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Luxury Taxes: Exposing The "Soak-The-Rich" Con Game

It's a rare occasion when the Congress recognizes, let alone admits, that it made a mistake in enacting a particular piece of legislation. This may be happening, however, in the case of the luxury taxes that were enacted as part of last year's budget fiasco. To put the best possible face on the second largest tax increase in the Nation's history, most of which was imposed on middle America, Congress enacted a group of new excise taxes supposedly targeting the wealthy. A ten percent tax was levied on the price of furs and jewelry over $10,000, autos over $30,000, boats over $100,000, and airplanes over $250,000. As usual, the decision to enact this legislation ignored even the most obvious response to the tax. Instead, it was guided by the false notion that the people who purchase such products are well off so wealthy people will bear the burden of the new tax.

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What was conveniently overlooked by our tax policy makers is that the buyers of these products can avoid the tax simply by not buying them. This is precisely what our well-to-do fellow citizens appear to be doing. The National Marine Manufacturers Association states that boat sales are down by 50 to 60 percent. A study by Temple, Barker, and Sloane, a Lexington, Massachusetts, consulting firm, finds that "high-line" automobile sales have fallen by more than 20 percent. That's about a $1.31 billion loss in sales for the dealerships selling these automobiles. Obviously, the "luxury" product buyers are staying away in droves. As a result, they aren't paying the luxury taxes. Primarily, the tax is causing these consumers to shift the composition of their purchases, or in many cases, move their purchases of the newly taxed items abroad, beyond the reach of the excise tax.

It's a different story, however, for the people who work in the industries that produce and sell these products. They have no option to avoid the punitive effects of the luxury taxes. With fewer large boats and yachts, luxury cars, and expensive furs being purchased, fewer of them are being produced. With fewer being produced, there are fewer workers, blue and white collar, employed in the affected businesses. The National Marine Manufacturers Association estimates that 19,000 boat builders will lose their jobs as a result of the boat tax. Automobile dealerships will be employing 3,320 fewer employees. And the small businessmen who sell, and in some cases produce, these products are closing their doors. These are the taxpayers picking up the chips for the luxury taxes.

What tax policy makers overlooked, clearly, was the law of demand, one of the most basic laws of economics. This law states, very simply, that the higher is the price of a product, the less of it that people will buy. As is now being demonstrated, wealthy consumers obey this law no less than the rest of us.

For the federal government, the likely result is a reduction in tax revenues compared to what they would have been without the new taxes. Relying on the usual static revenue estimating techniques that assume that tax changes have no effect on economic

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behavior, the government projected that these taxes would raise $20 million in the first year and $1.5 billion by 1995. The cutbacks now occurring in sales and production of the taxed products alone mean that these taxes will collect significantly less than the projected amounts. But that's just the beginning. The curtailment of sales and the loss of jobs means less wage and salary income and lower profits on which income taxes are collected. Consequently there are less payroll taxes flowing into the social security trust fund. Since many of the "high-line" cars on which the luxury tax is imposed are imported, the cutback in their sales means smaller tariff revenues. And since many of these cars are large and get relatively few miles per gallon of gasoline, there is a loss in the "gas guzzler" tax revenues. All things considered, repeal of the luxury taxes would probably be a revenue raiser for the federal government.

The effects of these taxes, from the perspective both of the economy and the federal treasury, are all bad. It is amazing that our policy makers could have failed to foresee these results. One role of federal excises has always been to discourage the consumption of the taxed product or service. The justification for the so-called "sin" taxes on tobacco products and alcoholic beverages has been that these taxes discourage unwholesome consumption activities. The avowed purpose of tariffs — excise taxes on imported products — is to reduce purchases of things made abroad. There is no mystery in the fact that a tax that reduces sales of a product also reduces its production. Unfortunately, when it came time to talk the public into supporting soak-the-rich tax schemes, our policy makers chose to overlook this simple fact of life.

Perhaps it is not too much to hope that Congress will learn important lessons from this unhappy experience. For one thing, they may come to realize that the law of demand, like other fundamental laws of economics, can't be repealed with the same stroke of a pen that brings new tax laws into effect. Sooner or later, public policy makers have to realize that their policy preferences can't overcome basic economic principles in determining economic outcomes.

More importantly, our legislators should discover in this unfortunate episode the basic fallacy and bankruptcy of a soak-the-rich tax policy focus. In an interdependent market economy such as ours, the effects of taxation cannot be segregated by income level. All taxes affect people's behavior, and changes in one group's behavior always has consequences for other groups. This is as true for income taxes as it is for excise taxes. It is time to put an end to the politics of envy that was so dominant in tax policy formulation last year. Public policies that pit one group of taxpayers against another have no potential for benefitting society as a whole and will, sooner or later, injure us all.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.