**What Sports Can Teach Tax Policymakers:**
**Lessons from the Luxury Tax**

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# What Sports Can Teach Tax Policymakers:

# Lessons from the Luxury Tax

Edward J. McCaffery[1]

Call me Ishmael. Having written about tax policy for over two decades by now, I find myself in a general state of gloom over our collective present and future. Our tax system is a mess –unfair, inefficient, overly complicated, and wildly unpopular to boot. Worse, it is inadequate to meet the ever-expanding revenue needs of governments at any level. We seem fated for a fiscal crisis on a massive scale, in which our public sector, unable to cut spending or raise taxes, falls off a cliff: we are a Greece waiting to happen. Thinking and writing in this vein, I have come to feel like an Old Testament prophet, exhorting my fellow citizens to awaken and repent of their evil ways, curb their spending, borrow less, start saving more, and reform the tax system to raise additional revenue in a fair and efficient way before it is too late. I want to shout from some mountaintop: The end is near! Reform tax now! Alas, my cursory reading of the fate of Old Testament prophets suggests that this gig can only end badly, for me and the nation.

Paraphrasing Herman Melville, then, whenever it is a damp drizzly November in my soul, whenever I find myself involuntarily pausing before coffin warehouses and bringing up the rear of every funeral I meet, I do what many red-blooded Americans of the 21st century do: I turn to sports. Lo and behold, two stories, from opposite coasts and different sports, gave me reason for hope about tax policy, of all things. From New York came word that the storied Yankees, captains of free-spending baseball capitalism, were considering slashing payroll in years to come.[1] From Los Angeles, word was

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that the mighty Lakers, mavens of media savvy as well as basketball championships, had “dumped” a beloved icon, point guard Derek Fisher, and had neglected to act on the opportunity to obtain a talented young player, Michael Beasley.[2] What was the common thread in these stories? That the fear of a *luxury tax* affected the teams’ decisions in a way that curtailed, or promised to curtail, their spending.

Now this was music to my ears, and not because I am a fan of the New York Knicks and San Francisco Giants, some form of rivals – in my dreams anyway – to the Lakers and Yankees. Rather, I am a fan of luxury taxes on a national scale, specifically, a progressive spending tax.[3] Details aside --- and details *are* critically important in tax[4] --- the sports luxury taxes work precisely as a broad-based progressive spending tax would, could and should work on a national level. Permit this prophet to make three quick points.

**One, luxury taxes identify the relevant social harm for tax**. Luxury taxes fall on *spending*, not earnings – or, in the tax policy context, not on work or savings. Work and savings are goods, for one and all. We do not want to discourage or overly tax productive, socially beneficial activities. It is *spending* by the rich that poses concerns. In the case of sports, profitability suggests a well-run franchise, responding to its fan base and, most likely, remaining competitive in the field of play. Aside from possibly inciting envy, no sports team harms any other team by making a profit: indeed, the successful team may help drive up the value of unsuccessful franchises by suggesting a better way to do business. It is when a rich team *spends* money on players that it creates a competitive advantage and harms the poorer teams who cannot keep up. So, too, it is in the society writ large. When an individual works hard to make money, she is contributing to the celebrated social pie. If she saves her earnings, she is further helping all by contributing to a common pool of capital that can help keep interest rates low and wages high. It is when the rich – and luxury taxes only fall on the rich – spend that questions arise. Spending by the rich skews the allocation of resources to the production of luxury goods. It incites envy, and leads the

middle-class in particular into a treadmill-like activity of trying to keep up – maintaining them and all of us in debt.[5] It is true that "consumption is the engine of the economy," and we need robust consumption for the macro-economy. But we also need savings, and *savings is nonconsumption*, as we can see from the oft-cited Haig-Simons definition of income, essentially that Income = Savings + Consumption.[6] A simple rearrangement tells us that Consumption = Income – Savings, showing us the commonsensical fact that savings is presently unconsumed wealth. This simple logic gives us the final harm from luxury spending: it is a failure to save by the segment of society best able to save. The lower and middle classes are generally living paycheck to paycheck: it is unreasonable and unfair to expect them to save much. Recent history has made abundantly clear that government cannot save. Where then to get our savings? The logical answer is from the rich. But we cannot get them to save if we allow them to spend all of their money on luxuries, as our present tax system does.

**Two, luxury taxes work on a *general* level**. Many people think that luxury taxes are infeasible. They imagine a list of luxury items that are subject to a tax: a taxonomy of decadence as it were. Some recall the first George Bush's brief experience with taxing yachts and such, which only led to a flourishing market in refurbishing older ships.[7] Others might recall from history decisions to tax homeowners based on the number of their windows, leading to the evolution of window-hiding architectural design.[8] But luxury taxes do not have to be specific. They can – and should -- work on the basis of *general* spending levels. In sports, for example, it is not that the Lakers are deemed to have too many point guards, or are overpaying for one of their players, like Kobe Bryant or Pau Gasol; the Yankees are not being taxed because they are spending too much on their starting pitching or splurging on a back-up catcher. The luxury tax looks at the total or over-all spending level. Expenditures above a certain level are taxed, and at a high rate – currently 50% in baseball, and, at a high enough level, 100% (tax exclusive) in basketball. This is how a progressive spending tax, what has been called a "consumed

income tax," would work. Return to the Haig-Simons definition: Income = Consumption + Savings. So Consumption = Income – Savings. If we were to have an unlimited deduction for savings under the current "income" tax, and find a way to pick up borrowing or debt in the tax base, we would get to a measure of annual spending that can be taxed on an annual basis, using forms just like the dreaded 1040. Spending in excess of, say, one million dollars a year can be subject to higher rates, say 50%. There is no need to save receipts, impose the tax at the gas register – or hide windows. And we could and should increase marginal tax rates on high-end spending, to get more, and more meaningful, progression in the tax structure.[9]

