

Luxury tax: solidarity and uncertainty of outcome?

Definition and modalities

Following the salary cap and the rookie draft, luxury tax is chronologically the third instrument for the regulation of the sports labour market implemented in certain North American leagues. Luxury tax was applied in the MLB from 1997 to 1999, then again from 2003. In 2006, it was renamed the "competitive balance tax". A luxury tax was first considered in the NBA in 1999 and used from 2003 onwards.

The payment of a luxury tax allows clubs to spend more than the salary cap when it exists (NBA), or more than an amount set by the league if it does not exist (MLB). Luxury tax is negotiated within the framework of the Collective Bargaining Agreement (CBA) between the league, the franchise owners and the players' unions. It is based on three main parameters: the threshold triggering the tax, the tax rate and the redistribution of the revenue collected. The first two levers determine the tax revenue [Gustafson, 2006].

In the NBA, the calculation of the tax is based on the revenues of the league's franchises (Basketball Related Income, BRI), as with the salary cap, but with a specific percentage. The threshold activating the tax is on average 21% higher than that of the salary cap and therefore only concerns the highest spending teams.

The luxury tax scale works exponentially: 150% for any excess over the ceiling between 0 and 5 million dollars, 175% from 5 to 10 million, 250% from 10 to 15 million, 325% from 15 to 20 million, 375% from 20 to 25 million, and so on. In other words, clubs may have to pay \$1.5 million for each million-dollar overrun, then 1.75 million, 2.5 million, 3.25 million, 3.75 million, etc.

Under pressure from NBA franchises located in small markets, a repeater luxury tax was created in 2013 for teams that exceed the luxury tax cap at least three times in the previous four seasons. Using the previous illustration, a club must pay an additional financial penalty for these repeat offences of \$2.5 million for each million exceeded for the first tier, then \$2.75 million, \$3.5 million, \$4.25 million, \$4.75 million, etc.

During its first application period (1997-1999) in the MLB, the trigger level for luxury tax was an average payroll calculated between that of the fifth and sixth highest spending franchises. The amount of the tax was 34% of the excess of the authorised salary cap. With the new tax in force since 2006, the tax rates become progressive as soon as there are successive repetitions: 20% for the second season of exceeding the ceiling, 30% for the third and, 50% for the fourth.

Objectives

The regulation of the player market is fundamental in a highly skilled industry like sport, whose value depends on the balance of the competition. Therefore, some economists have proposed a tax to strengthen economic solidarity within the league and to stimulate the uncertainty of the outcome.

Gary Becker [Becker, 1994] imagined a tax on all MLB teams' spending on sports performance. According to Becker, this would have three positive effects: a slowing down of the bidding war between clubs to improve their performance; redistribution of the proceeds of this tax to all clubs, especially the less wealthy ones; and equalisation of economic and sporting potential.

The luxury tax, created in two major North American leagues, is therefore not intended to prohibit any breach of the salary cap, but to make it more expensive. The purpose of the tax is to limit excessive bidding, contain salary cost inflation, equalise salary expenditure amongst teams, promote competitive balance in the league and avoid bankruptcies.

The economic and sporting consequences

The NBA is one of the professional leagues where the issue of competitive balance is problematic. The high rate of both the luxury tax and repeater luxury tax (several tens of millions of dollars per club per season for the biggest spenders) is intended to supplement the soft salary cap, which does not really reduce the disparities in the wage bill. However, few teams, and almost always the same ones, are affected.

There are three categories of franchises in the NBA, two of which do not pay tax or around 80% of the 30 clubs. A third of the league (about ten teams) is below the salary cap, a little less than half is above the salary cap but below the luxury tax (a dozen teams) and the rest exceed both the salary cap and luxury tax thresholds and thus pay one to two taxes (five/six teams). Between 2003 and 2016, \$1.233 billion was collected, an average per season of \$88 million. Unsurprisingly, five franchises based in a large demographic and economic market (New York, Los Angeles) pay 62% of the tax. Overall, the application of luxury tax and repeater luxury tax seems to have improved the NBA's competitive balance, compared to the seasons that preceded their introduction, albeit not in a very substantial way.

