Considerations for Tax Reform in California

Effects of Origin and Destination Taxes on State Competitiveness

Commission on the
21ST Century Economy

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There are many ways to categorize taxes. One way is according to location of assessment. Taxes are generally considered to be Origin-Based (origin) if they are payable at the location where taxable activities were performed. An example of an origin tax is the income tax on wages. Wages are normally taxed at the location where the employee is located, even if the employee is working electronically on projects in other states or countries. Other origin taxes include taxes on portfolio income, retirement income and taxes on property and wealth.

Taxes are generally considered to be Destination-Based (destination) if they are payable at the location where the product or service is sold or used. An example of a destination tax is the sales tax. Sales are normally taxed at the location of the sale, and not at the location of production. Other destination taxes include most user charges, such as park fees and utility and telecommunication charges.

Depending on how they're structured, business income taxes and value added taxes can be either origin or destination. For example, a corporate income tax that is apportioned among states with an apportionment formula using property, payroll and sales, would be a destination tax if it were to strictly rely on the location of sales, and origin if it were to strictly rely on the locations of property and payroll.

The value added tax as administered in Europe and other regions is a destination tax. The Single Business Tax (SBT), recently repealed in Michigan, was an origin tax.

State changes to their tax systems have short term and long term consequences on competitiveness of state exports. This discussion of origin versus destination is limited to a consideration of competitiveness. In the short run, a shift to a destination tax system is likely to improve a state's competitiveness, vis-à-vis its trading partners. Conversely, a shift toward an origin tax system is likely to make a state less competitive. In the long run, the effects of destination and origin taxes on state competitiveness are far less certain.

This principle can be demonstrated with an example. Let's take a hypothetical state; let's call it Cali. Take a corporation with production entirely in Cali and sales entirely outside of Cali. If Cali was to have an Origin-Based income tax, its income would be fully taxed in Cali – depending on laws in other states, it may also be taxed in other states. If Cali were to switch to a Destination-Based tax, its income would no longer be taxed in Cali, providing to the firm a cost advantage.

Economic models tend to indicate that this cost advantage would erode over time. In the long run, compensation to employees and the price of land in market states would decline (in relation to Cali) generating a new equilibrium. But these models assume effective adjustment mechanisms. If, for example, wage contracts do not effectively adjust to this change, the cost advantage could persist.

Property valuations are likely to adjust to tax changes more effectively than wages. Take for example a Cali farm that sells its product outside of Cali. Its income is partially due to the innate productivity of the land (rents) and from the ability of the farmer to extract this productivity (profits). If the Cali property taxes were to be increased, the stream of future after-tax income would be reduced. Because the value of business land is the discounted stream of expected future income, it is likely that the property tax increase would soon be capitalized into the value of land.

Destination taxes subsidize exports. This can be illustrated with an abstract model, the results of which may be generalized.

Let's assume that Cali has only two taxes: a broad-base consumption tax and a business income tax (BIT). The consumption sales tax is Origin-Based. The BIT can be either, but as currently administered, is also Origin-Based. Tax proceeds are used to provide government services. All factors of production – capital, labor and entrepreneurship – are from Cali residents.

In this model, residents pay all taxes and receive all government services.

Now, let's assume that there are better income growth opportunities in other states and residents are interested in higher growth. To take advantage of the higher growth opportunities outside of Cali, they agree to switch to a destination BIT, under which profits from export sales would not be taxed in Cali. That, of course, would result in lower BIT tax revenues, which would need to be offset with higher consumption tax revenues and/or reductions in government expenditures.

So, in this model, Cali residents would willingly subsidize exports by reducing current consumption for the opportunity to increase their income growth (future consumption).

Interestingly, within this model, if all states were assumed to use the same destination taxes, each state would benefit from subsidies provided by other states and in total, subsidies would wash, and the economy – that encompasses all states – would produce the optimum mix of goods and services – as it would if there were no subsidies. In other words, if all states but one were to charge a mix of destination and origin taxes, and one state was to only charge origin taxes, the economy would achieve a higher level of efficiency if the outlier state was to switch to the same mix used by other states.

The implication of this discussion is that in terms of competitiveness California could benefit from a move toward a higher mix of destination taxes—at least in the short run. Because the California tax structure is dominated by the personal income tax, it has a higher mix of origin taxes than the national average. This implies that the likely reduction in internal growth from higher subsidies could be more than offset by income growth due to exports.