Ward could be required to collect sales tax 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 include 1-800 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 methods 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 (SSUTA) to 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 be owed not by the purchaser, but by the seller, who would collect the sales tax that applied in his state. The tax would be imposed both on taxable sales to buyers in the same state as the seller and buyers who lived in other states (as, for 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.

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