**Three, luxury taxes work.** If they can persuade the Lakers and Yankees to alter their behaviors, why would not the approach work for wealthy American individuals and families? Luxury taxes, or a progressive spending tax, give the rich a choice of how to help all. "[Paying] the luxury tax is an option," Yankees President Hal Steinbrenner told reporters, "We go into it knowing exactly what we are doing. [But] being the only team that does it, I'm just not convinced we need to be as high as we've been in the past."[10] Steinbrenner gets it: the behavioral incentives of the tax. Luxury taxes give the rich a choice – they can continue to spend, and pay a tax for the privilege, or stop spending and save instead. In the sports world, the revenue from luxury taxes gets shared among all the teams, who would also benefit from the behavioral change if rich teams instead stopped spending so much on payroll. In the society writ large, all citizens would benefit from the revenues raised by the luxury tax, or all would gain instead from the behavioral change whereby the rich spent less and saved more – and, as noted above, savings itself is a public good, and one most reasonably provided by those private individuals who can most afford to save. The choices generated by a progressive spending tax comport with reasonable public judgments, unlike the case of income or payroll taxes, where the choice is to pay the tax or stop working (or saving) – a choice that helps no one. Paying a tax or cutting back on high-end spending, on the other

hand, is a good option to pose for our most fortunate taxpayers. Even for the rich who seem to be as addicted to spending as the Lakers and Yankees are to winning, there is reason to believe that a progressive spending tax would work. After all, the public is in a no-lose situation – we all "win" from the tax revenue, or from the induced behavioral change. The professional sports leagues have figured out that such a tax is good policy. Tax policymakers everywhere should take notice.

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[1] See Wallace Matthews, "Hal Steinbrenner Plans to Lower Payroll," ESPNNewYork.com, March 2, 2012, available online at http://espn.go.com/new-york/mlb/story/_/id/7633938/new-york-yankees-hal-steinbrenner-plans-lower-team-payroll.

[2] On "dumping" Fisher, see Kelly Dwyer, "Ball Don't Lie: In a Startling Salary Dump, the Lakers Trade Derek Fisher to Houston," Yahoo! Sports, March 15, 2012, available online at http://sports.yahoo.com/blogs/nba-ball-dont-lie/startling-salary-dump-lakers-trade-derek-fisher-houston-195520614.html; on not acquiring Beasley, see Josh Martin (featured columnist), "Lakers Trade Rumors: Money Concerns Will Keep Michael Beasley out of LA," Bleacher Report, Feb. 29, 2012, available at http://bleacherreport.com/articles/1084877-lakers-trade-rumors-money-concerns-will-keep-michael-beasley-out-of-la.

[3] See Edward J. McCaffery, Fair Not Flat: How to Make the Tax System Better and Simpler (Chicago, University of Chicago Press, 2002); see also Edward J. McCaffery and James R. Hines, *The Last Best Hope for Progressivity in Tax*, 83 Southern California Law Review 1031 (2010); Edward J. McCaffery, *A New Understanding of Tax*, 103 Michigan Law Review 807 (2005). See also Robert Frank, "Progressive Consumption Tax," Democracy: A Journal of Ideas, Issue #8, Spring 2008, available online at http://www.democracyjournal.org/8/6591.php ; N. Gregory Mankiw, "A Better Tax System (Assembly Instructions Included)," Economic View, NY Times, January 21, 2012, available online at http://www.nytimes.com/2012/01/22/business/four-keys-to-a-better-tax-system-economic-view.html.

[4] On the specific subject of sports luxury taxes, an excellent student note by Richard Kaplan points out that many of the complex details of the NBA's luxury tax (as it existed circa 2004) need fixing. See Richard A. Kaplan, *The NBA Luxury Tax: A Misguided Regulatory Regime*, 104 Columbia Law Review 1615 (2004).

[5] See the work of Robert Frank, especially Luxury Fever: Weighing the Costs of Excess, (New York: Free Press, 1999) and Falling Behind: How Rising Inequality Harms the Middle Class, (University of California Press: 2007).

[6] See Henry C. Simons, Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy (Chicago: University of Chicago Press), at 50.

[7] See Liu Pin, "US Luxury Tax – A Total Failure," translated by Paul Yuan, China Times, Taiwan, March 10, 2011, available online at http://watchingamerica.com/News/94396/u-s-luxury-tax-%E2%80%94-a-total-failure/.

[8] See "Window Tax" on Wikipedia, the free encyclopedia, last visited May 8, 2012, available at http://en.wikipedia.org/wiki/Window_tax ("The window tax was a property tax based on the number of windows in a house. It was a significant social, cultural, and architectural force in England, France and Scotland during the 18th and 19th centuries. To avoid the tax some houses from the period can be seen to have bricked-up window-spaces (ready to be glazed at a later date), as a result of the tax.").

[9] See McCaffery & Hines, *The Last Best Hope for Progressivity in Tax*, *supra* note 3.

[10] Matthews, *supra* note 1.