In the MLB, the ceiling at which taxation begins is so high that few teams are subject to it. In the first three years of the luxury tax (1997-1999), eight clubs were taxed for a total of \$31 million, an average of \$10 million per season. Two of them were taxed every year and paid 65% tax. Between 2003 and 2017, eight teams were also taxed,

out of the league's 30, for a total levy of \$518 million, or an average of \$35 million per season. Six of these teams were taxed on a one-time, marginal basis (9% of the total tax levied).

In contrast, two baseball franchises, also operating in large markets (New York, Los Angeles), pay the tax each season and contribute 91% of the total collection (\$470 million). The enduring sporting dominance of the New York Yankees, the league's most successful club (27 titles), seems to have been affected (only one title over these fifteen seasons) by the level of its tax levies (\$320 million, or \$21 million per season on average and 62% of the league total).

In the MLB, the first tax created in 1997 did not have a very significant impact on limiting the expenses of high-revenue clubs. Instead, several studies show that the luxury tax implemented from 2003 onwards has had a tangible effect on competitive balance, thanks in particular to the progressive nature of the rates in the event of successive overruns [Ajilore and Hendrickson, 2007]. Luxury tax has restricted the wage expenditure of high-revenue teams. The analysis of player transfers through their mobility between clubs makes it possible to observe a more balanced distribution of talent, with a decrease in the flow of the best players to the richest clubs being observed during the second period of the application of the tax [Maxcy, 2011].

Learnings

The organisational model of North American professional sport is supposed to serve an economic logic of maximising profits. The standard literature shows that, as competitive balance decreases, the interest of fans, media and sponsors also decreases. As a result, the revenues and profits of the league and the clubs are affected. The aim is therefore to reduce the financial inequality between franchises in large markets and those in small markets. The goal is to achieve an even distribution of talent amongst teams and to make sporting results less predictable. It is in this context that the luxury tax was introduced, either to compensate for the absence of a salary cap (MLB), which could not be adopted following the categorical refusal of the players; or to compensate for the weak impact of the soft salary cap reconciling freedom of salary expenditure and financial equalisation (NBA).

The tax transfers the income from the players to the beneficiaries of the tax proceeds, unlike the salary cap, which transfers the income to the franchise owners. The distribution of the tax revenue can be wholly independent of the teams' sporting results and turnover. This is the way the MLB operates, with 50% going to a fund to finance player training and 50% allocated to a baseball development programme. In this case, the tax has no impact on competitive balance.

Conversely, in the NBA, subsidies can be allocated to clubs whose wage bill is below the double taxation threshold, i.e., to the least expensive and theoretically weakest teams. The latter can thus achieve higher profits than the highest-spending teams after the league has paid back the subsidy [Dietl, Lang and Werner, 2010]. The tax may reduce the demand for superstars by taxed teams, as well as their remuneration, making these stars accessible to smaller teams amongst which the tax proceeds are distributed. Thus, the luxury tax has a direct redistributive effect.

If subsidies are distributed inversely to club revenues, then winning and thus increasing revenues decreases the subsidy to be received by the team and makes winning less profitable. This can worsen competitive balance in that smaller teams with less investment in talent have less incentive to win.

The numerous variants of luxury tax do not have the same effect on the level of wage expenditure, the degree of talent concentration and the balance of competition. The effectiveness of the tax depends on how it is implemented (trigger level, percentage levied, beneficiaries of the revenue collected). The mix of objectives of clubs within a league (financial gain/sporting gain) can also modulate the impact of the tax, as the investment in talent is more or less important depending on the priorities of the clubs, due to the absence of a sporting sanction at the end of the season (no relegation).

To conclude, generally the notion of competitive balance is put forward to justify the decisions of professional leagues to change the competition rules (salary cap, rookie draft, luxury tax, TV rights sharing). However, as shown by certain academic work the hypothesis that competitive balance increases the utility of fans, i.e., their expenses, and therefore the revenues of professional clubs, is far from obvious [Arrondel and Duhautois, 2019]. The uncertainty of the outcome does not seem to be the only factor explaining the demand for sporting spectacles since a portion of the fans declare themselves ready to follow the matches even in the case where there is no suspense. Many other factors influence the 'consumption' of sport: attachment to the club, the performance and prestige of the team, the quality of the matches, the comfort of the sports venue, the ticket prices and the presence of stars. The concept of competitive balance, which is at the heart of the economics of sport, with a mainstream vision, must be the subject of new research likely to question its relevance, its content and its interest.

Further information:

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